



## IFAC Ethics Committee

### Ethics Forum – Consultation Paper

### October 11<sup>th</sup>, 2005

#### **Purpose of Forum**

The IFAC Ethics Committee will hold a forum in Brussels on October 11th, 2005 to raise awareness of ethical issues facing professional accountants and obtain input on the activities of the Committee, in particular, proposed changes to independence requirements for accountants performing assurance engagements.

#### **Mission and Terms of Reference of IFAC Ethics Committee**

The mission of the International Federation of Accountants (“IFAC”), as set out in its constitution, is “to serve the public interest, strengthen the accountancy profession worldwide and contribute to the development of international economies by establishing and promoting adherence to high-quality professional standards, furthering international convergence of such standards, and speaking out on public interest issues where the profession’s expertise is most relevant”. In pursuing this mission, the IFAC Board has established the IFAC Ethics Committee (the “Committee”) to function as an independent standard-setting body under the auspices of IFAC.

The Committee develops and issues, in the public interest and under its own authority, high quality ethical standards and other pronouncements for professional accountants for use around the world. The IFAC Board has determined that designation of the Committee as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The Committee’s objectives are as follows:

- to establish high quality ethical standards and other pronouncements for professional accountants that will protect the public interest and strengthen public confidence in the accounting profession.
- to promote good ethical practices to IFAC member bodies and to the public at large.
- to foster international debate on ethical issues faced by professional accountants.

In fulfilling the above objectives, the Committee develops and issues the “*Code of Ethics for Professional Accountants*”(the “Code”), which establishes standard based principles of professional ethics for public accountants and provides a conceptual framework for applying these principles. No member body of IFAC or firm issuing reports in accordance with International Auditing and Assurance Standards is allowed to apply less stringent standards than those stated in the Code. However, if a law or regulation prohibits a member body or firm from complying with certain parts of the Code, they should comply with all other parts of the Code.

### **Independence – Foundation of an Assurance Engagement**

It is a fundamental principle in the Code of Ethics that professional accountants are objective and should not allow bias, conflict of interest or undue influence of others to override professional or business judgments. A professional accountant in public practice who provides assurance services is required to be independent. The Code defines independence as:

#### *Independence of Mind*

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

#### *Independence of Appearance*

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s integrity, objectivity or professional skepticism has been compromised.

The independence provisions in the Code were issued in November 2001 with an effective date for assurance reports dated after December 31, 2004. This implementation period was necessary to provide member bodies with sufficient time to follow their own due process to revise the requirements in their particular jurisdiction.

Since issuance, several failures have led to a loss in credibility in financial reporting and many jurisdictions have taken steps to restore this credibility. Some of these steps have related to auditor independence requirements. Therefore, the Committee has concluded that it is appropriate to consider whether any parts of the independence requirements contained in the Code should be revisited.

In considering what parts of the Code might need to be revised, the Committee sent out a questionnaire to member bodies of IFAC to obtain information on implementation experience and whether additional requirements had been added to the Code. The Committee considered recent developments and public expectations regarding independence requirements in light of the recent loss of credibility in aspects of the financial reporting process.

### **Conceptual Framework**

The Code establishes five fundamental principles of professional ethics for all professional accountants and provides a conceptual framework for applying those principles. Under the framework, all professional accountants are required to identify threats to these fundamental principles and if there are threats apply safeguards to ensure that the principles are not compromised

A professional accountant performing an assurance engagement is required to:

- Prior to accepting the engagement, and through out the engagement, identify and evaluate threats to independence;
- If an identified threat is other than clearly insignificant, apply safeguards to eliminate the threat, or reduce it to an acceptable level;
- If safeguards are not available to eliminate or reduce an identified threat, eliminate the relationship or activity creating the threat or not accept or discontinue the assurance engagement.

The Code also recognizes that there are circumstances and activities which a member of an assurance team and a firm must avoid when performing assurance engagements because adequate safeguards will not exist that would, in the view of a reasonable observer, eliminate the threat or reduce it to an acceptable level. Accordingly, the Code prohibits certain activities and relationships that are incompatible with the provision of an assurance service.

The Ethics Committee believes that this conceptual framework approach which contains certain prohibitions as noted above, has several benefits as the basis for standards. Principle-based standards are robust and can be applied to the diverse and varying circumstances faced by professional accountants in public practice. They avoid “technical” evasion of detailed rules.

### Threats and Safeguards

Many threats to independence fall into the following categories:

- *self-interest threats*, which may occur as a result of the financial or other interests of a professional accountant or of an immediate or close family members;
- *self-review threats*, which may occur when a previous judgment needs to be reevaluated by the professional accountant responsible for that judgment;
- *advocacy threats*, which may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised;
- *familiarity threats*, which may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others; and
- *intimidation threats*, which may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived.

If threats that are other than clearly insignificant are identified, safeguards must be applied to eliminate the identified threats or reduce them to an acceptable level. Safeguards are actions that will minimize or mitigate the threat and must be judged in the particular circumstances. A safeguard that may be effective to address a particular threat might not address another threat. For example, rotation of an engagement partner would be effective to address a familiarity threat but would not be effective to address a self-interest threat to the firm.

### Discussion

#### *Structure of Section*

Section 290 (formerly section 8) of the Code, which contains the independence requirements, applies to all assurance engagements irrespective of size. When the section was first developed, the Committee considered whether it should deal separately with audits of financial statements and other assurance engagements. The Committee determined at that time, that such a structure would create unnecessary duplication and accordingly, the section addresses all assurance engagements.

The whole Code is now based on a conceptual framework with Parts B and C applying to professional accountants in public practice and professional accountants in business, respectively.

[To be developed after June Ethics Committee meeting– depending on conclusion on splitting of Section 290]

*Clarity of prohibitions*

As noted above, the Code does contain prohibitions, situations where the threat to independence is so significant that not safeguards would be available to eliminate or reduce the threat to an acceptable level. Some of the feedback obtained by the Committee indicated that readers felt these prohibitions could be more clearly stated. Therefore, the Committee proposes to change the structure of some of the prohibitions to clarify the requirements.

*Application of safeguards*

Some have expressed the opinion that certain safeguards contained within the independence section are not as robust as others. It has also been noted that while certain safeguards assist in compliance with the independence requirements, they would not, on their own, address a specific threat to independence. The Committee has recognized these issues and has reviewed the identified safeguards and also explained that certain safeguards would not address a specific threat to independence.

*Application of framework*

The section contains examples that describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level. Some of the examples demonstrate that no safeguards would be able to effectively reduce the threat and accordingly the circumstances or relationships creating the threat are prohibited.

The Committee has reviewed all of the examples, in light of the changing environment and public expectations for independence requirements. The Committee has determined that the following changes would be appropriate:

[To be developed after June Ethics Committee meeting – to contain a high level summary of the changes proposed.