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## **Agenda Item**

# **3**

**Committee:** Ethics

**Meeting Location:** Helsinki

**Meeting Date:** September 20-21, 2004

### **Independence for Assurance Engagements**

#### **Objective of Agenda Item**

To approve the proposed changes to the Independence section to:

- Conform to the new IAASB Assurance Framework; and
- Conform the definitions to IAASB QC documents.

#### **Activities Since Last Ethics Meeting**

The Section 8 Task Force (the TF) held a task force meeting, followed by several conference calls, to discuss the proposed changes to Section 8. Michael Nugent (IAASB Staff who worked on the Assurance Framework) attended the Task Force meeting.

The proposed changes related to direct reporting engagements will be discussed with the IAASB at their September 13-17<sup>th</sup> meeting. A report on this discussion will be presented at the Ethics Committee meeting.

#### **Overview**

At its May meeting, the Ethics Committee discussed proposed changes to the independence section to conform to the revised IAASB assurance framework. The Committee was concerned that the material presented was too complex and requested the Task Force to reconsider the draft and simplify the approach.

The Task Force believes that it has accomplished this by the following:

- Reordering some of the paragraphs so that the description of independence is towards the beginning of the section (¶ 3-5);
- Providing a description of an assurance engagement (¶9), describing the difference between subject matter and subject matter information (¶10); describing the difference between an assertion-based engagement and a direct reporting engagement (¶12-13);

- Focusing on assertion-based engagements because direct reporting engagements are not commonly performed by professional accountants in public practice (¶14);
- Dealing separately with financial statement audit engagements (¶17), other assertion-based engagements (¶18-20) and restricted use reports (¶21).

#### RECAP OF ASSURANCE FRAMEWORK

An understanding of the assurance framework is necessary to understand the approach taken in the re-drafted independence section. At its May meeting, the Committee did not have a detailed technical discussion of the implications of the assurance framework on independence requirements. Consequently, a recap of the assurance framework is provided here as a lead in to the implications for independence requirements. The paragraph references are to the assurance framework and are denoted as A¶.

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.

The Assurance Framework (A¶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.

In a financial statement audit engagement:

Subject matter information = financial statements

Subject matter = financial position, financial performance and cash flows.

Assurance engagements may be (A¶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 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 subject matter information is provided to the intended users in the assurance report.

The practitioner provides a written report containing a conclusion that conveys the assurance (reasonable or limited A¶11) obtained about the subject matter information (A¶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 (A¶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 (A¶16). In such cases the engagement is not an assurance engagement within the scope of the Framework.

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 Requirements**

A summary of the implications of the new assurance framework on independence requirements has been presented in Agenda Paper 3-C. Members are cautioned that this 3-C is only a summary and is not a substitute for the full text contained in 3-A but it is provided as a overview for assistance.

#### **REFERENCE TO THE 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.

At the May meeting, the Committee discussed whether the Code should merely cross-refer to the Assurance Framework or whether it should contain extracts from the framework. The Committee agreed with the recommendation of the TF that the Code should merely cross-refer to the Framework.

In re-drafting and simplifying the document, the TF has reconsidered its initial recommendation and now believes that it is important to include some material from the Framework in the Code. For example, without an explanation of the difference between subject matter and subject matter information it is difficult to understand the independence requirements when there are two different responsible parties. Accordingly, the TF has included some material from the Framework (see ¶9-13).

#### ***Action required***

Do Committee members agree with the TF recommendation to include the above noted paragraphs?

#### **FOCUS ON ASSERTION-BASED ENGAGEMENTS**

When re-considering the draft presented at the May meeting, the TF concluded that much of the complexity in the draft stemmed from the way the document addressed financial statement audit engagements, other assertion-based engagements (with one responsible party and with two different responsible parties) and direct reporting engagements and also the additional independence complexities associated with restricted use reports.

The TF recognized that the vast majority of assurance engagements performed by professional accountants in public practice are assertion-based engagements, and the vast majority of those engagements have only one responsible party. Therefore, much of the complexity in the document was the result of addressing engagements that are quite rare in practice.

The TF determined that the document should focus on assertion-based engagements. Accordingly, the revised draft states that the section applies to assertion-based engagements (¶15) and before accepting a direct reporting engagement the principles in the section should be applied (¶14).

When discussing the application of the independence framework to direct reporting engagements the TF considered the self-review threat in such engagements. In a direct reporting engagement:

“the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users” A¶10

The TF is of the view that if the professional accountant in public practice directly performs the evaluation or measurement of the subject-matter the self-review threat created may be so significant that no safeguard would be available to reduce the threat to independence to an acceptable level.

This matter will be discussed with the IAASB at their September meeting and a report on any feedback will be presented at the Helsinki meeting.

***Action required***

Do Committee members agree that the section should focus on assertion-based engagements?

Do Committee members agree that before accepting a direct reporting engagement the principles of the section should be applied?

Do the Committee members agree that in a direct reporting engagement where there is no representation the self-review threat may be so significant that no safeguard would be available to reduce the threat to independence to an acceptable level?

**APPLICATION TO ASSERTION-BASED ENGAGEMENTS**

The existing Section 8 defines the assurance client as “an entity in respect of which a firm conducts an assurance engagement.” The TF considered how this definition should be amended to address situations where there are two different responsible parties. The TF concluded that in all circumstances independence from the party responsible for the subject matter information would be required. It is the subject matter information about which the professional accountant in public practice gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report (¶20)

The TF recognizes that threats to independence might be created by interests and relationships with the party responsible for the subject matter. Therefore, consideration should be given to any threats to independence created by interests or relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter (¶20).

Consider the following assurance engagement:

An environmental consultant has prepared a report about a particular sustainability practice for each company in the Fortune 500. The firm is engaged to provide assurance on the report prepared by the environmental consultant.

The environmental consultant is the party responsible for the subject matter information and is the assurance client.

Each Fortune 500 company is a party responsible for subject matter.

The engagement team and the firm are prohibited from having a direct or material indirect financial interest in the environmental consultant. Consideration should be given to any threats to independence the firm has reason to believe may be created by interests and relationships between members of the assurance team, the firm, a network firm and any of the Fortune 500 companies (parties responsible for subject matter).

***Action required***

Do Committee members agree with the approach taken by the TF for engagements where there are two different responsible parties?

**ENGAGING PARTY AND INTENDED USERS [PARAGRAPH 20]**

The TF discussed the appropriate treatment of the engaging party and intended users. In debating this issue the TF considered the following points:

1. To the TF's knowledge no other jurisdiction explicitly considers independence in terms of the engaging party and intended users. Therefore, it would likely be a significant departure from current independence standards.
2. The TF can construct a hypothetical assurance engagement where a threat to independence would be created by interests or relationships with the engaging party and/or intended users – for example, if a purchase price, to be paid by the intended users, was to be based on audited financial statements.
3. It could be argued that because the independence standard is based on a conceptual framework consideration of threats created by interests or relationships with such parties is already covered. However, if it is already covered it is done so quite subtly and is likely not understood to be covered by all readers.

The TF has considered alternative ways to address the issue. The alternative selected will change the content of paragraph 20. The TF was unable to reach consensus on a preferred approach and is, therefore, presenting all the options discussed for consideration by the Committee.

1. *No reference to engaging party or intended user*  
This option would be consistent with the status quo

Under this alternative paragraph 20 would not be needed.

2. *If a reference to engaging party/intended user is to be provided should this be limited to only non-financial statement audit assurance engagements?*

In most cases for a financial statement audit the engaging party is the client itself. Intended users could be a very broad, consider, for example, the shareholders of a listed company. It is reasonable that relationships with the engaging party or intended users would likely only create threats to independence in non-financial statement assurance engagements. Conversely it is difficult to see why a different subject matter would change a possible threat to independence.

3. *If a reference to engaging party/intended user is to be provided what “test” should be given?*  
The TF developed two different “tests” that could be used to consider threats created by engaging party/intended user.

#### Test 1

Use the same test as is currently used for interests and relationships between a non-audit assurance engagement and a network firm. – “consideration should be given to any threats that the firm has reason to believe may be created by interests and relationships”

#### Test 2

Use a different test – one that requires the firm to consider whether, because of the particular facts of the engagement, whether if any interests or relationships existed they would create a threat to independence. If there were such interests or relationships, then the firm would ascertain whether any such interests or relationships did exist. If they did exist, the firm would then evaluate the significance of the threat created and apply safeguards.

Some TF members believe that this test is more appropriate than Test 1.

The alternative for paragraph 20 under the two test options and subject matter distinction are presented below. The words in [square brackets] would be deleted if the Committee believes that no distinction between subject matter is appropriate (see question 2 above). The first part of the paragraph is the same Test 1 and 2 – it is only the underlined text that differs.

Paragraph 20 Test 1

“In certain limited circumstances, for an assertion-based assurance engagement [other than a financial statement audit engagement,] threats to independence may be created if the firm, network firms or a member of the assurance team has an interest in or relationship with either the party who engages the professional accountant in public practice (the engaging party), where that party is not a responsible party, and/or the intended user(s). For example, a self-interest threat may be created if the firm has a material financial interest in an intended user, where the conclusion of the assurance engagement could affect the value of that interest. Therefore, consideration should be given to any threats that the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, and network firm and the engaging party and/or intended user(s).”

Paragraph 20 Test 2

“In certain limited circumstances, for an assertion-based assurance engagement [other than a financial statement audit engagement,] threats to independence may be created if the firm, network firms or a member of the assurance team has an interest in or relationship with either the party who engages the professional accountant in public practice (the engaging party), where that party is not a responsible party, and/or the intended user(s). For example, a self-interest threat may be created if the firm has a material financial interest in an intended user, where the conclusion of the assurance engagement could affect the value of that interest. The assurance team should consider whether, in light of the specific engagement circumstances, the existence of any interests or relationships between the firm, network firms, or a member of the assurance team and the engaging party or the intended user(s) would potentially create a threat to independence that is other than clearly insignificant. If the circumstances are such that a threat would be created if such interest or relationships existed, the assurance team should determine whether such interests or relationships exist and, if so, evaluate the significance of any threats created. If the threats are other than clearly insignificant, appropriate safeguards should be applied to eliminate the threats or reduce them to an acceptable level.”

4. *Address the issue in the objectivity section*

The Code re-draft task force has proposed some language to provide the missing link between objectivity and independence (see Section 15 of Data Sheet 2). The independence TF considered whether consideration of engaging party/intended user interests and relationships should be addressed in the objectivity section. An advantage of this approach is that it maintains the focus of independence consideration on the “client”. A disadvantage is that might be more confusing to readers.

If the matter were to be addressed only in the objectivity section no paragraph 20 would be needed and the paragraph 15.2 would read as follows (mark-up test shows the new language):



The existence of threats to objectivity will depend upon the particular circumstances of the engagement and the nature of the work that the professional accountant in public practice is performing. For example [, in an assurance engagement that is not a financial statement audit engagement] a threat to objectivity may be created by interests or relationships with either the party who engages the professional accountant in public practice (the engaging party) where that party is not a responsible party, and/or the intended user(s). A self-interest threat to objectivity may be created if the professional accountant in public practice has a material financial interest in an intended user, where the conclusion of the assurance engagement would affect the value of the interest.

***Action required***

Do Committee members believe that explicit reference should be made to threats to independence created by interests and relationships with engaging parties and/or intended users?

If Committee members do believe such a reference is appropriate, should it be in terms of all assurance engagements or only non-financial statement audit engagements?

Is the appropriate “test” the Test 1 or Test 2?

Should the matter be addressed in the objectivity section?

Having answered these questions, Committee members are asked to select the appropriate paragraph provided and determine whether any changes are appropriate.

**Other Matters**

There are some other changes to the document which reflect the decisions taken at the May Committee meeting. Because the Committee did not fully discuss all these points they are presented again for completeness.

**DEFINITIONS**

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	New definition that is consistent with IAASB.

control review

Engagement partner      New definition that is consistent with IAASB – this new definition replaces the definition of lead engagement partner

#### ROTATION OF ENGAGEMENT QUALITY CONTROL REVIEWER

At the May Committee meeting, it was agreed that the person responsible for the engagement quality control on the audit of listed entities should be required to rotate in a manner similar to the engagement partner.

It was also agreed that the flexibility in the existing Section 8 for rotation requirements for the engagement partner should be extended to the person responsible for the engagement quality control review.

Extant ¶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.

A two-year transitional period for rotation of the EQCR will be proposed – 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 with the approach taken?

**Material Presented**

Agenda Paper 3-A      Revised independence section – clean copy

Agenda Paper 3-B      Revised independence section – mark-up

Agenda Paper 3-C      Summary of provisions

**The Clean copy (Agenda Paper 3-A) will be used at the meeting**

**Action requested**

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