IESBA

STAFF QUESTIONS AND ANSWERS

IMPLEMENTING THE CODE OF ETHICS—PART II

In December 2010, the staff of the International Ethics Standards Board for Accountants (IESBA) issued several Questions and Answers (Q&As) to assist member bodies and others as they adopt and implement the IESBA's *Code of Ethics for Professional Accountants* (the Code) issued in July 2009.[1] The Q&As that follow are additional to the 2010 Q&As.

This publication does not amend or override the Code, the text of which alone is authoritative. Reading a Q&A is not a substitute for reading the Code. Q&As are not meant to be exhaustive and reference to the Code itself should always be made. Q&As do not constitute an authoritative or official pronouncement of the IESBA.

Questions and Answers

Materiality

Q1. ***Some of the paragraphs in Section 290 that apply to the provision of non-assurance services to an audit client state that a service shall not be provided if it will have a material effect on the client's financial statements. The Code does not provide any guidance on materiality. How should materiality be determined?***

Reference should be made to the auditing standards. ISA 320, *Materiality in Planning and Performing an Audit* deals with an auditor's responsibility to apply the concept of materiality in planning and performing an audit. The ISA requires materiality to be determined for the financial statements as a whole. Under the ISA, however, if there are one or more particular classes of transactions, account balances, or disclosures for which misstatements of lesser amounts could reasonably be expected to influence the decisions of users, the auditor is required to determine the materiality level to be applied to those particular classes of transactions, account balances, or disclosures. In such circumstances, that materiality level should be used if the proposed non-assurance service relates to the particular class of transaction, account balance, or disclosure.

Q2. ***Paragraph 290.180 states that a firm shall not provide valuation services to an audit client that is a public interest entity if the valuations would have a material effect, separately or in the aggregate, on the financial statements on which the firm will express an opinion. If a firm assesses that the valuation service will not have a material effect on the financial statements, it starts the service and it becomes apparent that the service would have a material effect, can the firm continue the valuation service on the basis that the service initially met the materiality test?***

In this circumstance, the firm would not be independent if it continued the service. The Code prohibits a firm that is required to be independent from providing valuation services that would have

[1] See www.ifac.org/publications-resources/iesba-staff-questions-and-answers-implementing-code-ethics to access the 2010 Q&As.

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a material effect on the financial statements of a public interest entity audit client. Accordingly, if at any time after agreeing to perform the valuation service it becomes apparent that the valuation service will have a material effect on the financial statements, the firm may not provide the valuation service and continue to be the entity's auditor.

Partner Rotation

Q3. ***The Code contains two transitional provisions related to the new partner rotation requirements, which are effective for years beginning on or after December 15, 2011. Another transitional provision states that the additional independence provisions that are applicable because of the new definition of a public interest entity are effective on January 1, 2012. What effect does the transitional provision related to public interest entities have on the partner rotation transitional provisions?***

The interaction of the transitional provisions is shown in the tables below. The tables assume a December 31 year end. The years in bold indicate the last year that the individual could serve in that role before rotation would be required.

Listed Entity

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Note
-	EP	EP	EP	EP	EP	EP	**EP**	-	-	1
-	-	EP	EP	EP	EP	EP	EP	**EP**	-	1
-	-	-	EP	EP	EP	EP	EP	EP	**EP**	1
-	EQCR	EQCR	EQCR	EQCR	EQCR	EQCR	**EQCR**	-	-	1
-	-	EQCR	EQCR	EQCR	EQCR	EQCR	EQCR	**EQCR**	-	1
-	-	-	EQCR	EQCR	EQCR	EQCR	EQCR	EQCR	**EQCR**	1
OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	**OKAP**	-	2
OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	EP	EP	**EP**	-	3
OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	EP	**EP**	-	3

Public Interest Entity That Is Not a Listed Entity

2003	2004	2005	2006	2007	2008	2009	2010	2011	Note
EP	EP	EP	EP	EP	EP	EP	EP	**EP**	4
OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	OKAP	**OKAP**	2
OKAP	OKAP	OKAP	OKAP	OKAP	EP	OKAP	EP	**EP**	3

Legend

EP Engagement Partner

EQCR Engagement Quality Control Reviewer

OKAP Key Audit Partner who is neither the Engagement Partner nor the Engagement Quality Control Reviewer

Notes

1. No transitional provisions apply
2. Transitional paragraph 2 applies
3. Transitional paragraph 3 applies
4. Transitional paragraph 1 applies

Q4. ***Under paragraph 290.151, an individual shall not be a key audit partner for an audit client that is a public interest entity for more than seven years. After serving in such a role for seven years, paragraph 290.151 requires a two-year "time-out" period. Could that individual have a role in which he or she would have regular or ongoing contact with management or the audit committee of the client (for example, as the "client relationship partner," "client service partner" or "senior advisory partner") during the two year time-out period?***

No. Paragraph 290.151 states that during the time-out period the individual cannot be a member of the engagement team, be a key audit partner for the client, participate in the audit of the entity, provide quality control for the engagement, consult with the engagement team or the client regarding technical or industry-specific issues, transactions, or events, or otherwise directly influence the outcome of the engagement. This would preclude having any role that would enable the individual to exercise the duties or responsibilities of someone in those positions. An individual with a high level of contact with management or the audit committee, such as a client relationship partner, would be able to directly influence the outcome of the engagement.

Q5. ***The Code requires rotation of key audit partners, which include other audit partners on the engagement team who make key decisions or judgments on significant matters with respect to the audit. This might include audit partners responsible for significant subsidiaries or divisions. ISA 600, Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) states that the group engagement partner is responsible for the direction, supervision, and performance of the group audit. Does this mean that if an audit is conducted in compliance with ISA 600, the engagement partner is the only key audit partner (other than the engagement quality control reviewer) subject to the rotation requirements?***

No. While ISA 600 states that the group engagement partner is responsible for the direction, supervision, and performance of the audit, this does not override the Code's definition of a key audit partner and does not eliminate the judgment required in determining whether other partners on the engagement are key audit partners. Depending upon the circumstances, the size of the group, and the role of the individuals, there may be other audit partners who make key decisions or judgments on significant matters with respect to the group financial statements—as may be the case with an audit partner who was responsible for the audit of a significant subsidiary of the group.

Q6. ***The Code defines a key audit partner to include partners who make "key decisions or judgments" on significant matters with respect to the audit of the financial statements on which the firm will express an opinion. The Code does not provide guidance for determining when decisions or judgments are "key" decisions or judgments. What are some examples?***

Whether a decision or judgment is a key decision or judgment will depend on the specific facts and circumstances. Professional judgment is required to make that determination. Generally, the subject matter of the decision or judgment would be significant to the financial statements taken as whole. Examples might be reaching a conclusion about whether there was a material impairment of long-lived assets or about a significant tax uncertainty. Providing advice about such matters to the individual who has the responsibility to make such decisions would not make the person who provides the advice a key audit partner.

Public Interest Entities

Q7. ***Section 290 contains additional requirements, restrictions, and prohibitions that reflect the extent of public interest in certain entities that are referred to as "public interest entities." If an entity is required to have a statutory audit, does that mean the entity is a public interest entity?***

No. For an entity to be a public interest entity under the Code, it is not enough that the entity is required to issue audited financial statements, regardless of whether that requirement is attributable to law, regulation, statute, or other source, such as lenders, creditors, bonding agents, insurance carriers, partnership agreements, or other contracts. To be a public interest entity, the entity must either be a listed entity, defined by regulation or legislation to be a public interest entity, or be required by regulation or legislation to have its audit conducted in compliance with the same independence requirements that apply to listed entities. The Code does, however, in paragraph 290.26 encourage firms and member bodies 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.

Network Firms

Q8. ***Can firms that are members of an association of firms comprise a network that does not include all other firms in the same association?***

Yes. This would be the case if some of the firms share profits, costs, or a significant part of professional resources, or have common ownership, control, or management, common quality control policies and procedures, a common business strategy, or use a common brand name. For example, an association may comprise 50 firms that are separate and distinct legal entities. All the firms are listed in the association's global directory and each firm refers to its membership of the association in its marketing and promotional materials. There is no profit or cost sharing, or common ownership, control, or management. Each firm has its own system of quality control policies and procedures and there is no monitoring of such systems across the association. Fifteen of the firms sign audit reports using the name of the association as part of their firm names. The other 35 firms do not use the association name when signing audit reports. The 15 firms are a network for the purposes of the Code and the other 35 firms are not part of that network.

Q9. ***If a firm is part of a larger structure that is aimed at co-operation and the firms within that larger structure use a common brand name to sign assurance reports that are not audit or review reports, would that larger structure be deemed to be a network under the Code?***

Yes. Paragraph 291.17 calls for an evaluation to be made of the significance of any threats that the firm has reason to believe are created by network firm interests or relationships and footnote 3 refers to paragraphs 290.13 to 290.24 for guidance on what constitutes a network firm. Under paragraph 290.20, a firm is deemed to be using a common brand name if it includes, for example, the common brand name as part of, or along with, its firm name when a partner of the firm signs an audit report. Paragraph 290.21 states that care should be taken as to how a firm makes reference to membership of an association of firms or a perception may be created that the firm belongs to a network. The use of a common brand name in signing assurance reports that are not audit or review reports would give the perception to the users of those reports that the firm belongs to a network.

Q10. ***If a firm is part of a larger structure that is aimed at co-operation and the firms within that larger structure make reference to the larger structure in their stationery and promotional materials, would that larger structure be deemed to be a network under the Code?***

Possibly. The reference to membership of the larger structure in their stationery and other promotional materials would not in itself create a network under the Code. However, if one or more other factors were present, such as the sharing of profits, costs, and/or professional resources, that structure would be deemed to be a network.

Fees—Relative Size

Q11. ***Under paragraph 290.222, a "post-issuance review" equivalent to an engagement quality control review is one of two safeguards that a firm is required to apply. What would such a review entail?***

ISA 220, *Quality Control for an Audit of Financial Statements* addresses the responsibilities of the engagement quality control reviewer. In performing a post-issuance review that is equivalent to an engagement quality control review, the reviewer would provide an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor's report. The evaluation would involve:

- discussion of significant matters with the engagement partner; review of the financial statements and the auditor's report;
- review of selected audit documentation relating to the significant judgments of the engagement team and the conclusions it reached; and
- evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the auditor's report was appropriate.

Mergers and Acquisitions

Q12. ***Paragraphs 290.33-290.38 provide guidance on the actions to be taken when, as a result of a merger or acquisition, an entity becomes a related entity of an audit client. In some mergers a new entity is formed that is made up of the two entities involved in the merger, as opposed to one entity becoming a related entity of the audit client. Do the provisions in paragraphs 290.33-290.38 apply in such situations?***

Yes.

Reasonable and Informed Third Party

Q13. ***The Code contains a reasonable and informed third party test—for example, paragraph 100.7 requires a professional accountant to apply safeguards to eliminate threats to compliance with the fundamental principles in the Code or reduce them to an acceptable level. The Code defines an acceptable level as "a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant at that time, that compliance with the fundamental principles is not compromised." How should the reasonable and informed third party test be applied?***

Application of the test requires professional judgment. The reasonable and informed third party test is intended to establish an unbiased benchmark against which the professional accountant judges what action will be acceptable. Thus, for example, the professional accountant should consider whether a reasonable and informed third party would consider that the safeguards applied satisfactorily address the threat. It is important to note that the test focuses on information that is currently available and thus prevents the use of hindsight in determining whether the action was appropriate.

IESBA

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The objective of the IESBA is to serve the public interest by setting high-quality ethical standards for professional accountants and by facilitating the convergence of international and national ethical standards, including auditor independence requirements, through the development of a robust, internationally appropriate code of ethics.

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