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Agenda Item 2

Committee Ethics Committee

Meeting Location: Radisson SAS, Rome, Italy

Meeting Date: June 13-14, 2005

Alignment to Framework

Objectives of Agenda Item

1. To discuss and approve the changes to the Code to align to the assurance framework

Background

The October 2004 exposure draft (ED) proposed changes to Section 290 of the Code to align it with the IAASB Assurance Framework. The majority of the respondents to the ED felt that the proposed changes were not clear with respect to the application of the Code to assurance engagements that were non-financial statement audit engagements. These respondents commented on two issues:

- Linkage to the Assurance Framework and the fact that the terms “subject matter” and “subject matter information” were difficult to understand and were not clearly explained in the Code; and
- Application to direct reporting engagements – the ED could be read as precluding practitioners from performing direct reporting engagements.

A Task Force reviewed the comments received and develop revised wording for consideration by the Ethics Committee. The Task Force also recommended that explanatory material should be issued at the same time as the Code to provide a rationale for the positions taken and to assist in the application of the Code to assurance engagements.

The Committee generally agreed with the approach proposed but asked that the Task Force reconsider:

- The ordering of some of the paragraphs;
- The application to direct reporting engagements; and
- The application to multiple responsible parties

The Committee noted that there were issues with:

- the boundaries of an assurance engagement;

- developing realistic examples of assurance engagements;
- differentiating between assertion-based and direct reporting engagements; and
- understanding the nature of direct reporting engagements where no written representation is available from the responsible party that evaluates or measures the subject matter.

The Committee recommended that the working group meet with representatives of the IAASB to discuss these matters.

The Committee agreed that it would be useful to issue some form of explanatory material at the same time as changes to the Code were issued. The Committee recommended that, because such material would contain examples of assurance engagements, the IAASB be given the opportunity to provide input on the explanatory material.

Discussion

DISCUSSION WITH IAASB

In April, a Task Force of representatives from the Ethics Committee¹ met with representatives of the IAASB² to obtain a better understanding of the assurance framework and, in particular, direct reporting engagements where there is no written representation from the responsible party that evaluates or measures the subject matter.

After the meeting, a draft of the proposed changes to Section 290 and the draft interpretation were sent to the IAASB representatives for their comment to ensure that the assurance framework had been appropriately described.

PROPOSED CHANGES TO SECTION 290

Agenda Paper A-1 contains an extract of Section 290 marked from the Exposure Draft to show changes made to address concerns received on exposure and comments received from the Ethics Committee in February 2005.

At the February meeting, the Committee felt that the clarity of Section 290 would be improved if certain paragraphs were moved. Accordingly, in Agenda Paper 2-A:

- Paragraphs 290.1b-f are now towards the front of the document;
- The paragraph dealing with multiple responsible parties (¶290.11a) has been moved to after the paragraph dealing with restricted use reports (¶290.11).

The Committee also decided that reference should be made to an “assertion-based assurance engagement” and a “direct reporting assurance engagement.” This change is reflected in Agenda Paper 2-A.

¹ Lerner, George, Hughes, Moleveld, Pinkney, Rothbarth, Winetroub and Munro, staff

² Kellas, chair, Esdon, deputy chair, Dassen, chair of Assurance TF, Simnett, member of Assurance TF, and Nugent, staff

Action requested

Committee members are asked to consider whether they agree with the new placement of the paragraphs and the extent of the descriptive material, particularly paragraphs 290.1a-1f and 290.9b, 10 a and 11a

Direct reporting engagements

As indicated by ¶10 of the Assurance Framework, 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 and the representation is not available to the intended users.

The Task Force discussed with representatives of the IAASB those types of direct reporting engagements where the practitioner directly performs the evaluation or measurement of the subject matter. It was noted that in such engagements, the practitioner may obtain a representation from management after the practitioner has evaluated or measured the subject matter. In effect, management (the responsible party) is indicating their concurrence with the practitioner's evaluation or measurement.

Therefore in direct reporting engagements there are three possible alternatives with respect to management representations:

- The practitioner, before performing the engagement, obtains a representation from the responsible party that evaluates or measures the subject matter, this representation is not available to the intended users (“pre engagement representation”);
- The practitioner directly performs the evaluation or measurement of the subject matter and then requests and obtains a written representation from the responsible party (“post engagement representation”)
- The practitioner directly performs the evaluation or measurement of the subject matter and then requests but is unable to obtain a representation from the responsible party. There are two reasons why the responsible party may be unable to provide a representation:
 - The responsible party may not have sufficient understanding of the subject matter, identified criteria or subject matter information to able to concur with the practitioner's conclusion;
 - The responsible party may disagree with the outcome of the practitioner's evaluation or measurement.

The Task Force considered the self-review threat in those direct reporting engagements where there is either a post engagement representation or no representation. Paragraph 100.10 of the ED describes self-review threats as follows:

“Self-review threats, which may occur when a previous judgment needs to be re-evaluated by the professional accountant responsible for that judgment.”

The old Section 8 contained a more expansive definition that is focussed solely on a self-review threat to independence. It stated:

“Self-review threat occurs when (i) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or (2) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.”

A key point in both definitions is the concept of a *previous* judgment. A self-review threat arises when you have to re-evaluate a previous judgment. In the case of a direct reporting engagement where the practitioner is directly evaluating or measuring the subject matter there is no previous judgment. The process of evaluating or measuring the subject matter, and the process of gathering sufficient appropriate evidence about the subject matter information to provide a reasonable basis for expressing a conclusion are likely to be performed concurrently. However, for the purpose of illustration, assume that it is a two-step process. Using an engagement to provide assurance on proven oil reserves as an example. The practitioner is to perform a direct reporting engagement to provide assurance on the proven oil reserves of a company. The practitioner will directly measure the reserves of the company. The practitioner conducts the engagement in two separate phases:

- Measurement – the practitioner takes the raw data from the company and applying the criteria, measures the oil reserves. The data provided by the company will include matters such as details of concessions held, cost of extraction from each particular oil field, price of various types of grades of oil etc. Using this data and applying the criteria the practitioner calculates a proven reserves figure of 2 billion barrels;
- Evidence gathering – the practitioner now gathers evidence to provide a reasonable basis for expressing conclusion on the fair presentation of the oil reserves. The practitioner would test the date for completeness, test for ownership of the concessions held, test the cost of extraction etc.

The basis of a self-review threat is that if the practitioner has made judgment on a matter and then has to re-evaluate that judgment it will be more difficult to be objective, apply professional judgment and exercise professional scepticism – “it must be right because that is what I concluded last time”. There is also an element of a real or perceived reluctance to find fault with a previous judgment. However in the example noted above, there is no self-review threat when gathering evidence – even though the practitioner has measured the proven reserves, these have not been published or made available to the company. Therefore, in the evidence gathering process, if for example, the practitioner determines that the cost of recovery from a particular oil field was greater than that stated by the company (thus reducing the estimate of proven reserves) there would be no reluctance (real or perceived) on the part of the practitioner to adjust the number of proven reserves. Similarly, if in gathering the evidence, the practitioner determined that when applying the criteria and measuring the proven reserves an error of judgment has been made, there would be no reluctance (real or perceived) on the part of the practitioner to adjust the number of proven reserves.

Whether or not the practitioner subsequently obtains a representation from the company affects the evidence gathered by the practitioner but it does not affect any threat to independence. Accordingly, the Task Force is of the view that there is no increased self-review threat when a practitioner performs a direct reporting engagement.

Action requested

Committee members are asked to consider whether paragraph 10a appropriately addresses independence requirements for direct reporting assurance engagements.

Multiple responsible parties

In considering the application of the code to assurance engagements where there are multiple responsible parties, the Task Force has questioned whether it was necessary to apply the provisions of the Code to all of the responsible parties. The Task Force is of the view that in engagements where there are many responsible parties (for example, an engagement to provide a conclusion on the circulation statistics of 200 independent newspapers) it might not be necessary to apply all of the provisions to all responsible parties.

Accordingly, at the February 2005 Ethics Committee meeting the Task Force recommended that materiality should be taken into account in determining whether it was necessary to apply all of the provisions to all of the responsible parties.

The Committee agreed that it was appropriate to give consideration to whether all of the provisions should be applied to all of the responsible parties but questioned whether the consideration should be based solely on materiality.

The Committee noted that the consideration should take into account qualitative and quantitative matters.

The Task Force considered this input and is of the view that in addition to materiality the consideration should take into account the degree of public interest associated with the assurance engagement. The Task Force considered whether it was necessary to make explicit reference to the need to consider qualitative and quantitative factors and concluded that it was not necessary because this thought is implicit in the consideration of materiality and the degree of public interest.

The Committee also noted that the consideration of which responsible parties from which independence was needed would depend upon whether a practitioner was providing a conclusion on each individual subject matter information or on the subject matter information as a whole. For example, in the newspaper circulation example, the practitioner could provide an opinion on the total circulation of the 200 newspapers, or an opinion on the circulation of each newspaper. The Task Force has addressed this issue by noting that the threat to independence is considered in context of the subject matter information – i.e. the information on which the practitioner is expressing a conclusion.

The Committee also noted that it was important to take into account the effect of an omission or error on the users of the report. This point has not been reflected in revised paragraph 290.11a. Materiality is defined as:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement...”

Accordingly, the effect of an omission or error would affect the materiality calculation rather than the determination of the parties from whom independence is required.

The Committee also questioned whether a determination based on materiality was in accordance with the conceptual framework in the Code or whether the consideration should be whether an interest or relationship with a responsible party could give rise to a threat to independence that was other than clearly insignificant. The Task Force has addressed this issue by stating that the practitioner may take into account whether an interest or relationship with a particular responsible party would create a threat to independence.

Action requested

Committee members are asked to consider whether paragraph 11a appropriately addresses independence requirements when there are multiple responsible parties.

Family and personal relationships

The Code contains guidance on the independence implications of family and personal relationships between members of the assurance team, others within the firm and individuals employed by the assurance client. The position taken in the exposure draft can be summarized in the following table:

	Individual in position to exert direct and significant influence over	
	SM	SMI
Immediate family member	May create a threat (290.136)	Prohibited (290.135)
Close family member	Not mentioned	May create a threat (290.137)
Non immediate/close family member who has close relationship with member of assurance team	Not mentioned	Member of team are responsible for identifying such individuals and consulting in accordance with firm procedures (290.138)
Personal/family relationships between	Not mentioned	Partners and employees responsible for

partner or employee of firm (not on team)		identifying such individuals and consulting in accordance with firm procedures (290.139)
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The Task Force has reconsidered the above position and is of the view that it continues to be appropriate. The firm expresses a conclusion about whether the subject matter information is presented fairly in accordance with the criteria. Individuals who are in a position to exert direct and significant influence over the subject matter information evaluate or measure the subject matter (for example, in a financial statement audit engagement, these individuals would be in an accounting role determining the appropriate accounting treatment for transactions). The firm expresses a conclusion as to the appropriateness of the subject matter information – in effect the firm is checking the work of those in a position to exert direct and significant influence over the subject matter information – therefore it is appropriate that a member of the assurance team should not have an immediate family member who was in such a position because the closeness of the relationship is such that no safeguard could reduce the threat to an acceptable level (¶290.135). If a close family member was in such a position consideration should be given to the significance of the threat created. This consideration, as opposed to an absolute prohibition, is appropriate because the family relationship is not as close (¶290.137). Similarly threats may be created by relationships between a member of the assurance team and an individual in a position to exert direct and significant influence over the subject matter information (other than a close or immediate family member) if the relationship is close (¶290.138) and partners and employees of the firm not on the assurance team and individuals in a position to exert direct and significant influence over the subject matter information (¶290.139). Therefore, members of the assurance team and other partners and staff are responsible for identifying such individuals and consulting in accordance with firm procedures.

The Code also requires consideration of the significance of a threat created if an immediate family member of a member of the assurance team was in a position to exert direct and significant influence over the subject matter. For example, in an engagement to audit the financial statements of a bank, the spouse of a member of the assurance team might be the chief trader at the bank. The bank might generate 50% of its income from its trading book. Therefore, the chief trader would be in a position to exert direct and significant influence over the financial performance of the bank (the subject matter). Therefore, the Code requires consideration of threats to independence create by such relationships (¶290.136).

Action requested

Committee members are asked to consider the appropriateness of the independence provisions with respect to family relationships.

Proposed interpretation

Agenda Paper 2-B contains a draft of an interpretation. At its February meeting, the Ethics Committee determined that it would be useful to issue some form explanatory material containing examples of application of the Code. The Committee did not, however, discuss the form of the additional material.

The Task Force has considered the following alternatives:

- Issuing an explanatory memorandum with the revisions to the Code;
- Issuing a basis for conclusions document that explains the new approach and provides example;
- An article explaining the approach taken in the final Code and illustrating the application of Code to various types of assurance engagements.

The above three alternatives have the following drawbacks:

- The guidance would not remain with the final Code – for example, when the Code is reproduced in the Handbook the above documents would not be with the Code; and
- Level of authority – the level of authority of the Code and interpretations to the Code is clear but the level of authority of an explanatory memorandum or an article is not clear.

Accordingly, the Task Force is of the view that the explanatory material should be in the form of an interpretation to Section 290.

There are currently two interpretations to the Code of Ethics – both dealing with independence requirements. The introduction to the interpretations states:

“These interpretations are directed towards the application of the IFAC *Code of Ethics for Professional Accountants* to the topics of the specific queries received.”

If the guidance is issued as an interpretation it will likely be appropriate to revise the introduction as follows:

“These interpretations are directed towards the application of the IFAC *Code* to the topics of the specific queries received.”

Action requested

Committee members are asked to consider whether they agree the explanatory material should be issued in the form of an interpretation.

Committee members are asked to consider the content of the draft interpretation.

NEED FOR RE-EXPOSURE

After approving the revised wording it is necessary to consider whether there has been substantial change to the document that may warrant re-exposure. In considering whether re-exposure was necessary consideration was given to the following factors:

- Whether there had been changes to a exposure draft arising from matters that were not aired in the exposure draft such that commentators have not had an opportunity to make their views known to the Ethics Committee before it reaches a final conclusion;
- Whether there has been substantial change arising from matters that have not been previously deliberated by the Ethics Committee; or
- Whether there has been substantial change to the substance of the exposure draft.

The purpose of the exposure draft was to align the Code to the Assurance Framework and to extend the partner rotation provisions. The comments received on the partner rotation requirements were generally supportive. Comments received on the alignment to the framework focused on:

- Application to direct reporting engagements; and
- Clarity of requirements.

Both these issues have been addressed and an interpretation is proposed to aid clarity. Accordingly it is proposed that re-exposure is not required.

Action requested

After considering the appropriateness of the proposed changes and assuming the Committee is in favor of the release of the document, the Committee will be asked to vote as to whether re-exposure is required.

Material Presented

Agenda Paper 2	This Agenda Paper
Agenda Paper 2-A	Draft Section 290
Agenda Paper 2-B	Draft interpretation

Action Requested

1. Ethics Committee members are asked to consider the questions contained in this agenda paper.
2. Ethics Committee members are asked to approve the Code for release.
3. Ethics Committee members are asked to consider whether re-exposure is required.