

# In Practice



## Multinationals Face Tougher Rules On Auditor Independence, and a June 15 Deadline

By Cathy Allen

Audit committee members and others charged with overseeing auditors of multinational companies should maintain awareness of the global as well as local professional standards to which those auditors are subject. As part of their oversight function, audit committees should assess their auditors' independence and objectivity. For example, audit committee members should be comfortable asking the auditor how he or she ensures compliance with independence requirements. The audit committee should also be satisfied that the auditor exercises sufficient professional skepticism. For example, if the auditor is

not challenging management, this is a sign that independence might be threatened.

The International Ethics Standards Board for Accountants (IESBA) significantly enhanced, clarified, and strengthened its International Ethics Code for Professional Accountants, including International Independence Standards (henceforth referred to here as the Code), which includes the independence provisions with which auditors of multinational companies must comply. Enhancements to the Code include an increased focus on independence compliance, clearer and more robust safeguards to mitigate threats to

independence, and new guidance on professional skepticism. The Code also gives greater prominence to prohibitions on performing management responsibilities, introduces new prohibitions on recruitment services, and strengthens provisions for partner rotation.

### The Background

The International Federation of Accountants (IFAC) is a global professional accountancy organization with more than 175 members and associates in at least 130 countries and jurisdictions that serve the public interest and strengthen the

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profession by contributing to the development of strong international economies. IFAC supports four standard-setting bodies that develop global standards for ethics, auditing and assurance, education, and public sector accounting.

Members of IFAC are professional accountancy organizations, including the American Institute of Certified Public Accountants (AICPA). As a member, the AICPA agrees to adopt ethical and professional standards that are no less stringent than IFAC standards. Many of the larger global audit firms that belong to the IFAC Forum of Firms (FoF) agree to embed global professional standards, including the Code, into their firms' policies and methodologies.

Auditors of US-based multinational companies typically are subject to the Code through membership in an IFAC member professional body or the FoF. These auditors perform statutory audits under the International Standards on Auditing (ISAs), which require compliance with the Code plus (if applicable) more stringent local and national ethical requirements. Thus it's important for audit committee members—and others in similar governance roles in companies—to know that in 2018, the IESBA adopted a restructured and revised Code that becomes effective June 15, 2019.

### Three Key Messages

Changes to the Code impact its structure and applicability, conceptual underpinnings, formatting, language, and clarity. The restructured Code emphasizes three key messages:

1. Comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behavior.
2. Be independent, when required.
3. Apply the conceptual framework

to identify, evaluate, and address threats to compliance with the fundamental principles.

### Stronger Independence Standards

Professional accountants are required to be independent when performing audits, reviews, or other assurance engagements. Independence requires adherence to the fundamental principles—integrity and objectivity in particular—and the application of professional skepticism. Provisions in the Code help accountants comply with these principles in various contexts—for example, when the firm performs non-assurance services for an audit client, or a client offers employment to the auditor's spouse.

The Code expressly prohibits certain types of interests and relationships because the threats created by those interests and relationships cannot be reduced to an acceptable level by applying safeguards. However, the Code does not provide an exhaustive list of matters that could raise threats to independence. If an auditor encounters a matter that the provisions do not address, the auditor must apply the conceptual framework to identify, evaluate, and address threats to the firm's independence. If threats are not at an acceptable level, safeguards should eliminate or reduce threats to an acceptable level.

In this context, safeguards are defined as one or more actions an auditor takes to effectively reduce threats to independence to an acceptable level. "Acceptable level" means that the auditor has concluded that a reasonable and informed third party that weighs the relevant facts and circumstances would likely agree that the auditor complied with the fundamental principles.

If safeguards are not available to reduce threats to an acceptable level, the auditor should eliminate the circumstances creating the threat. If this is not possible, the

only acceptable course of action would be to decline to perform or terminate the services. For example, the auditor might determine that providing certain book-keeping assistance would create threats to independence that cannot be reduced to an acceptable level by safeguards. If the circumstances creating the threats can't be eliminated, the auditor would be expected to decline to perform those services.

Companies that are publicly traded or are listed on a recognized stock exchange are examples of public interest entities that generally warrant a heightened scrutiny of threats and are subject to more stringent independence provisions.

The IESBA strengthened several independence provisions in the Code. For example, audit personnel's long association with an audit client is subject to stricter rotation requirements, and restrictions on performing certain recruiting services now apply to all types of entities, such as privately owned or nonprofit organizations—not just public interest entities. Independence provisions distinguish requirements from application material and clarify who must perform certain actions so accountants know more clearly which provisions in the Code are mandatory versus guidance for their consideration and judgment, which was not as apparent in the previous Code.

### A Hypothetical Example

To illustrate an application of the Code's independence provisions, consider the following situation. An audit firm performs the calendar year-end consolidated audit of Verde Corp., a retail distributor of organic produce headquartered in the United States with subsidiaries located throughout Europe and Asia. The firm also performs numerous statutory audits of Verde's subsidiaries.

Verde's management is soliciting

proposals on a project to design and implement a cloud-based learning management system (LMS) that would integrate with Verde's human capital system and track compliance with internal training requirements. Could the firm provide this service to Verde while maintaining its independence under the Code?

### Evaluating Threats

The provisions on information system services indicate that "self-review" threats may arise, meaning the threat that an auditor may not appropriately address the results of the firm's previous judgments or activities. However, the firm should evaluate even more broadly whether threats to independence are at an acceptable level by considering the

- nature, scope, and purpose of the service;
- how the services would be performed;
- the extent to which the services would impact, or interact with, Verde's accounting records of financial statements;
- whether the services would have a material impact on Verde's financial statements;
- the degree of reliance (if any) the firm would place on the LMS and related systems in conducting the audit;
- whether services relate to systems that are related to internal control over financial reporting (ICFR);
- whether services relate to systems that generate information that is significant to Verde's accounting records or financial statements; or
- whether the service, coupled with other non-assurance services the firm is currently providing, would collectively create threats to independence.

### Delineating Responsibility

To avoid threats to its independence, the firm must avoid performing management

responsibilities by satisfying certain preconditions with the client's management. That is, Verde should acknowledge its responsibility for establishing and monitoring its internal control system and operating the LMS and the data it uses or generates. Verde must designate a competent person, preferably in senior management, to:

- make all management decisions with respect to the LMS's design and implementation; and
- evaluate the adequacy and results of the LMS's design and implementation.

## Enhancements to the Code include an increased focus on independence, clearer and more robust safeguards to mitigate threats to independence, and new guidance on professional skepticism.

Verde's management agrees to the preconditions and after considering the above factors, the firm concludes that threats to independence are at an acceptable level. The LMS that the firm would design and implement would integrate with Verde's human capital system to monitor employee completion of in-house training programs on food safety. These systems would not impact, or interact with, Verde's financial statements or related internal controls, which removes or greatly minimizes any threat of self-review.

### A Change to the Facts

What if the proposed services related to a procurement system that does impact Verde's financial statements, accounting

records, and related internal controls? Assume the results of the firm's services would feed into Verde's financial statements, and the impact to the financial statements would be significant. This changes the firm's response in terms of the level of self-review threat, which it now considers not to be at an acceptable level.

The firm should consider whether safeguards would sufficiently mitigate self-review threats. The Code identifies the use of separate personnel to perform the audit and non-assurance services as a possible safeguard, but that determination—and whether threats to independence would be sufficiently reduced—rests solely with the firm.

### Public Interest Entity

Let's add one more element to the equation: Verde lists its shares on a recognized stock exchange and is therefore a public interest entity. The Code prohibits auditors of public interest entities from designing or implementing an information system that generates information that is significant to the client's accounting records or financial statements on which the firm will express an opinion.

Even if the Code permitted these services, the auditor would need to consider local and national ethical requirements, which may impose more stringent requirements than the IESBA. For example, in this hypothetical example, the US Securities and Exchange Commission's independence rules would not permit the service. 

Cathy Allen is a certified public accountant with Audit Conduct LLC. She consults on independence and firm quality controls, and develops and provides education and training in professional ethics. For more information about the revised code as well as current standard-setting practices, visit [www.ethicsboard.org](http://www.ethicsboard.org).