

PES 1 CODE OF ETHICS FOR ASSURANCE PRACTITIONERS

Explanation of Decisions made by the NZAuASB in Finalizing PES 1

Issued January 2013

This document relates to, but does not form part of Professional and Ethical Standard (PES) 1, *Code of Ethics for Assurance Practitioners* which was approved by the NZAuASB in December 2012. It summarises the changes made by the NZAuASB to the International Federation of Accountants (IFAC) Code and provides the compelling reasoning as to why the changes were made. It also summarises the major issues raised by respondents to Exposure draft 2012-6 Professional and Ethical Standard 1 (Revised) *Code of Ethics for Assurance Providers and withdrawal of Professional and Ethical Standard 2 Independence in Assurance Engagements*, and how the NZAuASB has addressed them.

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BACKGROUND

1. The International Ethics Standards Board for Accountants (IESBA) started a project in December 2004 to strengthen the independence requirements in the IFAC Code. In addition, in March 2007, the IESBA started to consider the implications of the IAASB's clarity project on the IFAC Code. After IFAC's due process, the revised IFAC Code was approved by the IESBA in April 2009 and issued in July 2009, following the approval and consideration of due process by the Public Interest Oversight Board. These revisions by the IESBA have not previously been incorporated into the professional and ethical standards in New Zealand and therefore the New Zealand requirements were not aligned with the IFAC Code.
2. The NZAuASB issued an exposure draft ED 2012-6 proposing to revise Professional and Ethical Standard 1 and withdraw Professional and Ethical Standard 2 on 22 May 2012, with a comment deadline of 30 August 2012. The revision is based on the IFAC Code. PES 1 (Revised) also incorporates amendments made to the IFAC Code, subsequent to the 2009 version of the IFAC Code. PES 1 (Revised) adopts the IFAC Code paragraph numbering with any additions of paragraphs and definitions prefixed as NZ in PES 1 (Revised)

MAJOR ISSUES RAISED BY RESPONDENTS ON EXPOSURE

3. Nine submissions were received from professional bodies, firms and the Office of the Auditor-General. Key issues raised in the submissions received included:
 - The definition of a public interest entity proposed for New Zealand;
 - The practical challenges for smaller firms created by the partner rotation requirements for public interest entities, specifically because the individual responsible for the engagement quality control review is now also subject to the rotation requirements; and
 - The changes made in New Zealand to section 291 to tighten the requirements for public interest entities for engagements other than audits and reviews.

HOW THE NZAuASB RESPONDED

The Definition of a Public Interest Entity Proposed for New Zealand

4. The NZAuASB has decided to align the definition of a public interest entity with Tier 1 entities as per the accounting standards framework. The NZAuASB acknowledges that defining a public interest entity as all Tier 1 entities as per the accounting standards framework will result in a much broader application of the public interest entity requirements. It is acknowledged that this is broader than the application in Australia and is also far broader in application than the IFAC Code.
5. The NZAuASB is strongly in favour of applying the stricter independence requirements to all Tier 1 entities. Entities are included in Tier 1 based on public accountability. The External Reporting Board (XRB) has determined that all Tier 1

entities are required to meet the highest financial reporting requirements. The XRB have performed a cost benefit analysis to identify these Tier 1 entities. On that basis, the NZAuASB considers that it is appropriate and in the public interest that the most stringent independence criteria apply to the auditors of those entities.

6. The NZAuASB is of the view that extending the public interest entity definition, which will have the impact of extending the prohibitions on certain behaviour, should not disproportionately or significantly increase compliance costs. Audit firms will need to be aware of the tighter independence requirements in any event, and will need to apply these restrictions on more engagements.

The Practical Challenges for Smaller Firms Created by the Partner Rotation Requirements

7. The rotation requirements now require both the engagement partner and the individual responsible for the engagement quality control review to rotate after seven years, with a two year stand down period. The NZAuASB acknowledges the difficulties facing smaller firms in applying these provisions but notes that the significance of the threat does not differ just because the audit firm is a small firm.
8. The NZAuASB is of the view that it is unlikely that many sole practitioners or smaller firms will be affected by the rotation requirement for key audit partners. The only time it may affect smaller firms is where the firm audits issuers or engagements that require an engagement quality control review. Professional and Ethical Standard 3 (Revised), “Quality Control” requires an engagement quality control review for all audits of financial statements of issuers. This requirement does not apply if the firm does not perform such engagements. It is unlikely that many sole practitioners or smaller firms will perform issuer audits, or will undertake other assurance engagements that will meet the criteria set out in Professional and Ethical Standard 3 that will require an engagement quality control review.
9. The need for smaller firms to contract suitably qualified external people to conduct an engagement quality control review already exists in order to meet the requirements of Professional and Ethical Standard 3. Professional and Ethical Standard 3 explains that suitably qualified external persons may need to be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Professional and Ethical Standard 3 indicates that some sole practitioners or small firms may alternatively wish to use other firms to facilitate engagement quality control reviews.
10. Extending this need as a result of the more stringent independence rotation requirements should therefore not have large compliance costs, rather it extends a need that already exists. The NZAuASB has however acknowledged that this change may require additional time to implement and has therefore extended the transitional requirements for the key audit partner rotation requirements by one year, becoming effective from 1 January 2015.

The Changes made in New Zealand to Section 291 to Tighten the Requirements for Public Interest Entities for Engagements Other than Audits and Reviews.

11. The NZAuASB is of the view that the threats to independence do not differ when the subject matter of the engagement are financial statements or another subject matter. The NZAuASB is of the view that these prohibitions are appropriate for other assurance clients, if they are public interest entities. Prohibiting such services in these circumstances is appropriate to maintaining independence, given the high level of interest in a public interest entity. For example, the rotation requirements on the engagement partner responsible for the assurance report on controls at a service organisation. Having a list of prohibitions is clearer and appropriate to address the threat to independence if the circumstances arose. These prohibitions therefore best serve the public interest.
12. The submissions also requested that the compelling reasons for changes made to the IFAC Code should be clearly documented and explained. All of these compelling reasons are outlined below.

RATIONALE FOR AMENDMENTS MADE TO THE IFAC CODE OF ETHICS

13. The NZAuASB has developed this Code of Ethics for Assurance Practitioners based on the Revised IFAC Code of Ethics. It is closely aligned to the IFAC Code. The NZAuASB applied the [Principles of Convergence to International Standards](#) in developing this standard, and has only amended the international standard where there are compelling reasons to do so. Additional requirements are clearly identifiable as NZ paragraphs and are also described in the conformity with international requirements at the end of the standard. This Basis for Conclusions explains the compelling reasons identified by the NZAuASB to amend the IFAC Code.
14. The NZAuASB considers that it is unlikely that the IESBA will make changes, in the near future, at an international level for the changes that the NZAuASB has assessed to be compelling for New Zealand. International convergence is a long term goal of the IESBA.

Scope

15. The NZAuASB's mandate is limited to assurance engagements and therefore the scope of PES 1 (Revised) differs from the IFAC Code. PES 1 (Revised) is intended to apply to all assurance practitioners appointed or engaged to perform an assurance engagement. PES 1 (Revised) does not include Part C of the IFAC Code dealing with Professional Accountants in Business. In addition, Section 230 Second opinions has been deleted by the NZAuASB as it is not related to the performance of an assurance engagement.

Conflicts of Interest

16. PES 1 (Revised) includes more stringent requirements for dealing with conflicts of interest than the IFAC Code. Paragraph 220.11 has been amended, paragraph 220.14 has been deleted and paragraphs NZ220.10.1 and NZ220.14 have been added.
17. PES 1 (Revised) requires disclosure of the nature of a conflict of interest and related safeguards, if any, to all clients or potential clients affected by a conflict. The IFAC Code states that disclosure is generally necessary. In addition, paragraph NZ220.14 requires that an assurance practitioner disengage from the relevant assurance engagement if adequate disclosure to the client is restricted as a result of confidentiality requirements. The IFAC Code allows this in limited situations.
18. The NZAuASB recognises that the IFAC Code requirements have a broader application than assurance engagements. The NZAuASB believes that disclosure and a transparent process for handling conflicts of interest are always appropriate for assurance engagements.
19. Managing conflicts of interest in a small country like New Zealand is inevitable and has resulted in more stringent requirements than the IFAC Code. Practice has emerged to address these conflicts through the Office of the Auditor-General and guidance issued by the Institute of Directors. New Zealand's best practice has been added to PES 1 (Revised) which the NZAuASB believes to be appropriate in the New Zealand context for assurance engagements, and which will promote improvement in audit quality.

INDEPENDENCE REQUIREMENTS

Audits and Reviews of Financial Statements vs Other Assurance Engagements

20. The IFAC Code has separated independence requirements for audits and reviews of historical financial statements which are more restrictive in some instances from other assurance engagements (Section 290, dealing with audit and review engagements and Section 291, dealing with other assurance engagements). PES 1 (Revised) extends the scope of Section 290 to cover all assurance engagements in relation to an offer document of an issuer in respect of historical financial information, prospective or pro-forma financial information or a combination of these.
21. The NZAuASB is of the view that this amendment is necessary to promote audit quality. The nature of assurance provided where the subject matter is prospective information included in any offer document of an issuer, and the importance of those services to the broader public interest, warrant the same level of independence as an assurance engagement over historical financial information. The NZAuASB does not believe that broadening the scope of Section 290 will have large compliance costs as in most circumstances where an assurance engagement is performed on prospective information in an offer document, the client will already be an audit or review client and therefore these tighter independence requirements would already apply.

Public Interest Entities

22. The IFAC Code has introduced the concept of a ‘public interest entity’ and defined it to be all listed entities and any entity (a) defined by regulation or legislation as a public interest entity or (b) for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator. The International Ethics Standards Board for Accountants (IESBA) has the expectation that national standard setters will adopt a definition that is appropriate for their jurisdiction.
23. The NZAuASB has defined a public interest entity in paragraph NZ290.25 and NZ291.3.1 of PES 1 (Revised) as “any for-profit entity that is required or chooses to report in accordance with Tier 1 under XRB A1¹; and any other public benefit entity² that applies the full financial reporting standards”.
24. The NZAuASB acknowledges that defining a public interest entity as all Tier 1 entities as per the accounting standards framework will result in a much broader application of the stricter public interest entity requirements. This would therefore promote significant improvement in audit quality to all Tier 1 entities. It is acknowledged that this is broader than the application in Australia and is also far broader in application than the IFAC Code.
25. The NZAuASB is strongly in favour of applying the stricter independence requirements to all Tier 1 entities. Entities are included in Tier 1 based on public accountability. The External Reporting Board (XRB) has determined that all Tier 1 entities are required to meet the highest financial reporting requirements. The XRB have performed a cost benefit analysis to identify these Tier 1 entities. On that basis, the NZAuASB consider that it is appropriate and in the public interest that the most stringent independence criteria apply to the auditors of those entities.
26. The NZAuASB is of the view that extending the public interest entity definition, with the impact of extending the prohibitions on certain behaviour, should not disproportionately or significantly increase compliance costs. Audit firms will need to be aware of the tighter independence requirements in any event, and will need to apply these restrictions on more engagements.
27. The NZAuASB considers that it is appropriate to delete and replace the definition of a public entity in paragraph 290.25 as drafted by the IESBA as this paragraph would be inconsequential in New Zealand.
28. One issue identified by constituents was that the extension of the public interest entity definition could potentially create large compliance costs. The issue raised was in

¹ XRB A1 *Application of Accounting Standards*.

² XRB A1 for Tier 1 public benefit entities will only be finalised in 2014/2015. It is the intention of the NZAuASB that all Tier 1 entities will meet the definition of a public interest entity, for the purposes of this standard.

relation to the rotation requirements for key audit partners on public interest entity clients. The rotation requirements require both the engagement partner and the individual responsible for the engagement quality control review to rotate after seven years, with a two year stand down period. The NZAuASB acknowledges the difficulties facing smaller firms in applying these provisions but notes that the significance of the threat does not differ just because the audit firm is a small firm.

29. The NZAuASB is of the view that it is unlikely that many sole practitioners or smaller firms will be affected by the rotation requirement for key audit partners. Professional and Ethical Standard 3 (Revised), “*Quality Control*” requires an engagement quality control review for all audits of financial statements of issuers. This requirement does not apply if the firm does not perform such engagements. It is unlikely that many sole practitioners or smaller firms will perform issuer audits, or will undertake other assurance engagements that will meet the criteria set out in Professional and Ethical Standard 3 that will require an engagement quality control review.
30. Further, Professional and Ethical Standard 3 requires the firm to establish policies and procedures to maintain the objectivity of the engagement quality control reviewer. In the case of firms with few partners, Professional and Ethical Standard 3 explains that suitably qualified external persons may need to be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Professional and Ethical Standard 3 indicates that some sole practitioners or small firms may alternatively wish to use other firms to facilitate engagement quality control reviews.
31. The need for smaller firms to contract suitably qualified external people to conduct an engagement quality control review already exists in order to meet the requirements of Professional and Ethical Standard 3. Extending this need as a result of the more stringent independence rotation requirements should therefore not have large compliance costs, rather it extends a need that already exists. The NZAuASB has however acknowledged that this change may require additional time to implement and has therefore extended the transitional requirements by one year as outlined below.

Multiple Threats to Independence

32. PES 1 (Revised) explicitly requires in paragraphs NZ290.11.1 and NZ291.10.1 that an assurance practitioner should evaluate multiple threats to independence identified in aggregate, which individually may not be significant. This is not explicitly required by the IFAC Code. This has also been added as an explicit requirement in both Australia and the United Kingdom.
33. The NZAuASB is of the view that there is a compelling reason to explicitly state this as it provides clarity to assurance practitioners on how to appropriately consider and evaluate the threat of independence which is one of the fundamental principles of the Code. The NZAuASB considers that this addition will not have any compliance

costs, as it is explicitly stating something which is implicit in the IFAC Code, and will promote audit quality.

Liquidator or Receiver

34. PES 1 (Revised) specifically prohibits a firm from providing assurance services to an entity if the partner or an employee of the firm serves as a director or officer of the assurance client, or as a liquidator or receiver of the property of the entity, or in a similar role. The IFAC Code has a similar prohibition, but only in respect of a partner or employee serving as a director or officer of an assurance client.
35. The change to extend the prohibition of undertaking assurance services where the partner or employee of the firm serves as a liquidator or receiver of the property of the entity or a similar role is consistent with legislative requirements in New Zealand and therefore a compelling reason to include in PES 1 (Revised).

Fees – Relative Size

36. PES 1 (Revised) emphasises that an assurance practitioner is required to decline or withdraw from an engagement where the total fees from a client represent a large proportion of the total fees of the firm and safeguards have not reduced the threats to an acceptable level. This differs from the IFAC Code which only requires an assurance practitioner to evaluate the threat and to apply safeguards to eliminate the threat or reduce it to an acceptable level.
37. The NZAuASB considers that the relative size of fees is a significant threat to independence. The NZAuASB dismissed the option of establishing a prohibition on acting as the audit firm if a predefined level of annual fee income is exceeded, as done in other jurisdictions, as this may not address every circumstance. The NZAuASB supports the application of the conceptual framework to address the threat, with emphasis that this is a significant threat that must be appropriately managed and therefore has emphasised that it is not always possible to mitigate the threats using safeguards, and that the engagement may need to be declined. This emphasis is added to promote audit quality.

Breach of a Requirement of the Code

38. The IESBA has included an abbreviated version of the provisions for addressing a breach of the independence requirements for section 291. The NZAuASB is of the view that there is no reason why an abbreviated framework would apply to a breach of the independence requirements when performing an assurance engagement under section 291 compared to an audit engagement under section 290. The consequences of a breach of independence are as significant regardless of the subject matter of the engagement. The NZAuASB has therefore included the same framework as described in section 290 within section 291.

Temporary staff assignments

39. PES 1 (Revised) adds additional guidance from section 290 into section 291, on temporary staff assignments as it relates to assurance engagements that are not audit or reviews. This has been added to section 291 to emphasise the self-review threat that may arise, regardless of whether the subject matter of the engagement is financial statements or not. It is not intended to be a prohibition and will not apply where the role is not related to the subject matter of the assurance engagement.
40. The NZAuASB is of the view that this guidance, which is expanded guidance on the threats and safeguards approach, is as relevant to other assurance engagements as it is to audits and reviews and therefore the addition promotes audit quality. The NZAuASB believes that the threats to independence do not differ when the subject matter of the engagements are financial statements or another subject matter. Lending staff may create a self-review threat if that staff member is later involved in providing assurance over that subject matter or that subject matter information.

Assurance Clients, who are not Audit or Review Clients, but are Public Interest Entities

41. In the IFAC Code, section 290 includes more stringent requirements for audit or review clients that are public interest entities. Section 291 does not make any distinction between clients that are public interest entities and those that are not.
42. PES 1 (Revised) includes the definition of a public interest entity in section 291 and proposes to include the following more stringent requirements for assurance clients, who are not audit or review clients, but are public interest entities:
 - a. Impose a 7 year rotation period and a 2 year stand down period on key assurance partners;
 - b. Prohibit valuation services to assurance clients if the valuation is material to the subject matter on which the firm will express an opinion;
 - c. Prohibit the provision of IT system services involving the design or implementation of the IT systems that form a significant part of the internal control over the subject matter or generate information that is significant to the subject matter information;
 - d. Prohibit the provision of recruiting services for key positions that are able to exert significant influence over the subject matter or subject matter information of the engagement;
 - e. Require a pre- or post- issuance review where total fees from an assurance client represent more than 15% of the total fees received by the firm.
43. The NZAuASB is of the view that the threats to independence do not differ when the subject matter of the engagement are financial statements or another subject matter. The NZAuASB considers that these prohibitions are appropriate for other assurance

clients, if they are public interest entities. Given the high level of interest in a public interest entity prohibiting such services in these circumstances is appropriate to maintain independence. For example, the rotation requirements on the engagement partner responsible for the assurance report on controls at a service organisation. Also, having a list of prohibitions is clearer and appropriate to address the threat to independence if the circumstances arose, and therefore promotes audit quality. These prohibitions therefore best serve the public interest.

44. The NZAuASB is of the view that these additions will not have a large compliance cost. For example:
- a. In many instances, for assurance clients that are not audit or review clients, the engagement would not be of a recurring nature and the partner rotation requirement in section 291 would therefore not apply;
 - b. Assurance engagements other than audit or reviews are a small part of the market, and therefore the reviews required where the total fees received from a client represent more than 15% of the total fees received by the firm are unlikely to be required.

Reports that Include a Restriction on Use and Distribution

45. The NZAuASB has added exceptions to the independence requirements for public interest entities in paragraph NZ 291.27.1 in limited circumstances where the report includes a restriction on use and distribution. This is similar to the approach adopted in section 290, and are replicated in section 291 because public interest entity restrictions have been added to section 291 as described above.

TRANSITION

46. The NZAuASB considered the concerns raised with the application of the rotation provisions that apply to key audit partners, as highlighted above. The NZAuASB notes that the individual responsible for the engagement quality control review will now be required to apply the rotation requirements for the first time, due to the introduction of the key audit partner definition, and has therefore decided to defer the introduction of the rotation requirements for such individuals by one year, extending the effective date for these requirements to 1 January 2015. These transitional requirements are detailed at the end of PES 1 (Revised).