

Alert

Updates on financial reporting and auditing



Issue 15 (August 2011)

Dear members,

Implementation of revised Code of Ethics for Professional Accountants from SMP's perspective

In this issue, we would like to update members on actions that are being taken to address SMPs concerns in regards to the implementation of revised Code of Ethics for Professional Accountants.

Special task force on adoption of revised code of ethics by SMPs

In April, a special task force on adoption of revised code of ethics by SMPs was formed bringing together members from the ethics committee and the small and medium practitioners leadership panel. The objective of the task force is to look into implementation issues faced by SMPs following the introduction of the revised code.

In order to have a better understanding of SMP's concerns, a lunch forum was held on 24 May that was attended by 300 members. Based on the information collated from questions raised at the forum, we are now working on guidance to be issued ahead of the next auditing season. The guidance will mainly focus on the issues around the provision of non-assurance services by auditors.

Click [here](#) for the presentation slides that were used at the forum.

International developments

The Institute is represented on the IFAC SMP committee and has the opportunity to see the concerns of SMPs from around the world, and some of the initiatives that are being undertaken to support SMPs. Last November, the International Ethics Standards Board for Accountants approved the formation of the IESBA SME/SMP working group to help address the unique and challenging issues faced by SMPs in complying with the IESBA Code of Ethics for Professional Accountants. So far, the group has focused on research and data gathering to identify issues for consideration. The group plans to present its recommendations to the IESBA at its October meeting.

In addition, below are the links to useful IFAC publications in respect of the IESBA code

- [IESBA staff questions and answers: implementing the code of ethics](#)
- [IFAC presentation material on overview of the code](#)
- [IFAC presentation material for independence](#)
- [IFAC presentation material for overview of independence requirements](#)
- [IESBA comparisons between the old version and the revised code](#)

Public interest entities

While we are working on the proposed guidance, we would like to take this opportunity to provide some initial views on a concern raised with us through several channels.

As you may be aware, in the revised code, there is now a definition of the term "public interest entities". The ethical requirements for auditors of public interest entities are more stringent and therefore SMPs are concerned to understand what type of entity falls within the definition.

Public interest entities, for the purpose of auditor independence, is defined in paragraph 290.25 of the code to include:

- all listed entities; and
- any entity (a) defined by regulation or legislation as a public interest entity or (b) for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.

Paragraph 290.26 of the code further requires firms to determine whether to treat additional entities, or certain categories of entities, as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered include:

- The nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders. Examples may include financial institutions, such as banks and insurance companies, and pension funds;
- Size; and
- Number of employees.

It is also stated in footnote 1b of the revised code that currently under the legislation of Hong Kong, there is no definition of public interest entity or requirement for audit of an entity to be conducted with the same independence requirements applicable to the audit of listed entities. Therefore auditors have to review their own client base and determine whether any clients, other than listed entities, should be treated as public interest entities.



Some practitioners have expressed their concerns on the practical application of paragraph 290.26 of the revised code. While there is some guidance within paragraph 290.26 there are no mandated criteria for identification of public interest entities. It is possible for different practitioners to make different determinations based on different facts and circumstances. However, it is important for practitioners to document and to be able to explain sensibly the thought process that they have gone through and judgments involved in considering whether any of their clients are public interest entities.

As is the case whenever professional judgment is exercised auditors must be prepared to explain the basis for their decision or conclusion and be prepared to defend it against challenge from regulators, and in extreme cases the courts. Practice reviewers do look at professional judgments and will question them if there is a lack of clarity leading to the conclusion reached.

One question that is often asked is whether a subsidiary of a listed entity is considered to be a public interest entity?

This is a particularly practical issue for many SMPs as there are many private company subsidiaries of listed companies in Hong Kong that engage SMPs as their auditors. Their concern is that auditors of subsidiaries of listed companies who are not also the group auditors may have to comply with the more stringent requirements of the revised code that apply to public interest entities.

Paragraph 290.25(b) of the revised code does not contain an explicit requirement for a subsidiary of a listed entity to itself be regarded as a public interest entity. Auditors should therefore exercise their professional judgment in considering whether to treat subsidiaries of listed companies as public interest entities as they would do with any of their clients under paragraph 290.26 of the revised code.

If a subsidiary of a listed entity is not a public interest entity, the requirements in the revised code relating to public interest entities (including the mandatory key audit partner rotation requirement under paragraphs 290.151-155) are not applicable to the auditor in relation to the audit of that subsidiary, subject to any specific requirements imposed by the group or group auditor. The group auditor would of course need to observe the requirements specific to public interest entities for the purpose of auditing the group's consolidated financial statements.

Should members have further enquiries about the above guidance, please send an email via the Institute's [technical enquiry system](#).

Thank you for your kind attention.

Sincere regards,

Chris Joy
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