



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item

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Board International Ethics Standards Board for Accountants
Meeting Location: James Cook Ballroom, InterContinental, Sydney, Australia
Meeting Date: October 16-18, 2006

Independence

Objectives of Agenda Item

1. To review as a first read revised Section 290 Independence – Audit and Review Engagements and Section 291 Independence – Other Assurance Engagements

Background

At its June 2006 meeting the Board reviewed issues and provided input to the Task Force¹. While drafts of Sections 290 and 291 were included in the agenda papers, the Board did not discuss the document paragraph by paragraph. Board members were encouraged to provide any detailed wording comments directly to staff.

Since the June meeting, the Task Force has held three task force meetings for a total of eight days of meetings. The CAG met on September 13, 2006 and provided input on the most recent Task Force draft of the revised Section 290 (this input was considered by the Task Force at its meeting in late September).

The SMP Committee represents the interests of professional accountants operating in small and medium-sized practices and other professional accountants who provide services to small and medium-sized enterprises. A presentation on the independence requirements and the proposed changes will be provided to SMP Committee at their meeting on October 9-10, 2006. The feedback from the Committee will be presented at the IESBA meeting.

This paper addresses the issues which the Task Force would like to discuss with the Board and obtain their input. During the meeting, Board members will be taken through Section 290 and 291 paragraph by paragraph and asked for comments of substance. It

¹ Jean Rothbarth (chair), Tony Bromell, Ken Dakdduk, Jean-Luc Doyle, Geoff Hopper, Peter Hughes, Thierry Karcher, Neil Lerner, Michael Niehues, Andrew Pinkney, Volker Rohricht

would be helpful if any detailed wording suggestions or matter of a minor editorial nature are provided directly to Jan Munro (janmunro@ifac.org).

Issues

Split of Code

Extant section 290 addresses independence requirements for audit clients and independence requirements for other assurance clients. This approach was taken because the independence requirements for an audit engagement are more restrictive than for other assurance engagements (for example for audit engagements there are restrictions on network firms but for other assurance engagements consideration is given to any threats the firm has reason to believe may be created by network firm interests and relationships).

As discussed at the June meeting, the split between Sections 290 and 291 is by type of engagement rather than type of client. Accordingly, Section 290 deals with audit and review engagements and Section 291 deals with other assurance engagements. The Task Force recognizes that consideration of the provisions of Section 290 will be necessary if a non-audit assurance engagement is provided to an audit or review client. Therefore paragraphs 290.1 and 291.1 cross-refer to the other section and 291.1 states that if the assurance client is also an audit or review client, the requirements in 290 also apply to the firm and to the members of the audit or review team.

As discussed at the June meeting, Section 290 addresses independence requirements for audit and review engagements and 291 addresses requirements for all other types of assurance engagements.

In summary, the distinctions in the existing Code (or agreed changes) between financial statement (“f/s”) audit clients and other assurance clients are as follows:

- Assurance team – for f/s audit clients, the team includes those at successively senior levels above the engagement partner through the firm’s chief executive (chair of command)
- Network firm – for f/s audit clients, network firms are required to be independent – for other assurance clients consideration should be given to any threats that the firm has reason to believe may be created by network firm interests and relationships
- Management functions – for f/s audit clients, these are prohibited, for other assurance clients, these are prohibited if related to the subject matter of the assurance engagement
- Non-audit services – for f/s audit clients, prohibitions and identification of activities that might create a threat are quite specific and clear (because there is a consistent subject matter/subject matter information) – for other assurance clients, the guidance will likely not be as specific because of the wide range of possible subject matters and subject matter information.

The Task Force has reconsidered the decision at the June meeting that 290 should address the following types of engagements:

- *Audit Report on a Complete Set of General Purpose Financial Statements* – ISA 700 (revised) establishes standards and provides guidance for the independent auditor’s report on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation;
- *Audit Report on Other Historical Financial Information* – ISA 701 (ED) proposes standards and guidance for the independent auditor’s report on historical financial information other than a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation. Other historical financial information includes:
 - A complete set of financial statements prepared in accordance with a financial reporting framework designed for a general purpose, but not designed to achieve fair presentation;
 - A complete set of financial statements prepared in accordance with a financial reporting framework designed for a special purpose (for example a tax basis of accounting, the cash receipts and disbursements basis of accounting for cash flow information that an entity may prepare, the financial reporting provisions established by a regulator to meet the requirements of that regulator and the financial reporting provisions of a contract such as a bond indenture or loan agreement);
 - A single financial statement, or statements, that would otherwise be part of a complete set of financial statements; and
 - One or more specific elements, accounts or items of a financial statement.
- *Audit Report on Summary Audited Financial Statements* – ISA 800 (ED) proposes standards and guidance for the independent auditor’s report on summary financial statements derived from audited financial statements – given this type of engagement is performed by the auditor of the financial statements there is no separate decision to make with respect to independence requirements. The engagement was included in the list for completeness.
- *Review Engagements of Historical Financial Information* – ISRE 2400 establishes standards and provides guidance on engagements to review financial statements

The Task Force reconsidered this approach, in particular, to consider whether it was appropriate to apply all of the more restrictive audit requirements to review engagements and audits of single f/s items (such as revenue for a percentage rent calculation). The Task Force has re-confirmed the appropriateness of the split. It did, however, recognize that in some jurisdictions the term “review” is understood as a broad term – broader than an assurance engagement. Therefore, the Task Force has amended the definition of review engagement to indicate that it is an assurance engagement conducted in

accordance with International Standards on Review Engagements, or equivalent.

Action requested

Board members are asked to confirm the position taken.

Directness of language

As agreed at the June 2006 meeting, the Task Force has used language for the restrictions which is more direct. It has also reduced the level of duplication through the Code by stating the following in paragraph 290.2:

Throughout this section, the term(s):

- “financial statements” also includes other historical financial information when such information is the subject matter information of the engagement;
- “audit team”, “audit engagement”, “audit client” and “audit report” also includes review teams, review engagements, review clients and review reports;
- “firm” also includes network firm except where otherwise stated; and
- “entities of significant public interest” includes listed entities.

The Task Force is of the view that this streamlines the remainder of the document.

The Task Force has also changed the construction of the restrictions when there are two levels of restriction – one audit clients that are not entities of significant public interest and one for entities which are of significant public interest. For example 290.170 states:

If the valuation service has a material effect on the financial statements on which the firm will express an opinion 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 firm should withdraw from the audit engagement.

Paragraph 290.173 (which addresses entities of significant public interest) states:

A firm should not provide valuation services to an audit client that is an entity of significant public interest if the valuations would have a material effect, separately or in the aggregate, on the financial statements on which the firm will express an opinion.

The Task Force has developed this convention because it avoids what would otherwise be a contradiction (i.e. two different sets of circumstances both of which create a threat that is so significant safeguards could not reduce the threat to an acceptable level.)

Sections 290 and 291 have been sent for a “Plain Language” review. The Task Force will consider the input from this review at its next Task Force meeting.

Action requested

Board members are asked to consider the issues noted above and provide input to the Task Force.

Definition of engagement team

The extant definition of engagement team is:

“All personnel performing an engagement, including any experts contracted by the firm in connection with the engagement.”

This definition was adopted to be consistent with the definition used by IAASB in ISQC 1. The IAASB has started a project to revise ISA600 which deals with audit considerations regarding experts. As part of this project, the IAASB TF has focused on the definition of engagement team and has noted it is not entirely clear whether all experts, even those who are only peripherally involved, should be treated as part of the engagement team and, therefore subject to the requirements of ISQC1.

The IAASB discussed the definition at the July 2006 meeting. The minutes note that:

“...while the IAASB was of the view that the definition of ‘engagement team’ does not need to be changed for the purposes of ISQC1 and the ISAs, it acknowledged that IESBA may need to change it for purposes of the Code, The task force was, therefore, asked to continuing liaising with the IESBA’s independence task force and to consider how any changes to the definition that IESBA may consider necessary for the Code would affect ISQC1 and the ISAs. Mr. Sylph agreed to draw this matter to the attention of IESBA and to report back on the priority it is receiving.”

The Task Force discussed the issue and proposes a change to the definition of engagement team. The Task Force considered two issues in revising the definition:

- Addressing contracted staff; and
- Dealing with experts.

The Task Force is of the view that contracted staff (for example an individual who is contracted by the firm during busy season to be the senior on an assignment) should be subject to the same independence requirements as an employee of the firm who is a member of the engagements team.

In considering external experts used by the firm, the Task Force is of the view that this is not a matter for the Code. The Code addresses ethical requirements for professional accountants and section 290 and 291 address independence requirements for firms performing assurance engagements. Members of audit teams are required to be independent because they are performing an assurance engagement. When a professional accountant performs other services such as a valuation service or tax services he/she is

not required to be independent rather he/she is required to be objective. The Task Force is of the view that the level of objectivity of an expert is a matter of reliability of audit evidence and, as such, should be addressed in ISAs as opposed to the Code. Therefore, the Task Force recommends that the definition of engagement team does not address experts. The Task Force recommends the following changes to the definition of engagement team:

All personnel performing an engagement, regardless of their legal relationship with the firm, ~~including any experts contracted by the firm in connection with that engagement.~~

Action requested

Board members are asked to consider this guidance and provide input to the Task Force.

Entities of Significant Public Interest

At the June meeting, the Board concurred that it was impracticable to develop a definition of a public interest entity which would have global application and be suitable in all jurisdictions. The Task Force has refined the guidance on entities of significant public interest and has also provided more comment on why there are differing requirements for such entities. Paragraphs 290.22 and 23 now state:

The evaluation of the significance of threats to independence and the safeguards necessary to eliminate them or reduce them to an acceptable level takes into account the extent of public interest in the entity. Entities of significant public interest are listed entities and certain other entities that, because of their business, size or number of employees, have a large number and wide range of stakeholders. The extent of the public interest in these entities is significant, this section, therefore, contains enhanced safeguards to eliminate threats or reduce them to an acceptable level.

In some countries, the scope of all entities considered to be of significant public interest for independence purposes is defined by statute or regulation. In such cases, that definition should be used in applying the requirements in this section. In the absence of such a definition, member bodies should determine the types of entities that are of significant public interest and, thus, subject to the enhanced safeguards referred to above. Entities of significant public interest will always include listed entities, will normally include banks, insurance companies and other regulated financial institutions, and may, depending on the facts and circumstances, include pension funds, government-agencies, government-owned entities and not-for-profit entities.

Action requested

Board members are asked to consider this guidance and provide input to the Task Force.

Cooling-off Period

The Task Force has refined the language related to the cooling-off period before a key audit partner joins an audit client that is an entity of significant public interest. The Task Force has also amended the definition of a key audit partner to address a concern raised by the CAG. The definition discussed with the CAG was:

“The engagement partner, the individual responsible for the engagement quality control review, and other partners involved at the group level who are responsible for key decisions or judgments on significant matters with respect to the audit engagement.”

CAG members questioned what was meant by “at the group level” – for example would the lead partner on a significant subsidiary be included in the definition of key audit partner? After further discussion the Task Force concluded that the key factor was whether the individual was responsible for key decisions or judgments on significant matters irrespective of whether the individual was at the group level. Therefore the Task Force has revised the definition to read:

The engagement partner, the individual responsible for the engagement quality control review, and other partners on the engagement team who are responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.

Action requested

Board members are asked to consider this guidance and provide input to the Task Force.

Partner Rotation

The Task Force has refined the guidance on partner rotation. As discussed at the June 2006 meeting, for audits of entities of significant public interest:

- The engagement partner and the engagement quality control reviewer are required to rotate after seven years and not return to the audit team until two years have elapsed.
- Other key audit partners are generally required to rotate after seven years but some limited flexibility is provided to permit the individual to stay on the team for one additional year, if the individual’s continuity is especially important to audit quality.

There is no flexibility for small firms to apply alternative safeguards; rotation is required on all audits of entities of significant public interest.

Action requested

Board members are asked to consider this guidance and provide input to the Task Force

Provision of non-assurance Services

Not Subject to Audit Procedures ¶290.154

As agreed at the February IESBA meeting, the Task Force has incorporated the SEC notion that in the case of certain non-audit services, independence would not be impaired if it is reasonable to conclude that the results of the were not subject to audit procedures. The exemption exists when there is no self-review threat and does not apply to “downstream” entities such as subsidiaries or divisions.

Management Responsibilities ¶290.156 - 160

The discussion of management responsibilities has been moved to the section addressing non-assurance services. Management functions involve leading and directing an entity including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources. Examples of activities that would generally be considered management functions include:

- Setting policies and strategic direction
- Authorizing transactions;
- Deciding which recommendations of the firm or other third parties should be implemented;
- Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and
- Taking responsibility for designing, implementing and maintaining internal control.

The guidance also states that in order to reduce the risk of performing management functions when providing non-assurance services the firm should be satisfied that a member of management of the client has been designated to make all significant judgments and decisions connected with the performance of the services and to accept responsibility for the results of the services received.

Preparing Accounting Records and Financial Statements ¶290.161-168

As agreed at the February IESBA meeting, the Task Force has amended the guidance in this area to clarify that for non-listed entities, an auditor can prepare standard or adjusting journal entries provided the client reviews the entries and understands their purpose. In addition, changes have been made to make it clear that accounting advice can be provided to listed and non-listed audit clients.

Valuation Services ¶290.169-173

The guidance provides clarification of the meaning of significant subjectivity. Valuations would likely not have a significant degree of subjectivity when the underlying assumptions are determined by law or regulation, or are widely accepted and the techniques and methodologies to be used are based on generally accepted standards or even prescribed by law or regulation. In such circumstances, the results of a valuation performed by two or more parties are not likely to be materially different.

As agreed at the June meeting the guidance now restricts providing any valuation services for an audit client that is an entity of significant public interest if the valuations would have a material effect, separately or in aggregate, to the financial statements.

Taxation Services ¶290.174-186

As agreed at the June IESBA meeting, the Task Force has developed guidance on the provision of taxation services. The guidance addresses:

- Tax return preparation
- Preparation of tax calculations intended to be used as the basis for the accounting entries in the financial statements
- Tax planning and other tax advisory services
- Assistance in the resolution of tax disputes

Tax return preparation – the guidance explains that these services are generally based upon historical information; principally involve analysis and interpretation of such historical information based upon the constraints of existing tax law; and tax returns are subject to whatever review or approval process the tax authority considers appropriate. Therefore, such services do not normally create threats to independence.

Preparation of tax calculations intended to be used as the basis for the accounting entries in the financial statements – the guidance indicates that preparing such calculations may create a self-review threat, the significance of which will depend upon the degree of subjectivity involved and the materiality to the financial statements. If the self-review threat is other than clearly insignificant, safeguards should be applied to reduce the threat to an acceptable level. In addition, in the case of the audit an entity of significant public interest a firm should not prepare tax calculations the primary intention of which will be for the preparation of accounting entries that are material to the financial statements.

Tax planning and other tax advisory services – the guidance indicates that a self-review threat may be created where the advice will affect matters that will be reflected in the financial statements. The significance of the threat will depend upon matters such as:

- The degree of subjectivity involved in determining the appropriate treatment for the tax advice in the financial statements;
- The extent to which the advice is supported by tax authority or other precedent, established practice or basis in tax law;
- Whether the tax treatment is supported by a private ruling or has otherwise been cleared by the tax authority prior to the preparation of the financial statements; and

- Whether the effectiveness of the tax advice depends on a particular accounting treatment or presentation, there is doubt as to the appropriateness of the related accounting treatment and the outcome of the tax advice will have a material effect on the financial statements.

The significance of the threat should be evaluated and, if other than clearly insignificant, safeguards applied.

When the effectiveness of the tax advice depends on a particular accounting treatment or presentation and:

- There is reasonable doubt as to the appropriateness of the related accounting treatment or presentation; and
- The outcome of the tax advice will have a material impact on the financial statements the self-review threat would be so significant no safeguard could reduce the threat to an acceptable level. Therefore firms should not provide such services.

Assistance in the resolution of tax disputes – the guidance provides that an advocacy threat may be created when acting for an audit client in the resolution of a tax matter by representing the client before a public tribunal or court. If the amounts involved are material to the financial statements, the threat would be too great. The Task Force recognizes that what constitutes a public tribunal or court will vary from jurisdiction to jurisdiction. Accordingly, the guidance indicates that this will be determined according to how the tax proceedings are heard in a particular jurisdiction. The guidance further states that a firm or network firm would not be precluded from having a continuing advisory role in relation to the matter which is being heard before a public tribunal or court. If the firm is asked to act in an advisory role where the matters involved are not material to the financial statements, the firm should evaluate the significance of any threat created and apply safeguards as necessary. The CAG questioned whether the advocacy threat becomes too great only when the matter is before a public tribunal or whether this could occur before the matter is public. The Task Force considered this matter and concluded that public tribunal is the appropriate point for the restriction. The self-review threat is with respect to the financial statements. Once a matter is before a public tribunal it is more difficult for the auditor to question/challenge the position which the firm is advocating.

IT System Services ¶290.193- 198

As agreed at the June IESBA meeting, the Task Force has amended the guidance in this area to:

- In the case of audit clients which are not entities of significant public interest - require application of specific safeguards for services that involve the design *or* implementation of IT systems;
- In the case of audit clients that are entities of significant public interest restrict the provision of services that involve the design or implementation of IT systems.

In all cases the following services would not be considered to create a threat to independence:

- Design or implementation of IT systems that are unrelated to or do not form a significant part of the accounting records or financial statements;
- Implementation of “off-the-shelf” accounting or financial information reporting software that was not developed by the firm provided the customization required to meet the client’s needs is not significant; and
- Evaluating and making recommendations with respect to a system designed, implemented or operated by another service provider or the client.

Litigation Support Services ¶290.199-186

As agreed at the June IESBA meeting, the Task Force has amended the guidance in this area to mirror the guidance for valuation services and restrict certain litigation support services that involve a significant degree of subjectivity and are material to the financial statements.

Recruiting Senior Management ¶290.210-211

As agreed at the June IESBA meeting, the Task Force has amended the guidance in this area to restrict recruiting senior management who are in a position to exert significant influence over the preparation of the accounting records and financial statement of a audit client that is an entity of significant public interest.

Corporate finance ¶290.212-217

As agreed at the June IESBA meeting, the Task Force has expanded the guidance in corporate finance services to mirror the position taken with respect to the provision of tax advice.

Action requested

Board members are asked to consider this guidance and provide input to the Task Force

Compensation Policies ¶290.224-225

The guidance indicates that the basis on which a partner is compensated and evaluated may create a self-interest threat, particularly when the partner is compensated or evaluated for selling non-assurance services. The guidance restricts key audit partners from being compensated or evaluated for selling non-assurance services to their audit or review clients. The guidance also indicates that compensating or evaluating other members of the audit or review team for selling of non-assurance services to their clients may create threats.

Action requested

Board members are asked to consider this guidance and provide input to the Task Force

Section 291

Agenda Paper 2-C contains a draft of Section 291 Independence – Other Assurance Clients. This draft contains the pieces of existing section 290 which are applicable to other assurance engagements. While conforming amendments have been made to reflect, for example, matters such as management functions, more direct wording of restrictions etc, the Task Force has not tried to extend the section addressing non-assurance services to “other assurance clients”. The Task Force is of the view that the market for other assurance services is still developing. As this market matures it might become appropriate for the IESBA to established more detailed independence guidance related to such engagements.

Action requested

Board members are asked to consider and provide input to the Task Force on the proposed wording in Section 291.

Exposure Period

The IESBA due process requires a comment period of 90 days for exposure drafts. This comment period was used for the Network Firm exposure draft. In light of the time of year and the length of the document the Task Force recommends a four year comment period ending on April 30, 2007. The Task Force would be able to brief the IESBA at the June meeting about significant issues raised but the substantive discussion of issues would not occur until the October meeting. The CAG strongly favors a four month comment period to allow respondents an appropriate length of time to analyze a lengthy document and to consult with others if necessary.

Action requested

Board members are asked to consider the proposed exposure period.

Effective Date

The Task Force recommends an effective date for engagements starting after September 15, 2008, with appropriate transitional provisions. This effective date is based on the following timeline:

- April 30, 2007 – comment deadline
- June 2007 IESBA preliminary discussion of issues
- October 2007 IESBA substantive discussion of issues
- *December 2006* Feb/March 2007 – discussion of revisions and approval
- September 15, 2008 effective date.

This timetable does assume, a fourth meeting in 2007 and provides firms and member bodies with 18 months to implement the proposals.

Next Steps

The draft has been sent to for a Plain Language review.

At its September meeting, it was noted that there was not an opportunity for the CAG to provide further comment on the document before its planned exposure because the next CAG meeting is not until April 2007. Therefore, it was agreed that a further document would be circulated to the CAG after the October IESBA meeting, with a very short turn-around. This would provide the CAG the opportunity to provide further input, if needed.

The Task Force has scheduled a task force meeting in mid November at which it will consider the results of the Plain Language review, the Sydney input of the Board and any further input from the CAG. The Task Force will present an exposure draft for approval at the December 18-19, 2006. If approved, the ED will be released before the end of 2006.

Material Presented

Agenda Paper 2	This paper
Agenda Paper 2-A	Draft Section 290 – Independence Audit and Review Engagements Clean Copy
Agenda Paper 2-B	Draft Section 290 – Independence Audit and Review Engagements Mark-up from existing Section 290
Agenda Paper 2-C	Draft Section 290 – Independence Assurance Engagements Clean Copy

Please note that the clean copies of (Agenda Papers 2-A and 2-C) and not the mark-up will be used at the meeting for discussion.

Action requested

1. Board members are asked to consider the issues and the proposed wording and provide input to the Task Force.