

Management Functions

Background

At the October 2005 meeting, the IESBA concluded that the Task Force should consider whether additional guidance should be provided in Section 290 regarding accountants performing “management functions” for assurance clients.

The Task Force has considered this issue and examined guidance provided by other jurisdictions and is proposing some changes to guidance contained in the Code.

What is a “management function”?

Appendix 1 to this agenda paper contains extracts of guidance from other jurisdictions on management functions. It is clear from these examples that performing a management function or acting in the capacity of management is perceived in many jurisdictions to be a threat to independence. However, there is little discussion on what exactly is a management function and only the APB provides a discussion of what threats to independence are created by performing a management function. There are, however, several indirect references in the guidance in Appendix 1 as to what might be considered a management function. These include matters such as:

- Decision making
- Supervising
- Monitoring
- Designing
- Implementing
- Operating
- Authorizing
- Executing
- Consummating
- Preparing

Position taken in extant Section 290

Section 290 of the Code does not make specific reference to acting as management or acting in a management role. Instead there are several references direct or indirect to this issue.

Section 290.159 (which applies to all assurance clients) lists three activities that are deemed to create self-interest or self-review threats so great they should not be performed. Presumably, this is because they are management functions but that is not made explicit. The three activities are:

- authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so;

- determining which recommendation of the firm should be implemented; and
- reporting, in a management role, to those charged with governance.

Section 290.161 (which applies to all assurance clients) lists three further activities that may create threats to independence to which safeguards can be applied. These are also presumably management functions. The three activities are:

- having custody of an assurance client's assets;
- supervising assurance client employees in the performance of their normal recurring activities; and
- preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

Section 290.167 (which applies to only to financial statement audit clients) discusses a management responsibility to ensure that accounting records are kept and financial statements are prepared. The Section then prohibits three activities that are deemed "managerial decisions". The three activities are:

- determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the audit client;
- authorizing or approving transactions; and
- preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

Sections 290.170 and most of the following Sections contain suggested safeguards to implement policies and procedures prohibiting making "managerial decisions" or "management decisions" or assuming a "managerial role".

Matters considered

Management threat

At the February 2005 IESBA meeting, the Board considered whether a sixth category of threat should be included in the Code. At that time, IESBA concluded that a management threat was in effect a combination of the five existing categories of threat – in particular self-interest, self-review and advocacy threats.

At the December CAG meeting, it was noted that while it could be argued that a management threat is a combination of other threats, it was useful from a communications perspective to separately identify a management threat – since this would encourage assurance providers to consider whether they were inappropriately "stepping into management shoes".

The Task Force has reconsidered this matter and concluded that it was not appropriate for the Code to have another category of threat. The Task Force was of the view that it was a combination of other threats and further noted that the threats to fundamental principles apply to all professional accountants – which includes professional accountants in business in a management role.

Action requested

IESBA members are asked to reconfirm the position that the Code should not include a management threat as a sixth category of threat.

Distinction between audit clients and other assurance clients

The Code currently states that when certain activities are provided with respect to any assurance client the threats created are generally so significant safeguards are not available to reduce the threat to an acceptable level, for example authorizing, executing or consummating a transaction (¶290.159). The Code also prohibits making management decisions when providing assistance with respect to accounting records and preparing financial statements for an audit client.

The Task Force considered whether the threats created by performing management functions for a financial statement audit client were the same as the threats created when performing such functions for other assurance clients. The Task Force was of the view that management of an entity is responsible for many functions related to stewardship and acting in the best interests of shareholders or owners. The results of these decisions influence the financial position, performance and cash flows of the entity and are reflected in the financial statements. Performing management functions for an entity aligns the firm closely to the interests of the entity and is therefore incompatible with the objectivity and independence which is necessary for an audit of the financial statements, which reflects the results of those decisions.

With respect to assurance clients that are not financial statement audit clients, the Task Force noted that the assurance engagement might be discrete and limited only to one particular aspect of the entity's operations, for example, an engagement to provide assurance over the emissions of one plant of the entity. The Task Force was of the view that if the firm performed management functions that related to the engagement the threats created would be so significant no safeguards could reduce the threat. For example, a firm could not determine which emission measurement system should be installed in the plant and authorize the purchase of the system and then provide assurance on the volume of emissions. However, if the firm performed management functions for the client that were unrelated to the assurance engagement the threat created would not necessarily be so significant no safeguards would be available.

Therefore, the Task Force is of the view that there should be a distinction between financial statement audit clients and other assurance clients. Performing management functions for an audit client should not be permitted. For other assurance clients performing management functions related to the assurance engagement should not be permitted, if the management function is unrelated to the assurance engagement a threats and safeguards approach would be appropriate.

Action requested

IESBA members are asked to consider whether they agree with the proposal to prohibit performing management functions for an audit client and, for other assurance clients prohibit providing management functions that related to the assurance engagement.

Distinction between small and large entities

The Task Force noted that the APB does distinguish between audits and audits of “small entities” (defined inter alia as non-listed entities with under £5.6 million sales and £2.8 million balance sheet total and 50 employees). For the audit of such small entities the APB provides:

“When undertaking non-audit services for Small Entity audit clients, the audit firm is not required to adhere to the prohibitions in APB Ethics Standard 5, relating to providing non-audit services that involve the audit firm undertaking part of the role of management, provided that:

- a) It discusses objectivity and independence issuer related to the provision of non-audit services with those charged with governance; and
- b) It discloses the fact that it has applied this Standard in accordance with paragraph 22.

APB Ethical Standard 5, paragraph 28 provides that where an audit firm provides non-audit services to an audit client that does not have ‘informed management’, it is unlikely that any safeguards can eliminate the management threat or reduce it to an acceptable level with the consequence that such non-audit services may not be provided to that audit client. This is because the absence of a capable member of management, who has been designated by the audit client to:

- Receive the results of the non-audit services provided by the audit firm; and
- Make any judgments and decisions that are needed, on the basis of the information provided,

Means that there is an increased threat that the audit firm takes certain decisions and makes certain judgments, which are properly the responsibility of management.

An audit firm auditing a Small Entity is exempted from the requirements of APB Ethical Standard 5, paragraph 43(b) (internal audit services), 51(b) (information technology services), 70 (tax services), 99(d) (corporate finance services) 109(c) (transaction related services) and 117(b) (accounting services) in circumstances when there is no ‘informed management’ as envisioned by APB Ethics Standard 5, provided it discusses objectivity and independence issues related to the provision of non-audit services with those charged with governance and discloses the fact that it has applied this Standard in accordance with paragraph 22.”

The Task Force considered whether the Code should differentiate small entities. The Task Force concluded attempting to differentiate small entities was not appropriate given the wide variety of types, sizes and structures of business enterprises within the member bodies of IFAC.

Action requested

IESBA members are asked to consider whether they agree that the Code should not differentiate small entities.

Illustrative language

The Task Force has drafted language on a preliminary basis, and for illustrative purposes only, defining what is a management function, giving examples of management functions and prohibiting performing management functions. This draft language follows.

Management Functions

290.x1 Management of a business enterprise performs many functions in order to carry out their responsibility to manage the business enterprise in the best interests of stakeholders in the enterprise. It is not possible to enumerate every function which is a management responsibility. However, fundamentally management functions involve leading and directing a business enterprise and making significant decisions regarding the deployment and control of human, financial, physical and intangible resources.

290.x2 The determination of whether an activity is a management function will depend on the circumstances and requires the exercise of judgment. Examples of activities that would generally be considered management functions include:

- Deciding if a significant transaction should be authorized.
- Determining which recommendations of the firm or other third parties should be implemented.
- Supervising employees in the performance of their regular duties.

- 290.x3 Performing management functions for a financial statement audit client creates self review, self interest and advocacy threats. In performing management functions the firm becomes so closely aligned with management that the independence of the firm will be impaired. If a firm or network firm performs management functions the threats created could not be reduced to an acceptable level by any safeguard. Accordingly, in providing assurance and non-assurance services to a financial statement audit client, a firm or network firm should ensure that none of the services provided, nor any component part of the services, is a management function.
- 290.x4 Performing management functions for an assurance client that is not a financial statement audit client may create self review, self interest and advocacy threats depending on the circumstances. If a firm or network firm performs management functions as part of the assurance service the threats created could not be reduced to an acceptable level by any safeguard. Accordingly, in providing assurance services to an assurance client that is not a financial statement audit client, a firm or network firm should ensure that the assurance service, or any component part of the assurance service, is not a management function. When providing non-assurance services the firm or network firm should ensure that the non-assurance service, or any component part of the non-assurance service, considered to be a management function does not involve the subject matter information of the assurance engagement.

Action requested

IESBA members are asked to consider whether this language adequately describes management functions. Do the IESBA members believe the language is specific enough. Do the IESBA members agree the cited examples are management functions.

The Task Force also considered whether it would be helpful to cite examples of activities that would not be considered a management function. The Task Force has developed the following examples for illustrative purposes.

- 290.x5 Some activities would not normally be considered management functions because they are routine and administrative, involve matters that are clearly insignificant or do not otherwise represent a management responsibility. Examples of such activities include:
- Executing a clearly insignificant transaction that has been authorized by an assurance client.
 - Incurring incidental expenditures on behalf of an assurance client in the performance of a non-assurance service.

- Presenting findings or recommendations of the firm to those charged with the governance of an assurance client.
- Having temporary possession of a check drawn by, or in favor of, an assurance client.
- Requesting designated client employees to provide information or carry out specific tasks in relation to a non-assurance service.
- Monitoring the dates for filing statutory returns and advising the client before such dates.
- Assisting in the preparation of company information for inclusion in regulatory or tax returns or other documentation for third parties where the information is not prepared for inclusion in the client's financial statements and the information is reviewed by management.

Action requested

IESBA members are asked to consider if it is necessary to give examples of activities that would not be considered a management function. If yes, do the IESBA members agree that the illustrative examples are not management functions.

Appendix 1

Guidance in other jurisdictions

1. United States Securities and Exchange Commission (SEC)

The SEC in its introductory comments to the rules on auditor independence states:

... the Commission looks in the first instance to whether a relationship or the provision of a service: ... results in the accountant **acting as management** or an employee of the audit client;

The actual rule in this area states:

An accountant is not independent if ... the accountant provides the following non-audit services to an audit client: ... (vi) **Management functions**. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

In the release accompanying the 2003 rules there is not a great deal of discussion with respect to this particular rule. The focus is principally on the differentiation between evaluating and recommending changes to systems and controls versus designing and implementing such controls. For instance the SEC position is that:

... design and implementation of these controls involves decision-making...

Further, the SEC goes on to say:

... designing and implementing internal accounting and risk management controls impairs the accountant's independence because it places the accountant in the **role of management** ...

Under the discussion of actuarial services, the SEC says:

“The final rule states that an auditor's independence is impaired if the audit firm provides certain actuarially oriented advisory services involving the determination of insurance company policy reserves and related accounts, unless three conditions are met...All of these conditions are designed to ensure that the accountant does not assume a **management function** for the audit client.”

Additionally, under the discussion of prohibitions on financial information systems design and implementation, the SEC says:

Designing, implementing, or operating systems affecting the financial statements may place the accountant in a **management role** ...

Lastly, under the discussion of prohibitions on internal audit outsourcing, the SEC says:

... if the internal audit function is outsourced to an accountant, the accountant assumes a **management responsibility** and becomes part of the company's control system

2. American Institute of Certified Public Accountants (AICPA)

The AICPA under the heading General Requirements for Performing Nonattest services states:

The member should not perform **management functions** or make **management decisions** for the attest client. However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.

Further, in the same section the AICPA indicates that in an engagement to provide nonattest services the client must perform 5 specific functions, the first of which is:

Make all **management decisions** and perform all **management functions**.

Additionally, under the same section the AICPA lists several general activities that would be deemed to impair independence. Although, not specifically identified as management functions it could be presumed this is the intention:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities
- Determining which recommendations of the member should be implemented
- Reporting to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

The AICPA in its revision to the rules on independence issued in January 2005 stated that for the performance of nonattest services the client must perform 5 specific functions in connection with the engagement (one of which was described above). One of the five is that the client must:

Designate an individual who possesses suitable skill, knowledge, and/or experience, preferably within **senior management** to oversee the services.

In a Question and Answer document issued by the AICPA to explain this requirement the following (partial) response is given to the question “What are the underlying concepts that support the conclusion that a member’s independence would be impaired if an individual designated by the client with the suitable skill, knowledge and/or experience does not perform the activities described in the interpretation?”:

Two threats to a member’s independence arise if the member assumes the client’s responsibilities under Interpretation 101-3....The second threat that arises is a “**management participation threat**.” Making significant judgments on behalf of the attest client during the performance of the nonattest service causes the member to **function as management** in connection with the service.... By ensuring that an individual designated by the client with suitable skill, knowledge and/or experience oversees the members nonattest services and makes all **management decisions**, both threats are eliminated.

In the exposure draft “Proposed revision to ‘Other Considerations’ in Interpretation 101-1, Interpretation of Rule 101, Under Rule 101, and Proposed Conceptual Framework for AICPA Independence Standards”, the AICPA provides the following guidance with respect to management participation threat:

“Management participation threat – Taking on the role of **client management** or otherwise performing **management functions** on behalf of an attest client.

- a) Serving as an officer or director of the client;
- b) Establishing and maintaining internal controls for the client;
- c) Hiring, supervising, or terminating the client’s employees.”

3. European Commission

The revised EU 8th Directive contains one passage dealing with management functions and independence. Article 22 “Independence and objectivity” states:

Member States shall ensure, that when carrying out a statutory audit, the statutory auditor and/or the audit firm is independent from the audited entity and is not involved in the **decision-taking** of the audited entity.

In a Recommendation of the European Commission from May 2002 titled “Statutory Auditors' Independence in the EU: A Set of Fundamental Principles” there are several references to management roles.

The acceptance of a **managerial or supervisory role** in an Audit Client is not the only potential concern with regard to intimidation and self-review threats. Such threats can also arise when an individual within the scope of A.2 becomes a member of a managerial or supervisory body of an entity that is not an Audit

Client (non-client entity), but is either in a position to influence the Audit Client or to be influenced by the Audit Client. In these cases, the level of independence risk is unacceptably high. The acceptance of such positions should therefore be prohibited.

Further:

The Statutory Auditor, the Audit Firm or its Network member must be able to show that it is not involved in **management and control** of the internal audit.

Further:

An individual who is in a position to influence the outcome of the Statutory Audit ... should not be a member of any **management body** (e.g. board of directors) or **supervisory body** (e.g. audit committee or supervisory board) of an Audit Client.

And in discussing non audit services the Recommendation states as a general principle:

The individuals employed by either the Audit Firm or its Network member firm neither take any decision nor take part in any decision-making on behalf of the Audit Client or one of its Affiliates, or its **management** while providing a non-audit service.

4. APB

The APB has six categories of threats as opposed to the Code's five threats. The additional threat is a management threat which is defined as:

“A **management threat** arises when the audit firm undertakes work that involves making judgments and taking decisions which are the responsibility of **management** (for example, where it has been involved in the design, selection and implementation of financial information technology systems). In such work, the audit firm may become closely aligned with the views and interests of **management** and the auditors' objectivity and independence may be impaired, or may be perceived to be impaired.”

In the standard which deals with non-audit services, the APB provides the following guidance:

“A **management threat** exists when the audit team undertakes work that involves making judgments and taking decisions that are properly the responsibility of **management**.

A threat to objectivity and independence arises because, by making judgments and taking decisions that are properly the responsibility of **management**, the audit firm erodes the distinction between the audit client and the audit firm. The

auditors may become closely aligned with the views and interests of **management** and this may, in turn, impair or call into question, the auditors' ability to apply a proper degree of professional skepticism in auditing the financial statements. The auditors' objectivity and the appearance of their independence therefore may be, or may be perceived to be, impaired.

Factors to be considered in determining whether a non-audit service does or does not give rise to a management threat include whether:

- The non-audit service results in recommendation by the audit firm justified by objective and transparent analyses or the client being given the opportunity to decide between reasonable alternatives;
- The auditors are satisfied that a **member of management** (or senior employee of the audit client) has been designated by the audit client to receive the results of the non-audit service and make any judgments and decisions that are needed; and
- That **member of management** has the capability to make independent **management judgments and decisions** on the basis of the information provided ("**informed management**").

Where there is "**informed management**", the auditors assess whether there are safeguards that can be introduced that would be effective to avoid a **management threat** or reduce it to a level at which it can be disregarded. In the absence of such circumstances, it is unlikely that any safeguards can eliminate the **management threat** or reduce it to an acceptable level."