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OF ACCOUNTANTS**

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Agenda Item

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Committee IFAC Ethics Committee

Meeting Location: AICPA, New York, USA

Meeting Date: February 14-15, 2005

Independence

Objectives of Agenda Item

1. To consider the views of the Task Force regarding which areas of the independence section should be revisited.

Background

At its September 2004 meeting the Ethics Committee approved a project to consider whether any parts of the independence section should be revisited.

The independence provisions in the Code were issued in November 2001 with an effective date for assurance reports issued after December 31, 2004. Since issuance, numerous failures have led to a loss in credibility in financial reporting and many jurisdictions have taken steps to restore this credibility. Some of these steps have related to auditor independence requirements. Therefore, the Committee concluded that it was appropriate to consider whether any parts of the independence requirements should be revisited.

This project also responds to a concern expressed by IOSCO that “The current content of Section 8 of the Code does not, in our view, adequately reflect current public expectations for auditor independence. The code needs to undergo further revision as a matter of urgency.”

A questionnaire was sent to member bodies to obtain their experience with implementing the requirements. A similar, but shorter, questionnaire was sent to the members of the Forum of Firms to obtain their feedback. A summary of the comments received are presented in Agenda Paper 3-B.

The October ED contained changes to the independence requirements to conform to the assurance framework and the ISQC 1 and to extend the lead partner rotation requirements to the individual responsible for the engagement quality control review. While the comments requested were narrow in nature, some respondents did choose to provide wider comments on the independence requirements. Agenda Paper 2-B contains the detailed cut and paste of the comments received on exposure. In considering which parts of Section 290 needed to be revisited, the Task Force considered the broader comments that were received on exposure.

The Task Force, which met in December 2004 and held a conference call in January 2005, is comprised of:

Jean-Francois Cats (Chair) assisted by technical advisor Sandrine Van Bellinghen
Tony Bromell
Jean-Luc Doyle
Andrew Pinkney
Jean Rothbarth

Approach

The Task Force compared existing section 290 against the EU and recent SEC rules. It also considered comments received on exposure in response to the member body and firm questionnaire. In light of this input the Task Force considered whether any sections of 290 needed to be revisited. When forming a view as to whether a particular part should be revisited the Task Force considered the context of the application of the Code namely:

- Section 290 applies to all assurance engagements – not merely to audit engagements;
- Section 290 is a global standard;
- Section 290 applies to large global firms and to sole practitioners; and
- Assurance clients are of varying levels of sophistication.

Structure of section

Several survey respondents, and two ED respondents, commented in effect on the structure of the section. These respondents stated that because the requirements deal with all assurance engagements it can be difficult to focus on the specific requirements that apply to the audit of financial statements. IOSCO also stated that writing requirements that can apply to all assurance engagements “has the effect of obscuring or undermining what is expected on listed company audits.”

When the Committee first developed the independence requirements (then section 8) it discussed whether the section should be structured to deal separately with audits of financial statements and with other assurance engagements. At that time, it concluded that because independence was required for all assurance engagements and because the threats and safeguards approach applied in all cases it was better to structure the section by “topic” rather than type of engagement (for example financial interests, loans and guarantees, close business relationships etc). Within each topic, distinctions would be made, where necessary, between the types of engagement. For example 290.103-14 contains guidance with respect to financial interests in all assurance clients, 290.105-111 contains guidance specific to financial statement audit clients and 290.121-124 contains guidance specific to assurance engagements that are not financial statement audit engagements. Similarly the guidance with respect to the provision of non-assurance services contains a mixture of guidance for financial statement audit engagements and for other assurance engagements. When first drafting the guidance, the Committee felt that separating the financial statement audit engagements from other assurance engagements would result in a great deal of duplication.

The Task Force considered whether, given the framework has been moved to Part A of the Code, it would now be appropriate to restructure Section 290 to separate requirements/guidance for financial statement audit engagements from other assurance engagements.

In weighing the advantages and disadvantages of restructuring the section, the Task Force concluded that separating the section into for example, audits, listed audits, other assurance clients, would create a great deal of repetition. In addition, many practitioners perform several different types of assurance engagements. Many respondents to the July 2003 ED commented that there was too much repetition within that ED and the Committee took steps to reduce the amount of repetition. Respondents to the October 2004 ED commented favorably on the reduced repetition. Therefore, the TF is of the view that Section 290 should not be restructured.

Action required

Do Committee members agree with the TF view that Section 290 should not be restructured?

Clarity of prohibitions

The survey asked whether the principles and examples were clear and whether member bodies had used the same approach and structure to describe the prohibitions. Section 290 generally expresses the prohibitions in the following manner:

“...the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to perform the engagement.” (290.12).

In other instances the “prohibition” is described differently. For example 290.184 dealing with internal audit states that:

“Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:

- The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls,
- The audit client designates a competent employee, preferably within senior management to be responsible for internal audit activities; ...and
- The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.”

A few concerns/questions have been expressed with this approach:

- Ease of identification – some respondents stated that expressing the prohibitions in this manner makes it difficult for readers to identify easily what is a prohibited activity
- The section does not clearly distinguish between requirements and associated guidance. The APB has sought to address this by identifying the basic principles and essential procedures through the use of bold type – the existing IAASB convention

While Section 290 describes prohibitions as noted above, there are some instances in other sections of the revised Code where a prohibition is more clearly/succinctly described. For example:

150.2 “Professional accountants should be honest and truthful and should not make exaggerated claims for services they are able to offer...”

220.6 “Where a professional accountant...has requested consent from a client to act for another party...in respect of a matter where the respective interests are in conflict and that consent has been refused by the client, then they must not continue to act for one of the parties in the matter giving rise to the conflict of interest.”

The Task Force considered whether the style of presenting 290 should be revisited. The Task Force noted that, now the conceptual framework is more established, the style of expressing the prohibitions seems to have become more direct. The Task Force felt that in some cases the prohibitions in Section 290 could be expressed more directly.

The Task Force also reviewed two examples of “user friendly” guides to independence prepared by member bodies. The Task Force is of the view that such a guide would be a useful companion to Section 290 and consideration should be given to preparing such a guide once any revisions to Section 290 had been finalized.

Action required

Do Committee members agree with the TF view that Section 290 should be reviewed to determine which prohibitions should be expressed more directly and that a “user friendly” guide be prepared once any revisions to Section 290 have been finalized?

Staff Note

The IAASB uses an expert in plain language to provide suggestions on drafting. Staff has asked this expert to provide comment on an extract of Section 290. Any suggestions from this expert can be considered by the Task Force at its next meeting.

The IAASB also has a project dealing with clarity of ISAs. It issued an Exposure Draft and Consultation Paper in September 2004 with a comment deadline of December 31, 2004. The ED was partly in response to apparent confusion over the authority of the plain type lettering in ISA (containing explanatory and other material), as compared to the text presented in bold type. While this is not an issue that faces the Ethics Committee because the Code does not contain bold and plain lettering, the ED does address matters that may be of relevance to the Committee. The Task Force will be able to consider any preliminary feedback that might be relevant to the Ethics Committee at its next TF meeting.

Use of Safeguards

Some respondents have commented on how safeguards have been used in the guidance:

- While the Framework states that there may be circumstances when no safeguards are available to reduce the threat to an acceptable level and the only possible actions are to refuse to accept or continue the assurance engagement (290.16) this is not sufficiently carried out through out the section [Agenda Paper 2-B 127 IOSCO]

- Some of the actions put forward as safeguards are not safeguards but are additional publication or communication requirements [Agenda Paper 2-B 127 IOSCO, 128 APB). Firm-wide policies and procedures are not safeguards but rather are required in all audit firms as part of the control environment to ensure integrity, objectivity and independence.

The firm-wide safeguards are now contained in 200.12 and range from:

- Leadership of the firm that stresses the importance of compliance with the fundamental principles
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services.

In reviewing the safeguards the Task Force was of the view that certain safeguards rather than eliminating or reducing specific threats, help to ensure compliance with the fundamental principles. Such is the case with the safeguard of leadership that stresses compliance with the fundamental principles. The Task Force is of the view that this point should be made clear in the Code.

The Task Force also noted that some safeguards in the Code were not as robust as others. For example in 290.143, which deals with safeguards to address a threat to independence created by a member of the team joining an assurance client, includes the safeguard:

“considering the appropriateness of necessity of modifying the assurance plan for the assurance engagement.”

The Task Force noted that consideration of the necessity of modifying the plan was not in itself a particularly strong safeguard. The Task Force is of the view that the safeguards mentioned in section 290, from paragraphs 100 (the examples) onwards, should be reviewed to determine whether they sufficiently robust. Those that are considered not to be particularly robust should be modified or deleted.

The Task Force noted that the application of the framework to specific situations (paragraphs 290.100-213) does, in places, contain the statement that if safeguards are not available to address a threat the engagement should be declined. For example 290.163 states:

“...when a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate safeguards can be applied to eliminate the threat or reduce it to an acceptable level.”

However, the Task Force agreed that, if it is felt that this thought is not emphasized sufficiently in the Code it should be repeated more often.

Action required

Do Committee members agree with the Task Force view that:

- the Code should note that certain safeguards help compliance with the fundamental principles;
- the safeguards mentioned in 290-100 onwards should be reviewed to determine whether they are sufficiently robust; and
- more emphasis should be given to the thought that if safeguards are not available to eliminate or appropriately reduce a threat the engagement should be declined?

Application to public interest entities

Section 290.19 states that the evaluation of the significance of any threats to independence and safeguards necessary to reduce any threats to an acceptable level takes into account the public interest. It further states that certain entities may be of significant public interest and consideration should be given to the application of the framework in relation to the listed entities to audit clients that may be of significant public interest.

Survey respondents were asked whether they had provided any additional guidance in this area. Comments received in this area were mixed:

- One member body noted that other regulatory bodies have jurisdiction over significant public interest entities
- One member body noted that in its jurisdiction mutual funds (publicly available collective investment schemes) were not listed entities but were entities of significant public interest accordingly it is proposing to require mutual funds to follow the listed entity requirements.
- One jurisdiction provided a definition of a public interest entity.

The Task Force agreed that threat to independence in audits of publicly available collective investment schemes was similar to the threats in audits of listed entities. This matter and the Task Force's view are discussed further in Agenda Paper 3-A.

The Task Force considered whether additional guidance should be provided for public interest entities – for example by providing a definition. The Task Force noted the difficulty with creating a definition of a public interest entity that would be appropriate for a global standard and concluded that the existing description contained in 290.19 was appropriate.

Action required

Do Committee members agree with the Task Force's view that the existing description of public interest entities contained in 290.19 is appropriate?

Management threat

The APB has created a fifth category of threat a "management threat" which is described as follows:

"A management threat arises when the audit firms undertakes work that involves making judgments and taking decisions, which are the responsibility of management (for example, where it has been involved in the design, selection and implementation of financial information technology systems). In such work, the audit firm may become closely aligned with the views and interests of management and the auditors' objectivity and independence may be impaired or may be perceived to be impaired."

While the Code does not categorize this as a threat (indeed it would be impossible to have such a threat apply to the whole Code because professional accountants in business are in management

roles), Section 290 does recognize that there are certain types of “management activity” that would be inappropriate.

The Task Force is of the view that creating a fifth threat would not be appropriate.

Action required

Do Committee members agree with the Task Force’s view that it would not be appropriate to create fifth threat?

Specific prohibitions

Some member bodies/ jurisdictions have indicated that they had provided more stringent requirements with respect to the provision of non-assurance services, employment and rotation requirements In addition the SEC has more specific restrictions in this area.

Agenda Paper 3- contains the Task Force’s review of the specific prohibitions and the Task Force’s view on whether individual paragraphs need to be revisited.

Action required

Do Committee members agree with the Task Force’s views as to which specific prohibitions need to be revisited?

Material Presented

Agenda Paper 3	This Agenda Paper
Agenda Paper 3-A	Review of Section 290
Agenda Paper 3-B	Summary of responses to questionnaire
Agenda Paper 3-C	FEE – Consideration of Implementation of Framework Approach
Agenda Paper 3-D	CGA Canada – Guidance Bulletin
Agenda Paper 3-E	CICA – Guide to New Canadian Independence Standard

Agenda Paper 3-C contains the FEE Comparison Paper that was posted to the Ethics Committee Resource Centre in November 2004. Committee members may already have printed a copy of this long paper. While this paper is a lengthy comparison, Committee members are requested to at least read the introduction which is contained on pages 9-15.

Agenda Papers 3-D and 3-E are two examples of “user guidance” which have been issued by member bodies. It is not necessary for Committee members to read these papers in detail – rather they are presented as illustrative examples of such documents.

Action Requested

1. Committee members are asked to consider the questions raised in this agenda paper.