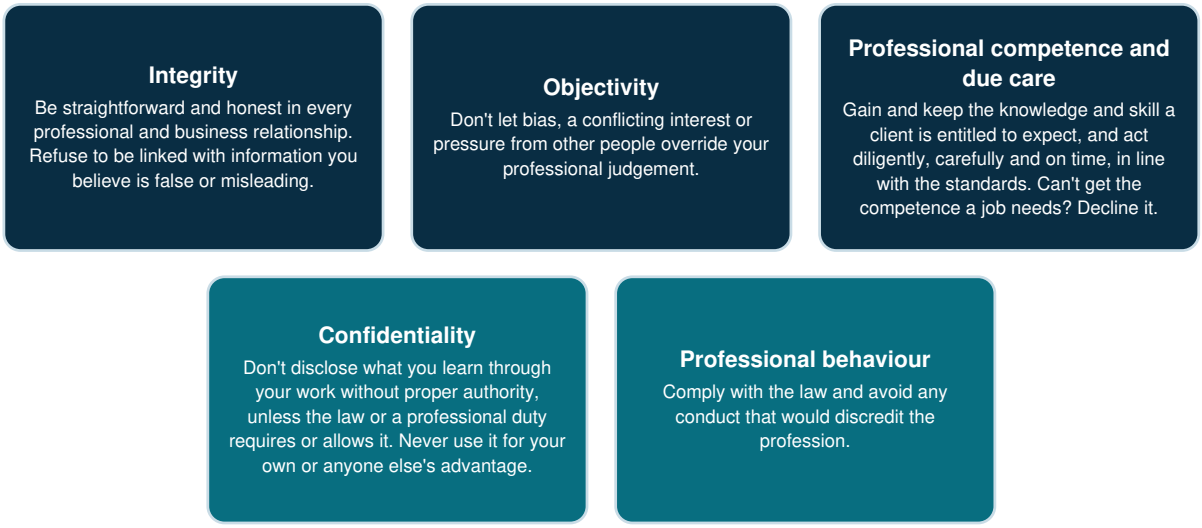
Fundamental principles, threats and safeguards

MODULE 1 | 1.2.1 | STUDENT COMPANION

Every assurance engagement rests on the Code of Ethics. Its **five fundamental principles** apply to every professional accountant. The **conceptual framework** asks you to identify threats to those principles, evaluate them through the eyes of a reasonable and informed third party, and address any that aren't acceptable. Threats come in **five types**, and independence must exist both **in mind and in appearance**. A threat is not a breach.

The five fundamental principles



Part 1 of the Code: these apply to every professional accountant, in business or in public practice

A quick map of the Code

In Australia the APESB issues the same Code, with a few local additions, as APES 110.

Part	Who it applies to, and what it covers
Part 1	Every professional accountant: the fundamental principles and the conceptual framework
Part 2	Professional accountants in business
Part 3	Professional accountants in public practice, including auditors and assurance practitioners
Part 4A	Independence standards for audit and review engagements
Part 4B	Independence standards for other assurance engagements
Part 5	Ethics and independence standards for sustainability assurance, added in 2025: in APES 110 from 1 January 2026; internationally for periods beginning on or after 15 December 2026

When confidential information may be disclosed: when the law requires it (for example, producing documents in court proceedings, or reporting a breach of the law to the proper authority); when the law permits it and the client authorises it; or when a professional duty or right applies and the law doesn't forbid it (for example, a professional body's quality review, a regulator's investigation, or defending yourself in legal proceedings). Even then, think about how much to disclose, and to whom. The duty continues after the engagement ends.

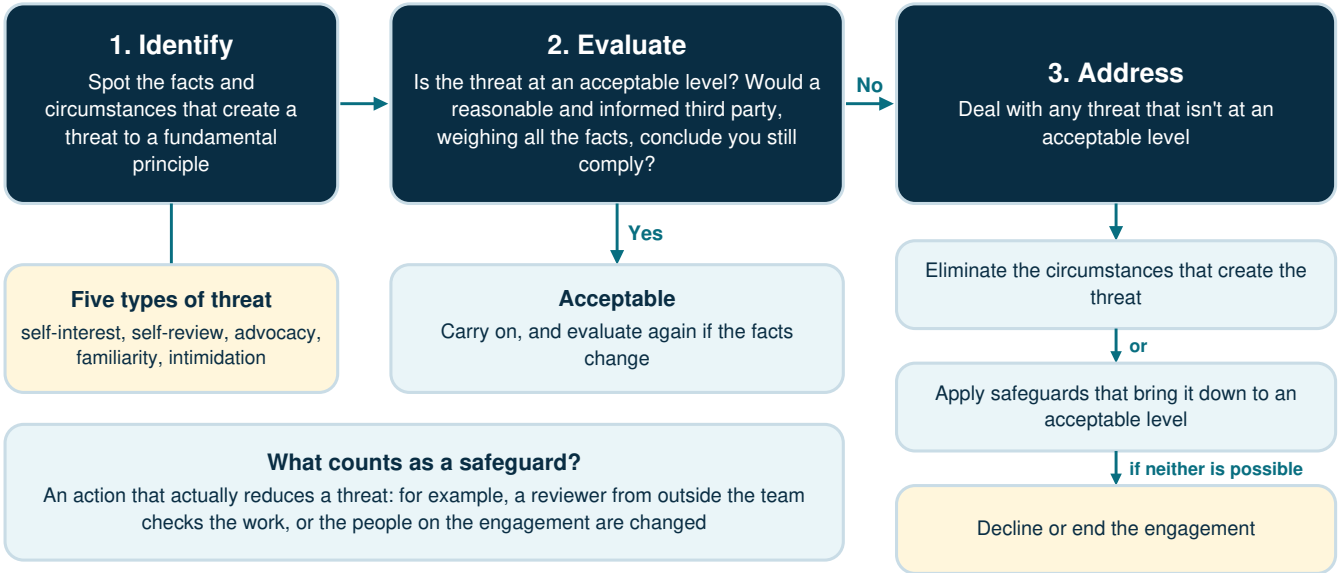
Case note: PwC Australia and the confidential tax consultations

Between 2013 and 2018, a senior tax partner at PwC Australia took part in confidential Treasury consultations about new laws targeting multinational tax avoidance: he sat on Treasury's advisory group on base erosion and profit shifting (November 2013 to June 2017) and joined consultations on the multinational anti-avoidance law and the diverted profits tax, under confidentiality agreements signed in 2013, 2016 and 2018. The Tax Practitioners Board later found that he had shared confidential information from those consultations with colleagues inside the firm, and that the information was used to win and advise clients on how to respond to the very laws being designed. In November 2022 the Board terminated his registration as a tax agent and banned him from registering again for two years; it published the decision in January 2023. When the scale of the matter became public in 2023, a Senate inquiry followed, the firm's chief executive stepped down in May 2023, and in July 2023 PwC Australia sold its government consulting business to Allegro Funds (it became Scyne Advisory).

Principles broken: confidentiality (information given in confidence was passed on and used), integrity (the conduct wasn't straightforward or honest with the government that had trusted the partner) and professional behaviour (few things discredit a profession faster). The damage reached the whole firm and public trust in the profession, not just one person.

Source: Tax Practitioners Board media release (23 January 2023); Treasury freedom of information release FOI 3269; Senate inquiry reports (2023).

The conceptual framework: three steps



Acceptable level: a level at which, in the judgement of a reasonable and informed third party, you still comply with the fundamental principles. Picture an objective outsider who weighs every relevant fact you knew, or could reasonably be expected to know; they don't have to be an accountant. The three ways of addressing a threat come in order: remove the cause if you can, reduce the threat with safeguards if you can't, and walk away if neither works.

Five types of threat, at Linden Ridge Partners

Threat	Arises when...	At Linden Ridge Partners (imagined)
Self-interest	A financial or other interest could improperly influence your judgement	One listed client's fees have grown to a fifth of the whole firm's income
Self-review	You will be evaluating your own work, or work done by your firm	The advisory team designed a manufacturer's inventory costing system; the audit team must now test the inventory figures it produces
Advocacy	You promote a client's position so far that your objectivity is compromised	The firm is asked to promote a client's shares to investors, or to represent a client in a dispute with the tax office
Familiarity	A long or close relationship makes you too sympathetic or too accepting	One client's engagement partner has led its audit for many years and holidays with its finance director
Intimidation	Actual or perceived pressure deters you from acting objectively	A chief executive hints that the firm will be replaced if it insists on an adjustment to profit

Where protection comes from

The current Code treats these as **conditions, policies and procedures** that help you identify and evaluate threats. It keeps the word **safeguard** for an action that actually reduces a threat on a particular engagement, such as rotating a partner or adding a reviewer.

Source	Examples
The profession, legislation and regulation	The Code itself; the auditing standards; the Corporations Act; ASIC's inspections; education and professional development requirements
The client's environment	An audit committee that oversees the auditor's appointment and approves any non-audit work; competent client staff who make the management decisions
The firm	Independence policies; partner rotation; reviews by partners outside the team; monitoring of whether staff hold shares in clients

Applying it at Linden Ridge: rotating the engagement partner and adding an independent reviewer could reduce the familiarity threat. For the fee dependence, a professional accountant from outside the firm might review the audit work before the report is issued. Because the client is listed (a public interest entity), the Code's fee rules also apply (periods beginning on or after 15 December 2022):

- fees are, or are likely to be, more than 15% of the firm's total fees: the firm must tell those charged with governance (here, the audit committee);
- above 15% for two years in a row: the firm must consider a pre-issuance review by a professional accountant from outside the firm, and the fee dependence must be publicly disclosed;
- above 15% for five years in a row: the firm must stop being the auditor, except in rare cases with a compelling public interest reason to continue.

Independence: in mind and in appearance

Both are needed: an honest auditor who looks compromised still damages the value of the opinion. In Australia, ASIC is responsible for surveillance and enforcement of auditor independence under the Corporations Act; Module 2 covers the legal rules, including partner rotation.

	Independence of mind	Independence in appearance
What it is	The state of mind that lets you reach a conclusion without being affected by influences that compromise your judgement	Avoiding facts and circumstances so significant that your integrity, objectivity or scepticism would seem compromised in the eyes of a reasonable and informed third party
What it allows	Integrity, objectivity and professional scepticism in the decisions you actually make	Users' trust in the opinion, which rests partly on their belief that the auditor is independent
Who can see it	Only you	Investors, regulators and the public

Threat or breach? Threats are a normal part of professional life. A breach happens when a threat isn't identified and dealt with, or when you do something the Code prohibits, such as an audit team member holding shares in the audit client.

Practice questions

MODULE 1 | 1.2.1 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Name the threat and the principle under pressure

Situation (all firms are imagined)	Threat type	Principle
(a) An audit manager at Quill & Merrow inherits units in a property trust that the firm audits, and plans to keep them for the income.		
(b) Bramblecote Accountants valued a client's investment properties for its financial statements. Its audit team will now audit those values.		
(c) A partner at Ferrier Lowe tells a radio interviewer that an audit client's new bond issue is 'the safest investment in the state'.		
(d) At Ostler Grey, a tax manager's brother-in-law, who runs a rival business, keeps asking him about a client's profit margins.		
(e) A client's finance director tells Ashdown Pell's audit manager that the firm will lose the tax work unless a large loan to the managing director is shown as an ordinary trade receivable.		
(f) To win its first listed audit, Merriden & Co quotes a fee covering only about 60% of the hours its own budget says the work needs.		

Question 2 - Apply the conceptual framework

Theo Tolland is the audit senior on the audit of Corrowa Freight (imagined), a road transport company. His domestic partner, Jarrah, has just started work in Corrowa's payroll team, processing the weekly wages of its 300 drivers. Wages are Corrowa's largest expense, and the audit plan gives Theo the payroll testing. Apply the three steps of the conceptual framework: identify the threats, evaluate them, and explain how they should be addressed.

Question 3 - When confidentiality and integrity fail together

Using the PwC Australia case, explain how a breach of confidentiality can also be a breach of integrity. Refer to what each principle requires.

Worked answers

MODULE 1 | 1.2.1 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Threats and principles

Situation	Type of threat	Principle under pressure
(a) Inherited units in an audit client	Self-interest: the income gives her a reason to favour the trust	Objectivity (independence): sell the units promptly or leave the team
(b) Auditing its own valuations	Self-review: the firm would be checking its own work	Objectivity (independence)
(c) Praising a client's bonds on radio	Advocacy: promoting the client's securities	Objectivity, and professional behaviour
(d) Questions from a brother-in-law	Familiarity: a close family tie (intimidation if he applies pressure)	Confidentiality
(e) Threat to the tax work	Intimidation: pressure to accept a misleading disclosure	Integrity (being linked to misleading information) and objectivity
(f) Fee far below the budget	Self-interest: a temptation to cut corners to protect the margin	Professional competence and due care

Question 2 - Theo Tolland and Corrowa Freight (sample answer)

- **Identify:** Jarrah is Theo's immediate family member (a domestic partner counts as a spouse). Testing the payroll she helps process creates a **self-interest** threat (he may want to protect her job), a **familiarity** threat (he may be too ready to accept her work) and possibly an **intimidation** threat to his objectivity, scepticism and independence; confidentiality is also at risk.
- **Evaluate:** it depends on both roles. If Jarrah could exert significant influence over the accounting records or the financial statements (say, as payroll manager posting the wages journals), the Code bars Theo from the audit team. As a new wages officer she probably can't, but wages are the largest expense and Theo would test her work directly, which a reasonable and informed third party is unlikely to accept.
- **Address:** Theo tells the engagement partner at once. **Eliminate** the threat by taking him off the team (required if Jarrah has significant influence), or apply **safeguards**: give the payroll testing and anything touching Jarrah's area to another team member, with review by an appropriate reviewer. If neither works, Theo comes off the engagement. Document the decision and evaluate again if Jarrah's duties change.

Question 3 - Confidentiality and integrity in the PwC case

Confidentiality forbids disclosing information gained through professional work without proper authority, or using it for anyone's advantage. The partner received Treasury information under confidentiality agreements and passed it to colleagues, who used it to win and advise clients. **Integrity** requires you to be straightforward and honest in every professional relationship. The government let him into the consultations because it trusted him; taking part while passing the content on was not straightforward or honest with that party. So one course of conduct breaches both principles, and professional behaviour too.