



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

545 Fifth Avenue, 14th Floor
New York, New York 10017
Internet: <http://www.ifac.org>

Tel: +1 (212) 286-9344
Fax: +1 (212) 856-9420

**Agenda Item
2**

Committee: Ethics
Meeting Location: Vienna
Meeting Date: May 10-11, 2004

Section 8

Independence for Assurance Engagements

Objective of Agenda Item

To approve the proposed changed to Section 8 to:

- Conform to the new IAASB Assurance Framework;
- Conform the definitions to IAASB QC documents; and
- Address partner rotation issues by responding to comments received on the November 2003 exposure draft and providing for rotation of the engagement quality control reviewer.

Activities Since Last Ethics Meeting

The Section 8 Task Force (the TF) held a two-day task force meeting, followed by a conference call, to discuss the proposed changes to Section 8. While the TF believes that the proposed changes contained in these agenda papers are appropriate to conform Section 8 to the new Framework, the TF recognizes that the proposed changes do significantly increase the complexity of the Code.

Assurance Framework

At its February meeting, the Ethics Committee discussed the implications of the new assurance framework. In particular, the Committee considered the changes necessary to address the five parties in an assurance engagement:

- The practitioner
- The intended user
- The party responsible for the subject matter
- The party responsible for the subject matter information
- The engaging party.

The Committee concluded that in all circumstances independence would be required from the party responsible for the subject matter and the party responsible for the subject matter information. It was further agreed that, in some assurance engagements, threats to independence may be created by the practitioner's relationship with the engaging party. Therefore, the practitioner should consider such threats to independence and, if the threats were other than clearly insignificant apply safeguards to reduce the threats to an acceptable level.

OVERVIEW OF ASSURANCE FRAMEWORK

The Assurance Framework is a long document (presented as reference material in Agenda Paper 2-G) – consequently, salient parts of the document and the implications for the independence standard are presented below (the paragraph references are to the Assurance Framework).

The Assurance Framework defines and describes the elements and objectives of an assurance engagement, and identifies engagements to which International Standard on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply. Agenda Paper 2-A illustrates the relationship between the Framework and the ISAs, ISREs, and ISAEs.

The Assurance Framework (¶7) defines an assurance engagement as:

An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example, 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). In the Framework the term "subject matter information" is used to mean the outcome of the valuation or measurement of a subject matter.

Assurance engagements may be (¶10):

- Assertion-based – 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.
- Direct-reporting – the practitioner either directly or indirectly performs the evaluation or measurement of the subject matter, or obtains a representation (which is not available to the intended users) from the responsible party that has performed the evaluation or measurement.

The practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information (¶56).

The Framework states (footnote 2) that for assurance engagements regarding historical financial information in particular, reasonable assurance engagements are called audits, and limited assurance engagements are called reviews.

The following engagements, which may meet the definition of an assurance engagement, need not be performed in accordance with the Framework (¶14):

- Engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters; and
- Engagements that include professional opinions, views or wording from which a user may derive some assurance, if all of the following apply:
 - Those opinions, views or wording are merely incidental to the overall engagement;
 - Any written report issued is expressly restricted for use by only the intended users specified in the report;
 - Under a written understanding with the specified intended users, the engagement is not intended to be an assurance engagement; and
 - The engagement is not represented as an assurance engagement in the professional accountant's report.

The Framework further states that the practitioner and the responsible party may agree to apply the principles in the Framework to an engagement where there are no intended users, other than the responsible party, but where all other requirements of the ISAs, ISREs or ISAEs are met (¶16). In such cases the engagement is not an assurance engagement within the scope of the Framework.

Paragraph 17 states that a practitioner accepts an assurance engagement only when his/her preliminary knowledge of the engagement circumstances indicates that:

- Relevant ethical requirements, such as independence and professional competence will be satisfied, and
- The engagement exhibits **all** of the following characteristics:
 - The subject matter is appropriate;
 - The criteria to be used are suitable and are available to the intended users;
 - The practitioner has access to sufficient appropriate evidence to support the practitioner's conclusion;
 - The practitioner's conclusion, in the form of either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and
 - The practitioner is satisfied that there is a rational purpose for the engagement. If there is a significant limitation on the scope of the practitioner's work it may be unlikely that the engagement has a rational purpose.

The parties involved in an assurance engagement are:

- Practitioner
- Responsible party
 - In a direct reporting engagement is responsible for the subject matter
 - In an assertion-based engagement, is responsible for the subject matter information (the assertion) and may be responsible for the subject matter

- Engaging party – may or may not be the responsible party
- Intended user – when engagements are designed for specific identified users or a specific purpose the practitioner considers including a restriction in the assurance report that limits its use to those users or that purpose

IMPLICATIONS FOR INDEPENDENCE STANDARD

1. While an engagement that meets the definition in paragraph 7 is an assurance engagement, the practitioner only accepts an assurance engagement if the practitioner's preliminary knowledge of the engagement circumstances indicates existence of the matters identified in paragraph 17 (independence, competence, appropriate subject matter, suitable criteria available to the users etc). Agenda Paper 2-B illustrates this point.
2. A footnote in the framework states that reasonable assurance engagements regarding historical financial information are called audits. Section 8 states that an audit engagement is an engagement to provide a high level of assurance that *financial statements* are free of material misstatement, such as an engagement in accordance with ISAs.
3. There are certain engagements that may meet the definition in paragraph 7 that need not be performed in accordance with the Framework.
4. There may be five separate parties in an assurance engagement (practitioner, user, party responsible for subject matter, party responsible for subject matter information and the engaging party).
5. In some direct-reporting engagements the practitioner may be the party responsible for the subject matter information.

REFERENCE TO ASSURANCE FRAMEWORK

The Code currently refers to the International Standards on Assurance Engagements (ISA 100) and also describes the nature of an assurance engagement. Paragraphs 8.3 – 8.6 of the existing Code are taken almost verbatim from ISA 100.

In many respects the new Assurance Framework is more complex than ISA 100 and it is necessary to understand the whole framework in determining whether an engagement would be an assurance engagement covered by the Framework.

The TF considered whether the revised Section 8 should continue to draw material from the Assurance Framework or whether it should rather merely cross-reference to the Framework. After consideration, the TF concluded that it was more appropriate to cross-reference for the following reasons:

- The Framework is complex and accountants need to read and comprehend all of the framework to determine whether it applies to the particular engagement;
- Incorporating extracts from the Framework into the Code runs the risk of interpreting or changing the meaning of the Framework; and
- Any future changes to the Framework would need to be considered for incorporation by the Ethics Committee.

Accordingly, the TF believes that the preferred option is for the Code to refer to the Framework rather than contain extracts from the Framework. Agenda Paper 2-C contains the mark-up of the preferred option. In addition to the reference to the Framework, the TF believes that it would be useful for the Code to refer to the fact that not all engagements performed by a professional accountant in public practice are assurance engagements. This is contained in paragraph 8.9 of the preferred option. This paragraph is drawn from paragraph 12 of the Framework.

The wording of 8.9 is the same as in the framework except for the final bullet. The final bullet of 8.9 states that:

“Consulting (or advisory) engagements, such as management, *business acquisition* and tax consulting” do not meet the definition of an assurance engagement.”

Paragraph 12 of the Framework states that the following engagements would not be an assurance engagement:

“Consulting (or advisory) engagements, such as management and tax consulting.”

Paragraph 13 of the Framework further states:

“An assurance engagement may be part of a larger engagement, e.g., when a business acquisition consulting engagement includes a requirement to convey assurance regarding historical or prospective financial information. In such circumstances, this Framework is relevant only to the assurance portion of the engagement.”

The TF believes that it is appropriate to make reference to business acquisition consulting in the description of engagements that do not meet the definition of an assurance engagement.

Action required

Do Committee members agree with the TF preferred approach (Agenda Paper 2-C) that the Code should cross-refer to the Framework rather than containing extracts of the Framework?

If Committee members do agree with the preferred approach, do Committee members agree that, as discussed above, reference should be made to the fact that business acquisition consulting is not an assurance engagement?

If Committee members do not agree with the preferred approach, do Committee members agree that the paragraphs contained in the alternative option (Agenda Paper 2-E) are appropriate?

PARTIES INVOLVED IN AN ASSURANCE ENGAGEMENT

- Assurance client - Definition changed to incorporate the party responsible for the subject matter and the party responsible for the subject matter information. No corresponding change to the definition of audit client is necessary because it is written in terms of the entity rather than the responsible parties.
- Engaging party – in several places in Section 8 the phrase “assurance engagements provided to a client that is not an audit client” has been used. With the explicit splitting out of the five parties and the new definition of an assurance client, this phrasing is no longer appropriate. Consequently the phrase “assurance engagements in respect of an assurance client” has been used (for example see new ¶8.21)
- Restricted use reports – Existing Section 8 provides that for assurance engagements to non-audit clients, if the assurance report is expressly for use by an identified user, members of the assurance team are required to be independent from the client and the firm should not have a material direct or indirect financial interest in the client. If the client was an audit client, the team, the firm and network firms would be precluded from having a direct financial interest or a material indirect financial interest. This approach was appropriate because the most rigorous independence requirements are applied to clients that are audit clients.

Under the new framework, there might be two separate responsible parties – one responsible for the subject matter and another responsible for the subject matter information. Therefore, hypothetically there could be an assurance engagement where one responsible party is the audit client and a third party is the other responsible party.

To maintain parity with the position taken in existing Section 8, the revised Section 8 therefore distinguishes between restricted use reports in respect of a financial statement audit client where one of the responsible parties is other than the financial statement audit client.

Proposed ¶8.21 provides that for restricted use non-financial statement audit assurance engagements where the party responsible for the subject matter or the subject matter information is other than the financial statement audit client, the members of the assurance team may not have a direct financial interest or material indirect financial interest in the third party and the firm may not have a material direct or indirect financial interest in the third party.

- Engaging party – In February, the Committee concluded that in certain circumstances relationships with the engaging party may create a threat to independence. The TF concluded that the assurance team should consider, in light of the specific engagement circumstances, whether the existence of any significant interests or relationships between the firm, network firm, a member of the assurance team and the engaging party would create a threat to independence. If the engagement is such that the existence of such relationships would create a threat then the assurance team would then consider whether any such interests or relationships do in fact exist – and if they do exist evaluate the significance of the threats and apply safeguards as necessary. ¶8.23 contains this discussion.
- Relationships with employees of the client – Existing ¶8.134 in effect prohibits a member of the assurance team from having an immediate family member who is an employee of the client in a

position “to exert direct and significant influence over the subject matter of the assurance engagement.”

The Framework distinguishes between subject matter and subject matter information. The TF carefully considered whether the revised Section 8 should prohibit such relationships between members of the assurance team and employees in a position to exert direct and significant influence over the subject matter and/or the subject matter information. The TF considered various examples of engagements including:

- engagements where the party responsible for the subject matter is different from the party responsible for the subject matter information; and
- direct-reporting engagements (where the accountant is in effect responsible for the subject matter information) and assertion-based engagement.

In considering this issue, the TF concluded that there is no ground to differentiate between responsibility for the subject matter and the subject matter information. In forming this conclusion the TF noted:

- In a direct reporting engagement and an assertion based engagement, the accountant provides a conclusion that conveys the assurance obtained about the subject matter information;
- If there were to be a distinction between responsibility for subject matter and subject matter information then the provision of an assertion would affect the accountant’s independence requirements.

In considering the implications of this conclusion, the TF considered the following scenario:

An assurance client is a financial institution that earns 90% of its income from trading activities. Neither the chief trader nor the chief financial officer are an officer or a director of the company. The partner on the assignment would be prohibited from have a spouse who is either:

- the head trader (able to exert direct and significant influence over the subject matter); or
- the chief financial officer (able to exert direct and significant influence over the subject matter information).

Action required

Do Committee members agree with the proposed definition of assurance client and the proposed phrase to deal with the engaging party?

Do Committee members agree with the proposed treatment of restricted use reports?

Do Committee members agree with the treatment of engaging party independence requirements?

Do Committee members agree that the prohibition with respect to relationships with client employees should cover employees who are in an ability to exert direct and significance over either the subject matter or the subject matter information? If Committee members do agree with the position taken, do Committee members believe that this is clear in ¶8.134 or should a specific example be provided?

IAASB QC Documents

To conform with the IAASB QC documents, as agreed in the December 2003 Ethics Committee conference call and the Feb 2004 Ethics Committee meeting, the following definitions have been changed/added:

Engagement team	New definition that is consistent with IAASB.
Assurance team	Part (a) of the definition has been replaced by the definition of engagement team and, for certainty, “those who perform the engagement quality control review for the assurance engagement” has been added to part (b) of the definition.
Engagement quality control review	New definition that is consistent with IAASB.
Engagement partner	New definition that is consistent with IAASB – this new definition replaces the definition of lead engagement partner

Action required

Do Committee members agree with the way these new definitions have been incorporated into the Code?

Partner Rotation

In November 2003, IFAC issued an exposure draft (ED) to clarify the intent of the rotation requirements contained in paragraph 8.151 of the Code.

Eleven responses to the ED were received.

- Auditing Practices Board
- International Organization of Securities Commissions
- Meadowbrook/TPA Associates
- IdW
- ACCA
- South African Institute of Chartered Accountants
- Deloitte Touche Tohmatsu
- Japanese Institute of certified Public Accountants
- Institute of certified Public Accountants of Singapore
- Malaysian Institute of Accountants
- FEE

In addition, the Ethics Committee received a letter from the Chair of the IAASB QC TF requesting consideration of rotation of the engagement quality control reviewer, and some other items.

A summary of issues raised is presented in Agenda Item 2-F. While the ED proposed only a specific narrow change to Section 8 with respect to partner rotation, several respondents chose to comment on broader issues. The Ethics Planning Committee when considering the priorities and strategic direction of the Committee will discuss these issues.

LEAD PARTNER

Eight of the eleven respondents agreed with the proposed change. Those that opposed the change did so because the change comes into effect on December 31 and it does not accurately reflect a principles approach (IdW & FEE) or because it would eliminate some needed flexibility (MIA).

Of those that supported the approach, two (APB and IOSCO) explicitly stated that the rotation period should be five on/five off and two (ACCA and MIA) stated that their codes had a five year rotation policy.

Based on the limited number of comment letters received on this issue and the fact that the ED did not explicitly call for comments on the rotation period itself there is not overwhelming evidence for moving towards a five on/five off cycle.

ENGAGEMENT QUALITY CONTROL REVIEWER

At the February meeting, the Ethics Committee discussed rotation of the engagement quality control reviewer (EQCR) and concluded that rotation of the person responsible for the engagement quality control review should be required and the rotation period should be the same as for the lead engagement partner.

The letter from the QC Chair raised two other matters with respect to the rotation of the EQCR:

- The EQCR should have a fresh start and should not have participated in the performance of any assurance or related service engagement for the client in the past year (or two years for a listed entity); and
- The EQCR should not concurrently be involved in any other assurance engagement for the same client.

Both of these matters were included in the QC ED as examples of policies and procedures that could be put in place. A few respondents to the QC ED commented on these matters, the majority of which were not supportive of the position proposed.

The TF concluded that it was not appropriate to address these matters in the revised Section 8. The matters were not exposed as requirements and the limited comment received was not generally supportive.

FLEXIBILITY IN ROTATION

Section 8 provides flexibility in the rotation requirements for the engagement partner:

- ¶8.153 states that some degree of flexibility may be necessary in certain circumstances such as when continuity is especially important to the client, such as when there will a major change to the client structure and situations where due to the size of the firm rotation is not possible and does not constitute an appropriate safeguard.

The proposal does contain the flexibility that is provided in ¶8.151 that rotation is required after a pre-defined period *normally no more than seven years*. The TF considered whether additional flexibility should be afforded to rotation of the EQCR. After deliberation, the TF concluded that such flexibility was not appropriate because:

- The EQCR does not have to be a partner and does not have to be someone within the firm. Therefore, even if a firm had a few individuals within the firm with the necessary knowledge and experience to serve as EQCR the firm could use someone outside the firm.
- The TF could not think of any specific circumstances analogous to those contained in ¶8.153 that would indicate rotation of the EQCR was inappropriate.

PROPOSED WORDING

- 8.151 Using the same lead engagement partner or the same individual responsible for the engagement quality control review on ~~a~~ financial statement audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the financial statement audit of a listed entity~~ies~~ and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly ~~for~~ in respect of the financial statement audit of listed entities:
- (a) The ~~lead~~ 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; and
 - (b) ~~A partner~~ Such an individual rotating after a pre-defined period should not participate in the audit engagement ~~resume the lead engagement partner role~~ until a further period of time, normally two years, has elapsed.

TRANSITIONAL PERIOD

The TF concluded that it would be appropriate to provide a transitional provision for such a requirement to rotate the EQCR. The TF further concluded that a two-year transitional period would be appropriate – which is consistent with the transitional period for the engagement partner provided in Section 8 interpretation 2003-02.

The requirement for firms to establish policies and procedures requiring an engagement quality control reviews for audits of financial statements of listed entities is established in ISQC 1. The effective date for this ISQC is as follows:

“Systems of quality control in compliance with this ISQC are required to be established by June 15, 2005. Firms should consider the appropriate transitional arrangements for engagements in process at that date.”

ISA 220 establishes guidance at the engagement level and is effective for periods commencing on or after June 15, 2005.

Therefore, assuming a December 31 year end, an EQCR would be required for financial statement audits of listed entities for the 2006 fiscal year and may, or may not, be required for 2005 depending upon what transitional arrangements for in process engagements are adopted by a firm.

The following wording for the transitional provision is proposed. This wording is modeled on the wording in Interpretation 2003-02.

“This requirement to rotate the individual responsible for the engagement quality control review is effective for periods commencing on or after June 15, 2005. On implementation, or early adoption of this requirement, while the length of time the individual responsible for the engagement quality control review has served in that capacity should be considered in determining when rotation should occur, the individual may continue to serve in that capacity for two additional years from the date of implementation (or early adoption) before rotating off the engagement. In such circumstances, the additional requirements of paragraph 8.153 to apply equivalent safeguards in order to reduce threats to independence to an acceptable level should be followed.”

Action requested

Do Committee members agree that the Code should not afford additional flexibility in the rotation of the EQCR? If Committee members believe additional flexibility is required, in which particular circumstances would additional flexibility be appropriate?

Do Committee members agreed with the proposed wording change?

Do Committee members agree with the proposed transitional provision wording?

Material Presented

Agenda Paper 2-A	Relationship between Assurance Framework and other pronouncements
Agenda Paper 2-B	Diagram of assurance engagements
Agenda Paper 2-C	Proposed changes to Section 8 – preferred option – mark-up preferred
Agenda Paper 2-D	Proposed changes to Section 8 – preferred option – clean
Agenda Paper 2-E	Proposed changes to Section 8 – alternative option
Agenda Paper 2-F	Responses to November 2003 Exposure Draft
Agenda Paper 2-G	Assurance Framework (provided for reference purposes)

Action requested

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