AGENDA PAPER

Item Number:	10.1
Date of Meeting:	16-17 November 2010
Subject:	APES 110 ED *Code of Ethics for Professional Accountants*

X	**Action Required**	☐	**For Information Only**

Purpose

To obtain the Board's direction on the key issues and other matters raised by respondents to ED 03/10 *Code of Ethics for Professional Accountants* in order to finalise the proposed Standard.

Background

At the May 2009 meeting, the Board approved a project to update APES 110 *Code of Ethics for Professional Accountants* (the Code) to bring the requirements of the Code into alignment with the revisions made internationally by IESBA in July 2009 to its *Code of Ethics for Professional Accountants* (IESBA Code).

At the November 2009 meeting, the Board decided to issue a Consultation Paper seeking views of stakeholders on three key areas:

- Consideration of the IESBA Code in the Australian Context and application of APESB drafting conventions;
- Reference to Australian legislative requirements; and
- Structure of sections 290 and 291 of the IESBA Code.

At the March 2010 meeting, the Board considered responses to its Consultation Paper along with ten potential drafting approaches that could used to update APES 110. Technical Staff then drafted an Exposure Draft based on the drafting conventions approved by the Board.

At the April 2010 meeting the Board considered the structure of sections 290 and 291 of the IESBA Code and agreed that the format of sections 290 and 291 in the IESBA Code be retained in the revised APES 110.

At the May 2010 meeting the Board reviewed the draft Code and discussed specific paragraphs requiring amendments. A further review was conducted at the July 2010

Board meeting. At this meeting the Board also considered the 61 decisions made by the Board in 2006. The Board directed Technical Staff to prepare a separate tabulation of previous 2006 Board insertions to APES 110 primarily relating to requirements of the *Corporations Act 2001.* The Board decided to remove the paragraphs that were based on the *Corporations Act 2001*.

The Board reviewed the draft ED at the August 2010 meeting and following which the Exposure Draft ED 03/10: APES 110 *Code of Ethics for Professional Accountants* was released for public comment for a 45 day comment period.

APESB received 10 submissions from the Auditing and Assurance Standards Board (AUASB), Australian Securities and Investment Commission (ASIC), Firms, Professional Bodies and a member.

Consideration of Key Issues

The key issues raised by respondents are as follows:

1. Additional Aust. provisions in respect of *inadvertent violations* of the Code;
2. Definition of Public Interest Entity;
3. Legislative references; and
4. Convergence.

1. Inadvertent violations of the Code

Some respondents raised concerns in respect of the proposed new requirements in section 290 and 291 of the Code to document and discuss inadvertent violations of the Code (that are not trivial and inconsequential) with Those Charged with Governance. Respondents are concerned that the Australian requirement places additional burden on Firms in circumstances where the individual Firm should have the ability to determine the extent of discussions required.

As currently written, the international Code requires Firms to determine whether discussions are required with Those Charged with Governance. Whilst under some circumstances this may be considered an appropriate safeguard, it is not commensurate with the threat level introduced by inadvertent violations that are not trivial. It should be best practice for Firms to document and communicate inadvertent violations with Those Charged with Governance. This then allows an independent party, such as an audit committee, to review the action taken by the Firm to address inadvertent violations.

This is an issue that has been raised by regulators such as IOSCO, US SEC and ASIC. ASIC state in their submission that the relevant provisions should be removed from the proposed Code. At the time of issuing the Exposure Draft the Board determined to retain the provisions and include additional Australian requirements to strengthen the provisions. Further, APESB is aware that there is another major jurisdiction that is concerned about these provisions and is reviewing potential improvements for their version of the Code.

IESBA has also recognised that inadvertent violations requires further consideration and has initiated a project to address this issue.

At the local level, whilst a higher requirement has been proposed, as noted by one big four firm:

"We note that the ED contains some additional Australia specific provisions in respect of financial interests, inadvertent violations, and reporting. While these additions are in excess of the IFAC Code requirements, they are, on balance, reasonable and manageable"

Some of the Firms do not support the additional Australian provisions on the basis that these are additional requirements to a global standard (refer to comments under section 4 *Convergence*).

Given the documentary requirements associated with audit and other assurance engagements, where inadvertent violations do occur, most firms will document these decisions as a matter of best practice. The additional task they will have to do under the proposed Code is to communicate it to *Those Charged with Governance* (for example, the audit committee).

Thus this then places a safeguard (i.e. audit committee oversight) as:

- if there are frequent inadvertent violations occurring then the audit committee can make appropriate inquiries from the Firm of its systems and processes;
- Where a threat to independence has occurred (which is not trivial or inconsequential), then it does not leave it to the Firm's judgement to determine whether or not they inform the audit committee.

Technical Staff Recommendation

Technical staff recommends the inclusion of inadvertent violations provisions in the proposed Code on the basis that:

- It improves the Code and provides oversight from *Those Charged with Governance* (i.e. the audit committee);
- Most Firms will document these decisions in any case and the additional task they will have to perform is to inform the audit committee. This should not be a onerous task; and
- Most of the G 20 jurisdictions have differing additional requirements to the IESBA Code and have stated that they are going to continue to maintain these additional provisions when they update their respective Codes. Thus Australia is not alone in having additional requirements to the IESBA Code.

2. *Definition of Public Interest Entity*

Respondents have raised the issue of Public Interest Entity. Generally the Firms are supportive of retaining the IESBA definition. At the APESB Board meetings Firms have stated that they believe that in Australia the definition of Public Interest Entities should capture listed entities. ASIC has recommended that Public Interest Entity be defined with reference to AASB's definition of Publicly Accountable Entity. The

Professional bodies support a Public Interest Entity definition in the Australian context.

The definition of Public Interest Entity (PIE) as currently drafted in the IESBA Code has two limbs as noted below:

Public Interest Entity

Section 290 contains additional provisions that reflect the extent of public interest in certain entities. For the purpose of this section, public interest entities are [emphasis added]:

*(a) A Listed Entity; **and** [emphasis added]*

(b) An entity (a) defined by regulation or legislation as a public interest entity or (b) for which the audit is required by regulation or legislation to be conducted in compliance with the same Independence requirements that apply to the audit of Listed Entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.

The previous IESBA Code applied the more restrictive independence provisions to listed entities. By defining Public Interest Entities in the manner noted above, IESBA clearly intended the more restrictive independence requirements to apply to entities that have a public interest element (i.e. not only listed entities). If the intention was to only apply it to the listed entities then limb (a) of the definition would have been sufficient and it is not necessary to have limb (b) or to change the application from listed entities to Public Interest Entities in the new Code.

The second limb considers that in some cases legislation or regulation may specify which entities have a public interest and thus those entities will need to comply with the more restrictive independence provisions.

Currently in Australia the audit regulator (ASIC) has not specified in regulation which entities have a public interest element. However, the Australian Accounting Standards Board (AASB) has defined Publicly Accountable Entity in AASB 1053 *Application of Tiers of Australian Accounting Standards* (AASB 1053) issued in June 2010. AASB standards are legislative instruments.

Further in October 2009 the Australian Auditing and Assurance Standards Board (AUASB) issued Auditing Standard ASA 102 *Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements* (ASA 102). ASA 102 is a legislative instrument made under the *Corporations Act 2001* and specifies that in Australia the relevant ethical requirements are specified in APES 110. The AUASB has noted in its submission that they will reissue ASA 102 once APESB issues the new version of the Code. Accordingly ASA 102 provides APES 110 with a “quasi” legal status and has a higher standing than just a professional requirement.

The AASB's definition of Publicly Accountable Entity is based on the International Accounting Standards Board's (IASB) definition. The IASB define "public accountability" to identify entities that are required to prepare financial statements based on full IFRS accounting standards. This definition with additional Australian guidance has been adopted by the AASB in Australia (refer below).

Extract from Appendix A of AASB 1053:

Public accountability means accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs.

A for-profit private sector entity has public accountability if:

(a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or

(b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

In AASB 1053 the AASB has deemed that in the for profit sector the following entities have public accountability.

B2 The following for-profit entities are deemed to have public accountability:

(a) disclosing entities, even if their debt or equity instruments are not traded in a public market or are not in the process of being issued for trading in a public market;
(b) co-operatives that issue debentures;
(c) registered managed investment schemes;
(d) superannuation plans regulated by the Australian Prudential Regulation Authority (APRA) other than Small APRA Funds as defined by APRA Superannuation Circular No. III.E.1 Regulation of Small APRA Funds, December 2000; and
(e) authorised deposit-taking institutions.

Definitions of these entities are given in Appendix 1.

The tier 1 reporting requirement in AASB 1053 applies to the Publicly Accountable Entities in the for profit sector and the Australian Government and State, Territory and Local Governments.

The AASB makes standards under Section 334 of the *Corporations Act* and in effect the standards issued by the AASB are legislative instruments. Accordingly legislation in Australia already specifies which entities have public accountability.

Technical Staff View

If viewed from a "principles" based manner, it can be argued that in substance the Public Interest Entity and Publicly Accountable Entity are addressing similar concepts (i.e. entities that have public interest element) and thus legislation already exist in Australia on what is a Public Interest Entity. However, Technical Staff believe further work needs to be done to either confirm this view or to define it in the Australian context.

Public Interest Entities in other Jurisdictions

The current or proposed treatment of Public Interest Entities in some of the other jurisdictions is described below.

European Union

One of the reasons that the IESBA adopted the term Public Interest Entity was to align the IESBA definition with the definition used in the European Union (EU).

The definition of Public Interest Entity adopted by the EU is as follows:

Public Interest Entities ('PIE') means;

- companies or other bodies corporate governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC;
- credit institutions as defined in point 1 of Article 1 of Directive 2000/12/EC relating to the taking up and pursuit of business of credit institutions, and
- insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC.

As indicated above, the EU definition is broader than listed entities and specifically includes credit institutions and insurance companies.

New Zealand

New Zealand has taken a similar approach in its ED on the Code by defining the term by reference to legislation and including a list of institutions that satisfy the definition:

Public interest entity:
(a) All issuers as defined in the Financial Reporting Act 1993; and
(b) All other Tier 1 entities (as outlined in the Accounting Standards Review Board's "Proposed Application of Accounting and

Assurance Standards under the Proposed New Statutory Framework for Financial Reporting").

Proposed Application of Tier 1 includes:

(a) In the For-Profit Sector:
- *(i) Issuers of Securities Traded in a Public Market;*
- *(ii) Fiduciary Holders of Assets.*

(b) Public Entities:
- *(i) Crown;*
- *(ii) Local Authorities;*
- *(iii) Other leviers of coercive revenue, which would include ACC, EQC, Fire Services Commission and any other entities that are leviers of coercive revenue;*
- *(iv) Other entities with expenditure ≥$20m.*

(c) Other Not-For-Profit Entities:
- *(i) Publicly accountable entities, which comprise registered charities and any other not-for-profit organisation that receives funds from the public, with expenditure ≥$10m;*
- *(ii) Other entities with expenditure ≥$10m.*

Canada

The current proposal in Canada is to use the existing Canadian definition of *Reporting Issuer*. They believe that the definition of "Reporting Issuer" is broad enough to capture the entities that need to be captured by the Public Interest Entity definition.

Reporting Issuer *means an entity that is deemed to be reporting issuer under the applicable Canadian provincial or territorial securities legislation whose shares, debt or other securities are quoted or listed in a recognised stock exchange, or are marketed under the regulations of a recognised stock exchange or other equivalent body, other than an entity that has, in respect of a particular fiscal year, market capitalisation and total assets that are each less than $ 10,000,000. An entity that becomes a reporting issuer by virtue of the market capitalisation or total assets becoming $ 10,000,000 or more in respect of a particular fiscal year shall be considered to be a reporting issuer hence forward unless and until the entity ceases to have its shares units or debt quoted, listed or marketed in connection with a recognised stock exchange or the entity has remained under the market capitalisation or total assets threshold for a period of two years.*

In the case of a period in which an entity makes a public offering:

a) the term "market capitalisation" shall be read as referring to the market price of all outstanding listed securities and publicly traded debt measured using the closing price on the day of the public offering; and
b) the term "total assets" shall be read as referring to the amount of total assets presented on the most recent financial statements prepared in accordance with generally accepted accounting principles included in the public offering document.

In the case of a Reporting Issuer that does not have listed securities or publicly traded debt, the definition of reporting issuer shall be read without reference to market capitalisation.

The definition of Reporting Issuer in Canada is considerably broader than a listed entity. However, it does allow an exemption for small cap entities in Canada.

Whilst some respondents suggested that consistency with the International Code be maintained, the IESBA intended that national standards setters or other appropriate member body adopt a definition that is appropriate for their jurisdiction as explicitly stated in the following paragraph of the IESBA Code:

290.26 Firms and member bodies are encouraged to determine whether to treat additional entities, or certain categories of entities, as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered include:

- *The nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders. Examples may include financial institutions, such as banks and insurance companies, and pension funds;*
- *Size; and*
- *Number of employees.*

Based on discussions with the IESBA Technical Staff, IESBA initially attempted to define what entities would be considered to be a Public Interest Entity. However, found it difficult task due to jurisdictional differences. Accordingly, the principles are given in the Code and it has been left for each jurisdiction to make an appropriate determination.

Technical Staff have prepared a high level preliminary analysis of applying the above principles in the context of the five types of entities identified by the AASB in AASB 1053. The preliminary results are tabulated below.

	Nature of Business/Stakeholders	Size	Number of Employees
Disclosing Entity	Yes	Yes (in most cases)	Yes (in most cases)
Co-operative	Yes	Maybe	Maybe
Registered Managed Investment Schemes	Yes	Maybe	Maybe
Superannuation Plans other than small APRA funds	Yes	Yes	Yes
Authorised Deposit Taking Institutions	Yes	Yes	Yes

Further work is required to confirm these high level preliminary results. However, we understand that AASB went through an extensive due process as part of the differential reporting project to identify which entities in Australia have public accountability.

The Australian regulator, ASIC, believes that the Australian definition should be consistent with the definition of Publicly Accountable Entity adopted by the Australian Accounting Standard AASB1053. As noted by ASIC this would increase simplicity and reduce any possible confusion amongst auditors and audit clients of which entities should be treated as Public Interest Entities.

The need to have an Australian definition is also supported by the professional bodies who have stated that the benefit of an Australian definition is in the public interest and that it would ensure that certain entities are always treated as Public Interest Entities rather than risking non-consensus between Firms.

At the recent World Congress of Accountants the IESBA Chairman publicly stated that it is intended that the definition of Public Interest Entities covers more than listed entities. As an example, he noted the EU definition which he said in addition to typical listed companies captures banks and insurance companies.

The argument by respondents that no change is done to the IESBA definition in respect of this definition, as otherwise international consistency will be lost, is not a valid one given that other major jurisdictions are defining it in their context. Further, the existing or proposed definitions in the jurisdictions noted above are broader than listed entities.

Technical Staff Recommendation

Technical Staff recommends that the Board consider this issue and provide a definition of what is a Public Interest Entity in Australia taking into consideration the AASB's definition of *Publicly Accountable Entity* on the basis that:

- IESBA intended that each jurisdiction should determine which entities should be treated as Public Interest Entities in their respective jurisdictions;
- Given the definition of Public Interest Entities that include limb (a) and (b), and the manner in which the previous IESBA Code was drafted to only include listed entities, the clear intention in the new Code was to extend it beyond listed entities (Refer to IESBA Chairman's comments above);
- If not defined may lead to inconsistent practices between Firms as noted by ASIC and professional bodies;
- If not defined and the Firms interpret it as only applying to listed entities then there will be a situation in Australia where the more stricter financial reporting requirements will be applied by clients to entities that have public accountability (as per AASB 1053 which is law). However, the clients' auditor will not comply with the stricter independence requirements in respect of these entities as it is not captured in the Code's definition;
- Further the operation of ASA 102 mean that APES 110 has "quasi" legal status and thus have a higher level of enforceability than a professional requirement;

- If not defined, it is quite possible for stakeholders (particularly in a legal dispute) to interpret that due to the operation of limb (b) of the definition in the Code and AASB 1053, that both Public Interest Entity and Publicly Accountable Entity are addressing similar concepts. Accordingly, how is it that the relevant Firm did not comply with the definition in AASB 1053 which clearly specifies in Australian law what entities have a public interest?
- If defined it will achieve consistency in practice and provide guidance to Firms on which entities are to be always considered to be Public Interest Entities in Australia. Further, this approach will be consistent with the other major jurisdictions noted above.

As a starting point the AASB definition can be considered by the Board. AASB went through an extensive consultation process to determine these entities in the Australian context and hence that definition should be considered as a starting point. APESB Technical staff can liaise with AASB Technical staff and obtain further information in this regard.

Technical Staff recommend that further work needs to be done to determine whether all entities deemed by AASB as Publicly Accountable Entities are Public Interest Entities for the purposes of the proposed Code.

Technical Staff strongly recommend that Public Interest Entity be defined in the Australian context rather than leaving it undefined due to the existence of AASB 1053 and ASA 102.

3. Legislative references

References to legislative requirements such as the *Corporations Act 2001* were removed from ED 03/10 to achieve closer alignment to the IESBA Code. However, some stakeholders note that as the requirements in the *Corporations Act* are more restrictive and if it is not appropriately signposted then it may lead to potential contraventions of the *Corporations Act* requirements.

Referencing to legislation can be done in a number of ways such as:

- Footnoting;
- Separate paragraphs which incorporate the requirements of the *Corporations Act 2001* (similar to the existing APES 110);
- Guidance material; or
- Appendix to the proposed Code.

The Board specifically considered this issue at the time of issuing the ED and determined to remove the paragraphs in the existing APES 110 that incorporated *Corporations Act* requirements. In respect of the guidance material option a weakness with that approach is that it is in a separate document.

The options of footnoting or including the *Corporations Act* requirements in an appendix has the advantage that the information will be in the same document and it is not paraphrasing or restating an existing requirement.

Technical Staff Recommendation

Technical staff recommends either footnoting the *Corporations Act* requirements (similar to AUASB) or including it in an appendix to the proposed Code. The benefit is primarily for sole or SMP practitioners who will not have the resources of a big four Firm. Further, as the previous Code did include the *Corporation Act* provisions, Members who have got used to using APES 110 over the last four years will at least be put on notice with any of one these two approaches.

4. Convergence

Some respondents to the ED 03/10 have argued that no changes should be done to the IESBA Code.

IESBA recently acknowledged that convergence is a long term objective and that there is much work to be done before there is one set of independence and ethics rules around the world.

Based on APESB's consultations with international counterparts (which represent the major G 20 jurisdictions) the current status of adoption in these countries is as follows:

- A minority are adopting the Code with minimal changes;
- A majority will continue with their additional requirements to the IESBA Code;
- Some of the key jurisdictions believe that their respective Codes are better written and thus will continue to maintain the manner in which those Codes are written rather than adopting the IESBA's Code;
- Some jurisdictions will not be adopting Section 290/291 and will continue to maintain their provisions as applicable to all assurance engagements;
- One jurisdiction has got legal advice not to adopt the IESBA Code as it will be difficult to enforce and discipline members.

The Australian Code has very few changes to the IESBA Code compared to some of these other major jurisdictions. Accordingly, as the convergence process is still in the early stages of its journey, the argument to do absolutely no change to the global Code is not an appropriate argument. However, if all the other countries had accepted the IESBA code without change then Australia should follow. As it currently stands in these major jurisdictions this is clearly not the case.

If at a future date all the IFAC member countries agreed to converge, then the Australian Code requires minimal changes compared to some of these other major jurisdictions.

Convergence is a long term objective of the IESBA and IESBA has commenced a journey to achieve this over a period of time. The IESBA Chairman stated this position at the World Congress of Accountants and noted that as a first step IESBA is looking at the Public Interest Entity provisions and the group audit situations.

Technical Staff Recommendation

As noted above convergence is a long term objective of the IESBA and this process will take a number of years to complete. Accordingly, as a developed nation where there are higher expectations of capital markets and auditor independence, it is appropriate for the Australian Code to have additional requirements to the IESBA Code. The IESBA Code is a minimum requirement for IFAC Member bodies and the majority of the developed nations have additional requirements to the IESBA Code.

Other Matters

The following issues require the Board's consideration:

Specific comments Issue Number	Code Paragraph Reference	Technical Staff comments /recommendations
3	Preface to Sections 290 and 291.	Additional information to remind Corporations Act Auditors of the Corporations Act requirements can be included.
20	240.3	Footnote cross reference to other APES Standards that prohibit this practice should be included.
35	290.29 & 291.29	Agree with ASIC's comments. If the Board determines to amend it then it will create a divergence with IESBA's Code.
53	290.172-174 and 290.185-186	Agree with ASIC's comments. If the Board determines to amend it then it will create a divergence with IESBA's Code.
56	290.199	Consistent with the international approach. If the Board determines to amend it then it will create a divergence with IESBA's Code.

Staff Recommendations

- The Board consider the respondents submissions and provide review comments on the issues raised;
- The Board provide direction on the key issues and other matters identified in this agenda paper. Based on the Board's drafting instructions Technical Staff will complete the drafting process for APES 110 *Code of Ethics for Professional Accountants* and present it for the Board's consideration in late November 2010.

Material Presented

- General comments table;
- Specific comments table;
- Respondents submissions;
- Extracts from Exposure Draft 03/10 APES 110 *Code of Ethics for Professional Accountants*

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Date: 12th November 2010

APPENDIX 1: Definitions of the five for-profit entities that the AASB has deemed to have public accountability

Disclosing Entities

A disclosing entity is a body or undertaking (prescribed interest schemes) that has issued securities that are Enhanced Disclosure (ED) securities. The two most common classes of ED securities that are quoted on a stock market (quoted ED securities) and securities to which a prospectus relates. The definition of Disclosing Entity is as per s.111AC of the *Corporations Act 2001*.

Co-operatives that issue debentures

Co-operatives are people-centered organizations that are owned, controlled and used by their members. A co-operatives main purpose is to benefit its members.

The International Co-operative Alliance (ICA), an independent, non-government association that unites and represents co-operatives worldwide, has given the generally accepted definition of a co-operative as being:

"…an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise".

Co-operatives are different from other forms of incorporation because of their member ownership, democratic structure and the use of funds for mutual, rather than individual, benefit. Co-operatives have their own state based legislations.

Registered managed investment schemes

A managed investment scheme is a scheme (often in the form of a unit trust) in which people contribute money (or money's worth) to acquire interest to benefits produced by the scheme. These contributions are pooled or used in a common enterprise and members of the scheme do not have day to day control over the operation of the scheme. There are carve outs for certain types of schemes such as superannuation trusts. A managed investment scheme must be registered with the Australian Securities and Investments Commission (ASIC) where:

- the scheme has 20 or more members; or
- the scheme is promoted by a person who was in the business of promoting managed investment schemes.

The governing regulation for management investment schemes is the *Managed Investments Act* (Cth) *1998.* Managed investment schemes cover a wide variety of investments.

Superannuation plans regulated by APRA other than small APRA Funds

A retirement (including pensions) program in Australia. It has a compulsory element whereby employers are required by law to pay an additional amount based on a proportion of an employee's salaries and wages (currently 9%) into a complying superannuation fund, which can be accessed when the employee meets one of the conditions of release contained in Schedule 1 of the *Superannuation Industry (Supervision) Regulations 1994.*

As per definition in s.*10 Superannuation Industry (Supervision) Act 1993*, it is:

(a) a fund that:

(i) is an indefinitely continuing fund; and

(ii) is a provident, benefit, superannuation or retirement fund; or

(b) a public sector superannuation scheme.

Authorised Deposit-taking Institutions

These are Corporations which are authorized under the *Banking Act 1959* to take deposits from customers. Authorised Deposit-Taking Institutions (ADI) includes banks, building societies, and credit unions.