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Agenda Item

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Task Force International Ethics Standards Board for Accountants

Meeting Location: Park Plaza Victoria, Amsterdam, Netherlands

Meeting Date: January 21-23, 2008

Independence II

Objective of Agenda Item

1. To discuss comments received on issues raised on the Independence Exposure Draft, to review a first draft to respond to comments and provide direction to the Task Force.

Background

In July 2007, the IESBA issued an exposure draft (ED) proposing revisions to Sections 290 and 291 addressing the areas of internal audit services, relative size of fees and contingent fees. The exposure period was three months and ended on October 15, 2007.

Comments have been received from the following:

Member Bodies of IFAC	24
Firms	5
Regulators	2
Government Organizations	1
Other	12
Total Responses	44

All of the comment letters received have been posted on the IFAC website and may be downloaded at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0085.

The Task Force[1] met on December 3, 2007 to discuss the comments received and develop proposed changes for the consideration of the IESBA. The Task Force also held conference calls on January 9 and 11, 2008 to discuss a response letter which was received after the December Task Force meeting.

[1] David Winetroub (chair), Heather Briers, Ken Dakdduk, Barbara Majoor, Michael Niehues, Andrew Pinkney and Sylvie Soulier

Prepared by: Jan Munro (January 2008)

Principles Based Approach

Seven respondents commented on this issue. The respondents expressed concern that exposure draft seems to be moving away from a principles based approach. Illustrative comments are:

- We are, nevertheless, concerned that proposed revisions has further moved the Code to become a legalistic, rules-based standard, which can only encourage creative, loophole-based avoidance. We believe the robustness of the principles-based approach is being undermined by the proliferation of detailed underlying rules;
- While we support the IESBA's efforts to create consistency internationally where possible, our concern is that this does not lead to the imposition of an additional layer of prescriptive rules; and
- The code should not be made longer or more detailed, as it risks becoming difficult for users to follow, and so less effective.

This issue was also raised by respondents to the December 2006 exposure draft. The matter was discussed by the IESBA at its June meeting in Berlin. The IESBA noted that changes in the exposure draft included those to make the requirements more clear and direct. The change was made to address concern expressed by some that it was difficult to identify the restrictions. The IESBA determined that the issue was best addressed when considering the comments on each specific topic to determine whether the proposals in the exposure draft do stem from the application of the principles-based approach.

The IESBA is of the view that there is no conflict between a principles-based approach and absolute restrictions or prohibitions, provided that such restrictions or prohibitions flow directly from the application of the principles. The IESBA concluded that the matter will be considered on an item by item basis as the IESBA discusses proposed changes to respond to comments received on exposure – consideration will be given to whether the individual proposals are consistent with the principles-based approach.

The matter was discussed with the CAG who also noted that there is no contradiction between a principles-based approach and specific restrictions. It was further noted that many of the additional public interest entity provisions in Independence I relate to matters with which the CAG has previously expressed specific support.

Internal Audit Services

Background
As noted in the explanatory memorandum, existing Section 290 states that a self-review threat may be created when a firm provides internal audit services to an audit client. It also states that a firm should not provide any internal audit services to an audit client unless the client takes certain specified actions and the findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance. The exposure draft proposed amending the guidance of internal audit services to clarify the wide range of services that comprise internal audit services. The

exposure draft also stated that depending on the nature of the services a threat to independence may be created if the services involve the firm performing management functions or are such that it would review its own work. The exposure draft further indicated that assisting an audit client in the performance of a significant part of the client's internal audit activities increases the risk that firm personnel providing the service may perform a management function. The proposed changes, therefore, stated that before accepting such an engagement the firm should be satisfied that the client has designated appropriate resources to the activity.

The exposure draft indicated that certain services, such as the outsourcing of all or a portion of the internal audit function whereby the firm is responsible for determining the scope of the work and the recommendations that should be implemented and performing procedures that firm parts of the internal controls of the audit client, involve management functions. The exposure draft therefore indicated that the auditor should not provide such services.

The exposure draft indicated that to ensure the firm does not perform management functions, the firm should only provide assistance to an audit client's internal audit function if specified conditions are in place including that the findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance.

The proposed revisions require a firm, prior to accepting an engagement to provide internal audit services to an audit client, to consider the scope and objective of the proposed engagement and whether the assignment is expected to create a self-review threat because it is likely to be relied upon in the making of significant audit judgments related to a matter that is material to the financial statements.

As noted in explanatory memorandum, IESBA considered whether there should be a more restrictive requirement for an audit client that is an entity of significant public interest. The IESBA concluded that procedures performed as part of internal audit services and procedures performed during an audit conducted in accordance with International Standards on Auditing can be similar and that prohibiting procedures simply because they are done as part of an internal audit service is unnecessary as long as the procedures do not entail the performance by the firm of management functions. Accordingly, the IESBA was of the view that internal audit services can be provided as long as the firm does not perform management functions and eliminates or reduces to an acceptable level any remaining threat that is not clearly insignificant. Therefore, the IESBA was of the view that it is not appropriate to have a more restrictive requirement for audit clients that are entities of significant public interest.

Overall responses
The majority of respondents either expressly (16 respondents) or implicitly (21 respondents) agreed with the proposal to permit the provision of internal audit services provided that certain specified conditions are met. Illustrative comments include:

- Prohibiting procedures simply because they are done as part of an internal audit service is unnecessary as long as procedures do not entail the performance by the firm of management functions; and
- We also agree that the requirements should be similar for all audit clients, and not be dependent on whether the audit client is an entity of significant public interest or not.

Seven respondents were not supportive of the overall approach. Two respondents (NASBA and IIA) were of the view that a firm that provides financial audit services should not also provide internal audit services to the same client. Three respondents (CICA, Basel and Mazars) expressed the view that an audit firm should not provide internal audit services for a public interest entity. One respondent (APB) expressed the view that where the auditor is likely to place significant reliance on the internal audit work performed by the audit firm, the self-review threat would be unacceptably high and such services should be prohibited, rather than allowing safeguards to be applied. One respondent (ICAS) stated that they did not that believe the proposed changes to the provision of internal audit services to audit clients by audit firms were sufficiently restrictive – no further detail was provided. One respondent (IOSCO) expressed the view that the safeguards provided are not sufficiently robust and that the Code should contain a statement that not all self-review threats can be mitigated with safeguards and that a firm may need to decline to perform certain non-audit services.

Description/Definition of Internal Audit Services
Eleven respondents commented on the description of internal audit services contained in 290.186. Seven respondents expressed the view that it would either be helpful if the section started with a definition of internal audit services or provided a longer description of what these activities comprise. One respondent (AICPA) suggested that it would be beneficial if the examples of internal audit functions were more closely aligned with the internal audit function activities described in the explanatory material of the proposed redraft of ISA 610 "The Auditor's Consideration of the Internal Audit Function" Four respondents (ICAEW, E&Y, FAR and CARB) expressed the view that are differing opinions as to which activities come within this term and in particular whether "fraud investigations" would always be construed as an internal audit function.

The Task Force has considered these comments and proposes that paragraph 290.186 should contain a description of internal audit activities that is the same as that provided in ISA 610.

Management Responsibilities
The description of management responsibilities (as developed under the Independence I project) has evolved since the Independence II Exposure Draft was issued. The Task Force has reflected these changes in the revised document. The Task Force is also proposing changes to provide additional guidance on examples of internal audit services that involve management responsibilities.

Nature of Threat Created by Providing Internal Audit Services
The Exposure Draft stated that depending upon the nature of the services the provision of internal audit services may create a threat to independence the firm subsequently relies on the internal audit work in the external audit. Some respondents expressed the view that a self-review threat would be created.

In considering this matter the Task Force noted that ISA 610:

- Indicates that an external auditor may use the work of an internal audit function;
- Requires the external auditor to evaluate certain matters if the auditor intends to use the work of the internal audit function. (These matters are (a) the objectivity and technical competence of members of the internal audit function; (b) whether the internal audit function is carried out with professional care; and (c) the effect of any constraints or restrictions placed on the internal audit function by management or those charged with governance); and
- Requires the external auditor to perform procedures to evaluate the adequacy of the work when the auditor uses specific work of the internal audit function.

The Task Force is of the view that, if the a firm performs internal audit services for an audit client, and intends to use that work in the course of the external audit, the adequacy of the internal audit work should be evaluated and that the procedures performed should be no less rigorous than procedures required if the services were performed by individuals who are not members of the firm. The Task Force is also of the view that individuals who perform internal audit activities should not be given audit responsibility for any internal audit function of activity with which they were involved as part of performing the internal audit services (which is consistent with the position taken in temporary staff assignments).

The Task Force is also proposing an additional paragraph to address the question of the self-interest threat that may be created if the external audit procedures performed to evaluate the adequacy of the firm's internal audit services identify a deficiency in the internal audit services. The Task Force is of the view that this threat is similar to the threat that may be created when a deficiency in an external audit procedure is identified as a result of performing a subsequent external audit procedure.

Fees – Relative Size

Background
The proposed revisions to Section 290 provided additional guidance with respect to the relative size of fees from an audit client that is an entity of significant public interest. As proposed in the exposure draft when, for two consecutive years, the total fees from such a client represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client the self-interest threat created would be too significant unless disclosure is made to those charged with governance of the client and one of the following safeguards is applied:

- After the audit opinion has been issued a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs a review that is equivalent to an engagement quality control review ("a post issuance review"); or
- Prior to the issuance of the audit opinion a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs an engagement quality control review.

In subsequent years, in determining which of these safeguards should be applied, and the frequency of their application, consideration should be given to the significance of the relative size of the fee. The exposure draft stated that at a minimum a post-issuance review should be performed not less than once every three years to reduce the threat to an acceptable level.

The professional accountant who performs the engagement quality control review (or equivalent) may be a member of a network firm. As noted in the explanatory memorandum the IESBA considered whether there should be a threshold of relative size which, if exceeded, would indicate that the threat created was so significant that no safeguard could adequately address the threat and therefore the firm should either not act as auditor for the client or take steps to reduce the relative size of the fee below the threshold. The IESBA was of the view that such an absolute threshold is not appropriate in a global Code.

Overall responses
Respondents were mixed in their views as whether should be a specific percentage threshold after which safeguards were mandatory. Eleven respondents expressed either support for the approach or noted that they did not disagree with the proposal. Illustrative comments include:

- Although the 15% may appear somewhat arbitrary, it seems, in our view, to be a reasonable threshold and represents what would be a clearly significant client of the firm;
- We consider that 15% is an appropriate threshold, given that the safeguards to be applied would be mandatory;
- We believe that establishing such a specific percentage of a threshold would clearly state the requirements of the independence provisions and avoid confusion: thereby, efficient to implement; and
- The Institute is of the view that the 15% threshold is practical and not overly onerous on firms.

14 respondents expressed the view that it was inappropriate for the Code to have a bright-line 15% test. Illustrative comments include:

- We are of the view that the Code should be drafted using a conceptual framework approach rather than in a prescriptive manner to facilitate ease of application by all jurisdictions;

- A fixed percentage by its very nature, is arbitrary and does not take into account specific circumstances. This could mean 14.9% of total fees would be acceptable whereas 15.1% would not;
- The imposition of a fixed percentage or absolute limit (rather than another appropriate fee limit) might have a disproportionate impact on smaller audit firms having one or very few significant public interest entities as an audit client;
- A fixed percentage might also impact on the concentration and choice in the audit market; and
- Should the IESBA continue to believe that a definitive threshold is needed, we suggest that this issue be dealt with by means of a presumption so that the firm would have to demonstrate that the self-interest threat is not of such significance as to warrant these safeguards.

Four respondents expressed the view that the proposals were too permissive. Two respondents (Mazars and ICANZ) expressed the view that the 15% threshold should not be limited to public interest entities but should apply to all audit clients. One respondent (RM) expressed the view that the threshold should be 10% and one respondent (APB) expressed the view that there should be a threshold over which no safeguards could address the threat. This respondent felt this threshold was 10% for audit clients that were listed entities and 15% for other audit client.

One respondent indicated that there Committee was unable to reach consensus as to whether a 15% threshold was appropriate.

The Task Force has considered the comments and is of the view that a fixed threshold percentage is necessary to ensure consistent application.

Safeguards
The exposure draft proposed that after the 15% threshold had been reached this fact should be disclosed to those charged with governance. The majority of those who commented on this area were supportive of the need to disclose to those charged with governance. Eight respondents expressed support for this approach. Illustrative comments include:

- This would enable the audit client to form its own opinion of any potential self interest threat to the audit firm;
- This will allow those charged with governance to confer with the auditors regarding issues of risk that could arise as a result of the fee dependency and also to address the perception that the independence of the auditor may be impaired as a result of the fee dependency.

Six respondents disagreed with the approach. Illustrative comments include:

- We cannot see what this achieves as it doesn't change the situation – independence is still threatened;
- We recognise the potential intimidation threat that may arise where information regarding the financial stability of the individual partner and the firm is disclosed.

The Task Force has considered the comments and is of the view that disclosure to those charged with governance is appropriate. The Task Force is also of the view that the discussion with those charged with governance should include a discussion the safeguard the firm will put in place to address the threat.

Pre and post-issuance Review
The exposure draft proposed that after the 15% threshold had been reached there should be a periodic pre-issuance or post-issuance review.

Nine respondents expressed support for this approach. Illustrative comments include:

- The options to have either a pre- or post-issuance review provides firms with flexibility and are, in our view, appropriate; and
- We support the proposed mandatory safeguards and believe that either a pre-issuance or post-issuance review provides an appropriate and practical approach to safeguarding independence under these circumstances. We believe that when an individual knows that his or her judgments will be scrutinized by a disinterested party, whether it is in the form of a pre- or post-issuance review, they are deterred from making judgments in their own self interest.

Four respondents expressed the view that a pre-issuance review should be conducted and not a post-issuance review. Illustrative comments include:

- A post issuance review is impractical and if it should be recommended as a safeguard FAR. SRS is of the opinion that it could be improved by the addition of further guidelines on how to deal with e.g. adverse findings; and
- We believe that the pre-issuance review is the only appropriate safeguard.

One respondent expressed the view that a post-issuance review was the only appropriate safeguard because a pre-issuance review "seems to create some considerable difficulty in practice, because we understand that the firm would be shouldered with dual obligations to carry out an internal quality control review and a similar external quality control review during the limited timeframe before the issuance of the audit report."

One respondent stated that neither pre-issuance nor post-issuance reviews were practical. One respondent stated that the safeguards were insufficient to reduce the self-interest threat to an acceptable level.

The Task Force has considered the comments and is of the view that the guidance should be strengthened to require the application of safeguards to the second audit opinion that is issued after the fees reach the 15% threshold.

Alternative Safeguards
The exposure draft asked respondents whether there were alternative safeguards that could address the threat arising from the relative size of fees from an audit client. The following suggestions were provided:

- An inspection by an independent quality assurance system under the responsibility of a public oversight system of an audit firm auditing public interest

entities every three years, as this is for instance stipulated in Articles 29, 32 and 43 of the Statutory Audit Directive;
- The auditor is subjected to quality reviews of relevant professional body; and
- The joint statutory audit as it is currently in place in our country, which involves two audit teams being independent from each other, who confront their opinions on significant technical issues while performing a double-sided examination, would at least constitute an alternative and even more appropriate safeguard to reduce the threat of economical dependence.

The Task Force has considered these comments and is of the view that a pre or post issuance review conducted by a professional regulatory body could be an effective safeguard.

Contingent Fees

Background

The exposure draft provided additional guidance with respect to contingent fees. Under the proposed revisions a firm should not perform a non-assurance service for an audit client if either the fee is material, or expected to be material, to the firm or the fee is dependent upon the outcome of a future or contemporary judgment related to the audit of a material amount in the financial statements. In the case of a non-assurance service provided to an assurance client that is not an audit client a firm should not provide a non-assurance service for a contingent fee if the amount of the fee is dependent on the result of the assurance engagement.

Overall Comments
Eleven respondents indicated that they were generally supportive of the approach taken in this area (subject to some specific comments). Four respondents (CNCC, AGNZ, Mazars and IIA) expressed the view that for audit clients no fees whether received on other assurance or non-assurance engagement should ever be contingent, since they would lead the statutory auditor to enter into a position of having to negotiate its fees with the client based on the result of its work.

Two respondents (GTI and CICA) recommended that the guidance be expanded to include a prohibition of contingent fee arrangements between a firm and third parties where an outcome is dependent on the audited financial statements of the firms' audit client.

One respondent expressed the view that the guidance should address contingent fees charged by network firms.

The Task Force considered these comments and is of the view that a contingent fee charged by a network firm for a non-assurance service would create an unacceptable self-interest threat if the fee was material to the firm expressing the opinion on the financial statements.

Contingent Fees – Section 291
Eight respondents noted that the guidance related to a contingent fee for an assurance engagement in Section 291 is not aligned with the guidance in Section 290.

The Task Force has revised the guidance to align it with Section 290.

Material Presented

Agenda Paper 4	This Agenda Paper
Agenda Paper 4-A	Proposed revised – clean
Agenda Paper 4-B	Proposed revised – mark-up
Agenda Paper 4-C	Exposure Draft
Agenda Paper 4-D	Detailed cut and paste of comments received

Action Requested

1. IESBA members are asked to consider the Task Force proposals and provide direction to the Task Force.

Appendix

Index to comment letters received.

Respondents Legend

ACCA	
AGNZ	Auditor General New Zealand
AICPA	American Institute of Certified Public Accountants
APB	Auditing Practices Board (UK)
APESB	Accounting Professional and Ethical Standards Board – Australia
Aus	Australian Member Bodies (CPA Australia, NIA and Institute of Chartered Accountants of Australia)
CARB	Chartered Accountants Regulatory Board – Ireland
CICA	Canadian Institute of Chartered Accountants
CIMA	Certified Institute of Management Accountants (UK)
CPAA	CPAmerica
DnR	Den norske Revisorforening - The Norwegian Institute of Public Accountants
DTT	Deloitte Touche Tohmatsu
E&Y	Ernst & Young
FAR	The Institute for the Accountancy Profession in Sweden
FEE	Federation des Experts Comptables Europeens
GTI	Grant Thornton International
HKICPA	Hong Kong Institute of Chartered Accountants
ICAEW	Institute of Charted Accountants of England and Wales
ICPAC	Institute of Chartered Accountants of Cyprus
ICANZ	Institute of Chartered Accountants of New Zealand
ICAP	Institute of Chartered Accountants of Pakistan
ICAS	Institute of Chartered Accountants of Scotland
ICJCE	Instituto de Censores Jurados de Cuentas de España
ICPAS	Institute of Public Accountants in Singapore
IDW	Institut der Wirtschaftsprufer (Germany)
IIA	Institute of Internal Auditors
IOSCO	International Organization of Securities Commissions
IRBA	Independent Regulatory Board for Auditors (South Africa)
IRBAA	Independent Regulatory Board for Auditors (South Africa) Addendum
JICPA	Japanese Institute of Certified Public Accountants
KICPA	Korean Institute of Certified Public Accountants
MIA	Malaysian Institute of Accountants
NIVRA	Nederlands Instituut Van Registeraccountants (Netherlands)
PAOC	Public Accountants Oversight Committee (Singapore)
PV	Piet Veltman, IT AdvisoryDirector Professional Practice
PwC	PricewaterhouseCoopers
RM	Ramachandran Mahadevan
SICATC	Swiss Institute of Certified Accountants and Tax Consultants