

# HKSA adopts International Audit Independence Rules

The HKSA has issued new Independence Pronouncements in line with that used by accountancy professionals around the world. The new Professional Ethics Statement 1.203A 'Independence for assurance engagements' <<http://www.hksa.org.hk/professionaltechnical/ethics/index.php>> provides a systematic, principles-based framework for analysing independence for each assurance engagement, including new types of services that may emerge. The new Professional Ethics Guidance 1.308 'Independence for assurance engagements' <<http://www.hksa.org.hk/professionaltechnical/ethics/guidance/index.php>> provides the examples that are intended to illustrate the application of the principles in Professional Ethics Statement 1.203A to specific situations.

The new Independence Pronouncements are part of the proposed HKSA Code of Ethics which was issued in October 2002 for consultation.

The new Independence Pronouncements, effective for audits of financial statements for accounting

periods commencing on or after 1 January 2004 and for other assurance engagements, assurance reports dated after 31 December 2004, are consistent in all material respects with section 8 of the Code of Ethics for Professional Accountants issued by the International Federation of Accountants (IFAC).

## New conceptual framework to audit independence

This Framework introduces the positive requirements for members and firms to:

- consider independence before and throughout each assurance engagement;
- consider whether any threats to independence exist;
- where threats are identified, consider whether there are safeguards that exist or may be applied to eliminate the threat or reduce it to an acceptable level; and
- where safeguards are found to be inadequate, decline or discontinue the engagement.

These requirements can be illustrated in a flowchart below.

## Threats and safeguards

The new Independence Pronouncements identify five categories of threats to independence and three categories of safeguards that auditors should put in place to mitigate threats in order to preserve their independence.

### Threats to independence

- self-interest threat
- self-review threat
- advocacy threat
- familiarity threat
- intimidation threat

### Safeguards to mitigate threats

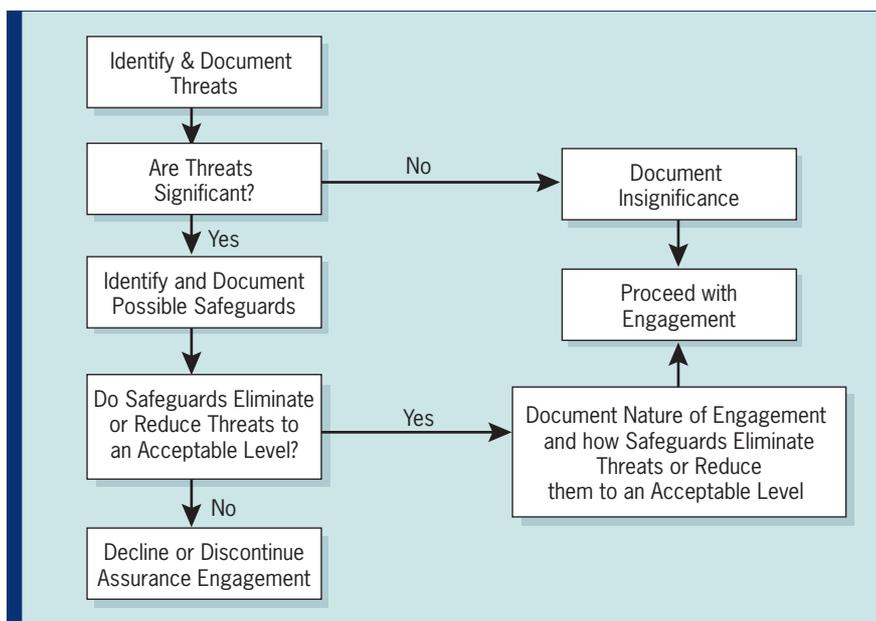
- created by the profession, legislation or regulation
- within the client
- within the audit firm's own systems and procedures



## Five categories of threats

A **self-interest threat** occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client. Circumstances that may create a **self-interest threat** include having a financial interest in the assurance client.

A **self-review threat** occurs when any product or judgement of a previous engagement needs to be evaluated in reaching conclusions on the assurance engagement, or 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. Circumstances that may create a **self-review threat** include there being 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 engagement.



An **advocacy threat** occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may be, or may be perceived to be, impaired. This would occur if the judgement of a member of the assurance team were to be subordinated to that of the client. Circumstances that may create an **advocacy threat** include the dealing in, or being a promoter of, shares or other securities of the assurance client.

A **familiarity threat** occurs when, by virtue of a close relationship with an assurance client, its director, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests. Circumstances that may create a **familiarity threat** include there being a person on the engagement team having an immediate or close family member who is a director or officer of the assurance client.

An **intimidation threat** occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client. Circumstances that may create an **intimidation threat** include the threat of being replaced due to a disagreement with the application of an accounting principle.



**Three categories of Safeguards**  
Safeguards created by the profession, legislation or regulation include:

- (a) education, training and experience requirements for entry into the profession;
- (b) continuing education requirements;
- (c) professional standards and monitoring and disciplinary processes;
- (d) practice review inspection; and
- (e) legislation governing the independence requirements of the firm.

**Safeguards within the assurance client include:**

- (a) ratification or approval of the firm's appointment by persons other than management;
- (b) employees of the client who are competent to make management decisions;
- (c) client policies and procedures that emphasise the client's commitment to fair financial reporting;
- (d) internal procedures that ensure objective choices in commissioning non-assurance engagements; and
- (e) an audit committee that provides appropriate oversight and communications regarding a firm's services.

**Safeguards within the firm's own systems and procedures include:**

- (a) firm-wide safeguards, which are primarily in the nature of policies, procedures and the like, which promote a high degree of awareness and compliance with the requirements for independence; and

- (b) engagement-specific safeguards, which include, for example, third party consultations, rotation of senior personnel, discussions with audit committees, etc.

Some safeguards, such as practice review inspection, are structural or environmental because they remain in the background of a professional accountant's thinking. Others, such as removing a particular member from the engagement team, are specifically applicable in appropriate circumstances.

**Illustration of the application of principles to specific situations**

The provision of non-assurance services is chosen to illustrate the application of the 'Threats and Safeguards' Conceptual Framework. This is set out in the Table on the next page. The paragraph references in the Table are that of Guidance 1.308.

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## Non-assurance services identified as posing a threat to audit independence

Non-assurance services	Possible threats to independence	Safeguards to protect independence
Preparing accounting records and financial statements (paras. 63 – 70)	 <p>A self-review threat may be created.</p>	 <p>Services should not be provided to listed audit clients except in emergency situations.</p> <p>In other cases, adequate safeguards may be available.</p>
Valuation services (paras. 71 – 76)	A self-review threat may be created.	<p>Services should not be provided where they involve the valuation of matters that are material to the subject matter of the assurance engagement and the valuation involves a significant degree of subjectivity.</p> <p>In other cases, adequate safeguards may be available.</p>
Internal audit services (paras. 78 – 83)	A self-review threat may be created.	<p>The audit client should be responsible for establishing, maintaining and monitoring the system of internal controls. An employee of the client should be responsible for internal audit activities, with the client approving the scope, risk and frequency of the internal audit work and which recommendations of the firm should be implemented.</p>
IT systems services (paras. 84 – 88)	A self-review threat may be created.	<p>The audit client must be responsible for establishing and monitoring a system of internal controls. The client or one of its employees should have responsibility for all management decisions concerning the design and implementation of the system, for evaluating the adequacy and results of the design and implementation, and for the operation of the system and the data used or generated by it.</p>
Temporary staff assignments (para. 89)	A self-review threat may be created.	<p>Assistance may be given provided the client is responsible for directing and supervising the activities of the firm's staff and the firm's staff will not be required to make management decisions, approve or sign agreements or similar documents, or exercise discretionary authority to commit the client.</p>
Acting for or assisting an assurance client in the resolution of a dispute or litigation (paras. 90 – 92)	An advocacy threat may be created.	<p>Except where the amounts involved are immaterial or the threat is insignificant, a firm should not provide such services to an audit client.</p>
Legal services (paras. 93 – 99)	Self-review and advocacy threats may be created.	<p>Whether the service should be provided will depend on a range of factors, including the nature of the service and whether there would be a material impact on the financial statements.</p>
Recruiting senior management for an assurance client (para. 100)	Self-interest, familiarity and intimidation threats may be created.	<p>While the firm might advertise for and interview prospective staff and produce a list of potential candidates, the decision about who should be hired is one for the client to make.</p>
Corporate finance and similar activities (paras. 101 – 102)	Advocacy and self-review threats may be created.	<p>In the case of some corporate finance services (e.g. promoting, dealing in, or underwriting an audit client's shares), the threat to independence is so significant that no adequate safeguards are available.</p> <p>In other cases, adequate safeguards may be available.</p>