



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item

7

Committee: IFAC Ethics Committee
Meeting Location: Radisson SAS, Rome, Italy
Meeting Date: June 13-14, 2005

Independence

Objectives of Agenda Item

1. To consider the proposed changes to Section 290
2. To consider and approve the proposed content of a consultation document to be presented to the Forum participants

Background

At its September 2004 meeting, the Ethics Committee approved a project to consider whether any parts of the independence section should be revised.

The independence provisions in the Code were issued in November 2001 with an effective date for assurance reports issued after December 31, 2004. Since issuance, several failures have led to a loss in credibility in aspects of the financial reporting process and many jurisdictions have taken steps to restore this credibility. Some of these steps have related to auditor independence requirements. Therefore, the Committee concluded that it was appropriate to consider whether any parts of the independence requirements should be revisited.

At the February 2005 Ethics Committee meeting, the Committee considered the Task Force¹ proposals as to which parts of Section 290 should be revisited.

The Committee provided direction to the Task Force and it was agreed that proposed wording changes would be presented at the next Ethics Committee meeting for discussion.

The Task Force has met twice since the February Committee meeting.

Discussion

Clarity of prohibitions

The Committee agreed with the Task Force recommendation that Section 290 should be reviewed to determine which prohibitions could be expressed more directly but cautioned that the

¹ Jean-Francois Cats (chair), Neil Lerner, Tony Bromell, Jean Luc Doyle, Geoff Hopper, Neil Lerner, Andrew Pinkney, Volker Rohricht, Jean Rothbarth, Sandrine Van Bellinghen (TA to Jean-Francois Cats)

prohibitions should be categorized within the context of the framework and not become a list of rules.

The Task Force has reviewed Section 290 and has, in places, reworded a prohibition to make the wording more direct.

Action requested

When reviewing Section 290, Committee members are asked to consider whether the prohibitions are now clearer or whether additional changes should be made.

User friendly Guide

The Committee concluded that such guides were useful and agreed that a Guide should be prepared when the changes to the independence requirements are approved.

The Task Force proposes to prepare a guide that can be issued at the same time as the final revisions are approved and issued.

Safeguards

The Committee concluded that, while it was important to recognize there are a wide variety of safeguards, the specific examples should be reviewed to ensure that the safeguards noted are sufficiently robust. The Committee also agreed that it would be useful to explain that certain safeguards assist in compliance with the fundamental principles. The Committee also concluded that Section 290 should be reviewed with the view to emphasizing that if safeguards are not available to reduce a threat the engagement should be declined. The Committee did, however, caution the Task Force not to incorporate unnecessary repetition.

The Task Force has reviewed Section 290 and, in certain cases deleted some safeguards because these safeguards, on their own, would seldom be sufficient to reduce a threat of any significance. The Task Force has also added language to ¶290.7 to state that certain safeguards assist in compliance with fundamental principles rather than addressing a specific threat.

Action requested

When reviewing Section 290, Committee members are asked to consider the appropriateness of additional language in ¶290.7 and the safeguards deleted.

Communication with the audit committee

The Committee recommended that the Code should clearly explain why communication with an audit committee was an effective safeguard.

The Task Force has expanded the discussion (¶290.20) regarding communication with the audit committee to state that such communication may be an effective safeguard when the audit committee considers the judgments made by the assurance team in identifying and evaluating threats to independence and the effectiveness of the safeguards applied to reduce the safeguards to an acceptable level.

Action requested

When reviewing Section 290, Committee members are asked to consider the appropriateness of the additional discussion in ¶290.20.

Other specific comments

With respect to the detailed review of Section 290, the Committee provided the following guidance to the Task Force:

- It would be useful to clarify the interpretation of the engagement team as it relates to specialists. The IAASB has commenced a project to revise ISA 620 *Using the Work of an Expert* and it would be appropriate to co-ordinate with the IAASB.

The Task Force is proposing a change to the definition of assurance team, without a corresponding change to the definition of engagement team. The Task Force is of the view that such a change would not impact the IAASB because the only references to “assurance team” in the ISAs relate to direct references to the Code of Ethics.

- The definition of a listed entity should not be expanded to include publicly available collective investment vehicles. Such vehicles vary from jurisdiction to jurisdiction and it would not be possible to find a definition that was appropriate for all legal environments. Therefore, if there is a need to specifically address such vehicles, it should be done by each jurisdiction.
- Consideration should be given to extending the restrictions on holding financial interests in an audit client that is not a listed entity to certain related entities of that audit client. The Committee agreed that it was appropriate not to extend the restrictions related to the provision of non-audit services but asked the Task Force to consider whether the restrictions on employment relationships should also be extended.

The Task Force is proposing such changes in ¶290.114 to state that a member of the assurance team should not have a material financial interest in an entity that has a controlling interest in a financial statement audit client.

- The existing documentation requirement should be given more prominence.

The Task Force is proposing that the documentation requirement be moved to a separate paragraph and be given a separate heading (¶290.21b).

- The restrictions on employment with an audit client should require a cooling off period that would normally be no less than one year. There should be an exemption to this cooling off period for individuals who, subsequent to accepting employment with an entity, find themselves in a restricted position solely because of a business combination or other similar transaction.

The Task Force considered this issue and concluded that the greatest threat to independence was created when a former engagement partner joined a financial statement audit client before an appropriate period of time had passed and has drafted guidance to address this matter (¶290.143a). The Task Force considered whether additional guidance was necessary to address situations where other members of the assurance team joined the audit client. The Task Force concluded that this was adequately addressed by the general framework to identify and evaluate the significance of threats created and apply safeguards to eliminate the threat or to reduce it to an acceptable level. The Task Force also considered whether it was necessary to explicitly include the exemption for an engagement partner who, subsequent to accepting employment with an entity, finds him or herself in a restricted position solely because of a business combination or other similar transaction. The Task Force felt that this was additional detail that was not necessary and was addressed by the statement that accepting a position would “generally” create too significant a threat to independence.

- If it is known that a person is to join an audit client, it should be mandatory to perform a review of the significant judgments made by that individual. The significance of the judgments would be considered in the context of the whole audit. Thus, judgments made by a lower level staff person might not warrant review whereas judgments made by a senior manager likely would.

The Task Force is proposing a change in ¶290.144 to address this issue.

- Paragraph 290.152 recognizes that long association of senior personnel may create a familiarity threat. The task force should consider whether the section should be strengthened to indicate that in some engagements it might be necessary to extend the rotation provisions to partners other than the engagement partner and the individual responsible for the engagement quality control review.

The Task Force proposes additional guidance on a familiarity threat that may be created by prolonged service of partners other than the engagement partner or the individual responsible for the engagement quality control review (¶290.154).

- Paragraph 290.158 states that certain activities would generally create too significant a threat to independence. In all circumstances it would be inappropriate to determine which recommendations of the firm should be implemented or to report in a management role to those charged with governance. Also greater guidance should be provided as to what is meant by authorizing or consummating a transaction.

The Task Force proposes changes to ¶290.158.

- Greater guidance should be given in the area of taxation services which encompass a broad range of services and while they generally do not create unacceptable threats to independence consideration should be given to certain tax services to determine whether they create a threat to independence.

The Task Force proposes additional guidance in the area of taxation services ¶290.179a.

- The guidance on recruiting senior management should be clarified to explain that a practitioner cannot act as a negotiator (i.e., one who can commit the client to the terms of a transaction) for an assurance client because this would create an unacceptable advocacy threat.

The Task Force proposes additional guidance in ¶290.202.

- The restrictions on corporate finance services should apply only to audit clients rather than all assurance clients.

The Task Force proposes changes in ¶290.203 & 290.204.

- The Code should recognize that a threat to independence in appearance may be created if a partner is compensated for procuring non-audit services from a listed entity audit client.

The Task Force proposes a new paragraph dealing with partner compensation ¶290.11a.

The Committee also asked the Task Force to revisit the guidance in paragraph 290.25 and the phrase “exert direct and significant influence over”.

The Task Force has carefully considered this issue and has concluded that the threat would be better expressed by referring to an individual in a position to exert significant influence over the preparation of the subject matter information (290.134). In the case of a financial statement audit engagement this would mean significant influence over the preparation of the audit client’s accounting records or financial statements (¶290.135)

Action requested

When reviewing Section 290, Committee members are asked to consider the appropriateness of Task Force proposals in response to the above points raised by the Committee.

Other Services

The Task Force, in addition to considering changes to the existing guidance on non-assurance services, considered whether there were any other types of non-assurance services that should be discussed in the Code. Accordingly, the Task Force considered new and emerging services and reviewed guidance in other jurisdictions, and comments received as a result of the survey of member bodies.

The Task Force considered the following types of services and approaches taken by different jurisdictions:

- *Actuarial services* – some jurisdictions prohibit such services for listed entity audit clients, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures – an alternative approach is to prohibit such services unless all of the significant judgment are made by “informed management” and the valuation has no material effect on the financial statements.
- *Expert services* – some jurisdictions prohibit providing an expert opinion or other expert service for a listed audit client for the purposes of advocating the client’s interest in

litigation or in a regulatory or administrative proceeding or investigation. However, the auditor is permitted to provide factual accounts, including testimony, of work performed or explain the positions taken or conclusions reached.

- *Transactions related services* – a jurisdiction states that threats to independence may be created when a firm undertakes transaction related services (for example investigations into possible acquisitions or disposals, investigations into the tax affairs of possible acquisitions or disposals, or the provision of information to sponsors in relation to prospectuses and other investment circulars). This jurisdiction prohibits such engagements
 - if the partner has reasonable doubt as to the appropriateness of the accounting treatment that is related to the advice, having regard to the requirement for the financial statements to give a true and fair view; or
 - the services are provided on a contingent fee basis and the fees are material to the firm, or the part of the firm that is performing the engagement, or the outcome is dependent on a future or contemporary audit judgment or the engagement would involve the audit firm undertaking a management
- *Pension benefits* – some jurisdictions provide specific guidance on providing pension benefit services to an audit client and, for example, prohibits matters such as making policy decisions on behalf of the plan, dealing with plan participants and making disbursements on behalf of the plan.
- *Business risk consulting* – a jurisdiction provides guidance on business risk consulting, and, for example, prohibits making or approving business risk decisions and presenting business risk considerations to those charged with governance on behalf of management.
- *Contingent fees* – some jurisdictions prohibit an audit firm from providing any service or product to a listed audit client for a contingent fee or commission or receiving a contingent fee or commission from such an audit client.
- *Gifts and hospitality* – some jurisdictions provide guidance on gifts and hospitality given to an audit client;

The Task Force concluded that it was not necessary to add additional guidance on these additional types of services. The Task Force was mindful that the Code is principles based and was concerned that adding additional guidance on services, unless there was a demonstrated need, would detract from the framework.

Action requested

Committee members are asked to consider the appropriateness of not including additional guidance on the above noted non-audit services.

Structure of Section

At the February 2005 meeting, the Committee discussed whether the section should be restructured. Several respondents to the survey on experience with implementation, and two respondents to the October 2004 ED, commented on the structure of the section. These respondents stated that because the requirements deal with all assurance engagements it is difficult to focus on the specific requirements that apply to the audit of financial statements. IOSCO also stated that writing requirements that can apply to all assurance engagements “has the effect of obscuring or undermining what is expected on listed company audits.”

The Task Force considered whether, given the framework has been moved to Part A of the Code, it would now be appropriate to restructure Section 290 to separate requirements/guidance for financial statement audit engagements from other assurance engagements. In weighing the advantages and disadvantages of restructuring the section, the Task Force concluded that separating the section into for example, audits, listed audits, other assurance clients, would create a great deal of repetition. The Committee agreed with the Task Force recommendation.

The Task Force has given further thought to the issue reflecting on the proposed changes to the section and also the experience of the Task Force addressing the alignment to the framework. The Task Force is of the view that the matter should be reconsidered. The majority of assurance engagements are financial statement audit engagements and accountant's performing such engagements are not concerned with, for example, the independence requirements associated with direct reporting engagements or engagements where there are multiple responsible parties. Accordingly, the Task Force is of the view that the Committee should reconsider the issue.

To assist the Committee in reconsidering this issue, the Task Force has taken a first cut at splitting the section. The revised section is provided for illustrative purposes only – the Task Force has not deliberated on the exact nature of the split. Therefore, it should be viewed as indicative of what the sections would look like. Should the Committee agree with the Task Force that the sections should be split, the Task Force will at its next meeting refine the split, and present a fully developed document for the deliberations of the Committee.

Action requested

Committee members are asked to consider whether the section should be split. Committee members will not be asked for comments on the content of the split.

Draft Consultation Paper

Agenda Paper 7-D contains a draft of a consultation paper, which would be included in the pre-reading material for the forum. The purpose of the consultation paper is to provide forum participants with:

- Background on why the Ethics Committee felt it was appropriate to revisit the independence requirements contained in the Code;
- The process the Committee has followed to determine the changes it feels appropriate; and
- An overview on the changes to be proposed.

Action Requested

Committee members are asked to consider the content of the consultation paper.

Material Presented

Agenda Paper 7	This agenda paper
Agenda Paper 7-A	Proposed revisions to Section 290 (clean)
Agenda Paper 7-B	Proposed revisions to Section 290 (mark-up)
Agenda Paper 7-C	Illustrative split of Section 290
Agenda Paper 7-D	Proposed content of Forum consultation paper

Clean and mark-up copies of the proposed revisions to Section 290 have been provided for the convenience of Committee members. At the Rome meeting the discussion will follow the mark-up copy.

Action Requested

1. Committee members are asked to consider the questions contained in this agenda paper.
2. Committee members are asked to approve the content of the consultation document for distribution to forum participants.