



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

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**Agenda Item  
3**

**Board** International Ethics Standards Board for Accountants

**Meeting Location:** Prague Renaissance Hotel, Prague, Czech Republic

**Meeting Date:** June 13- 14, 2006

## **Independence**

### **Objectives of Agenda Item**

1. To provide input to the Task Force on the first draft of a sections 290 and 291.

### **Background**

At its September 2004 meeting, the IESBA 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 credibility. Some of these steps have related to auditor independence requirements. Therefore, the IESBA concluded that it was appropriate to consider whether any parts of the independence requirements should be revisited.

A public forum was held with the October 2005 meeting. One of the main objectives of the Forum was to solicit feedback on the independence project. After the forum, the IESBA discussed the way forward for the independence project and concluded that it was important to “bench mark” the existing Section 290 against other jurisdictions and to re-examine some of the positions taken. At its February 2006 meeting the Board reviewed certain position papers and illustrative wording and provided direction to the Task Force.

Since the February meeting, the Task Force<sup>1</sup> has held three task force meetings and one conference call. In addition, the following consultations have taken place:

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<sup>1</sup> Jean Rothbarth (chair), Tony Bromell, Ken Dakdduk, Jean-Luc Doyle, Geoff Hopper, Peter Hughes, Thierry Karcher, Neil Lerner, Michael Niehues, Andrew Pinkney, Volker Rohricht

- The February views of the Board and subsequent deliberations of the Task Force were presented to the CAG;
- A short presentation has been given to TAC;
- The Task Force's views on tax services was discussed with representative of small and large firms;
- The Board provided input to the Task Force on the direction taken with tax services.

The Task Force has split section 290 into two sections, 290 which deals with audit and review and 291 which deals with other assurance (as discussed in more detail below). The Task Force has not yet discussed 291 and it is, therefore presented in these papers for the information of the Board. Board members will be asked for high level comments on Section 291 but it will not be addressed in detail at the meeting.

This paper addresses the issues which the Task Force would like to discuss with the Board and obtain their input. The Task Force will not take the Board through the document paragraph by paragraph. During the meeting, Board members will be asked for their views on the matters noted below and any other matters of substance. They will not be asked for detailed wording suggestions. Board members are, however, encouraged to provide any wording suggestions directly to Jan Munro.

## **Issues**

### *Split of 290 – Extent of Duplication*

The feedback from the Forum was that the IESBA should not be concerned with the extent of duplication in splitting the Code. Therefore, the Task Force has developed two stand alone sections: Section 290 which addressed audit and reviews; and 291 which addresses other assurance engagements.

This has resulted in duplication of the general paragraphs which discuss independence – for example 290.1 & 291.3; 290.2 & 291.4; 290.2a & 291.5; 290.2-4 & 291.6-8 2, 3, 4, 11, 12, 13 and 14.

The Task Force considered whether to split section 290 into three (290 general, 291 audit/review, 292 other assurance engagements) but concluded that benefit of having two complete, self-contained sections outweighed the additional duplication.

### ***Action requested***

Board members are asked to consider and provide input on the approach taken.

### *Split of Code – Type of Engagements Addressed in each Section*

Extant section 290 addresses independence requirements for audit clients and independence requirements for other assurance clients. This approach was taken because

the independence requirements for an audit engagement are more restrictive than for other assurance engagements (for example for audit engagements there are restrictions on network firms but for other assurance engagements consideration is given to any threats the firm has reason to believe may be created by network firm interests and relationships).

In splitting section 290, the Task Force considered whether the split should be by type of client or by type of engagement. The Task Force recognized that if the split was by client this would likely more duplication and more confusion. Section 290, addressing the independence requirements for audit clients, –would need to provide guidance on the independence requirements for audit engagements for those clients and other assurance engagements for those clients. Therefore, the Task Force concluded that a better approach was to split the section by type of engagement. Accordingly, section 290 deals with audit and review engagements (as discussed in more detail below) and Section 291 deals with other assurance engagements. The Task Force recognizes that consideration of the provisions of Section 290 will be necessary if a non-audit assurance engagement is provided to an audit or review client.

***Action requested***

Board members are asked to consider and provide input on the approach taken

***Split of Code – Type of Engagement***

Extant section 290 distinguishes between financial statement audit clients and other types of assurance clients.

The Code contains the following definition of a financial statement audit engagement:

“A reasonable assurance engagement in which a professional accountant in public practice expresses an opinion whether financial statements are prepared in all material respects in accordance with an identified financial reporting framework, such as an engagement conducted in accordance with International Standards on Auditing. This includes a Statutory Audit, which is a financial statement audit required by legislation or other regulation.”

In summary, the distinctions in the existing Code (or agreed changes) between financial statement (“f/s”) audit clients and other assurance clients are as follows:

- Assurance team – for f/s audit clients, the team includes those at successively senior levels above the engagement partner through the firm’s chief executive (chair of command)
- Network firm – for f/s audit clients, network firms are required to be independent – for other assurance clients consideration should be given to any threats that the firm has reason to believe may be created by network firm interests and relationships

- Management functions – for f/s audit clients, these are prohibited, for other assurance clients, these are prohibited if related to the subject matter of the assurance engagement
- Non-audit services – for f/s/ audit clients, prohibitions and identification of activities that might create a threat are quite specific and clear (because there is a consistent subject matter/subject matter information) – for other assurance clients, the guidance will likely not be as specific because of the wide range of possible subject matters and subject matter information.

In light of the above factors and considering the public interest, the Task Force considered the differing types of audit and review engagements to determine which should be treated for independence purposes as financial statement audit engagements (Section 290) and which should be treated as other assurance engagements (Section 291).

- *Review engagements* - Accountants in certain jurisdictions perform a large number of review engagements – i.e. an engagement to obtain limited assurance (as opposed to reasonable assurance) for a full set of financial statements (this is not to be confused with reviews of interim information for audit clients). The subject matter and subject matter information in such a review engagement is identical to that in an audit engagement, the users and “public interest” are likely to be the same – what differs are the procedures performed by the practitioner and therefore the assurance provided. Review engagements consist primarily of inquiries and analytical procedures such that the practitioner can express a conclusion that nothing has come to his/her attention that causes him to believe that the financial statements are not prepared in all material respects in accordance with an identified financial reporting framework.

Review engagements are performed when there is no statutory audit report – for example, a banker might request reviewed financial statements. The same banker might in a subsequent year request an audit report. Many such review engagements are performed in the US and Canada and these jurisdictions have established the same independence requirements for audits and reviews.

Extant section 290 differentiates between financial statement audit clients and other assurance clients. The Task Force considered the auditing standards issued by the IAASB to determine whether all types of audit engagements should be dealt with in section 290 or whether any should be treated as “other assurance engagements” and therefore dealt with in section 291. The following types of engagements were considered:

- *Audit Report on a Complete Set of General Purpose Financial Statements* – ISA 700 (revised) establishes standards and provides guidance for the independent auditor’s report on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation;
- *Audit Report on Other Historical Financial Information* – ISA 701 (ED) proposes standards and guidance for the independent auditor’s report on historical financial information other than a complete set of general purpose financial statements prepared

in accordance with a financial reporting framework that is designed to achieve fair presentation. Other historical financial information includes:

- A complete set of financial statements prepared in accordance with a financial reporting framework designed for a general purpose, but not designed to achieve fair presentation;
  - A complete set of financial statements prepared in accordance with a financial reporting framework designed for a special purpose (for example a tax basis of accounting, the cash receipts and disbursements basis of accounting for cash flow information that an entity may prepare, the financial reporting provisions established by a regulator to meet the requirements of that regulator and the financial reporting provisions of a contract such as a bond indenture or loan agreement);
  - A single financial statement, or statements, that would otherwise be part of a complete set of financial statements; and
  - One or more specific elements, accounts or items of a financial statement.
- *Audit Report on Summary Audited Financial Statements* – ISA 800 (ED) proposes standards and guidance for the independent auditor's report on summary financial statements derived from audited financial statements – given this type of engagement is performed by the auditor of the financial statements there is no separate decision to make with respect to independence requirements. The engagement was included in the list for completeness.

The Task Force is of the view that all of these engagements should be subject to the same independence requirements. Accordingly, the Task Force recommends section 290 address all audit and review engagements.

***Action requested***

Board members are asked to consider and provide input on the approach taken.

***Language – directness and clarity***

At previous meetings, the IESBA agreed that the revised section 290 should be written in a more direct manner, in particular where the section contains specific restrictions on a particular action (for example, a member of the assurance team should not have a direct or a material indirect financial interest in an assurance client.) The Task Force has, therefore, edited the document to make the language more direct. An example of this is paragraph 290.106.

The Task Force considered whether, for clarity, section 290 should contain a statement that the term “audit client” and “audit engagement” should be read as also encompassing review clients and review engagements. This would somewhat streamline the remainder of the section in that it would be possible to refer only to “audit clients” and “audit engagements”. However, an argument against such an approach is that practitioners who

perform only review engagements might not realize that section 290 addresses both audit and review engagements.

In addition, the Board is asked to consider whether there should be an early reference to network firms indicating that unless otherwise specified all reference to audit firm include network firms.

***Action requested***

Board members are asked to consider and provide input on the clarity of the language and the references to audits and reviews and to network firms.

***Responsibility***

In response to the IESBA exposure draft on Network Firms, one respondent (APB) noted that in some cases the Code is not clear whether the responsibility for a particular requirements rests with a firm, a network firm, an individual or all parties concerned. The respondent further noted that clarity as to who is responsible for a particular action is a key element to ensuring that the Code is applied in practice.

The matter was discussed at the February IESBA meeting. The Board was concerned that re-writing the Code in this manner could be time consuming and possibly delay the issuance of the exposure draft. Therefore, the IESBA was of the view that if this would delay issuing the exposure draft the matter should not be addressed at this time.

The matter was discussed at the April CAG meeting. It was noted that ISQC 1 imposes a requirement that a firm establish policies and procedures designed to provided it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements maintain independence when required. In addition, ISA 220 requires the engagement partner to form a conclusion on compliance with independence requirements that apply to the audit engagement. CAG members indicated that it would be useful if the independence sections of the Code could provide further guidance on who is responsible for the specified actions.

The Task Force has discussed this matter further and is of the view that there should be guidance on responsibility. However, the Task Force is of the view that the section should not be prescriptive as to the specific responsibility of individuals within the firm or network firm because responsibility may differ depending upon the size and structure of the firm.

Accordingly, the Task Force has developed a paragraph (¶290.2) which addresses responsibility at an overall level.

***Action requested***

Board members are asked to consider and provide input on the guidance contained in ¶290.2.

***Management Functions***

At the February meeting, the IESBA discussed management functions and provided input on some illustrative wording. The IESBA agreed with the recommendation of the Task Force that the Code should not include a management threat as an additional category of threat – rather the Code should make it clear that acting in the capacity of management gives rise to a combination of the existing threats.

Consistent with the direction of the IESBA, the proposed guidance does not define a management function but rather provides a list of examples of what would be considered to be a management function. The guidance also provides some examples of activities that would not be considered to be management functions because they are routine and administrative, involve matters that are clearly insignificant or do not otherwise represent a management responsibility.

***Action requested***

Board members are asked to consider and provide input on the guidance contained in ¶290.15-18.

***Public Interest Entities***

At the February meeting, the IESBA discussed the Task Force's deliberations on the application of the Code to public interest entities. It was noted that many jurisdictions have developed a definition of a public interest entity. While the definitions vary, the existence of a wide range of stakeholders is a common feature.

The IESBA agreed with the Task Force's view that it was impracticable to develop a definition of a public interest entity which would have global application and be suitable in all jurisdictions.

The Task Force has considered this matter further and has developed guidance (¶290.26-27c) which indicates that:

- Entities of significant public interest are those which, because of the nature of their business, their size or their numbers of employees, have a wide range of stakeholders;

- Entities of significant public interest will normally include banks, insurance companies and other regulated financial institutions; and may, depending upon their size, include pension funds, government-owned entities and not-for-profits such as large charitable organizations;
- In some countries, the scope of all entities considered to be of significant public interest is defined by statute or legislation – in the absence of such a definition, the member body should determine the types of entity that are of significant public interest;
- For audit clients which are listed entities, references to the client include its related entities. In the case of other entities of significant public interest, references to audit client will generally include its related entities.

***Action requested***

Board members are asked to consider and provide input on the guidance contained in ¶290.26-27c.

***Documentation***

The Task Force has moved the paragraph addressing documentation (new 290.31a). This move is to respond to a previous comment received on exposure that indicated documentation should be required. As agreed at a previous IESBA meeting, moving the paragraph and providing a heading now emphasizes the requirement.

The Task Force has had some discussion as to whether the paragraph is needed and, if it is needed, whether the content is appropriate. The Task Force notes that ISA 220 ¶12 states:

“The engagement partner should form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner should:... Document conclusions on independence and any relevant discussions with the firm that support these conclusions.”

Therefore, documentation is required by the ISA addressing quality control for audit engagements. The ISA requirement does not, however, require documentation of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

***Action requested***

Board members are asked to consider ¶290.31 and provide input on whether a paragraph addressing documentation is needed in Section 290 and, if it is, whether the content is appropriate.



*Cooling-off Period*

At the February meeting, the IESBA discussed cooling-off and provided input on some illustrative wording. The IESBA was of the view that:

- The cooling-off period should apply to all key partners and not be restricted to the engagement partner;
- The cooling-off period should be such that there is one audit opinion with which the partner was not involved;
- There should be an exemption if a former partner is in such a position as the result of a business combination or merger.

The Task Force revised the guidance to reflect the direction of the IESBA and has developed the following definition of a key audit partner:

“The engagement partner, the individual responsible for the engagement quality control review, and other partners involved at the group level who are responsible for key decisions or judgments on significant matters with respect to the audit engagement.”

This definition is used in the paragraphs addressing cooling-off, partner rotation and compensation.

***Action requested***

Board members are asked to consider and provide input on the definition of key audit partner and the guidance contained in ¶290.146a-c.

*Temporary Staff Assignments*

As agreed at the February meeting, the Task Force has revised this guidance to indicate that such assignments should be short in nature and the assigned staff should not provide non-audit services that would otherwise be prohibited. The guidance (¶290.146d) has also been moved from the section addressing the provision of non-audit services.

***Action requested***

Board members are asked to consider the guidance contained in ¶290.146d

*Partner Rotation*

At the February meeting, the IESBA discussed partner rotation and provided input on some illustrative wording. The IESBA was of the view that:

- The rotation requirements should extend beyond the engagement partner and the individual responsible for the engagement quality control review – it should also address other partners with responsibility for key decisions or judgments;
- There should be some flexibility on rotation of these other key partners if their rotation would be detrimental to audit quality;
- Rotation should occur after seven years and the time out period should be two years – and during the time-out period there should be no meaningful activity which would mean that any transitioning should be completed before the end of the seven year period;
- There should be no flexibility for small firms to apply other safeguards in the place of rotation.

The Task Force has revised the illustrative wording presented at the February meeting to reflect the direction provided by the IESBA.

***Action requested***

Board members are asked to consider the guidance contained in ¶290.154-156

*Provision of non-assurance Services*

Informed Management ¶290.162 a & b

The concept of “informed management” has been added to the guidance provided on the provision of non-assurance services. The Task Force is of the view that threats created by the provision of non-assurance services will be reduced when the firm is working with informed management. If management is not appropriately informed they may seek to rely on the firm to take responsibility for decisions.

Not Subject to Audit Procedures ¶290.165a

As agreed at the February IESBA meeting, the Task Force has incorporated the SEC notion that in the case of certain non-audit services, independence would not be impaired if it is reasonable to conclude that the results of the were not subject to audit procedures. The exemption exists when there is no self-review threat and does not apply to “downstream” entities such as subsidiaries or divisions.

Preparing Accounting Records and Financial Statements ¶290.166-173

As agreed at the February IESBA meeting, the Task Force has amended the guidance in this area to clarify that for non-listed entities, an auditor can prepare standard or adjusting journal entries provided the client reviews the entries and understands their purpose. In

addition, changes have been made to make it clear that accounting advice can be provided to listed and non-listed audit clients.

Valuation Services ¶290.174-177

As agreed at the February IESBA meeting, the Task Force has provided clarification of the meaning of significant subjectivity. Valuations would likely not have a significant degree of subjectivity when the underlying assumptions are determined by law or regulation, or are widely accepted and the techniques and methodologies to be used are based on generally accepted standards or even prescribed by law or regulation. In such circumstances, the results of a valuation performed by two or more parties are not likely to be materially different.

Taxation Services ¶290.180-194

As agreed at the February IESBA meeting, the Task Force has developed guidance on the provision of taxation services. The guidance addresses:

- Tax return preparation
- Preparation of tax calculations to be used as the basis for the accounting entries in the financial statements
- Tax planning and other tax advisory services
- Assistance in the resolution of tax disputes

Tax return preparation – the guidance explains that these services are generally based upon historical information; principally involve analysis and interpretation of such historical information based upon the constraints of existing tax law; and tax returns are subject to whatever review or approval process the tax authority considers appropriate. Therefore, such services do not normally create threats to independence.

Preparation of tax calculations to be used as the basis for the accounting entries in the financial statements – the guidance indicates that preparing such calculations may create a self-review threat, the significance of which will depend upon the degree of subjectivity involved and the materiality to the financial statements. If the self-review threat is other than clearly insignificant, safeguards should be applied to reduce the threat to an acceptable level. In addition, in the case of the audit of a listed entity, if the tax calculations are material to the group financial statements, the provision of such services would generally create a threat that could not be reduced to an acceptable level by the application of any safeguard.

Tax planning and other tax advisory services – the guidance indicates that a self-review threat may be created where the advice will affect matters that will be reflected in the financial statements and an advocacy threat when the firm or a network firm promotes the tax advice. The significance of the threat will depend upon matters such as:

- The degree of subjectivity involved in determining the appropriate treatment for the tax advice in the financial statements;
- The extent to which the advice is supported by tax authority or other precedent, established practice or basis in tax law;

- Whether the tax treatment is supported by a private ruling or has otherwise been cleared by the tax authority prior to the preparation of the financial statements; and
- Whether the effectiveness of the tax advice depends on a particular accounting treatment or presentation, there is doubt as to the appropriateness of the related accounting treatment and the outcome of the tax advice will have a material effect on the financial statements.

The significance of the threat should be evaluated and, if other than clearly insignificant, safeguards applied.

The Task Force considered having a restriction on providing advice on situations when the effectiveness of the tax advice depends on a particular accounting treatment or presentation when:

- There is reasonable doubt as to the appropriateness of the related accounting treatment or presentation; and
- The outcome of the tax advice will have a material impact on the financial statements.

The approach was discussed with the CAG who questioned what was meant by “reasonable doubt” and asked whether any threshold was necessary. The Task Force considered this question and concluded that the reasonable doubt threshold for a restriction was probably not appropriate because there could be circumstances where there is not reasonable doubt but it would still be inappropriate to provide the tax advice. Therefore, this is included as a factor which would be considered in evaluating the significance of the threat.

Assistance in the resolution of tax disputes – the guidance provides that an advocacy threat may be created when acting for an audit client in the resolution of a tax matter by representing the client before a public tribunal or court. If the amounts involved are material to the financial statements, the threat would be too great. The Task Force recognizes that what constitutes a public tribunal or court will vary from jurisdiction to jurisdiction. Accordingly, the guidance indicates that this will be determined according to how the tax proceedings are heard in a particular jurisdiction. The guidance further states that a firm or network firm would not be precluded from having a continuing advisory role in relation to the matter which is being heard before a public tribunal or court. If the firm is asked to act in an advisory role where the matters involved are not material to the financial statements, the firm should evaluate the significance of any threat created and apply safeguards as necessary.

#### IT System Services ¶290.187a-290.xxxa

As agreed at the February IESBA meeting, the Task Force has amended the guidance in this area to restrict such services for listed audit clients that involve the design *or* implementation of IT systems that form a significant part of the accounting systems or generate significant information used in the preparation of the group’s financial statements.

Litigation Support Services ¶290.103-290.194c

As agreed at the February IESBA meeting, the Task Force has amended the guidance in this area to mirror the guidance for valuation services and restrict certain litigation support services that involve a significant degree of subjectivity and are material to the financial statements.

Recruiting Senior Management ¶290.203-203a

As agreed at the February IESBA meeting, the Task Force has amended the guidance in this area to restrict recruiting senior management who are in a position to exert significant influence over the preparation of the accounting records and financial statement of a listed audit client.

***Action requested***

Board members are asked to consider and provide input on the guidance contained in ¶290.158-205

Compensation Policies ¶290.212a-212b

The guidance indicates that the basis on which a partner is compensated may create a self-interest threat, particularly when the partner is compensated for selling non-assurance services. The guidance restricts key audit partners from being compensated for selling non-assurance services to audit or review clients. The guidance also indicates that compensating other members of the audit or review team may create threats.

***Action requested***

Board members are asked to consider and provide input on the guidance contained in ¶290.212a-212b

*Other Matters*

The Task Force has identified matters which it believes should be considered in the next round of independence revisions:

- Auditor indemnification
- Independence requirements for mutual funds
- Internal audit services
- Corporate finance services
- Contingent fees when there is an audit relationship
- Commissions
- Independence guidance for compilations and specified procedures

- Definitions of listed entity, control and significant influence

***Action requested***

Board members are asked to consider whether they agree that these matters should be considered in the next round of revisions.

***Section 291***

Agenda Paper 3-C contains a first draft of Section 291 Independence – Other Assurance Clients. The Task Force has not yet discussed this draft. It is provided for the information of the Board and to solicit any high level input that members wish to provide the Task Force. The Task Force will consider the input when it discusses the draft at its next Task Force meeting.

***Action requested***

Board members are asked to consider whether they have any overall comments on Section 291.

**Next Steps**

The Task Force has scheduled a conference call for June 1, 2006. If there are additional matters arising from this conference call on which the Task Force would like Board input an addendum to this agenda paper will be issued. Some hard copies will be available at the meeting for those Board members who will be traveling before the meeting.

The Task Force has scheduled three task force meetings before the October IESBA meeting (in July, August and September). The Task Force will present revised Sections 290 and 291 and the accompanying exposure draft explanatory memo at the October meeting.

### **Material Presented**

Agenda Paper 3	This paper
Agenda Paper 3-A	Draft Section 290 – Independence Audit and Review Engagements Mark-up from existing Section 290
Agenda Paper 3-B	Draft Section 290 – Independence Audit and Review Engagements Clean Copy
Agenda Paper 3-C	Draft Section 290 – Independence Assurance Engagements Clean Copy

Please note that the clean copy of section 290 (Agenda Paper 3-B) and not the mark-up version will be used at the meeting for discussion.

### **Action requested**

1. Board members are to consider and provide input on the paragraphs noted.
2. Board members are asked to raise any other matters of substance.
3. Board members are asked to provide any detailed wording suggestions directly to Jan Munro.