Preface

The auditing profession has evolved considerably over the years and this has not only been due to well-publicised corporate disasters (such as Enron and Parmalat), but also because of the way in which business itself has evolved. Increased use of information technology has meant more computer-assisted audit techniques have been developed as well as the fast pace at which International Financial Reporting Standards (IFRS) are currently gathering. More companies around the world are adopting the use of IFRS meaning audit techniques have to deal with some radically different accounting treatments that national generally accepted accounting practice may allow (or disallow).

Accounting and auditing standards change on a frequent basis in attempts to improve and clarify their application. The last major overhaul by the International Auditing and Assurance Standards Board (IAASB) was the 'Clarity Project' and the issuance of clarified International Standards on Auditing in October 2009 which became effective for audits commencing on or after 15 December 2009. Time does not stand still and accounting and auditing standards are amended, withdrawn and introduced as appropriate to cope with emerging issues. For example, at the time of writing this Preface, there were proposals issued by the IAASB to radically change the auditor's report so that more information is to be included within the report itself in order to give users a greater understanding of the risks faced by the business as well as how auditors have dealt with very subjective and controversial areas of an audit, such as going concern. These proposals are essentially reflective of the changing needs of users and given the recent economic crisis, the audit profession has had to change to meet these needs.

This publication will take a look at full ISAs as issued by the IAASB. Some jurisdictions (for example, the United Kingdom) have adopted ISAs but they have been tailored to be country-specific. This publication aims to give auditors an 'at a glance' insight as to the most frequently asked questions where the ISAs are concerned. It is not intended to be a substitute for the official standards, but merely to offer some guidance as to how contentious issues could be dealt with. Where subjective or contentious issues are encountered by audit firms, my advice would be to refer to the official ISAs or to seek further advice from the technical advisory section of your professional body to ensure that correct interpretation is achieved.

Steve Collings

April 2014

Foreword

In the wake of numerous corporate scandals at the start of the century, there was a growing distrust of published financial information and of the auditor's reports that accompany them. Partly in response to this, in the last few years, the auditing profession has embraced a new set of regulations which has helped to harmonise audit practice on a global basis, and which, it is hoped, will instil more faith in the work of auditors. The new regulation is embodied by the International Standards on Auditing (ISAs), issued by the International Audit and Assurance Standards Board, whose Clarity Project resulted in a set of high quality auditing standards and one quality control standard which provide the framework for conducting an audit that is used by auditors around the world.

It is important that auditors, and those wishing to understand the process of planning and executing an effective audit, get to grips with the ISA requirements and application guidance. The standards are often simply worded, but can be difficult to apply; involving the use of significant judgement and requiring detailed documentation of audit evidence and conclusions. It is essential that the auditor can demonstrate compliance with the ISAs in order to justify the opinion that is provided on financial statements, but the complexities involved in the practical application of ISAs can sometimes leave the auditor uncertain as to whether the requirements of an ISA have been adequately satisfied.

This book will help auditors to understand the key ISA requirements and to ensure they have followed the principles of the ISAs, as well as their exact requirements.

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January 2014

Author of *Managing the Transition to IFRS-based Financial Reporting*

Frequently Asked Questions

1. Who can be an auditor and sign the auditor's report?
2. What are the fundamental principles of professional ethics?
3. What gives rise to a threat to an auditor's independence and objectivity and how can those threats be managed?
4. What are the issues an auditor has to consider before accepting appointment as auditor and how does the auditor deal with conflicts of interest?
5. Are there any rules governing the way in which fees are charged to clients?
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7. What happens if family or close relationships exist between an auditor and the client?
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10. What is an 'assurance engagement'?
11. What terms have to be agreed between an auditor and their client?
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17. What happens when an auditor finds a material error?
18. How does the auditor plan for an audit of financial statements?
19. What factors does an auditor take into consideration when performing a risk assessment on their client?
20. What is the concept of 'materiality' and how is it applied in an audit?
21. What constitutes audit evidence and how is it gathered?
22. If a client uses the services of an expert to carry out certain valuations in the financial statements, does the auditor have to carry out any procedures?
23. Can an auditor appoint their own expert to corroborate certain aspects of the financial statements?
24. What are the financial statement assertions?
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27. What are 'external confirmations'?
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30. How does an auditor make sure accounting estimates, fair value

accounting estimates and the related disclosures are fairly stated in the financial statements?

31. What are 'related parties' and how does the auditor audit these?
32. Does the auditor have to do any work beyond the year-end date?
33. What is meant by 'error projection'?
34. What are written representations?
35. If the company is the parent of a group of companies, are there any other issues the auditor should consider?
36. What is the auditor's report and how is it structured?
37. What is the difference between 'reasonable assurance' and 'limited assurance'?
38. What happens if the auditors conclude the financial statements do not give a true and fair view (or do not present fairly in all material respects)?
39. What is an emphasis of matter paragraph?
40. In what circumstances must an auditor resign?

Chapter 1

What is the Role of the International Auditing and Assurance Standards Board?

The International Auditing and Assurance Standards Board (IAASB) is responsible for setting the International Standards on Auditing (ISAs). It is an independent standard-setting body that sets high-quality, international standards on aspects of:

- Auditing;
- Assurance;
- Quality control;
- Review; and
- Related services.

The IAASB was founded in March 1978 and was previously known as the International Auditing Practices Committee (IAPC) whose work was then focused on three areas, namely:

- Objects and scope of audits of financial statements;
- Engagement letters; and
- General auditing guidelines.

As one can appreciate, the work of the IAASB has significantly evolved and in 1991 the IAPC's guidelines were renamed the International Standards on Auditing.

In 2002, the IAPC changed its name to the IAASB and the International Federation of Accountants (IFAC) approved a series of reforms that were primarily designed (among other things) to strengthen the standard-setting process, which included the processes at the IAASB, in order to best serve the public interest.

The IAASB is a technical standing committee of IFAC which is also closely linked to the International Ethics Standards Board for Accountants (IESBA) which produces the Code of Ethics for Professional Accountants. An illustration of the hierarchy is as follows:

The standards issued above by the IAASB are authoritative material (as stated in the *Preface to International Standards on Quality Control, Auditing, Assurance and Related Services Pronouncements* (Revised 2011)). As these standards are authoritative, they must be followed in an audit that is conducted in accordance with the ISAs.

In addition to 'authoritative' material published by the IAASB, they also publish 'non-authoritative' materials which offer a form of 'guidance' rather than mandatory requirements. These are:

- International Auditing Practices Notes (IAPNs). These are designed to provide practical assistance to auditors rather than impose mandatory requirements.

- Practice Notes Relating to Other International Standards.
- Staff Publications: these are designed to raise awareness of new or emerging issues in relation to the standards and to direct attention to the relevant parts of IAASB pronouncements.

Some jurisdictions will have their own standard-setting bodies. For example, the Financial Reporting Council is responsible for standard-setting in the UK. Some countries do adopt ISAs but have to amend them to be country-specific. For example, in the UK, ISAs are adopted but are amended in some areas to be compatible with UK practices and these are then referred to as ISA (UK and Ireland).

Example

ISA 570 *Going Concern* requires the auditor to consider whether management have made a going concern assessment which covers a period of 12 months from the date of the financial statements. However, in the UK and Ireland, this going concern assessment should cover a period of 12 months from the date of approval (or expected date of approval) of the financial statements.

The UK and Ireland ISA therefore covers a different time span which demonstrates how the standard-setters have amended the mainstream ISA to be specific to the UK and Ireland. In the UK the going concern ISA is known as ISA (UK and Ireland) 570 *Going Concern*. In the UK and Ireland ISAs are often coined 'ISA *pluses*' because they contain additional or amended requirements to the mainstream ISA issued by the IAASB.

The Clarity Project

In 2004, the IAASB undertook a programme in which the objective was to enhance the clarity of the ISAs. The overall aim of this Clarity Project was to enhance the understandability of the ISAs which would, in turn, enable consistent application of the standards and go to improve overall audit quality on a worldwide level. This was an important exercise following some well-publicised corporate disasters and the decimation of confidence within the auditing profession.

Following the Clarity Project, each standard now has a clear structure with transparent objectives, definitions and requirements, together with application and other explanatory material which drill down further into the requirements of the ISAs. The structure of the new standards makes it easier to understand what is required and what is guidance. In addition, ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* has been re-written and the revised guidance on quality control procedures also became effective at the same time as the clarified ISAs did. The structure of each standard is as follows:

- Introduction
- Objective
- Definitions

- Requirements
- Application and Other Explanatory Material

Introduction

This paragraph contains information concerning the standard including the purpose, scope and subject matter of the ISA. It also contains information regarding the responsibilities of the auditor and others in the context of which the ISA is set.

Objective

Each ISA contains a statement of the auditor's objective in the audit area in which the ISA is set.

Definitions

The Clarity Project included adding an element for greater understanding of the ISAs and as such applicable terms contained within the ISAs have now been defined.

Requirements

Each ISA is supported by clearly stated requirements. Phrases such as '*the auditor should …*' have now been replaced by '*the auditor shall …*'. This improvement was welcomed by the profession because it clears any ambiguity. The word 'shall' indicates that the standard expects the auditor to do something rather than 'should' which implies that the standard 'may' expect something of the auditor in certain circumstances.

Application and other explanatory material

Each ISA clearly explains more precisely what the auditor is required to do in order to achieve the objective of the ISA in question. Where applicable, the ISA may also contain illustrative examples of procedures that may apply in certain circumstances.

Other explanatory material may be contained within an ISA in order to help the auditor understand the ISA's overall objective and application.

The impact of the Clarity Project was one which contributed significantly to the enhancement and uniformity of audit quality on a worldwide level. The IAASB set out to undertake the project in the hope that it will also encourage international convergence and assist audit firms that operate internationally by harmonising auditing standards.

In summary, the Clarity Project had the following effect on the ISAs and ISQC:

- 19 ISAs and ISQC 1 were redrafted.
- 16 ISAs were revised and redrafted to reflect the new clarity convention.
- Two new standards were issued: one relating to communication, ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, and another relating to the evaluation of misstatements, ISA 450 *Evaluation of Misstatements Identified during the Audit*.
- ISA 540 *Audit of Accounting Estimates* and ISA 545 *Auditing Fair Value Measurements and Disclosures* were combined in ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

The Clarity Project brought about some significant changes in the work that auditors are required to undertake which can be seen in the following summaries.

ISA 260 *Communication with Those Charged with Governance*

This clarified ISA emphasises the important of effective two-way communication between the auditor and those charged with governance of the entity. Where the auditor encounters significant difficulty during the course of an audit, the auditor is required to notify such significant difficulties to the appropriate level of management, or those charged with governance. Where auditors feel that the two-way communication has *not* been effective, they should consider their ability to accept re-appointment as auditors if the conclusion is that the level of two-way communication has been inadequate for their purposes.

ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

This was a new ISA born out of the Clarity Project and is designed to address the way in which auditors report control deficiencies to those charged with governance. The main objective is to increase the quality of the communication to management and also to focus on the definition of a significant deficiency in internal control and/or a missing control which requires formal reporting.

It is important that auditors' risk assessments include consideration of the types of control they would expect to find at an audit client, taking into consideration its size, complexity and nature. If relevant controls are missing, their absence should be reported to the appropriate level of management or to those charged with governance, even if they do not directly impact on the planned audit procedures.

ISA 450 *Evaluation of Misstatements Identified During the Audit*

This new ISA, born out of the Clarity Project, requires (among other things) the accumulation of misstatements, reassessment of materiality and specific documentation.

ISA 530 *Audit Sampling*

This ISA sets a foundation for risk-based auditing which means that the auditors will plan their procedures using a risk assessment which is, in turn, built on an understanding of the entity and the environment in which it operates.

The clarified ISA emphasises the point that it would be extremely rare for any deviation or misstatement identified in a sample to be considered an *anomalous error* (a one-off error) and not representative of the whole population. Where auditors wish to make a decision as to whether a deviation or misstatement is anomalous, they should obtain sufficient appropriate audit evidence to support this position.

ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

This clarified ISA requires greater rigour and understanding in the audit of accounting estimates, including the consideration of indicators of possible management bias. The ISA also includes requirements in respect of:

- Specific matters for the auditor to gain an understanding of in order to assess risk;
- Evaluation of estimation uncertainty and determining any significant risks; and
- Requirement to perform substantive procedures to respond to significant risks.

The scope of this standard was updated to be extended to fair values. This extension was hardly surprising given the ongoing debate concerning the use of fair values in financial reporting frameworks.

ISA 550 *Related Parties*

This revised ISA includes a number of specific requirements to ensure that auditors place a greater emphasis on a risk-based approach in the area of related parties and improve the identification of related party relationships and transactions which have not already been disclosed by management.

The clarified ISA recognises that the risks of material misstatement are higher when related parties are involved and requires related party relationships and transactions to be considered explicitly in the engagement team's fraud discussion. This is required in order to understand the controls relevant to related parties.

The ISA also requires that where controls are not present in this area, the auditor may be required to report such facts to those charged with governance. In addition, the clarified ISA requires the auditor to challenge any management assertion that transactions with related parties are on an arm's length basis.

ISA 570 *Going Concern*

ISA 570 did not see much revision during the Clarity Project. However, it was redrafted in such a way that it saw much elevation in a number of areas. In particular, where events or conditions cast significant doubt on the entity's ability to continue as a going concern. In this respect, auditors should obtain evidence concerning management's assertion where they conclude that the going concern basis is appropriate in their particular circumstances by evaluating management's plans for future actions and considering whether those plans are, in fact, feasible.

ISA 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

This revised ISA became far more wide-ranging than the previous standard and sets out new requirements in respect of the relationship between the group engagement team and the component auditors. This revised ISA has the most impact on group audits where the component auditor is not the auditor for the whole group hence requiring additional thought and documentation, such as:

- Consideration of whether the engagement is a group audit within the scope of ISA 600;
- Scoping the group audit, including determining significant components within the group;
- Gaining an understanding of the group-wide internal control environment and the consolidation process;
- Determining materiality and performance materiality for the group and its components; and
- Obtaining an understanding of the component auditors involved in the work.

ISAs in Issue

ISA Number	Title
200	Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
210	Agreeing the Terms of Audit Engagements
220	Quality Control for an Audit of Financial Statements
230	Audit Documentation
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with Those Charged with Governance
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
300	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment (Revised)
320	Materiality in Planning and Performing an Audit
330	The Auditor's Responses to Assessed Risks
402	Audit Considerations Relating to an Entity Using a Service Organisation
450	Evaluation of Misstatements Identified during the Audit
500	Audit Evidence
501	Audit Evidence—Specific Considerations for Selected Items
505	External Confirmations
510	Initial Audit Engagements—Opening Balances
520	Analytical Procedures
530	Audit Sampling
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties

560	Subsequent Events
570	Going Concern
580	Written Representations
600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)
610	Using the Work of Internal Auditors (Revised)
620	Using the Work of an Auditor's Expert
700	Forming an Opinion and Reporting on Financial Statements
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
710	Comparative Information—Corresponding Figures and Comparative Financial Statements
720	The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
ISQC 1	Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements

Chapter 2

Frequently Asked Questions

Who can be an auditor and sign the auditor's report?

In order to act in the capacity of an auditor, the individual signing the auditor's report must be a member of a regulatory professional body. The professional body will offer qualifications for its student members to undertake in order to progress to full membership of that professional body. Upon successful completion of a programme of examinations, many professional bodies require the individual to have completed a certain amount of work experience before progressing to full membership to ensure that the member has the required examinations and experience in the workplace to satisfy qualification as a full member of the professional body.

Once qualified as a full member, the member may then have to complete a certain element of work-based activities in order to obtain a practising certificate—other bodies have different rules relating to the issuance of a practising certificate. In order to be able to act as an auditor and sign the auditor's report for a reporting entity, the individual will (in the vast majority of cases) have to be a registered auditor.

In the United Kingdom, eligibility to act in the capacity as auditor can only be granted if the member is a member of one of the Consultative Committee of Accountancy Bodies (CCAB). Five professional bodies in the UK belong to the CCAB as follows:

- Institute of Chartered Accountants in England and Wales;
- Association of Chartered Certified Accountants;
- Chartered Institute of Public Finance and Administration;
- Institute of Chartered Accountants in Scotland; and
- Chartered Accountants Ireland.

Students and non-qualified members of staff working for an audit practice may undertake audit work, but they may not act in the capacity of responsible individual or senior statutory auditor as they will not be members of a professional body.

What are the fundamental principles of professional ethics?

Professional accountants and auditors are governed by ethical standards with which they must comply. Auditors have a direct responsibility to the shareholders of a reporting entity (as auditors are appointed by the shareholders, not by management) but it is widely understood that the fundamental principles of professional ethics are not just restricted to auditors—they apply to all professional accountants. The *Code of Ethics for Professional Accountants* (the Code) has been issued by the International Ethics Standards Board for Accountants (IESBA) and at the time of writing the latest version was the 2013 Edition (readers are directed to www.ifac.org.uk to keep a check on later versions published by IESBA).

The Code prescribes the requirements for professional accountants, whether they work in audit practice or not. Member bodies of the International Federation for Accountants (IFAC) must not apply any less stringent standards than those stated in the Code. In some jurisdictions, there could be ethical requirements which differ from the IESBA Code. Professional accountants must be aware of the differences and must comply with the more stringent requirements and guidance unless a law or regulation prohibits such compliance.

The Code is split into three component parts:

- Part A establishes the fundamental principles of professional ethics for accountants, which provides a professional framework for applying those principles.
- Part B applies to professional accountants who work in practice.
- Part C applies to professional accountants who work in business and those professional accountants who work in practice may find Part C relevant to their needs.

A professional accountant is required to observe compliance with five fundamental principles which are:

- Integrity;
- Objectivity;
- Professional Competence and Due Care;
- Confidentiality; and
- Professional Behaviour.

Integrity

At all times during the course of their work, a professional accountant must be honest and straightforward in all professional and business relationships. In order for a professional accountant to observe the fundamental principles of integrity, the professional accountant should not allow their name to be associated with reports, returns or other forms of communication where the professional accountant believes that the information:

a. contains a materially false or misleading statement;

b. contains statements or information obtained recklessly; or

c. omits or obscures information required to be included where such omission or obscurity would be misleading.

Where auditors are concerned, it may be the case that an auditor's opinion on the financial statements is modified because the financial statements do not give a true and fair view (or do not present fairly in all material respects). In such circumstances, the auditor will not be considered to be in breach of the circumstances shown in (a) to (c) above.

Objectivity

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

In some cases, the auditor may be exposed to situations that may impair objectivity. The auditor should, in all cases, ensure that objectivity is not impaired by implementing safeguards to maintain independence and objectivity.

Professional competence and due care

A professional accountant has a duty to maintain professional knowledge and skill at the level required to ensure that their client receives a competent and professional service. Audit firms must not, therefore, accept appointment as auditor unless they are competent and have sufficient resources available to undertake the required work.

Professional accountants also have an obligation to act diligently in accordance with appropriate technical and professional standards when providing professional services. Professional competence comprises:

- Attaining professional competence; and
- Maintaining professional competence.

In order to achieve the latter, professional accountants must be up-to-date with technical developments. Continuing Professional Development (CPD) will assist in the maintenance of professional competence, providing the CPD undertaken is relevant to the professional accountant's work. It will also serve to assist the professional accountant in performing work competently within their professional environment.

Confidentiality

Confidentiality is of paramount importance and Section 140 *Confidentiality* of Part A of the Code contains the obligations of a professional accountant to maintain confidentiality as well as establishing the circumstances where the professional accountant's duty of confidentiality can be overridden.

In recognition of the professional accountant's duty of confidentiality, the accountant should refrain from:

- Disclosing, outside the audit/accountancy firm, confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose.
- Using confidential information acquired as a result of professional and business relationships to their personal advantage or to the advantage of third parties.

This duty of confidentiality extends to outside of the business or practice environment where the professional accountant must observe the duty of confidentiality and not, inadvertently or otherwise, disclose information in a social environment.

A professional accountant is also required to maintain confidentiality of information disclosed by a prospective client or employer.

A professional accountant should also consider the need to maintain confidentiality of information within a firm or employing organisation.

A professional accountant should take all reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is sought also respect the professional accountant's duty of confidentiality.

Despite the fact that auditors and professional accountants have a professional duty of confidentiality, there may occasions where the professional accountant is required by law, or considers it to be in the public interest, to disclose details of clients' affairs to third parties. The duty of confidentiality is required to be applied at all times by the professional accountant during the course of their work, except where:

a. Disclosure is permitted by law and is authorised by the client or the employer.

b. Disclosure is required by law.

c. There is a professional duty or right to disclose when not required by law, for example:

i. when professional bodies are carrying out reviews of work done by professional accountants and the bodies require sight of the firm's files to review this audit work;

ii. to respond to an enquiry or investigation by a professional body or regulatory body;

iii. to protect the professional interests of a professional accountant in legal proceedings; or

iv. to comply with technical standards and ethical requirements.

There are two types of disclosure where the duty of confidentiality is to be overridden:

- Obligatory disclosure; and
- Voluntary disclosure

Obligatory disclosure

Where the professional accountant knows, or suspects, the client to have committed money laundering, treason, drug-trafficking or terrorist offences, the professional accountant is required to disclose all the information at his disposal to a regulatory authority.

Voluntary disclosure

Voluntary disclosure may be required in the following situations:

- Disclosure is required by law;
- Where it is in the public interest to disclose (such as where a criminal offence against the public has been committed);
- Disclosure is required to protect the professional accountant's interests (for example defending the professional accountant in a legal case).

Example

During the audit of Breary Enterprises Co, the audit senior noticed round sum amounts of money being transferred into the bank account of one of the directors of the company. Over the year the amounts had become material when aggregated and so the audit senior made enquiries with the director as to what these transactions were for. The director refused to offer any valid explanations to the audit senior and said, in a threatening and aggressive manner, that it was private and must not be disclosed to anyone. The tone and manner of the director's reply raised the suspicions of the audit senior that the director was committing money laundering.

In many jurisdictions, anti-money laundering regulations require the suspicion, or knowledge, of money laundering acts to be reported to a Money Laundering Reporting Officer (MLRO) within a professional practice. In this scenario, the audit senior would be required to inform the MLRO of his suspicions. It would then be up to the judgement of the MLRO to decide whether the suspicions warranted a report to the regulatory authorities whose duty it is to investigate such suspicions.

In such cases, it is vital that neither the audit senior nor the MLRO make the client aware of any such reports as this will constitute 'tipping off' the client and may prejudice any investigation.

Professional behaviour

At all times, professional accountants must comply with relevant laws and regulations and avoid all action which would bring the profession into disrepute. Accountants need to be seen to behave in a professional manner at all times, and this behaviour extends to the professional accountant's marketing and advertising.

The professional accountant must not mislead clients or employers by stating that they have professional qualifications, when they have not. Nor should they offer themselves as available for work which they are not professionally competent to undertake. Professional accountants also have an obligation to ensure that they do not make disparaging references or unsubstantiated comparisons to the work of others.

What gives rise to a threat to an auditor's independence and objectivity and how can those threats be managed?

Professional accountants and auditors will have to comply with a Code of Ethics (such as the IESBA's *Code of Ethics for Professional Accountants*) (the Code). Many professional bodies throughout the world have adopted the IESBA's Code and have made certain amendments to it to be country-specific. However, by and large, the content of the Code issued by IESBA applies to most professional bodies and their members.

The overarching principle of an auditor is to act independently and with objectivity. There are two key aspects to independence:

- Independence of mind; and
- Independence in appearance.

Independence of mind

This is the state of mind that permits the provision of an opinion without being affected by influences that compromise the professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.

Independence in appearance

This is 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 that the integrity, objectivity or professional scepticism of a firm, or a member of the assurance team, had been compromised.

As a result, the audit of a set of financial statements should be able to provide objective assurance on whether the financial statements give a true and fair view (or present fairly in all material respects) which the directors of a reporting entity will never be able to provide.

In many cases there are at least *some* threats to the independence and objectivity of an auditor and it would be commercially unreasonable to expect auditors to resign from every audit where there was even the smallest threat to independence and objectivity. Where threats to independence and objectivity are in existence, the key is to put adequate safeguards in place to eliminate, or reduce, the threats to acceptable levels.

Where threats to independence and objectivity are concerned, there are generally five such threats:

- Self-interest threat
- Self-review threat
- Advocacy threat
- Familiarity threat
- Intimidation threat.

Self-interest threat

A self-interest threat occurs when a financial or other interest in the entity will inappropriately influence the professional accountant's judgement or behaviour. This could occur, for example, where the professional accountant or auditor holds shares in the reporting entity, or where the audit firm has undue dependence on the fees from the audit client. Other self-interest threats can include:

- Loans and guarantees to the client;
- Overdue fees from the client;
- Family and personal relationships;
- Close business relationships;
- Gifts and hospitality from the client; and
- Contingent fees.

Self-review threat

A self-review threat occurs when the professional accountant relies on information prepared by themselves or another individual in the professional accountant's firm. An example of a self-review threat is where the professional accountant prepares a set of financial statements for a reporting entity and then audits the same financial statements. In addition, where a member of the audit or assurance team has joined the audit firm from the audit client, this will also give rise to a self-review threat if that person is engaged on the audit of his/her previous employer.

Advocacy threat

An advocacy threat occurs when the professional accountant promotes a client's or employer's position to the point that the professional accountant's objectivity is compromised. Such an example would be where the professional accountant is representing the client in legal proceedings.

Familiarity threat

A familiarity threat arises when a professional accountant becomes disproportionately close, or familiar, with the client to the extent that they may be too sympathetic to their interests.

Intimidation threat

An intimidation threat occurs when the professional accountant is put under pressure by a client, or employer, to the extent that the professional accountant may be deterred from acting objectively.

Safeguards to reduce threats to an acceptable level

The term 'safeguards' refers to actions by the professional accountant in their attempts to either eradicate the threats to objectivity and independence in totality, or reduce such threats to an acceptable level. Safeguards can fall into two separate categories:

- Safeguards created by the professional, legislation or regulation; and
- Safeguards in the actual working environment.

Safeguards created by the profession include compliance with professional standards, including those laid down by the professional body of which the accountant/auditor is a member. There are also additional safeguards, including:

- Training and development;
- Corporate governance regulations;
- Regulatory monitoring by professional bodies; and
- External reviews.

Training and development includes training and experience requirements for entry into the profession and maintenance of those skills by undertaking Continuing Professional Development (CPD).

Regulatory monitoring includes reviews