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Agenda Item

2

Committee: Ethics
Meeting Location: New York
Meeting Date: February 14-15, 2005

Code Exposure Draft

Objective of Agenda Item

To approve the changes to the Revised Code of Ethics.

Overview

At its September 2004 meeting, the Ethics Committee approved revisions to the Code of Ethics to conform to:

- the independence section to the *International Framework for Assurance Engagements* (Assurance Framework) issued by the International Auditing and Assurance Board (IAASB);
- definition in ISQC1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance Related Services Engagements* (ISQC1) issued by the IAASB; and
- require rotation of the individual responsible for the engagement quality control review.

The Exposure Draft (ED) was issued in October 2004. The Committee determined that it was appropriate to re-issue the whole Code in the ED because this would enable readers to understand the independence section in context of the changes that will be made to the entire Code. While, the ED contained all of the Code, comments were requested on only those points noted above.

There were 27 responses to the ED (a complete listing of the respondents is contained in Appendix 1 to this agenda paper.) A detailed cut and paste of comments sorted by topic is contained in Agenda Paper 2-B, and a PDF file of all the comment letters is contained in Agenda Paper 2-C (Parts 1 and 2). Throughout this paper respondents comments have been either quoted or summarized – where relevant a reference to a particular respondent is provided in [square brackets]. The number after the respondent's initials refers to the comment number contained in Agenda Paper 2-B.

While the Committee requested comments on only certain specific changes, some respondents did comment more broadly, and in particular on the continued appropriateness of the independence requirements contained in Section 290. These broader comments [123-145] are not considered as part

of this agenda item. The Task Force that is considering which parts of the independence requirements need to be revisited will consider these points.

Conforming to Assurance Framework

While five respondents commented that the changes to conform to the assurance framework were clear and appropriate, the majority of respondents felt that the changes made were not clear with respect to the application to assurance engagements that were non-financial statement audit engagements. These respondents commented on two issues:

- Linkage to the Assurance Framework; and
- Application to direct reporting engagements.

No respondent expressed concern with the treatment of financial statement audit engagements.

A working group was formed to consider the comments received on how the ED conformed to the framework for assurance engagements that are not financial statement audit engagements. The working group comprised:

- Peter Hughes
- Neil Lerner
- Andrew Pinkney
- Jan Munro (staff)

The working group recognizes that, at its September meeting, the Committee was concerned with the complexities that had been created by addressing assertion-based and direct reporting engagements. In responding to the comments received on exposure the working group tried to develop a simple solution. However, if as respondents requested, the Code is to address both types of engagements one test does not fit all situations, because of the wide variety of different types of assurance engagements. Accordingly, it has been necessary to re-introduce some complexity into the Code. However, the working group believes that, as demonstrated below, it has developed a logical basis for the approach taken. The group has also developed some examples to illustrate the application of the proposal. As discussed below, the working group believes that it would be useful to issue an explanatory memorandum/discussion paper with the revised Code that includes the logic and provides examples.

Linkage to the Assurance Framework

Respondents noted that the terms “subject matter” and “subject matter information” were difficult terms to understand and were not clearly explained in the Code. While respondents recognized that the terms were from the Assurance Framework, they believed that greater guidance on these terms should be contained in the Code. Various alternatives for providing such guidance were suggested:

- Provide a reference to the appropriate paragraph of the Framework [CNCC 31, OAGNZ 33, IDW 38]
- Provide definitions of subject matter and subject matter information in the Code [ICANZ 34, FEE 35]
- Introductory paragraph in the code should include a short discussion of key terms and readers should be advised that it is necessary to refer to the Framework for a complete understanding of the key terms and assurance engagements [PwC 40]

- The terms should be clarified, preferably by way of example [CICA – PIIC 30].

The Framework describes, but does not define, subject matter and subject matter information. Therefore, it might be problematic if the Code defined these terms.

While a cross-reference from the Code to the Framework would help practitioners understand that the Framework establishes what is meant by the terms a reader would have to go to the Framework for any guidance as to what these terms mean.

The Framework does provide some examples of subject matter and subject matter information, For example paragraph 8 states that:

“The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as International Financial Reporting Standards, (criteria) to an entity’s financial position, financial performance and cash flows (subject matter).”

The Framework also provides an example of an assertion-based engagement where there the responsible party is responsible for the subject matter information but not the subject matter (Framework paragraph 25(b)).

It would be useful to provide additional examples of assurance engagements that illustrate the difference between a direct reporting engagement and an assertion-based engagement, differentiate between subject matter and subject matter information, and describe situations where the party responsible for the subject matter information is not responsible for the subject matter. However, such examples illustrate the application of the Framework rather than the application of the Code – and as such are best developed by the IAASB rather than the Ethics Committee. The chair of the Ethics Committee wrote to the Chair of the IAASB on this matter in November 2004.

To address the comments received it is proposed that Section 290 contain a short discussion of the key terms and provide a reference back to the Framework with a statement that for a full understanding of the elements and objectives of an assurance engagement is necessary to refer to the Framework.

Action required

Do Committee members agree with the additional language in ¶290.7a-e?

Application to Direct Reporting Engagements and Assertion Based Engagements

Paragraph 290.10 of the ED states:

In some assurance engagements that are not financial statement audit engagements there are two responsible parties. In such engagements, the members of the assurance team and the firm are required to be independent of the assurance client (the party responsible for the subject matter information). In addition, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

Seven respondents commented on the application of this paragraph to direct reporting engagements. The comments were:

- In a direct reporting engagement the practitioner may directly perform the evaluation or measurement of the subject matter, the practitioner will then be the party responsible for the subject matter information. This paragraph therefore appears to prohibit such engagements. Respondents questioned whether this was intended. [CICA-PIIC 42, CICA-AASB 48, IAASB 45]
- The guidance should provide specific guidance on direct reporting engagements – without such guidance practitioners will not be able to evaluate their independence in the context of these engagements [D&T 43, KPMG 46, PwC 47]

Given the comments received, the working group felt it was appropriate to re-consider the Committee's previous decision to provide no reference in the Code to direct reporting engagements.

As drafted, paragraph 290.10 of the ED could be read as precluding the practitioner from performing direct reporting engagements. It was not the intention of the Committee to prohibit such engagements. Rather the intention of the Committee was to focus the guidance contained in the Code on assertion-based engagements because these engagements comprise the vast majority of assurance engagements performed by practitioners. The Committee was concerned that providing specific guidance for direct reporting engagements would overly complicate the Code. However respondents have requested guidance for such engagements.

In considering the appropriate independence requirements for assurance engagements that are not financial statement audit engagements the working group compared and contrasted assertion-based and direct reporting engagements.

Paragraph 10 of the Framework provides the following description of direct reporting engagements and assertion-based engagements:

In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called "assertion-based engagements."

In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements."

Paragraphs 25 and 26 of the Framework provide the following guidance on the subject of the responsible party:

The responsible party is the person (or persons) who:

- (a) In a direct reporting engagements, is responsible for the subject matter; or
- (b) In an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter. An example of when the responsible party is responsible for both the subject matter information and the subject matter, is when an entity engages a practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices. An example of when the responsible party is responsible for the subject matter information but not the subject matter, is when a government organization engages a practitioner to perform an assurance engagement regarding a report about a private company's sustainability practices that the organization has prepared and is to distribute to intended users.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

The responsible party ordinarily provides the practitioner with a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. In a direct reporting engagement, the practitioner may not be able to obtain such a representation when the engaging party is different from the responsible party.

In a direct reporting engagement and in an assertion-based engagement it is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in the assurance report [Framework ¶8]. Also the form of reporting might be the same – Framework ¶57 provides that the report in an assertion-based engagement can be worded in terms of the responsible party's assertion or directly in terms of the subject matter and criteria. In a direct reporting engagement the conclusion will always be worded in directly in terms of the subject matter and criteria.

In both assertion-based engagements and direct reporting engagements there could be more than one responsible party.

There are in effect two categories of direct reporting engagements:

- An engagement where the responsible party provides the practitioner with a written representation that evaluates or measures the subject matter against the identified criteria. These appear to be the most common type of direct reporting engagement as the Framework ¶26 states that the practitioner “ordinarily” obtains such a representation. This representation, which is essentially the same as an assertion by the responsible party, might or might not be available as an assertion to the intended users; and
- An engagement where the practitioner may not be able to obtain such a representation and therefore directly evaluates or measures the subject matter.

A direct reporting engagement where a written representation is prepared is very similar to an assertion-based engagement where the responsible party is also responsible for the subject matter. In both engagements:

- The responsible party evaluates or measures the subject matter against the identified criteria; and
- The practitioner gathers sufficient appropriate evidence about the subject matter information to provide a reasonable basis for expressing a conclusion in the report.

The practitioner's report might even be the same if the practitioner in the assertion-based engagement words the conclusion directly in terms of the subject matter or criteria.

Given the engagements are essentially the same, it is logical that the independence requirements should also be comparable.

Having identified the similarities and differences between the engagements, the working group concluded that independence requirements should consider and address the following aspects of various types of assurance engagements:

- Engagements where there are multiple responsible parties;
- Independence requirements for assertion-based engagements should be the same as independence requirements for direct reporting engagements where there is a written representation that evaluates or measure the subject matter against the identified criteria; and
- Direct reporting engagements where there is no such written representation.

Multiple Responsible Parties

In both assertion-based engagements and direct reporting engagements there may be several responsible parties. For example, a firm may be asked to provide assurance on the monthly circulation statistics of a number of independently owned newspapers. The assignment could be an assertion based engagement where each newspaper measures its circulation and the statistics are presented in an assertion that is available to the intended users. Alternatively, the assignment could be a direct reporting engagement, where there is no assertion and there may or may not be a written representation from the newspapers.

The working group considered the parties from which independence should be required. The working group concluded that as the number of responsible parties increases, the potential threat to independence created by an interest in or relationship with one responsible party likely decreases, irrespective of whether the engagement is assertion-based or direct reporting.

Consider the following example:

A firm is engaged to provide assurance on the circulation statistics of the following:

| | Circulation |
|-------------|-------------|
| Newspaper 1 | 250,000 |
| Newspaper 2 | 300,000 |
| Newspaper 3 | 150,000 |

| | |
|-------|---------|
| Total | 700,000 |
|-------|---------|

The working group concluded that in such an engagement because the circulation of each newspaper is material to the total circulation, independence would be required from all three responsible parties (i.e. all three newspapers).

However if there were several hundred independently owned newspapers, an interest or relationship with the ownership of one of the newspapers would not automatically create a threat to independence that was so significant that no safeguard could reduce the threat to an acceptable level. For example:

| | Circulation |
|-----------------------|-------------|
| Newspaper 1 | 250,000 |
| Newspaper 2 | 300,000 |
| Newspaper 3 | 150,000 |
| Newspaper 4 | 2,250 |
| Newspaper 5, 6, 7 etc | |
| Newspaper 100 | 19,000 |
| Total | 1,400,000 |

The working group concluded that in the above engagement an interest in or relationship with the entity that owned newspaper 4 would not automatically create a threat to independence that was so significant no safeguard could reduce the threat to an acceptable level. Newspaper 4 accounts for only 0.16% of the circulation statistics.

New paragraph 290.9 contains text explaining that, in engagements where there are many responsible parties, when determining the parties from which independence is required, consideration may be given to the materiality of the subject matter (or subject matter information) for which a particular party is responsible.

Action required

Do Committee members agree with the position taken and additional language in ¶290.9?

Assertion-based and Direct Reporting with a Written Representation

As noted above, an assertion-based engagement is very similar to a direct reporting engagement where the responsible party that has performed the evaluation or measurement of the subject matter provides a written representation to the practitioner. In both engagements:

- The responsible party evaluates or measure the subject matter against the identified criteria; and

- The practitioner gathers sufficient appropriate evidence about the subject matter information to provide a reasonable basis for expressing a conclusion in the report.

Given the engagements are essentially the same, it is logical that the independence requirements should also be comparable. In both circumstances, the practitioner should be independent from the responsible party. As stated in the Assurance Framework this is the person who:

- In a direct reporting engagement, is responsible for the subject matter; and
- In an assertion-based engagement, is responsible for the subject matter information and may be responsible for the subject matter.

Action required

Do Committee members agree with the position proposed in paragraphs 290.9 and 290.10a?

Direct reporting Engagements with no Written Representation

The Code states that a self-review threat may occur when a previous judgment needs to be re-evaluated by the professional accountant responsible for that judgment. In a direct reporting engagement when no representation is available from the responsible party that has performed the evaluation or measurement of the subject matter, the practitioner directly evaluates or measures the subject matter. In such cases a self-review threat will be created because, when gathering sufficient appropriate evidence about the subject matter information, the practitioner will need to re-evaluate the judgments made when evaluating or measuring the subject matter. The significance of the threat created will depend on the degree of judgment that is required to evaluate or measure the subject matter.

Assurance engagements potentially cover a wide range of engagements with subject matter and criteria that may take many forms. While the Framework states that the subject matter must be appropriate and the criteria must be suitable there is still a wide range of subject matters and criteria that will affect the significance of any self-review threat created. For example, as noted in the Framework [¶35], if the subject matter is customer satisfaction, the criteria could be the number of customer complaints resolved to the acknowledged satisfaction of the customer. If a practitioner were engaged to perform a direct reporting engagement, the degree of professional judgment needed to evaluate whether the complaints were resolved to the customer's acknowledged satisfaction would be less than, for example, the degree of professional judgment needed to apply the criteria of IFRS to an entity's financial position, financial performance and cash flows. If significant judgment is needed to apply the criteria it is possible that the self-review threat created in a direct reporting engagement where the practitioner directly evaluates or measures the subject matter would be so significant no safeguards would be available to reduce the threat to an acceptable level.

This concept is already incorporated in ¶290.175 of the ED that states:

If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the financial statement audit engagement.

Therefore, for direct reporting engagements where there is no written representation from the responsible party that has evaluated or measured the subject matter, there should be a statement that the professional accountant should consider because the professional accountant is directly evaluating or measuring the subject matter safeguards are available to reduce any self-review threat to independence to an acceptable level. This is contained in new paragraph 290.10a.

Action required

Do Committee members agree with the proposal and the additional language in ¶290.10a?

In some assertion-based engagements the responsible party may not be responsible for the subject matter. The proposal will require independence from the responsible party (who is responsible for the subject matter information). This leaves the issue of whether independence is required from the party responsible for the subject matter. It is proposed that depending upon the engagement circumstances, threats to independence could be created by relationships with and interests in this party. Accordingly, it is appropriate for the practitioner to be required to consider whether any threats are created by relationships with or interests in the responsible party.

Action required

Do Committee members agree with the proposal and language contained in ¶290.9a and 290.10?

Several ED respondents stated that it would be useful to illustrate the proposals by way of example. While it is up to the IAASB to determine whether specific examples of assurance engagements should be developed, the following examples might be useful to the Committee to consider the cumulative effect of the above proposals. In all cases it is assumed that the engagement is an assurance engagement and therefore is within the scope of the Framework.

Example 1

A firm is engaged by a company to audit the financial statements of the company. The engagement is an assertion-based engagement with the assertion provided by management of the company.

The assurance team, the firm and any network firms are required to be independent of the company (¶290.8)

Example 2

A firm is engaged by a company to provide assurance on the company's sustainability practices. The engagement is an assertion-based engagement with the assertion provided by the management of the company.

The assurance team and the firm are required to be independent of the company (¶290.8).

Example 3

A firm is engaged by a company to provide assurance on the company's sustainability practices. The engagement is a direct-reporting engagement with the company providing a written representation that evaluates or measures the company's sustainability practices against identified criteria.

The assurance team and the firm are required to be independent of the company (the party responsible for the subject matter) (¶290.10).

Example 4

A firm is engaged by a company to provide assurance on the company's sustainability practices. The engagement would be a direct reporting engagement but the company will not provide the firm with a written representation that evaluates or measures the company's sustainability practices against criteria. The firm would directly evaluate or measure the sustainability practices.

Before accepting the engagement the professional accountant in public practice should evaluate the significance of any threat that may be created and determine whether appropriate safeguards would be available to eliminate the threat or reduce it to an acceptable level. In considering the self-review threat the significance of the threat will depend on the degree of judgment needed to evaluate or measure the sustainability practices against the identified criteria. If the professional accountant in public practice concludes that appropriate safeguards are available to adequately reduce the self review threat, for example by using one team to evaluate or measure the sustainability practices and using a separate team to gather sufficient appropriate evidence about the subject matter information, and accordingly the engagement is accepted, the assurance team and the firm are required to be independent of the company (the party responsible for the subject matter) (¶290.10a)

Example 5

A firm is engaged by OPEC to provide assurance on the proven reserves of member countries. Each member country has conducted geographical and engineering surveys to determine their reserves (subject matter), OPEC has established the criteria which determine when a reserve may be considered to be proven (criteria).

OPEC has eleven member countries and at December 31, 2003 the proven reserves for each country were as follows:

| | Proven reserves mb |
|----------------------|--------------------|
| Algeria | 11,800 |
| Indonesia | 4,722 |
| IR Iran | 133,250 |
| Iraq | 115,000 |
| Kuwait | 99,000 |
| SP Libyan AJ | 39,126 |
| Nigeria | 35,355 |
| Qatar | 15,207 |
| Saudi Arabia | 262,730 |
| United Arab Emirates | 97,800 |
| Venezuela | 77,226 |
| Total | 891,116 |

The engagement could be structured in differing ways:

Assertion based engagements

A1 The national oil company in each member country measures the reserves of that country and provides an assertion to the firm and to intended users

A2 OPEC measures the reserves and provides an assertion to the firm and to intended users

Direct reporting engagements

D1 The national oil company in each country provides the firm with a written representation that measures the countries reserves against the OPEC criteria for measuring proven reserves. The representation is not available to the intended users.

D2 Some or all of the national oil companies of the member countries are not able to provide the written representation and accordingly the firm would directly measure the reserves of some or all of the member countries.

Application of approach

A1 Each national oil company measures the reserves of that country and provides an assertion to the firm and to intended users.

There are several responsible parties in this engagement. When determining whether it is necessary to apply the independence provisions to all of the responsible parties the firm may take into account the materiality of the subject matter information for which a particular party is responsible in determining whether it is necessary to apply the independence requirements to each responsible party (¶290.9). For example Indonesia accounts for 0.5% of the reserves, therefore a business relationship or interest

with the national oil company of Indonesia would create less of a threat than a similar relationship with Saudi Arabia which accounts for approximately 30% of the reserves.

Having determined those national oil companies to which the independence requirements apply, the assurance team and the firm are required to be independent of the assurance client (those national oil companies, which are responsible for the subject matter information) (¶290.9a)

A2 OPEC measures the reserves and provides an assertion to the firm and to intended users.

The firm would be required to be independent of OPEC who is the responsible party (¶290.10). OPEC is not responsible for the subject matter and so consideration should be given to any threats the firm has reason to believe may be created by interests/relationships with the parties responsible for the subject matter. (¶290.10) There are several parties responsible for the subject matter and the significance of any threats will depend on the materiality of the subject matter to the subject matter information taken as a whole.

D1 The national oil company of each country provides the firm with a representation that measures the reserves against the OPEC criteria for measuring proven reserves. The representation is not available to the intended users.

There are several responsible parties in this engagement. When determining whether it is necessary to apply the independence provisions to all of the responsible parties the firm may take into account the materiality of the subject matter for which a particular party is responsible in determining whether it is necessary to apply the independence requirements to each responsible party (¶290.9). For example Indonesia accounts for 0.5% of the reserves, therefore a business relationship or interest with the national oil company of Indonesia would create less of a threat than a similar relationship with Saudi Arabia which accounts for approximately 30% of the reserves.

Having determined those national oil companies to which the independence requirements apply, the assurance team and the firm are required to be independent of the assurance client (those national oil companies, which are responsible for the subject matter) (¶290.10a)

D2 Some or all of the member countries are not able to provide the representation and accordingly the firm would directly measure the proven reserves of some of all member countries.

In determining whether to accept such an engagement the firm would consider the potential threats to independence. The significance of any such threats will depend upon the degree of judgment that is needed to measure whether the reserves are proven. If the OPEC criteria are relatively straight forward and easy to apply this would indicate a lower threat to independence as compared to criteria that were more subjective and involved significant judgment. (¶290.10a)

There are several responsible parties in this engagement. When determining whether it is necessary to apply the independence provisions to all of the responsible parties the firm may take into account the materiality of the subject matter for which a particular party is responsible in determining whether it is necessary to apply the independence requirements to each responsible party (¶290.9).

The interrelationship between ¶290.9 and ¶290.10a is that even if the criteria were complex and required a significant degree of judgment, the firm could conclude that that it could perform a direct-reporting engagement even though it would not be able to obtain written representation from the national oil company of each member country. For example, if the criteria were complex and all the countries other than Indonesia were able to provide a written representation that measured the reserves against the OPEC criteria, the firm might conclude that because the Indonesian reserves account for less than 0.5% of the total reserves, the potential self-review threat created by the firm directly measuring the reserves could be reduced to an acceptable level by safeguards – even though significant judgment is needed to measure the reserves.

Action requested

Committee members are asked to consider the examples and confirm that the examples demonstrate that the approach taken is logical and internally consistent.

Additional Guidance

The working group is of the view that the examples and explanation presented above are very useful tools to explain the rationale of the position proposed. The working group believes that it would be useful if the explanation is available to those who have to use the Code. It would not be appropriate to include all of the explanation in the Code. Therefore, the group recommends that an explanatory memorandum/discussion paper be issued at the same time as the revised Code.

Action requested

Committee members are asked to consider whether such an explanatory memorandum/discussion paper should be issued.

If Committee members believe that such a document should be issued, Committee members are asked to consider an appropriate process for development and approval. Committee members may wish to consider asking the Task Force to perform the detailed review of a staff draft, after which it is circulated for comment to the full committee with the Chair having the responsibility for final approval.

Definitions

In light of the proposed changes above the definition of an assurance client needs to be changed because the examples in 290.100 refer to the assurance client. The ED definition of assurance client was:

The party responsible for the subject matter information.

(For an assurance client that is a financial statement audit client see the definition of financial statement audit client).

The definition needs to incorporate direct reporting and assertion-based engagements. The following definition is proposed. It is consistent with ¶25 of the Framework.

Assurance client The responsible party that is the person (or persons) who:
 (a) In a direct reporting engagement, is responsible for the subject matter; or
 (b) In an assertion-based engagement, is responsible for the subject matter information and may be responsible for the subject matter.

Action requested

Committee members are asked to consider whether the revised definition is appropriate.

Communication with the IAASB

Several respondents noted that the challenges of drafting the ED reflected the difficulties that the Ethics Committee had in interpreting the framework. These respondents commented that it would be useful for the Ethics Committee to communicate these difficulties to the IAASB, so that their implications for the Framework can be considered. Some respondents also expressed concern with how to interpret the Framework. [D&T-49, FEE-50, IOSCO-51, KPMG-52, PwC-53]

At the instruction of the Ethics Committee, the Ethics Chair informed the IAASB Chair of the difficulties the Committee faced in interpreting the framework and stated that it would be particularly helpful if the IAASB developed some specific types of examples of different types of assurance engagements that:

- Illustrated the difference between an assertion-based and a direct reporting engagement;
- Distinguished between subject matter and subject matter information; and
- Described engagements where there are two different responsible parties.

This paper contains examples of such engagements and it is proposed that these examples and the independence implications, are included in an explanatory memorandum to be issued with the Code.

Action requested

Committee members are asked to consider whether further communication with the IAASB on this topic is appropriate and if so what form it should take.

Partner Rotation

The ED proposed extending the partner rotation requirements applicable to the engagement partner to the individual responsible for the engagement quality control review (EQCR).

When IAASB exposed ISQC 1 it proposed rotation of the engagement quality control reviewer. Through discussions with the IAASB it was agreed that the Code, and not ISQCs, should establish rotation requirements.

17 respondents commented on this proposal. Ten were supportive of the proposal stating that this provides for objectivity in the review process and avoids familiarity with the client and/or the engagement partner, [AGA-60, ACAG-61, ACCA-62, AICPA-63, CNCC-OEC-64, ICANZ-65, ICPAS-66, PwC-67, JICPA-68, D&T-69]

Two respondents stated that rotation of the EQCR was not necessary, stating that the individual has no direct contact with the client, and as such any threat would not be significant and as such rotation is not required [AAT-70, CPA-Aus-71].

Five respondents noted that rotation of the EQCR is appropriate as the “ultimate” safeguard when no other safeguards would be available to reduce the threat to an acceptable level – but it should not be mandatory. The respondents made the following comments:

- EQCR generally do not maintain close contact with management and accordingly the familiarity threat would not be significant [FEE-73, FSR-74, IDW-75]
- Requiring the EQCR to rotate would be problematic in some jurisdictions where there are a limited number of professionals with the relevant expertise and would be difficult for small firms with few people with listed entity experience [FAR-72, FEE-73, IDW-76, MIA-77]

¶290.153 states that for the financial statement audit of listed entities the engagement partner and the individual responsible for the engagement quality control review should be rotated after serving in either capacity, or a combination thereof, for a pre-defined period of time, normally no more than seven years.

¶290.155 further states that while these individuals should be rotated after a pre-defined period, some degree of flexibility over timing of rotation might be necessary in certain circumstances. An example of such a circumstance is when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard. If the person is not rotated after a pre-defined period equivalent safeguards should be applied to reduce any threats to an acceptable level.

Action requested

Committee members are asked to consider the comments received on rotation of the EQCR and determine whether any changes should be made to the position taken in the ED.

Gifts and Hospitality

Two respondents [D&T-101, AICPA 102] noted that Sections 260, which applies to all professional accountants in public practice, and Section 350, which applies to all professional accountants in business, appear to be inconsistent with 290.212 which is applicable only to assurance clients.

¶290.212 states:

“Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.”

Section 260 states that an offer of gifts and hospitality from a client ordinarily gives rise to threats to compliance with the fundamental principles. (¶260.1) The significance of the threat depends on the nature, value and intent behind the offer. If a reasonable and informed third party would consider the gifts/hospitality to be clearly insignificant the accountant may conclude there is no significant threat to compliance with the fundamental principles. (¶260.2) If evaluated threats are other than clearly insignificant, an accountant should not accept the offer. (¶260.3)

Therefore if a reasonable observer would not conclude the gift to be clearly insignificant, the option of applying safeguards to reduce the threat to an acceptable level is not available.

One respondent proposes the following changes to address the issue:

¶260.3

If evaluated threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Where the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in public practice should not accept such an offer.

¶350.4

If evaluated threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Where the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in business should not accept the inducement.

Action requested

Committee members are asked to consider the proposed change to ¶260.3 & ¶350.4.

Other issues

Review Engagements

One respondent [IAASB-59] commented that the independence requirements for audits should be extended to review engagements. The most significant implication of such an extension would be that network firms would be required to be independent from a review client. As stated in 290.8:

“Financial statement audit engagements are relevant to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance. Accordingly, for financial statement audit client, the members of the assurance team, the firm and network firms are required to be independent of the financial statement audit client.”

Review engagements are not relevant to a wide range of potential users and therefore do not have the particular public interest associated with financial statement audit engagements. Accordingly, it is not appropriate to extend the audit independence requirements to review engagements.

Reference to National Standards

One respondent [IAASB-59] recommended that the definition of financial statement financial audit engagement refer to national standards. No change is proposed. The definition of financial statement audit in the ED is substantially the same as the definition of audit client in the Code and states that it is an engagement:

“...such as an engagement conducted in accordance with International Standards on Auditing. This includes a Statutory Audit, which is a financial statement audit required by legislation or other regulation.”

Accordingly no change is proposed.

Continuous process

Several respondents noted that review of the Code is and should be a continuous process (FEE-14, FAR-9, FSR-12, CNCC-113] One respondent noted that it would be useful for the Code to contain a statement that review of the Code is a continuous process. No change proposed.

Repeated Comments

Some respondents raised comments on parts of the Code on which comment had not been requested. The full Code, other than then Section 8, was exposed in 2003 and at its three meetings in 2003, the Ethics Committee carefully considered all of the comments raised. The Committee only re-exposed the entire Code because it felt that respondents needed to see the changes to the independence section in the context of the whole Code. Because these comments have already been deliberated by the Committee further re-deliberation is not considered necessary. The comments are:

[IDW-103-107, IDW 109-111, IDW-117]

Action requested

Committee members are asked to consider whether they agree with the proposed disposition of these “other issues”.

Effective Date

The ED proposed an effective date of December 31, 2005.

Twenty respondents commented on the effective date with all but one [AICPA-99] stating that the date was appropriate. Five respondents indicated that early adoption should be encouraged.

One respondent [AICPA-99] stated that due to the extensive due process procedures required by many member bodies it would be appropriate to extend the effective date until June 30, 2006.

Some respondents noted that existing 8 (proposed section 290) was effective for assurance reports issued on or after December 31, 2004 and as such is already in effect. These respondents noted that it was important to ensure that the effective date of the revised Code does not interfere with the existing effective date of the independence requirements. One respondent [APB-88] recommended that the current version of the Code (including Section 8) remains in place in 2005, and the revised Code comes into force from December 31, 2005.

Assuming the Committee agrees with the majority view of respondents for an effective date of December 31, 2005 with encouragement, for early adoption, it is proposed that the APB suggestion be adopted and the existing Code be adopted with an effective date of December 31, 2005 with early adoption encouraged.

The Committee needs to consider how future changes will be incorporated into the Code. For example, the definition of a network firm may be revised before the end of 2005, and the Committee’s consideration of independence requirements will result in future changes to the Code.

It is proposed that an effective date appear after the title of each section. If a Section is revised, or a new Section is added, a new effective date for that particular section would be established.

If this approach is adopted, the wording of the two interpretations to 290 need to be considered:

- IT 2003-01 provides a one-year transition period for firms to complete existing contracts for the provision of certain non-audit services to assurance clients. The transitional period stated on December 31, 2004 and, therefore, would be complete by December 31, 2005. Accordingly this transitional provision would not be needed at December 31, 2005 and could be dropped.
- IT 2003-02 relates to partner rotation and states that the partner, irrespective of the number of years she has served as engagement partner, may continue in that role for an additional two

years from the date of implementation of the Code. One respondent to the ED questioned the intent of this IT (see discussion below) – depending upon the intent of the wording, it might no longer be relevant at December 31, 2005 and could therefore be dropped.

Action requested

Committee members are asked to consider whether they agree with the proposal that the existing Code (including Section 8) would remain in effect until December 31, 2005. After this date, the revised Code would come into effect and each Section would state that it was effective for all professional accountants from December 31, 2005 onwards.

Committee members are asked to consider whether, subject to the discussion on IT 2003-02, the two 2003 ITs should be dropped.

Transition Rule for Audit Partner Rotation (IT 2003-02)

One respondent [D&T-100] stated that greater clarity should be provided to determine how 2003-02 is to be applied.

The Code was required to be applied to reports dated on or after December 31, 2004. The Code requires partner rotation after an individual has been in that position for 7 years. The Committee concluded that it was appropriate to provide some flexibility for partners that had, at the time the Code was implemented, served in that capacity for a long period of time. Therefore the interpretation states:

“while the length of time the lead engagement partner has served in the audit client in that capacity should be considered in determining when rotation should occur, the partner may continue to serve as the lead engagement partner for an additional two years from the date of implementation (or early adoption) before rotating off the engagement.”

Assuming a December 31st year-end, the Code would be effective for the 2004 audit, because the opinion would be issued after December 31, 2004. Assuming that at December 31, 2003 the partner had served the audit client in that capacity for 10 years, which for which additional two years could the partner continue to serve in that capacity 2004 & 2005 or 2005 & 2006?

The respondent also notes that it seem illogical to get a different answer for an October 31st audit depending on whether the audit report was issued in the last week of December or the first week in January.

Action requested

Committee members are asked to consider the intention of Interpretation 2003-02 and determine whether clarification is needed.

Transitional Rule for EQCR Rotation

(assuming the Committee agrees that rotation of the EQCR, as proposed in the ED, it will be necessary to consider an appropriate transitional rule)

Two respondents [D&T-78, ICPAS-79] stated that a transitional rule be adopted for the rotation of the EQCR. After the Committee issued the revisions to require rotation of the engagement partner, the Committee issued Interpretation 2003-2. Which provided for a two-year transition period before rotation was required (although there is some question as to the clarity of the wording – see above).

ISQC1 requires firms to establish policies and procedures to require an engagement quality control review. The ISQC1 requires firms to have such systems in place by June 15, 2005 and states that firms consider the appropriate transition arrangements for engagements in process at that date.

ISA 220, which establishes standards on specific firm policies for financial statement audits, is effective for audit periods commencing on or after June 15, 2005.

Therefore, firms will be required to have an EQCR for all audit periods commencing on or after June 15, 2005. The requirement will not be new for many firms that already require an EQCR on certain engagements, particularly audits of listed entities.

When considering the appropriate transition period of engagement partners the Committee felt that two years was appropriate. Assuming this period is also appropriate for the EQCR, the following transitional provision is proposed:

Interpretation 2005-1

Rotation of Individual Responsible for the Engagement Quality Control Review

The *Code of Ethics for Professional Accountants* addresses the issue of rotation of the individual responsible for the engagement quality control review for financial statement audit clients that are listed entities. Paragraph 290.153(a) states “The engagement partner and the individual responsible for the engagement quality control review should be rotated after serving in either capacity, or a combination thereof, for a pre-defined period, normally no more than seven years”

The requirement to rotate the individual responsible for the engagement quality control review is first effective for fiscal periods beginning after December 31, 2005. The Ethics Committee has concluded that it is appropriate to allow a transitional period relating to this provision. Therefore, notwithstanding the requirements in 290.153(a) an individual responsible for an engagement quality control review may continue in that role for a particular client up to and including the second fiscal year of the client commencing after December 31, 2005.

Action requested

Committee members are asked to consider whether it is appropriate to provide a transition for the rotation of the EQCR and, if so, whether a two year period is appropriate.

Committee members are asked to consider the appropriateness of the transitional provision.

Material Presented

| | |
|------------------|---|
| Agenda Paper 2-A | Revised Code of Ethics – Mark-up |
| Agenda Paper 2-B | Detailed Cut and Paste of Comments Received |
| Agenda Paper 2-C | PDF file of Comment letters received |
| Agenda Paper 2-D | IAASB Assurance Framework |

Please note that Agenda Paper 2-D is provided for reference purposes only, and has been included in previous agenda material. It is provided in case Ethics Committee members wish to review the Framework when considering what changes should be made to the Code to respond to comments received on exposure.

Action requested

1. Please consider the individual questions contained in this paper.

Appendix 1
Exposure Draft

Respondent Summary

| | | |
|----|---|----------------|
| 1 | Association of Chartered Certified Accountants | ACCA |
| 2 | American Institute of Certified Public Accountants | AICPA |
| 3 | Association of Accounting Technicians | AAT |
| 4 | Canadian Institute of Chartered Accountants – AASB Staff | CICA - AASB |
| 5 | Canadian Institute of Chartered Accountants - PIIC | PIIC |
| 6 | Compagnie Nationale des Commissaires aux Comptes and the Conseil Supérieur de l'Ordre des Experts-Comptables (CNCC) | CNCC |
| 7 | CPA Australia/Institute of Chartered Accountants in Australia | CPA - Aus |
| 8 | Federacion Argentina de Consejos Profesionales de Ciencias Economicas | FACPC |
| 9 | Foreningen Auktoriserade Revisorer | FAR |
| 10 | Foreningen af Statsautoriserede Revisorer | FSR |
| 11 | Institut Der Wirtschaftsprufer | IDW |
| 12 | Institute of Certified Public Accountants of Kenya | ICPAK |
| 13 | Institute of Certified Public Accountants of Singapore | ICPAS |
| 14 | Institute of Chartered Accountants in England and Wales | ICAEW |
| 15 | Institute of CA of New Zealand | ICANZ |
| 16 | Malaysian Institute of Chartered Accountants | MICA |
| 17 | The Japanese Institute of Certified Public Accountants | JICPA |

Firms

| | | |
|----|--------------------------|------|
| 18 | Deloitte Touche Tohmatsu | D&T |
| 19 | KPMG | KPMG |
| 20 | PricewaterhouseCoopers | PwC |

Others

| | | |
|----|--|-------|
| 21 | Auditor General - Australia | |
| 22 | Auditor General – New Zealand | OAGNZ |
| 23 | Australasian Council of Auditors General | ACAG |
| 24 | Federation des Experts Comptables Europeens | FEE |
| 25 | International Auditing and Assurance Standards Board - staff | IAASB |
| 26 | International Organization of Securities Administrators | IOSCO |
| 27 | The Auditing Practices Board | APB |