



PROFESSIONAL AND ETHICAL STANDARD 2

Independence in Assurance Engagements (PES 2)

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Overview

Professional and Ethical Standard 1 requires that:

Assurance providers must be fair, impartial and intellectually honest and must not allow prejudice or bias, conflict of interest or influence of others to override Objectivity. Assurance providers undertaking assurance engagements must be, and be seen to be, Independent.

Independence requires:

- (a) Independence of mind – The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.
- (b) Independence in appearance – The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the *assurance team's* integrity, objectivity or professional scepticism had been compromised.

Threats

Independence may be threatened by the following:

“Self-interest Threat” which occurs when a firm, *network firm*, or a member of the assurance team could benefit from a *financial interest* in, or other self-interest conflict with, an *assurance client*.

“Self-review Threat” which occurs when

- (a) any product or judgement of a previous *assurance engagement* or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement; or
- (b) a member of the assurance team was previously a *director or officer* of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.

“Advocacy Threat” which occurs when a firm, a member of the assurance team, or a member of the network firm, as applicable, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgement to that of the client.

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

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

Safeguards

It is the responsibility of the *assurance provider* to ensure that they remain independent of the client entity. In situations when no effective safeguards are available to reduce the threats to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or to continue the assurance engagement.

In assessing threats to independence and the possible safeguards to mitigate or eliminate these threats, assurance providers are required at all times to consider what is in the public interest. It is also important to note that adoption of certain safeguards may not address “independence in appearance”.

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Definitions

Note: Defined words appear in italics the first time they appear in the main body of the document.

Introduction

1. Professional and Ethical Standard 2 establishes standards and provides guidance on independence for assurance engagements.
2. It is the responsibility of assurance providers conducting assurance engagements to ensure that they are independent and to carefully consider and respond appropriately to circumstances that threaten independence.

Why is Independence Important?

3. In general, users of financial statements (or other information) have limited access to detailed information about an entity. They are reliant on the governing body and management to report fairly on the performance and position of the entity. The performance of the governing body and management is often judged against the reported performance of the entity. This fact may create uncertainty for users regarding the fairness and accuracy of unaudited information.
4. Information substantiated by an independent third party is considered more reliable and accurate than information that has not been confirmed by an independent third party. The objective of an assurance engagement is to enhance the credibility of the

information provided by the governing body and the management through an expression of an opinion from an independent assurance provider about the accuracy and fairness of the information presented. There is less risk that audited information will be inaccurate or misleading, hence users of audited information are able to place greater reliance on it and, as a result, are able to make decisions with more confidence.

5. Independence is the qualitative characteristic that gives value to the assurance provider's opinion. Without being, and being seen to be independent, the assurance provider's opinion will not enhance the credibility of the information.

Public Interest

6. *[Not used]*.
7. Professional and Ethical Standard 1 defines the public interest as the collective well-being of the community of people and institutions the accountancy profession serves. In assessing their independence in relation to assurance engagements, assurance providers need to consider whether accepting or continuing an assurance engagement would be in the public interest.

Relationship to Professional and Ethical Standard 1

8. The Fundamental Principle of Objectivity and Independence set out in Professional and Ethical Standard 1 states:
Assurance providers must be fair, impartial and intellectually honest and must not allow prejudice or bias, conflict of interest or influence of others to override Objectivity. Assurance providers undertaking assurance engagements must be, and be seen to be, Independent.
9. Rule 4 of Professional and Ethical Standard 1 requires that:
Assurance providers performing assurance engagements must be Independent of the entity and the subject matter on which they are reporting.

Application

10. Assurance providers conducting assurance engagements must be able to demonstrate at all times that their actions, behaviour and conduct comply with Professional and Ethical Standard 2.
11. Assurance providers must be guided not merely by the terms, but also by the spirit of Professional and Ethical Standard 2. The fact that particular behaviour or conduct does not receive a mention within Professional and Ethical Standard 2 does not prevent it from amounting to a breach of the independence requirements.
12. Professional and Ethical Standard 2 is confined to the professional aspect of independence, as distinct from any requirements that may be imposed by law. Assurance providers must also ensure that they comply with the spirit and the letter of the law.
13. The requirements within Professional and Ethical Standard 2 apply to the extent that they do not conflict with legislation relating to a statutory appointment of the Auditor-General.

14. The fact that an assurance provider is performing an assurance engagement in a voluntary capacity does not relieve the member from the requirements of Professional and Ethical Standard 2.
15. *[Not used]*.
16. The provisions of Professional and Ethical Standard 2 which are drafted in terms applicable to a company apply in the case of other entities. For this purpose, “other entity” means any business organisation, incorporated or otherwise, other than a company, including a partnership or trust.

Small Entities and Small Firms

17. The independence requirements set out in Professional and Ethical Standard 2 apply to all entities and all assurance providers. Small entities and small firms, in certain circumstances, may face difficulties implementing the independence requirements set out in Professional and Ethical Standard 2. Many of the safeguards discussed as being available, within either the entity or the audit practice, will not be available to small entities and small firms.
18. For example, small entities are unlikely to have the resources or the need to operate detailed corporate governance mechanisms such as audit committees. Small firms may not have the resources or the need to develop and maintain detailed internal policies and procedures to identify and evaluate threats to independence, or the ability to access independent accountants to review work undertaken. In some cases the costs of the appropriate safeguards will not be significant. In other cases, achieving satisfactory safeguards will not be possible without significant cost.
19. In the case of a small firm, as applies to all other firms, if independence is threatened and no alternative safeguards can be identified, the assurance provider must decline the engagement.

Independence

20. Objectivity and Independence is one of the Fundamental Principles contained in the Professional and Ethical Standard 1. Professional and Ethical Standard 1 contains the Fundamental Principles that guide assurance providers in the performance of their professional responsibilities and express the basic tenets of professional and ethical behaviour. The fundamental principles are:
 - Integrity;
 - Objectivity and Independence;
 - Competence;
 - Quality Performance;
 - Professional Behaviour.
21. Independence is an essential factor of assurance engagements. Without independence an assurance provider’s ability to provide assurance on the subject matter is seriously impaired.

Independence for Assurance Engagements

22. It is in the public interest and, therefore, required by Professional and Ethical Standard 2, that members of assurance teams, firms and, when applicable, network firms must be independent of assurance clients.
23. Assurance engagements are intended to enhance the credibility of information by evaluating whether the subject matter conforms in all material respects with suitable criteria. The objective of an assurance engagement is to provide either a high or a moderate level of assurance.
24. Professional and Ethical Standard 2 provides a framework, built on principles, for identifying, evaluating and responding to threats to independence. It is the responsibility of assurance providers involved in assurance services to ensure that they remain independent and that they respond appropriately to the threats to independence. The framework establishes principles for members of assurance teams, firms and network firms to use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. Judgement is needed to determine which safeguards are to be applied. Some safeguards may eliminate the threat while others may reduce the threat to an acceptable level. Certain safeguards may not address threats to independence in appearance. Professional and Ethical Standard 2 requires members of assurance teams, firms and network firms to apply the principles to the particular circumstances under consideration. The examples presented in paragraph 72 to paragraph 184 are intended to illustrate the application of the principles in Professional and Ethical Standard 2 and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to independence. Consequently, it is not sufficient for a member of an assurance team, a firm or a network firm merely to comply with the examples presented; rather they are to apply the principles in Professional and Ethical Standard 2 to the particular circumstances they face.

Networks and Network Firms

- 24-1. An entity that belongs to a network might be a firm, defined in Professional and Ethical Standard 2 as a sole practitioner, partnership or corporate practice and an entity that controls or is controlled by such parties, or the entity might be another type of entity, such as a consulting practice or a professional law practice. The independence requirements in Professional and Ethical Standard 2 that apply to a network firm apply to any entity that meets the definition of a network firm irrespective of whether the entity itself meets the definition of a firm.
- 24-2. If a firm is considered to be a network firm, the firm is required to be independent of the *audit clients* of the other firms within the network. In addition, for assurance clients that are not audit clients, consideration should be given to any threats the firm has reason to believe may be created by financial interests in the client held by other entities in the network or by relationships between the client and other entities in the network.
- 24-3. To enhance their ability to provide *professional services*, firms frequently form larger structures with other firms and entities. Whether these larger structures create a network depends upon the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct. For example, a larger

structure may be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network. Alternatively, a larger structure might be such that it is aimed at cooperation and the firms share a common brand name, a common system of quality control, or significant professional resources and consequently is considered to be a network.

- 24-4. The judgement as to whether the larger structure is a network should be made in light of whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the entities are associated in such a way that a network exists. This judgement should be applied consistently throughout the network.
- 24-5. Where the larger structure is aimed at cooperation and it is clearly aimed at profit or cost sharing among the entities within the structure, it is considered to be a network. However, the sharing of immaterial costs would not in itself create a network. In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals, or training courses, this would not in itself create a network. Further, an association between a firm and an otherwise unrelated entity to jointly provide a service or develop a product would not in itself create a network.
- 24-6. Where the larger structure is aimed at cooperation and the entities within the structure share common ownership, control or management, it is considered to be a network. This could be achieved by contract or other means. Where the larger structure is aimed at cooperation and the entities within the structure share common quality control policies and procedures, it is considered to be a network. For this purpose common quality control policies and procedures would be those designed, implemented and monitored across the larger structure.
- 24-7. Where the larger structure is aimed at cooperation and the entities within the structure share a common business strategy, it is considered to be a network. Sharing a common business strategy involves an agreement by the entities to achieve common strategic objectives. An entity is not considered to be a network firm merely because it co-operates with another entity solely to respond jointly to a request for a proposal for the provision of a professional service.
- 24-8. Where the larger structure is aimed at cooperation and the entities within the structure share the use of a common brand name, it is considered to be a network. A common brand name includes common initials or a common name. A firm is considered 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 assurance report.
- 24-9. Even though a firm does not belong to a network and does not use a common brand name as part of its firm name, it may give the appearance that it belongs to a network if it makes reference in its stationery or promotional materials to being a member of an association of firms. Accordingly, a firm should carefully consider how it describes any such memberships in order to avoid the perception that it belongs to a network.
- 24-10. If a firm sells a component of its practice, the sales agreement sometimes provides that, for a limited period of time, the component may continue to use the name of the firm, or an element of the name, even though it is no longer connected to the firm. In such circumstances, while the two entities may be practising under a common name,

the facts are such that they do not belong to a larger structure aimed at cooperation and are, therefore, not network firms. Those entities should carefully consider how to disclose that they are not network firms when presenting themselves to outside parties.

24-11. Where the larger structure is aimed at cooperation and the entities within the structure share a significant part of professional resources, it is considered to be a network. Professional resources include:

- common systems that enable firms to exchange information such as client data, billing and time records;
- partners and staff;
- technical departments to consult on technical or industry specific issues, transactions or events for assurance engagements;
- audit methodology or audit manuals; and
- training courses and facilities.

24-12. The determination of whether the professional resources shared are significant, and therefore the firms are network firms, should be made based on the relevant facts and circumstances. Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be considered to be significant. The same applies to a common training endeavour. Where, however, the shared resources involve the exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created within the larger structure to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

A Conceptual Approach to Independence

25. Independence requires:

- (a) Independence of mind – The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.
- (b) Independence in appearance – The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised.

26. The use of the word “independence” on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgement ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships must also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

27. Many different circumstances or combinations of circumstances may be relevant, and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that must be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is therefore in the public interest.
28. Professional and Ethical Standard 2 is based on such a conceptual approach: one that takes into account threats to independence, accepted safeguards and the public interest.
29. Firms and members of assurance teams must identify and evaluate circumstances and relationships that create threats to independence and must take appropriate action to eliminate these threats or reduce them to an acceptable level by the application of safeguards. Assurance providers must decline or withdraw from an assurance engagement if the threats to independence are unable to be reduced to an acceptable level through the application of appropriate and effective safeguards. In addition to identifying and evaluating relationships between the firm, network firms, members of the assurance team and the assurance client, consideration must be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.
30. Professional and Ethical Standard 2 provides a framework of principles for members of assurance teams, firms and network firms to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level, such that independence of mind and independence in appearance are not compromised.
31. The nature of the threats to independence and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual engagement: whether the assurance engagement is an *audit engagement* or another type of engagement; and in the case of an assurance engagement that is not an audit engagement, the purpose, subject matter and intended users of the report.
32. A firm must evaluate the relevant circumstances, the nature of the assurance engagement and the threats to independence in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the assurance team.
33. Audit engagements provide assurance to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance.
34. Accordingly, for audit clients, the members of the assurance team, the firm and network firms must be independent of the audit client. Similar considerations in the case of assurance engagements provided to non-audit assurance clients require that the members of the assurance team and the firm must be independent of the non-audit assurance client. In the case of these engagements, consideration must be given to

any threats that the firm has reason to believe may be created by network firm interests and relationships.

35. In the case of an assurance engagement report to a non-audit assurance client expressly restricted for use by identified users, the users of the report are considered to be knowledgeable as to the purpose, subject matter and limitations of the report through their participation in establishing the nature and scope of the firm’s instructions to deliver the services, including the criteria by which the subject matter are to be evaluated. This knowledge and enhanced ability of the firm to communicate about safeguards with all users of the report increase the effectiveness of safeguards to independence in appearance. These circumstances may be taken into account by the firm in evaluating the threats to independence and considering the applicable safeguards necessary to eliminate the threats, or reduce them to an acceptable level.
36. For all assurance engagements it will be necessary, as a minimum, to apply the provisions of Professional and Ethical Standard 2 in evaluating the independence of members of the assurance team and their immediate and *close family*. Further, if the firm had a material financial interest, whether direct or indirect, in the assurance client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level. For any threats created by network firm interests and relationships a limited consideration of any threats may be sufficient.
37. Accordingly:
 - (a) for assurance engagements provided to an audit client, the members of the assurance team, the firm and network firms must be independent of the client;
 - (b) for assurance engagements provided to clients that are not audit clients, when the report is not expressly restricted for use by identified users, the members of the assurance team and the firm must be independent of the client; and
 - (c) for assurance engagements provided to clients that are not audit clients, when the assurance report is expressly restricted for use by identified users, the members of the assurance team must be independent of the client. In addition, the firm must not have a material *direct financial interest* or a material *indirect financial interest* in the client.

These independence requirements for assurance engagements are illustrated below.

		Type of Assurance Engagement		
		Audit (Financial Statements)	Non-audit — unrestricted use	Non-audit — restricted use
Client	Audit client	Assurance team, firm and network firms		
	Non-audit assurance client		Assurance team and firm	Assurance team and firm must have no material financial interest

38. The threats and safeguards identified in Professional and Ethical Standard 2 are generally discussed in the context of interests or relationships between the firm, network firms, a member of the assurance team and the assurance client.
39. The firm and any network firms must consider the interests and relationships that involve that client's related entities.
40. Ideally, those entities and the interests and relationships should be identified in advance. When the assurance team has reason to believe that a *related entity* of the client is relevant to the evaluation of the firm's independence of the client, the assurance team must consider that related entity when evaluating independence and applying appropriate safeguards.
41. The evaluation of threats to independence and subsequent action must be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm, a network firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. There may be occasions when the firm, a network firm or an individual inadvertently violates Professional and Ethical Standard 2. If such an inadvertent violation occurs, it would generally not compromise independence with respect to an *assurance engagement* client provided the firm has appropriate quality control policies and procedures in place to promote independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.
42. Throughout Professional and Ethical Standard 2, reference is made to significant and clearly insignificant threats in the evaluation of independence. In considering the significance of any particular matter, qualitative as well as quantitative factors are to be taken into account. A matter is considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

Threats and Safeguards

43. The objective of Professional and Ethical Standard 2 is to assist firms and members of assurance teams in:
 - (a) identifying threats to independence;
 - (b) evaluating whether these threats are clearly insignificant; and
 - (c) in cases when the threats are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.

In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.
44. Professional and Ethical Standard 2 outlines the threats to independence (paragraph 48 through to paragraph 53). It then analyses safeguards capable of eliminating these threats or reducing them to an acceptable level (paragraph 54 through to paragraph 65). It concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships (paragraph 72 onwards). Professional judgement is

used to determine the appropriate safeguards to eliminate threats to independence or to reduce them to an acceptable level. In certain examples, the threats to independence are so significant the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement. In other examples, the threat can be eliminated or reduced to an acceptable level by the application of safeguards. The examples are not intended to be all-inclusive.

45. When threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the assurance engagement, the decision must be documented. The documentation must include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.
46. The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, must take into account the public interest.
47. All auditors are encouraged to apply the highest standards of independence to the entities that they audit. Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Such publicly accountable entities include entities required by legislation to prepare audited general purpose financial reports, such as *issuers*, credit institutions, insurance companies, pension funds, public entities (as defined in the Public Audit Act 2001), and certain charitable organisations. Because of the strong public interest in the financial statements of issuers, certain paragraphs in Professional and Ethical Standard 2 deal with additional matters that are relevant to the audit of issuers. Consideration must be given to the application of the principles set out in Professional and Ethical Standard 2 in relation to the audit of issuers must also be applied to other publicly accountable audit clients.

Threats to Independence

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

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

- (a) a direct financial interest or material indirect financial interest in an assurance client;
 - (b) a loan or guarantee to or from an assurance client or any of its directors or officers;
 - (c) undue dependence on total fees from an assurance client;
 - (d) concern about the possibility of losing the engagement;
 - (e) having a close business relationship with an assurance client;
 - (f) potential employment with an assurance client; and
 - (g) contingent fees relating to assurance engagements.
50. “Self-review Threat” occurs when:

- (a) any product or judgement of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement; or
- (b) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.

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

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

51. “Advocacy Threat” occurs when a firm, a member of the assurance team, or a member of the network firm, as applicable, promotes, or may be perceived to promote, an assurance client’s position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgement to that of the client.

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

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

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

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

- (a) a member of the assurance team having an *immediate family* member or close family member who is a director or officer of the assurance client;
- (b) a member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- (c) a former partner of the firm being a director, officer of the assurance client or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- (d) long association of a senior member of the assurance team with the assurance client; and

(e) acceptance of gifts or hospitality, unless the value is clearly insignificant, from the assurance client, its directors, officers or employees.

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

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

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

Safeguards

54. The firm and members of the assurance team must remain independent by taking into account the context in which they practise, the threats to independence and the safeguards available to eliminate the threats or reduce them to an acceptable level.

55. When the safeguards available, such as those described below, are insufficient to eliminate the threats to independence or to reduce them to an acceptable level, or when a firm chooses not to eliminate the activities or interests creating the threat, the only course of action available must be refusal to perform, or withdrawal from, the assurance engagement. It is important to note that while certain safeguards may address “independence in mind” they may not satisfy the “independence in appearance test”. Independence in appearance is equally as important as independence in mind because, unless an auditor is considered by users of the information as independent, the auditor’s independence in mind is largely irrelevant. In deciding whether to accept an assignment, the firm must ensure that they are independent in mind and in appearance.

56. When threats are identified, other than those that are clearly insignificant, appropriate safeguards must be identified and applied to eliminate the threats or reduce them to an acceptable level. This decision must be documented.

57. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration must always be given to what a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. The consideration will be affected by matters such as the significance of the threat, the nature of the assurance engagement, the intended users of the assurance report and the structure of the firm.

58. Safeguards fall into three broad categories:

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

The firm and the members of the assurance team must select appropriate safeguards to eliminate or reduce threats to independence, other than those that are clearly insignificant, to an acceptable level. It is the responsibility of assurance providers conducting assurance engagements to ensure that they are independent and to

carefully consider and respond appropriately to circumstances that threaten independence. In general, safeguards adopted by an assurance provider will be those within the firm's own systems and procedures as these will be within the control of the assurance provider.

59. Safeguards created by the accountancy profession, legislation or regulation include the following:
 - (a) educational, training and experience requirements for entry into the accountancy profession;
 - (b) continuing education requirements;
 - (c) professional standards, monitoring and disciplinary processes;
 - (d) external review of a firm's quality control system; and
 - (e) legislation governing the independence requirements of the firm.
60. Safeguards within the assurance client include the following:
 - (a) when management appoints the firm, persons other than management must ratify or approve the appointment;
 - (b) that competent employees are able to make managerial decisions;
 - (c) policies and procedures that emphasise the assurance client's commitment to fair financial reporting;
 - (d) internal procedures that ensure objective choices in commissioning non-assurance engagements; and
 - (e) a corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm's services.
61. Audit committees can have an important corporate governance role when they are independent of client management, and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There must be regular communication between the firm and the audit committee (or other governance body if there is no audit committee) regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.
62. Firms must establish policies and procedures relating to communications on the matter of independence with audit committees or others charged with governance. In the case of audit clients, the firm must communicate orally and in writing at least annually, all relationships and other matters between the firm, network firms and the audit client that, in the firm's professional judgement, may reasonably be thought to bear on independence.
63. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in Professional and Ethical Standard 2.
64. Safeguards within the firm's own systems and procedures may include firm-wide safeguards such as:
 - (a) leadership that stresses the importance of independence and the expectation that members of assurance teams will act in the public interest;

- (b) policies and procedures to implement and monitor quality control of assurance engagements;
 - (c) documented independence policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the identification and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level;
 - (d) internal policies and procedures to monitor compliance with firm policies and procedures as they relate to independence;
 - (e) policies and procedures that will enable the identification of interests or relationships between the firm or members of the assurance team and assurance clients;
 - (f) policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single assurance client;
 - (g) using different partners and teams with separate reporting lines for the provision of non-assurance services to an assurance client;
 - (h) policies and procedures to prohibit individuals who are not members of the assurance team from influencing the outcome of the assurance engagement;
 - (i) timely communication of a firm's policies and procedures, and any changes thereto, to all partners and professional staff, including appropriate training and education thereon;
 - (j) designating a member of senior management as responsible for overseeing the adequate functioning of the safeguarding system;
 - (k) a means of advising partners and professional staff of those assurance clients and related entities from which they must be independent;
 - (l) a disciplinary mechanism to promote compliance with policies and procedures; and
 - (m) policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them, including informing staff of the procedures open to them.
65. Safeguards within the firm's own systems and procedures may include engagement specific safeguards such as the following:
- (a) involving another assurance provider to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or network firm, or someone within the firm or network firm who was not otherwise associated with the assurance team;
 - (b) consulting a third party, such as a committee of independent directors, a professional regulatory body or another assurance provider;
 - (c) rotation of senior personnel;
 - (d) discussing independence issues with the audit committee or others charged with governance;
 - (e) disclosing to the audit committee, or others charged with governance, the nature of services provided and extent of fees charged;

- (f) policies and procedures to ensure that members of the assurance team do not make, or assume responsibility for, management decisions for the assurance client;
- (g) involving another firm to perform or re-perform part of the assurance engagement;
- (h) involving another firm to re-perform the non-assurance service to the extent necessary to enable it to take responsibility for that service; and
- (i) removing an individual from the assurance team, when that individual's financial interests or relationships create a threat to independence.

Engagement Period

- 66. The members of the assurance team, the firm, and, where applicable, the network firm, must be independent of the assurance client during the period of the assurance engagement.
- 67. The period of the engagement starts when the assurance team begins to perform assurance services and ends when the assurance report is issued, except when the assurance engagement is of a recurring nature. If the assurance engagement is expected to recur, the period of the assurance engagement ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is later.
- 68. In the case of an audit engagement, the engagement period includes the period covered by the financial statements reported on by the firm.
- 69. When an entity becomes an audit client during or after the period covered by the financial statements that the firm will report on, the firm must consider whether any threats to independence may be created by:
 - (a) financial or business relationships with the audit client during or after the period covered by the financial statements, but prior to the acceptance of the audit engagement; or
 - (b) previous services provided to the audit client.

Similarly, in the case of an assurance engagement that is not an audit engagement, the firm must consider whether any financial or business relationships or previous services may create threats to independence.
- 70. If non-assurance services were provided to the audit client during or after the period covered by the financial statements, but before the commencement of professional services in connection with the audit and those services would be prohibited during the period of the audit engagement, consideration must be given to the threats to independence, if any, arising from those services. If the threat is other than clearly insignificant, the firm should decline the audit engagement.
- 71. Non-assurance services provided to a non-issuer audit client will not impair the firm's independence when the client becomes an issuer, provided that:
 - (a) the previous non-assurance services were permissible under this document for non-issuer audit clients;

- (b) the services will be terminated within a reasonable period of time of the client becoming an issuer, if they are not permitted under Professional and Ethical Standard 2 for issuer audit clients; and
- (c) the firm has implemented appropriate safeguards to eliminate any threats to independence arising from the previous services or to reduce them to an acceptable level.

Application of Principles to Specific Situations

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Introduction

72. The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance. The examples are not exhaustive. In practice, the firm, network firms and the members of the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards, including the safeguards in paragraph 59 through to paragraph 65 can be applied to satisfactorily address the threats to independence. Paragraph 70 through to paragraph 71 provide conceptual guidance to assist in this process.
73. Some of the examples deal with audit clients while others deal with assurance clients that are not audit clients. The examples illustrate how safeguards are applied to fulfill the requirement for the members of the assurance team, the firm and network firms to be independent of an audit client, and for the members of the assurance team and the firm to be independent of an assurance client that is not an audit client. The examples do not include assurance reports to a non-audit assurance client expressly restricted for use by identified users. As stated in paragraph 37 for such engagements, members of the assurance team and their immediate and close family are required to be independent of the assurance client. Further, the firm must not have a material financial interest, direct or indirect, in the assurance client.

Financial Interests

74. A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).
75. When evaluating the type of financial interest, consideration must be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (e.g. a mutual fund, unit trust or similar intermediary vehicle), to those where the individual has control over the financial interest (e.g. as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider

the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control or influence exists, the financial interest must be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control or influence, the financial interest must be considered indirect.

Provisions Applicable to All Assurance Clients

76. If a member of the assurance team, or any of their immediate family, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be so significant that the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:
- (a) dispose of the direct financial interest prior to the individual becoming a member of the assurance team;
 - (b) dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material, prior to the individual becoming a member of the assurance team; or
 - (c) remove the member of the assurance team from the assurance engagement.
77. If a member of the assurance team, or any of their immediate family receives, for example by way of an inheritance, gift or as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards must be applied to eliminate the threat or reduce it to an acceptable level:
- (a) disposing of the financial interest at the earliest practical date;
 - (b) remove the member of the assurance team from the assurance engagement.
- During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration must be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:
- (a) discussing the matter with those charged with governance, such as the audit committee; or
 - (b) involving an additional assurance provider to review the work done, or otherwise advise as necessary.
78. When a member of the assurance team knows that any of their close family has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration must be given to the nature of the relationship between the member of the assurance team and the close family member and the materiality of the financial interest. Once the significance of the threat has been evaluated, safeguards must be considered and applied as necessary. Such safeguards might include:
- (a) the close family member disposing of all or a sufficient portion of the financial interest at the earliest practical date;
 - (b) discussing the matter with those charged with governance, such as the audit committee;

- (c) involving an additional assurance provider who did not take part in the assurance engagement, to review the work done by the member of the assurance team with the close family relationship or otherwise advise as necessary; or
 - (d) removing the individual from the assurance engagement.
79. When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest may only be held when:
- (a) the member of the assurance team, or any of their immediate family, and the firm are not beneficiaries of the trust;
 - (b) the interest held by the trust in the assurance client is not material to the trust;
 - (c) the trust is not able to exercise significant influence over the assurance client; and
 - (d) the member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.
80. Consideration must be given to whether a self-interest threat may be created by the financial interests of individuals outside of the assurance team and their immediate and close family members. Such individuals would include:
- (a) partners, and their immediate family members, who are not members of the assurance team;
 - (b) partners and managerial employees who provide non-assurance services to the assurance client; and
 - (c) individuals who have a close personal relationship with a member of the assurance team.

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

- (a) the firm's organisational, operating and reporting structure; and
- (b) the nature of the relationship between the individual and the member of the assurance team.

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

- (a) where appropriate, policies to restrict people from holding such interests;
 - (b) discussing the matter with those charged with governance, such as the audit committee; or
 - (c) involving an additional assurance provider who did not take part in the assurance engagement to review the work done or otherwise advise as necessary.
81. An inadvertent violation of Professional and Ethical Standard 2 as it relates to a financial interest in an assurance client would not impair the independence of the firm, the network firm or a member of the assurance team when:

- (a) the firm, and the network firm, has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;
 - (b) the firm, and the network firm, promptly notifies the professional that the financial interest must be disposed of; and
 - (c) the disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.
82. When an inadvertent violation of Professional and Ethical Standard 2 relating to a financial interest in an assurance client has occurred, the firm must consider the application of safeguards. Such safeguards might include:
- (a) involving an additional assurance provider who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
 - (b) excluding the individual from any substantive decision-making concerning the assurance engagement.

Provisions Applicable to Audit Clients

83. If a firm, or a network firm, has a direct financial interest in an audit client of the firm, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.
84. If a firm, or a network firm, has a material indirect financial interest in an audit client of the firm, a self-interest threat is also created. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
85. If a firm, or a network firm, has a material financial interest in an entity that has a controlling interest in an audit client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the direct or indirect material financial interest in total or, in the case of an indirect material financial interest, to dispose of a sufficient amount of it so that the remaining interest is no longer material.
86. If the retirement benefit plan of a firm, or network firm, has a financial interest in an audit client, a self-interest threat may be created. Accordingly, the significance of any such threat created must be evaluated and, if the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.
87. If other partners, including partners who do not perform assurance engagements, or any of their immediate families, in the *office* in which *the lead engagement partner* practises in connection with the audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level.

Accordingly, partners or their immediate family must not hold any such financial interests in an audit client.

88. The office in which the lead engagement partner practises in connection with the audit is not necessarily the office to which that partner is assigned. Accordingly, when the lead engagement partner is located in a different office from that of the other members of the assurance team, judgement must be used to determine in which office the partner practises in connection with that audit.
89. If other partners and managerial employees who provide non-assurance services to the audit client, except those whose involvement is clearly insignificant, or any of their immediate families, hold a direct financial interest or a material indirect financial interest in the audit client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level. Accordingly, these personnel or their immediate families must not hold any such financial interests in an audit client.
90. A financial interest in an audit client that is held by:
 - (a) an immediate family member of a partner located in the office in which the lead engagement partner practices in connection with the audit; or
 - (b) a partner or managerial employee who provides non-assurance services to the audit client is not considered to create an unacceptable threat provided it is received as a result of their employment rights (e.g. pension rights or share options) and, where necessary, appropriate safeguards are applied to reduce any threat to independence to an acceptable level.
91. A self-interest threat may be created if the firm, or the network firm, or a member of the assurance team has an interest in an entity, and an audit client or a director, officer or controlling owner of that client also has an investment in that entity. Independence is not compromised with respect to the audit client if the respective interests of the firm, the network firm, or member of the assurance team, and the audit client, or its director, officer or controlling owner, are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm, the network firm or the audit client, and the audit client can exercise significant influence over the entity, no safeguards are available to reduce the threat to an acceptable level and the firm, or the network firm, must either dispose of the interest or decline the audit engagement. Any member of the assurance team with such a material interest must:
 - (a) dispose of the direct financial interest prior to becoming a member of the audit team;
 - (b) dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the audit team; or
 - (c) withdraw from the audit team.

Provisions Applicable to Non-audit Assurance Clients

92. If a firm has a direct financial interest in an assurance client that is not an audit client, the self-interest threat created would be so significant that no safeguard could reduce

the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

93. If a firm has a material indirect financial interest in an assurance client that is not an audit client, a self-interest threat is also created. The only action appropriate to permit the firm to perform the engagement would be for the firm either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
94. If a firm has a material financial interest in an entity that has a controlling interest in an assurance client that is not an audit client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level. The only action appropriate to permit the firm to perform the engagement would be for the firm either to dispose of the financial interest in total, or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
95. When a restricted use report for an assurance engagement that is not an audit engagement is issued, exceptions to the provisions in paragraph 76 through to paragraph 80 and paragraph 92 through paragraph 94 are set out in paragraph 35.

Loans and Guarantees

96. A loan from or a guarantee for a loan by an assurance client that is a bank or a similar institution to the firm would not create a threat to independence, provided the loan is made under normal lending procedures, terms and requirements, and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional assurance provider from outside the firm, or network firm, to review the work performed.
97. A loan from or a guarantee for a loan by an assurance client that is a bank or a similar institution to a member of the assurance team, or any of their immediate family would not create a threat to independence provided, the loan is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.
98. Similarly, deposits made by, or brokerage accounts of a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution, would not create a threat to independence, provided the deposit or account is held under normal commercial terms.
99. If the firm or a member of the assurance team makes a loan to an assurance client that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.
100. Similarly, if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

101. The examples in paragraph 96 through paragraph 99 relate to loans and guarantees between the firm and an assurance client. In the case of an audit engagement, the provisions must be applied to the firm, all network firms and the audit client.

Close Business Relationships with Assurance Clients

102. A close business relationship between a firm or a member of the assurance team and the assurance client or its management, or between the firm, a network firm and an audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:

- (a) having a material financial interest in a joint venture with the assurance client or with a controlling owner, director, officer or other individual who performs senior managerial functions for that client;
- (b) arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties; and
- (c) distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the firm's products or services.

In the case of an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm, the network firm and the audit client, no safeguards could reduce the threat to an acceptable level. In the case of an assurance client that is not an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm and the assurance client, no safeguards could reduce the threat to an acceptable level. Consequently, in both these circumstances the only possible courses of action are to:

- (a) terminate the business relationship;
- (b) reduce the magnitude of the relationship so that the financial interest is immaterial and the relationship is clearly insignificant; or
- (c) refuse to perform the assurance engagement.

Unless any such financial interest is immaterial and the relationship is clearly insignificant to the member of the assurance team, the only appropriate safeguard would be to remove the individual from the assurance team.

103. In the case of an audit client, business relationships involving an interest held by the firm, a network firm or a member of the assurance team or any of their immediate family, in a closely held entity when the audit client or a director or officer of the audit client, or any group thereof, also has an interest in that entity, do not create threats to independence provided:

- (a) the relationship is clearly insignificant to the firm, the network firm and the audit client;
- (b) the interest held is immaterial to the investor, or group of investors; and
- (c) the interest does not give the investor, or group of investors, the ability to control the closely held entity.

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

Family and Personal Relationships

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

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

- (a) removing the individual from the assurance team;
 - (b) where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of their close family member; or
 - (c) policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.
108. In addition, self-interest, familiarity or intimidation threats may be created when a person who is not an immediate or close family member of a member of the assurance team, has a close relationship with the member of the assurance team and is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement. Therefore, members of the assurance team are responsible for identifying any such persons and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.
109. Consideration must be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the assurance team and a director, an officer or an employee of the assurance client who is in a position to exert direct and significant influence over the subject matter of the assurance engagement. Therefore partners and employees of the firm are responsible for identifying any such relationships and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm partner or employee with the assurance team, the position held within the firm, and the role of the individual within the assurance client.
110. An inadvertent violation of this section as it relates to family and personal relationships would not impair the independence of a firm or a member of the assurance team when:
- (a) the firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;
 - (b) either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom they have a family or personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and
 - (c) additional care is given to reviewing the work of the professional.
111. When an inadvertent violation of this section relating to family and personal relationships has occurred, the firm must consider whether any safeguards must be applied. Such safeguards might include:

- (a) involving an additional assurance provider who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- (b) excluding the individual from any substantive decision-making concerning the assurance engagement.

Employment with Assurance Clients

112. A firm or a member of the assurance team's independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats, particularly when significant connections remain between the individual and their former firm. Similarly, a member of the assurance team's independence may be threatened when they participate in the assurance engagement knowing, or having reason to believe, that they will or may, join the assurance client some time in the future.
113. If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:
- (a) the position the individual has taken at the assurance client;
 - (b) the amount of any involvement the individual will have with the assurance team;
 - (c) the length of time that has passed since the individual was a member of the assurance team or firm; and
 - (d) the former position of the individual within the assurance team or firm.

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

- (a) considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- (b) assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;
- (c) involving an additional assurance provider who was not a member of the assurance team to review the work done or otherwise advise as necessary; or
- (d) quality control review of the assurance engagement.

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

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

114. A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that they will or may, join the assurance client some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:
- (a) policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client; and
 - (b) removal of the individual from the assurance engagement.

In addition, consideration must be given to performing an independent review of any significant judgements made by that individual while on the engagement.

Recent Service with Assurance Clients

115. To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the assurance team has to report on, for example, subject matter they had prepared or elements of the financial statements they had valued while with the assurance client.
116. If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement, the threat created would be so significant that no safeguard could reduce the threat to an acceptable level. Consequently, such individuals must not be assigned to the assurance team.
117. If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement, this may create self-interest, self-review and familiarity threats. For example, such threats would be created if a decision made or work performed by the individual in the prior period while employed by the assurance client, is to be evaluated in the current period as part of the current assurance engagement. The significance of the threats will depend upon factors such as:
- (a) the position the individual held with the assurance client;
 - (b) the length of time that has passed since the individual left the assurance client; and
 - (c) the role the individual plays on the assurance team.

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

- (a) involving an additional member of the firm to review the work done by the individual as part of the assurance team or otherwise advise as necessary; or
- (b) discussing the issue with those charged with governance, such as the audit committee.

Serving as an Officer or Director on the Board of Assurance Clients

118. If a partner or employee of the firm serves as an officer or as a director on the governing body, or as a liquidator, provisional liquidator, receiver, statutory manager or administrator of an assurance client, or in a similar role, the self-review and self-interest threats created would be so significant that no safeguard could reduce the threats to an acceptable level. In the case of an audit engagement, if a partner or employee of a network firm were to serve as an officer or as a director on the governing body of an audit client, the threats created would be so significant that no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position they must refuse to perform, or to withdraw from the assurance engagement.
119. Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial or administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Long Association of Senior Personnel with Assurance Clients

General Provisions

120. Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:
- (a) the length of time that the individual has been a member of the assurance team;
 - (b) the role of the individual on the assurance team;
 - (c) the structure of the firm; and
 - (d) the nature of the assurance engagement.

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

- (a) rotating the senior personnel of the assurance team;
- (b) involving an additional member of the firm who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- (c) independent internal quality reviews.

Audit Clients that are Issuers

121. Using the same lead engagement partner on an audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the audit of issuers, and safeguards must be applied in such situations to reduce the threat to an acceptable level. Accordingly, for the audit of issuers:
- (a) the lead engagement partner must be rotated after a pre-defined period, normally no more than seven years; and
 - (b) a partner rotating after a pre-defined period must not resume the lead engagement partner role until a further period of time, normally two years, has

elapsed. During this period the partner concerned must not be involved with the audit client in any other capacity.

122. When an audit client becomes an issuer, the length of time the lead engagement partner has served the audit client in that capacity must be considered in determining when the partner is to be rotated. However, the partner may continue to serve as the lead engagement partner for two additional years before rotating off the engagement.

Provision of Non-Assurance Services to Assurance Clients

123. The provision of non-assurance services to assurance clients may create threats to the independence of the firm, a network firm or the members of the assurance team, particularly with respect to perceived threats to independence. Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from these firms, who have a good understanding of the business, applying their knowledge and skill in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces. It is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by the application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.
124. The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threats to an acceptable level:
- (a) authorising, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so;
 - (b) determining which recommendation of the firm should be implemented;
 - (c) reporting, in a management role, to those charged with governance; and
 - (d) any other activity barred by legislation (for example a liquidator, or a receiver).
125. The examples set out in paragraph 131 through paragraph 174 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will most frequently arise when a non-assurance service is provided to an audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter of other assurance services, however, may be limited in nature. Threats to independence may also arise when a firm provides a non-assurance service related to the subject matter of a non-audit assurance engagement. In such cases, consideration must be given to the significance of the firm's involvement with the subject matter of the non-audit assurance engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the non-assurance engagement must be declined. When the non-assurance service is not related to the subject matter of the non-audit assurance engagement, the threats to independence will generally be clearly insignificant.

126. The following activities may also create self-review or self-interest threats:

- (a) having custody of an assurance client's assets;
- (b) supervising assurance client employees in the performance of their normal recurring activities; and
- (c) preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

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

- (a) making arrangements so that personnel providing such services do not participate in the assurance engagement;
- (b) involving an additional assurance provider to advise on the potential impact of the activities on the independence of the firm and the assurance team; or
- (c) other relevant safeguards set out in New Zealand legislation.

127. New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all situations where providing non-assurance services to an assurance client might create threats to independence. Nor is it possible to outline all of the different safeguards that might eliminate these threats or reduce them to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement, provided any threats to independence have been reduced to an acceptable level.

128. The following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-assurance services to assurance clients:

- (a) policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions;
- (b) discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee;
- (c) policies within the assurance client regarding the oversight responsibility for provision of non-assurance services by the firm;
- (d) involving an additional assurance provider to advise on the potential impact of the non-assurance engagement on the independence of the member of the assurance team and the firm;
- (e) involving an additional assurance provider outside of the firm to provide assurance on a discrete aspect of the assurance engagement;
- (f) obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm;
- (g) disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged; or

- (h) making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.
129. Before the firm accepts an engagement to provide a non-assurance service to an assurance client, consideration must be given to whether the provision of such a service would create a threat to independence. In situations when a threat created is other than clearly insignificant, the non-assurance engagement must be declined unless appropriate safeguards can be applied to eliminate the threat or reduce it to an acceptable level.
130. The provision of certain non-assurance services to audit clients may create threats to independence so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a related entity, division or discrete financial statement item of such clients may be permissible when any threats to the firm's independence have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm, or when another firm re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

Preparing Accounting Records and Financial Statements

131. Assisting an audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.
132. It is the responsibility of client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, firm personnel must not make such decisions. Examples of such managerial decisions include:
- (a) determining or changing journal entries, or the classifications for accounts or transactions or other accounting records without obtaining the approval of the audit client;
 - (b) authorising or approving transactions; and
 - (c) preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.
133. The audit process involves extensive dialogue between the firm and management of the audit client. During this process, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for audit clients are an appropriate means to promote the fair presentation of the financial statements. The provision of such advice does not generally threaten the firm's independence. Similarly, the audit process may involve assisting an audit client in resolving account reconciliation problems, analysing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial statements (including the adaptation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Financial Reporting Standards or accounting

standards applicable in another country), drafting disclosure items, proposing adjusting journal entries, and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.

General Provisions

134. The examples in paragraph 135 through paragraph 138 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter of an audit engagement of the firm. This notion may be equally applicable in situations when the subject matter of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information, and subsequently provided assurance on this prospective financial information. Consequently, the firm must evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant, safeguards must be considered and applied as necessary to reduce the threat to an acceptable level.

Audit Clients that are not Issuers

135. The firm, or a network firm, may provide an audit client that is not an issuer with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:
- (a) recording transactions for which the audit client has determined or approved the appropriate account classification;
 - (b) posting coded transactions to the audit client's general ledger;
 - (c) preparing financial statements based on information in the trial balance; and
 - (d) posting audit client approved entries to the trial balance.

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

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

Audit Clients that are Issuers

136. The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of an audit client that is an issuer, may impair the independence of the firm or network firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services, except in emergency situations and when the services fall within the statutory audit mandate, could reduce the threat created to an acceptable level. Therefore, a firm or a network firm must not, with the limited exceptions below, provide such services to audit clients that are issuers.
137. The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of issuer audit clients would be seen as impairing independence with respect to the audit client unless the following conditions are met:
- (a) the services do not involve the exercise of judgement;
 - (b) the divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary; and
 - (c) the fees to the firm, or network firm, from such services are collectively clearly insignificant.

If such services are provided, all of the following safeguards must be applied:

- (a) the firm, or network firm, must not assume any managerial role nor make any managerial decisions;
- (b) the issuer audit client must accept responsibility for the results of the work; and
- (c) personnel providing the services must not participate in the audit.

Emergency Situations

138. The provision of accounting and bookkeeping services to audit clients in emergency or other unusual situations, when it is impractical for the audit client to make other arrangements, would pose an unacceptable threat to independence unless:
- (a) the firm, or network firm, does not assume any managerial role or make any managerial decisions;
 - (b) the audit client accepts responsibility for the results of the work; and
 - (c) personnel providing the services are not members of the assurance team.

Valuation Services

139. A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.
140. A self-review threat may be created when a firm or network firm performs a valuation for an audit client that is to be incorporated into the client's financial statements.
141. If the valuation service involves the valuation of matters material to the financial statements, the self-review threat created could not be reduced to an acceptable level

by the application of any safeguard. Accordingly, such valuation services must not be provided or, alternatively, the only course of action would be to withdraw from the audit engagement.

142. Performing valuation services that are neither separately, nor in the aggregate, material to the financial statements may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:

- (a) involving an additional member of the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary;
- (b) confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- (c) obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm; and
- (d) making arrangements so that personnel providing such services do not participate in the audit engagement.

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

- (a) the extent of the audit client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgement;
- (b) the degree to which established methodologies and professional guidelines are applied when performing a particular valuation service;
- (c) for valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned;
- (d) the reliability and extent of the underlying data;
- (e) the degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved; and
- (f) the extent and clarity of the disclosures in the financial statements.

143. When the firm performs a valuation that forms part of the subject matter of an assurance engagement that is not an audit engagement, the firm must consider any self-review threats. If the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

Provision of Taxation Services to Audit Clients

144. A firm may be asked to provide taxation services to an audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments may create threats to independence.

145. Threats to independence need to be considered depending on the nature of the tax services to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entity's financial statements.

The safeguards set out in paragraph 128 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances when the threat to independence cannot be reduced to an acceptable level the only available action is to decline to provide such services or withdraw from the audit engagement.

146. The provision of tax services to audit clients which involve matters that would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.
147. Tax services to support an audit client in the execution of a transaction may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Such a service would not generally impair independence, provided that:
 - (a) members of the assurance team are not involved in providing the service; and
 - (b) in relation to the advice provided, the audit client makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the audit client.
148. Acting for an audit client in the resolution of a tax dispute or tax litigation when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and self-review threats so significant that no safeguard could reduce the threat to an acceptable level. Therefore, the firm must not perform this type of service for an audit client.
149. When a firm is asked to act in an advocacy role for an audit client in the resolution of a tax dispute or tax litigation, when the amounts involved are not material to the financial statements of the audit client, the firm must evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:
 - (a) policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client; or
 - (b) using professionals who are not members of the assurance team to perform the service.

Provision of Internal Audit Services to Audit Clients

150. A self-review threat may be created when a firm, or a network firm, provides internal audit services to an audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.
151. Services involving an extension of the procedures required to conduct an audit in accordance with auditing standards would not be considered to impair independence with respect to an audit client provided that the firm's, or network firm's, personnel do not act or appear to act in a capacity equivalent to a member of the audit client's management.

152. When the firm, or a network firm, provides assistance in the performance of a client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by audit client management and the internal audit activities themselves.
153. Performing a significant portion of the audit client's internal audit activities may create a self-review threat and a firm, or a network firm, must consider the threats and proceed with caution before taking on such activities. Appropriate safeguards must be put in place and the firm, or network firm, must, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.
154. Safeguards that must be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:
- (a) the audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;
 - (b) the audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;
 - (c) the audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;
 - (d) the audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;
 - (e) the audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and
 - (f) the findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.
155. Consideration must also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.

Provision of Information Technology Systems Services to Audit Clients

156. The provision of services by a firm or network firm to an audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.
157. The self-review threat is likely to be too significant to allow the provision of such services to an audit client unless appropriate safeguards are put in place ensuring that:
- (a) the audit client acknowledges its responsibility for establishing and monitoring a system of internal controls;
 - (b) the audit client designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

- (c) the audit client makes all management decisions with respect to the design and implementation process;
 - (d) the audit client evaluates the adequacy and results of the design and implementation of the system; and
 - (e) the audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
158. Consideration must also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.
159. The provision of services by a firm or network firm to an audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may also create a self-review threat. The significance of the threat, if any, must be evaluated and, if the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.
160. The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls is not considered to create a threat to independence provided that firm or network firm personnel do not perform management functions.

Temporary Staff Assignments to Audit Clients

161. The lending of staff by a firm, or a network firm, to an audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's, or network firm's, personnel will not be involved in:
- (a) making management decisions;
 - (b) approving or signing agreements or other similar documents; or
 - (c) exercising discretionary authority to commit the client.

Each situation must be carefully analysed to identify whether any threats are created and whether appropriate safeguards must be implemented. Safeguards that must be applied in all circumstances to reduce any threats to an acceptable level include:

- (a) the firm's staff providing the assistance must not be given audit responsibility for any function or activity that they performed or supervised during their temporary staff assignment; and
- (b) the audit client must acknowledge its responsibility for directing and supervising the activities of the firm's, or network firm's, personnel.

Provision of Litigation Support Services to Audit Clients

162. Litigation support services may include such activities as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

163. A self-review threat may be created when the litigation support services provided to an audit client include the estimation of the possible outcome, and thereby affect the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:

- (a) the materiality of the amounts involved;
- (b) the degree of subjectivity inherent in the matter concerned; and
- (c) the nature of the engagement.

The firm, or network firm, must evaluate the significance of any threat created and, if the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- (a) policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client;
- (b) using professionals who are not members of the assurance team to perform the service; or
- (c) the involvement of others, such as independent experts.

164. If the role undertaken by the firm, or network firm, involved making managerial decisions on behalf of the audit client, the threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm or network firm must not perform this type of service for an audit client.

Provision of Legal Services to Audit Clients

165. Legal services are defined as any services for which the person providing the services must either be admitted to practise before the courts of the jurisdiction in which such services are to be provided, or have the required legal training to practise law. Legal services encompass a wide and diversified range of areas, including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support, and the provision of assistance to clients' internal legal departments. The provision of legal services by a firm, or a network firm, to an entity that is an audit client may create both self-review and advocacy threats.

166. Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entity's financial statements. The safeguards set out in paragraph 128 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances when the threat to independence cannot be reduced to an acceptable level, the only available action is to decline to provide such services or withdraw from the audit engagement.

167. The provision of legal services to an audit client which involve matters that would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.

168. There is a distinction between advice and advocacy. Legal services to support an audit client in the execution of a transaction (e.g. contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards

may be available to reduce these threats to an acceptable level. Such a service would not generally impair independence, provided that:

- (a) members of the assurance team are not involved in providing the service; and
- (b) in relation to the advice provided, the audit client makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the audit client.

169. Acting for an audit client in the resolution of a dispute or litigation when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and self-review threats so significant that no safeguard could reduce the threat to an acceptable level. Therefore, the firm must not perform this type of service for an audit client.

170. When a firm is asked to act in an advocacy role for an audit client in the resolution of a dispute or litigation when the amounts involved are not material to the financial statements of the audit client, the firm must evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- (a) policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client; or
- (b) using professionals who are not members of the assurance team to perform the service.

171. The appointment of a partner or an employee of the firm or network firm as general counsel for legal affairs to an audit client would create self-review and advocacy threats so significant that no safeguards could reduce the threats to an acceptable level. The position of general counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, a member of the firm or network firm must not accept such an appointment for an audit client.

Recruiting Senior Management

172. The recruitment of senior management for an assurance client, such as those in a position to affect the subject of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. The significance of the threat will depend upon factors such as:

- (a) the role of the person to be recruited; and
- (b) the nature of the assistance sought.

The firm could generally provide such services as reviewing the professional qualifications of a number of applicants and advising on their suitability for the post. In addition, the firm could generally produce a short-list of candidates for interview, provided it has been drawn up using criteria specified by the assurance client.

The significance of the threat created must be evaluated and, if the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to reduce the threat to an acceptable level. In all cases, the firm must not make management decisions and the decision as to whom to hire must be left to the client.

Corporate Finance and Similar Activities

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

Fees and Pricing

Fees – Relative Size

175. When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:
- (a) the structure of the firm; and
 - (b) whether the firm is well established or newly created.

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

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

176. Where an assurance client provides a firm with an unduly large proportion of its total fees, the member must decline, or withdraw from, the assurance engagement.
177. A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat must be evaluated and, if the threat is other than clearly insignificant, safeguards must be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:
- (a) policies and procedures to monitor and implement quality control of assurance engagements; and
 - (b) involving an additional member of the firm, who was not a member of the assurance team, to review the work done or otherwise advise as necessary.

Fees – Overdue

178. A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:
- (a) discussing the level of outstanding fees with the audit committee, or others charged with governance; and
 - (b) involving an additional member of the firm who did not take part in the assurance engagement to provide advice or review the work performed.

The firm must also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

Pricing

179. When a firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:
- (a) the firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and
 - (b) all applicable assurance standards, guidelines and quality control procedures are being complied with.

Contingent Fees

180. Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of Professional and Ethical Standard 2, fees are not regarded as being contingent if a court or other public authority has established them.
181. A contingent fee charged by a firm in respect of an assurance engagement, creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. A firm must not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of

the assurance work, or on items that are the subject matter of the assurance engagement.

182. A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. If the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement, the threats could not be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such arrangements. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:

- (a) the range of possible fee amounts;
- (b) the degree of variability;
- (c) the basis on which the fee is to be determined;
- (d) whether the outcome or result of the transaction is to be reviewed by an independent third party; and
- (e) the effect of the event or transaction on the assurance engagement.

The significance of the threats must be evaluated and, if the threats are other than clearly insignificant, safeguards must be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

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

Gifts and Hospitality

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

Actual or Threatened Litigation

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

- (a) the materiality of the litigation;
- (b) the nature of the assurance engagement; and

(c) whether the litigation relates to a prior assurance engagement.

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

- (a) disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;
- (b) if the litigation involves a member of the assurance team, removing that individual from the assurance team; or
- (c) involving an additional assurance provider in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

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

Definitions

For the purpose of Professional and Ethical Standard 2 the following terms have the meanings specified.

Audit client means an entity in respect of which a firm conducts an audit engagement. The audit client will always include its related entities.

Audit engagement means an assurance engagement to provide a high level of assurance that financial statements are free of material misstatement, such as an engagement in accordance with International Standards on Auditing (New Zealand). This includes a Statutory Audit, which is an audit required by legislation or other regulation.

Assurance client means an entity in respect of which a firm conducts an assurance engagement.

Assurance engagement means an audit engagement or a review engagement. Assurance engagements are conducted to provide:

- a high level of assurance that the subject matter conforms in all material respects with identified suitable criteria; or
- a moderate level of assurance that the subject matter is plausible in the circumstances.

This would include an engagement in accordance with International Standards on Auditing (New Zealand) and Review Engagement Standards No. 1 (RS-1).

Assurance provider means a person or organisation appointed or engaged to provide assurance services.

Assurance team means:

- All professionals participating in the assurance engagement;
- All others within a firm who can directly influence the outcome of the assurance engagement, including:
 - those who recommend the compensation of, or who provide direct supervisory, management or other oversight of the assurance engagement partner, in connection with the performance of the assurance engagement. For the purposes of an audit engagement this includes those at all successively senior levels above the lead engagement partner through the firm's chief executive;
 - those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement;
 - those who provide quality control for the assurance engagement; and
 - for the purposes of an audit client, all those within a network firm who can directly influence the outcome of the audit engagement.

Close family means a parent, non-dependent child or sibling.

Direct financial interest means a financial interest:

- owned directly by and under the control of an individual or entity (including those managed on a discretionary basis by others); or

- beneficially owned through a collective investment vehicle, estate, trust or other intermediary, over which the individual or entity has control.

Director or officer includes any person occupying the position of a member (by whatever name called) of the governing body of the entity.

Financial interest means an interest in an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest, and derivatives directly related to such interest.

Firm means:

- A sole practitioner, partnership or corporate practice;
- An entity that controls such parties through ownership, management or other means; and
- An entity controlled by such parties through ownership, management or other means.

Immediate family means a spouse (or equivalent) or dependent.

Independence is:

- Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and
- Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's integrity, objectivity or professional scepticism had been compromised.

Indirect financial interest means a financial interest beneficially owned through a collective investment vehicle, estate, trust or other intermediary, over which the individual or entity has no control.

Issuer means an entity referred to under section 4 of the Financial Reporting Act 1993 and includes an entity whose shares, stock or debt are quoted or listed on a recognised stock exchange, or are marketed under the regulations of a recognised stock exchange or other equivalent body.

Lead engagement partner means, in connection with an audit, the partner responsible for signing the report on the consolidated financial statements of the audit client, and, where relevant, the partner responsible for signing the report in respect of any entity whose financial statements form part of the consolidated financial statements, and on which a separate stand-alone report is issued. When no consolidated financial statements are prepared, the lead engagement partner would be the partner responsible for signing the report on the financial statements.

Network¹ means a larger structure that is aimed at cooperation and:

- that is clearly aimed at profit or cost sharing, or

¹ This definition is to be read in the context of the guidance provided in paragraphs 24-1 to 24-12.

- that shares any of the following: common ownership, control or management; common quality control policies and procedures; common business strategy; the use of a common brand-name; or a significant part of professional resources.

Network firm means a firm or entity that belongs to a network.

Office means a distinct sub-group of a firm, whether organised on geographical or practice lines.

Professional services means any work or services in which the assurance provider is required to use professional expertise on behalf of a client or employer, irrespective of whether payment is received for this work.

Related entity means an entity that has any of the following relationships with the client:

- (a) An entity that has direct or indirect control over the client provided the client is material to such entity;
- (b) An entity with a direct financial interest in the client provided that such entity has significant influence over the client and the interest in the client is material to such entity;
- (c) An entity over which the client has direct or indirect control;
- (d) An entity in which the client, or an entity related to the client under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material to the client and its related entity in (c); and
- (e) An entity which is under common control with the client (hereinafter a “sister entity”) provided the sister entity and the client are both material to the entity that controls both the client and sister entity that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional scepticism had been compromised.