



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

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**Agenda Item  
2**

**Board** International Ethics Standards Board for Accountants

**Meeting Location:** WpK, Berlin, Germany

**Meeting Date:** June 25-27, 2007

**Independence Part II**

**Objectives of Agenda Item**

1. To review and approve for exposure proposed changes to Section 290 Independence – Audit and Review Engagements and new Section 291 Independence – Other Assurance Engagements.
2. To review the explanatory memorandum.

At its March 2007 meeting, the IESBA reviewed proposals from the Task Force<sup>1</sup> and provided input regarding changes to Sections 290 and 291 to address:

- Whether it is appropriate to revise the existing guidance related to the provision of internal audit services to audit clients;
- Whether it is appropriate to include additional guidance related to economic dependence in the paragraph dealing with fees in Section 290 (and proposed Section 291); and
- Whether it is appropriate to revise the existing guidance relating to contingent fees.

Since the March meeting the Task Force has met once and held a conference call to develop proposed guidance that is responsive to the direction provided by the Board at the March 2007 meeting.

**Discussion**

*Internal Audit*

At the March meeting the Task Force recommendation was:

1. An explanation that internal audit services comprise performing audit procedures.
2. A statement that internal audit services may be provided to an audit client provided the firm does not perform management functions. Guidance would be provided on what would be considered to be a management function. This would include:

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<sup>1</sup> David Winetroub (Chair), Heather Briers, Ken Dakdduk, Barbara Majoor, Michael Niehues, Andrew Pinkney and Sylvie Soulier

- Designing and/or implementing internal accounting controls or controls related to the financial systems or financial statements;
  - Deciding which recommendations of the firm should be implemented;
  - Performing ongoing monitoring activities or control activities;
  - Approving the audit work plan including the scope, risk and frequency of the internal audit work; and
  - Authorizing transactions.
3. Stating that if a firm performs a significant portion of the client's internal audit activities the firm should take particular care that it does not perform management functions. The client needs to dedicate appropriate resources to the internal audit function to ensure that it performs all the management decisions.
4. A statement that it would not be acceptable to perform an activity that would otherwise be prohibited by the Code as part of an internal audit activity.

The IESBA provided the following direction to the Task Force:

- Internal audit activities comprise a wide spectrum of services from operational internal audit activities unrelated to the financial statements to activities which are integral to the monitoring of the internal control of the company;
- The threats to independence are dependent upon the nature of the internal audit service;
- The proposed guidance should aim to describe the spectrum of services and indicate which services could be provided and which could not. For example, at one end of the spectrum would be internal audit services which are an extension of external audit procedures and at the other end of the spectrum would be activities such as monitoring of controls – which would not be acceptable because this is a management function and a part of the company's internal control;
- It should be clear from the proposed guidance that personnel performing internal audit activities should not perform management functions;
- The Task Force should consider whether because of the sensitivities and perception there should be a more restrictive position for entities of significant public interest;
- The IOSCO survey of non-audit services provides some useful input in this area and should be considered by the Task Force as they develop proposed wording.

The Task Force considered the direction provided by the Board. The proposed draft wording (which is presented in Agenda Papers 2-A and 2-B clean and mark-up respectively):

- States that internal audit services comprise a wide range of services and provides examples of the types of services and the various ways in which they might be conducted;
- States that depending upon the nature of the internal audit service a threat to independence may be created;
- States that a firm should not perform internal audit services that involve management functions and provides some examples of such services;
- Maintains the existing position that services involving the extension of procedures to conduct an audit in accordance with ISAs and operational internal audit services

unrelated to the internal controls over financial reporting would not be considered to compromise independence;

- Permits the firm to provide assistance to and audit client's internal audit function only if specified conditions are satisfied and requires the firm to evaluate the significance of any remaining threat and if the threat is other than clearly insignificant apply safeguards to eliminate the threat or reduce it to an acceptable level;
- Emphasizes that before accepting an engagement to perform a significant part of the audit clients internal audit activities the firm should be satisfied that the client has designated appropriate resources to meet the conditions necessary to perform those activities; and
- States that an internal audit service should not include any non-assurance service that would otherwise not be permitted under Section 290. The Task Force recognizes that this is not the typical construction with the provision of non-audit services but, because of the broad range of matters which could be labelled "internal audit services"; it is a useful reminder. It is somewhat similar to the guidance on temporary staff assignments [ED¶290.138].

#### *Economic Dependence*

At the March meeting the Task Force recommendation was:

- Retaining the existing guidance regarding the threat created when the total fees from an audit client represent a large proportion of the total fees of the firm expressing an audit opinion and retaining the guidance regarding the threat created when the fees generated from an audit client represent a large proportion of the revenue from an individual partner's clients;
- New guidance stating that in the case of an audit client that is an entity of significant public interest when for more than two consecutive years the total fees from that client, and its subsidiaries, received by the firm expressing the audit opinion, amount to more than 15% of the total fees of the firm that signs the audit opinion, the self-interest threat to independence would generally be so significant it could not be reduced to an acceptable level unless both of the following safeguards are applied:
  - An engagement quality control review performed by a professional accountant who was not a member of the firm expressing the audit opinion (the review would be performed before the issuance of the audit opinion in the third year); and
  - Disclosure to those charged with governance that the total fees from the client and its subsidiaries represented more than 15% of the total fees of the firm.
- New guidance stating that if the audit client is an entity of significant public interest and it is a subsidiary of an entity that is not an entity of significant public interest, the firm should consider the significance of the self-interest threat created by total fees from the audit client, its subsidiaries and the parent. If the threat is other than clearly insignificant apply safeguards to eliminate the threat or reduce it to an acceptable level.

The IESBA provided the following direction to the Task Force:

- The Task Force should develop proposed wording that establishes a bright-line test at the 15% threshold level;
- The Task Force should consider whether there were alternative safeguards that should be applied if the threshold level was reached;
- The Task Force should consider fees received from not only subsidiaries of the audit client but also other “downstream entities” such as those over which the client has significant influence.

The Task Force considered the direction provided by the Board. The proposed draft wording (which is presented in Agenda Papers 2-A and 2-B clean and mark-up respectively):

- Removes in paragraph 290.213 the reference to “client group” because this is redundant. ED¶290.24 and 25 state that for listed entities “audit client” always includes related entities, for other entities of significant public interest generally includes related entities and for other entities the audit team should consider related entities when it knows or has reason to believe that the related entity is relevant to the evaluation of the firm’s independence;
- Contains a new requirement (¶290.215) for audit clients that are entities of significant public interest that when for two or more consecutive years the total fees from the audit client and its related entities represent more than 15% of the total fees received by the firm the threat would be too significant unless disclosure is made to those charged with governance and one of the following safeguards is applied either :
  - not less than once every three years a review that is equivalent to and engagement quality control review performed by a professional accountant who is not a member of the firm signing the audit opinion; or
  - prior to the issuance of the audit opinion an EQCR is performed by a professional accountant who is not a member of the firm.

The guidance also states that the relative significance of the fee level should be considered in determining which of the two safeguards is appropriate to reduce the threat to an acceptable level. It states that if the safeguard is a post issuance review the relative size of the fee should be considered in determining whether the review should be performed more frequently than every three years. The Task Force is of the view that flexibility is appropriate because depending upon the relative size of the fees it might not be necessary to have a pre-issuance review because the deterrent effect of a post issuance review would be appropriate to address the threat.

Section 290 (ED¶290.24) and the definition of audit client) states that when the audit client is a listed entity references to audit client will include related entities, unless otherwise stated. For other entities of significant public interest, Section 290 (ED¶290.24) states that references to client will generally include related entities. The Task Force recognizes that referencing related entities in the proposed revisions for fees could be seen as redundant (because it is addressed in ED¶290.24 and the definition of audit

client). However, for clarity, the Task Force is of the view that it is useful to make the reference.

The Task Force did consider whether there were any alternative safeguards other than an engagement quality control review by a professional accountant who is not a member of the firm. The Task Force considered, for example, whether an additional review by another partner in the firm coupled with additional reporting to those charged with governance might be acceptable. The Task Force was of the view that such a safeguard was not sufficiently robust to address the self-interest threat because the additional review is performed by second partner within the firm and presumably that second partner also has a self-interest threat because of the relative size of the fees to the firm. The Task Force is, therefore, of the view that the additional review should be performed by someone who is not a member of the firm signing opinion.

#### *Contingent Fees*

At the March meeting the Task Force recommendation was:

1. No change to the existing description of a contingent fee.
2. No change to the existing restriction regarding performing an audit engagement for a contingent fee.
3. Restricting providing a non-assurance service to an audit client for a contingent fee if the contingent fee is material to the firm or the fee relates to a matter that is material to the financial statements.
4. Maintaining the existing requirements that for other types of contingent fee arrangements the significance of the threat should be evaluated and safeguards applied to reduce the threat to an acceptable level.
5. Section 291 contain the same guidance with respect to a restriction on a contingent fee that was material to the firm or related to a transaction that was material to the subject matter information of the assurance engagement.

At the March meeting the IESBA provided the following direction to the Task Force:

- The existing definition of a contingent fee was appropriate;
- The existing restriction regarding performing an assurance engagement for a contingent fee was appropriate;
- The revised guidance should contain a restriction on contingent fees for non-assurance services provided to an assurance client if the contingent fee is material to the firm signing the audit opinion or relates to a matter which is material to the financial statements; and
- The Task Force should consider the threats contingent fees received by network firms for the performance of non-assurance services to an audit client of the firm.

The Task Force considered the direction provided by the Board. The proposed draft wording (which is presented in Agenda Papers 2-A and 2-B clean and mark-up respectively):

- Contains a new paragraph (¶290.220) which indicates that a firm should not enter into a contingent fee arrangement for a non-assurance service for an audit client

where the fee relates to a matter that is material to the financial statements or the fee is material to the firm signing the audit opinion;

- Contains a new paragraph (¶290.221) which indicates that a network firm that participates in the audit should not enter into a contingent fee arrangement in respect of a non-assurance service provided to audit client where the fee relates to a matter that is material to the financial statements; and
- Amends the guidance regarding consideration of threats for other non-assurance engagements to refer to a contingent fee for an engagement performed by a network firm.

### **Material Presented**

Agenda Paper 2	This Agenda Paper
Agenda Paper 2-A	Draft Section 290 and Section 291 clean
Agenda Paper 2-B	Draft Section 290 and Section 291 mark-up
Agenda Paper 2-C	Draft Explanatory Memorandum

### **Action Requested**

1. IESBA members are asked to review and approve for exposure changes to proposed Section 290 and new Section 291. The affirmative vote of 12 members of the Board is required for exposure.
2. IESBA members are asked to review the explanatory memorandum and provide comments.