



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

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**Agenda Item**

**5**

**Board** International Ethics Standards Board for Accountants

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

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

**Drafting Conventions**

**Objectives**

1. To provide feedback and reaction to the Task Force.

**Background**

At the March 2007 IESBA meeting there was a discussion of implications of the IAASB Clarity project on the Code. The following is an extract from the draft minutes:

“The Board discussed the implications of the IAASB Clarity project on the Code. It was noted that the IAASB Clarity project had adopted four conventions:

- Each ISA will state the objective to be achieved in relation to the subject matter of the ISA;
- Each ISA will specify requirements designed to achieve the stated objective. The requirements are to be applied in all cases, where they are relevant to the circumstances of the engagement, and are identified by the word “shall”. In exceptional circumstances where the professional accountant judges it necessary to depart from a requirement in order to achieve the purpose of that requirement the accountant will be required to document how the alternative procedures performed achieve the purpose of the requirement, and, unless otherwise clear, the reasons for the departure;
- The present tense will no longer be used in ISAs to describe actions taken or procedures performed by the professional accountant;
- Each ISA will contain application material which provides further explanation and guidance supporting proper application of the standards. While the professional accountant has a responsibility to consider the entire text of a standard in carrying out an engagement the application material is not intended to impose a requirement for the professional accountant.

It was noted that the structure of the Code was very different from the structure of the ISAs. Therefore, the drafting convention of stating the objective for each element and separating the requirements and the application guidance was not particularly helpful

for the Code. The Planning Committee had reviewed a section of the Code which had been re-drafted using all of the IAASB Clarity conventions and did not find the result an improvement in the clarity of the section. The Planning Committee was, however, of the view that the use of the word “shall” to denote a requirement was something which should be considered by the IESBA. It was agreed that a small Task Force would be formed to address this issue.”

The Task Force<sup>1</sup> has considered this issue and held a conference call on June 8, 2007 to discuss an approach. Prior to the conference call, each Task Force member individually reviewed the Code to identify provisions that appear to reflect “requirements.” (The Code reviewed by the Task Force was the existing Code with the proposed revised Section 290 and the proposed new Section 291 in place of the existing Section 290.) Task Force members then considered whether each requirement was best denoted by the use of the term “shall” or “should” or some other term. Task Force members considered an extract of the drafting directions prepared by IAASB staff as general instructions to national standard setters to assist in the re-drafting of ISAs under the Clarity project. While the IAASB approach might not be completely transferable to the Code, the document was reviewed to assist Task Force members in forming their thinking of what changes would be appropriate for the Code. (This paper is included as Agenda Paper 5-A.)

The Task Force reviewed the composite of the suggestions for change and from this developed a principle that Task Force member have begun using as a guide in determining what changes to the Code are appropriate.

## **Discussion**

### *Requirements*

The Task Force noted that there are several different types of “requirements” in the existing Code (paragraph references are to the existing Code with the exception of any 290 or 291 references, which are to the exposure draft):

1. The accountant should not do something – for example “a professional accountant should not be associated with reports, returns, communications or other information where they believe that the information contains a materially false or misleading statement” ¶110.2
2. The accountant should consider doing something – for example “a professional accountant should also consider the need to maintain confidentiality of information within the firm or employing organization.” ¶140.4 and “In deciding whether to disclose confidential information, professional accountants should consider the following points...” ¶140.8 and “Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the audit team and a director or an officer of the audit client...” ¶290.129
3. A statement that the accountant is required to do something – for example “it is in the public interest and, therefore, required by this Code of Ethics, that members of audit

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<sup>1</sup> Ken Dakdduk (Chair), Jean-Luc Doyle, Kariem Hoosain, Peter Hughes and Tim Volkmann

teams, firms and network firms be independent of audit clients” ¶290.3, If a firm is considered to be a network firm, the firm is required to be independent of the audit clients of the other firms within the network.” ¶290.10.

4. A statement that the accountant can only do something if certain safeguards are put in place – for example, under employment with an audit client “In all cases the following safeguards are necessary to ensure that no significant connection remains between the firm and the individual: the individual is not entitled to any benefits or payments from the firm, unless made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be material to the firm.” ¶290.132.
5. A statement of an expectation of a professional accountants – for example “A professional accountant in business is expected, therefore, to encourage an ethics-based culture in an employing organization that emphasizes the importance that senior management places on ethical behavior.” ¶300.5

After reviewing the different types of potential “requirements” in the Code, the Task Force developed a principle for determining when changes would be appropriate. In developing this principle, the Task Force noted that the term “shall,” as used by the IAASB, represents a requirement that is to be applied in all cases where they are relevant to the engagement. Consistent with that approach, the Task Force proposes that the term “shall” in the Code should denote a requirement to comply with:

- A fundamental principle; and
- A clear prohibition.

In both cases, the professional accountant is not permitted to avoid complying with the requirement and cannot exercise professional judgment to conclude that non-compliance is acceptable.

The Task Force is of the view that the use of the term “should” may be appropriate in those circumstances where the action called for involves a judgment to be made by the professional accountant as to whether the required action is necessary (e.g., see the use of “should” in paragraph 290.196) and in other circumstances where the term “shall” would be grammatically incorrect<sup>[k1]</sup>.

Appendix 1 to this Agenda Paper contains illustrative examples of the changes that would result from the application of this principle.

***Action requested***

Members are asked to consider the principle proposed and the application of the principle as illustrated in the Appendix.

*Clearly Insignificant*

During the review of the Code, an issue was raised with respect to the term “clearly insignificant” and the requirement to apply safeguards to eliminate a threat or reduce it to an acceptable level. A question on “clearly insignificant” was also raised by two respondents to the December 2006 exposure draft (see Agenda Paper 5-B for the comments received on exposure).

The term “clearly insignificant” is used throughout the Code. The first instance where the term is used is in paragraph 100.2, which states:

“Professional accountants are required to apply this conceptual framework to identify threats to compliance with the fundamental principles, to evaluate their significance and, if such threats are other than **clearly insignificant**\* to apply safeguards to eliminate them or reduce them to an acceptable level such that compliance with the fundamental principles is not compromised.”

Because the issue relates to clarity and is relevant to the entire Code, it has been considered by this Task Force rather than the Independence 1 Task Force.

The issue can be summarized as follows. The Code requires identification of threats to compliance with the fundamental principles, evaluation of the significance of those threats and, if such threat are not clearly insignificant, the application of safeguards to eliminate the threat or reduce it to an acceptable level. “Clearly insignificant” is defined in the Code as “A matter that is deemed to be both trivial and inconsequential.”

This raises the following matters:

- Is “clearly insignificant” the same as an “acceptable level”? While “clearly insignificant” is defined, “acceptable level” is not. A reader of the Code would likely conclude that there is a difference between the two terms because presumably the different terms are meant to convey different meanings;
- Given the definition of “clearly insignificant” it would seem unlikely that “acceptable level” is lower than “clearly insignificant”;
- If “clearly insignificant” is a lower level than “acceptable,” this would presumably mean that if a threat is not “clearly insignificant” but is at an “acceptable level” no safeguards need to be applied. This concept could be seen as implicit in, for example 210.3 which states:

“The significance of any threats should be evaluated. If identified threats are other than clearly significant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.”

The “as necessary” could be interpreted to mean either:

- To the extent necessary; or
- The appropriate safeguards should be applied.

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\* See Definitions.

- The documentation requirement and some of the new language in the Section 290 exposure draft further complicate the matter. ED 290.26 requires the following documentation:

“...when threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the engagement, the decision should be documented. The documentation should describe the threats identified and the safeguards applied to eliminate them or reduce them to an acceptable level.”

This raises the question of what documentation would be required if a threat was not clearly insignificant but was acceptable such that no safeguards needed to be applied. Further, if documentation were required in that circumstance, there is a question of how that documentation serves to protect the public interest.

The Task Force is of the view that the meaning of the Code could be clearer in this area.

It was noted that the EU Recommendation text and the APB text both establish a principles-based approach of identification of threats and application of safeguards. Relevant excerpts are contained in Appendix 2 to this agenda paper.

The EU Recommendation does not use the term “clearly insignificant.” Under the EU Recommendation, the auditor is required to:

- Identify threats to independence;
- Evaluate their significance;
- Where threats exist, consider and document whether safeguards are appropriately applied to negate or reduce the significance of the threat to acceptable levels.

The APB does use the term “clearly insignificant” but not in exactly the same way as the Code. Under the APB Ethical Standard 1 (ES 1), auditors:

- Identify and assess the circumstances which could adversely affect the auditor’s objectivity (“threats”); and
- Apply procedures (“safeguards”) which will either eliminate the threat or reduce the threat to an acceptable level.

ES 1 further states that the nature and extent of safeguards to be applied depend on the significance of the threats and that where a threat is clearly insignificant no safeguards are needed.

In considering the EU Recommendation and the APB ES 1 and the lack of clarity with the current wording of the Code, the Task Force is of the view that it might be clearer if the overall requirement in 100.2 was expressed as follows:

“This Code is in three parts. Part A establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles. The conceptual framework provides guidance on fundamental ethical principles. Professional accountants are required

to apply this conceptual framework to identify threats to compliance with the fundamental principles, to evaluate their significance, and to apply safeguards to eliminate the threats or reduce them to an acceptable level such that compliance with the fundamental principles would not be compromised.”

In this example, an "acceptable level" would be that at which it would be reasonable to expect that the threat would not compromise the accountant's professional judgment, among other things.

***Action requested***

Members are asked to consider the proposal.

**Material Presented**

Agenda Paper 5	This Agenda Paper
Agenda Paper 5-A	Extracts from IAASB Clarity drafting conventions
Agenda Paper 5-B	Comments received on the December 2006 ED on “clearly insignificant”

**Action Requested**

1. Members are asked to consider the principle proposed and its implications for re-drafting of the Code and provide input to the Task Force.
2. Members are asked to consider the issue raised regarding “clearly insignificant” and provide input to the Task Force.

## Appendix 1 Changes Resulting from Application of the Principle

- 100.1 A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a **professional accountant's**\* responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest a professional accountant ~~should~~ shall observe and comply with the ethical requirements of this Code.
- 100.4 A professional accountant ~~is required to~~ shall comply with the following fundamental principles:
- (a) *Integrity*  
A professional accountant ~~should~~ shall be straightforward and honest in all professional and business relationships.
- (b) *Objectivity*  
A professional accountant ~~shall~~ should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
- 100.6 A professional accountant ~~shall~~ should evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.
- 100.15 The nature of the safeguards to be applied will vary depending on the circumstances. In exercising professional judgment, a professional accountant ~~shall~~ should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would conclude to be unacceptable.
- 290.103 If a member of the audit team, an **immediate family**\* member, or a firm has a **direct financial interest**\* or a material **indirect financial interest**\* in the audit client, the self-interest threat would be so significant no safeguard could eliminate the threat or reduce it to an acceptable level. Therefore, none of the following ~~shall~~ should have a direct financial interest or a material indirect financial interest in the client: a member of the audit team; his or her immediate family member; or the firm.
- 290.127 The significance of any threat ~~should~~ shall be evaluated and, if the threat is not clearly insignificant, safeguards ~~should~~ shall be considered and applied when necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Removing the individual from the audit team; or
- Structuring the responsibilities of the audit team so that the professional does not deal with matters that are within the responsibility of the close family member.

290.171 If the valuation service has a material effect on the financial statements on which the firm will express an opinion and the valuation involves a significant degree of subjectivity, no safeguard could reduce the self-review threat to an acceptable level. Accordingly, the firm *should* either not provide the valuation service or *should* withdraw from the audit.

290.196 Depending on the degree of reliance that will be placed on the particular IT systems as part of the audit, consideration ~~should~~shall be given to whether such non-assurance services *should* be provided only by personnel who are not members of the audit team and who have different reporting lines within the firm. The significance of any remaining threat ~~should~~shall be evaluated and if it is not clearly insignificant, safeguards ~~should~~shall be considered and applied, when necessary, to eliminate the threat or reduce it to an acceptable level. Such safeguards might include having an additional professional accountant review the work or otherwise advise as necessary.



## **Appendix 2**

### **Extracts from EU Recommendation**

In order to avoid or resolve facts and circumstances that might compromise a Statutory Auditor's independence, it is essential firstly to identify the threats to independence which arise in specific circumstances. Secondly, one must evaluate their significance so as to determine the level of risk that a Statutory Auditor's independence may be compromised.

The more clearly a Statutory Auditor is able to identify the nature of the threats, the more clearly he can judge the level of risk to his independence that they create. Based on their general nature the following types of threats to independence have been recognised:

— *Self-interest threat*: the Statutory Auditor's independence may be threatened by a financial or other self-interest conflict (e.g., direct or indirect financial interest in the client, over-dependence on the client's audit or non-audit fees, the desire to collect outstanding fees, fear of losing the client);

— *Self-review threat*: relates to the difficulty of maintaining objectivity in conducting self-review procedures (e.g., when taking decisions, or taking part in decisions, that should be taken wholly by the Audit Client's management; or when any product or judgement of a previous audit or non-audit assignment performed by the Statutory Auditor or his firm needs to be challenged or re-evaluated to reach a conclusion on the current audit);

— *Advocacy threat*: the Statutory Auditor's independence may be threatened if the Statutory Auditor becomes an advocate for, or against, his client's position in any adversarial proceedings or situations (e.g. dealing in or promoting shares or securities in the client; acting as an advocate on behalf of the client in litigation; when the client litigates against the auditor);

— *Familiarity or trust threat*: a risk that the Statutory Auditor may be over-influenced by the client's personality and qualities, and consequently become too sympathetic to the client's interest through, for example, too long and too close relationships with client personnel, which may result in excessive trust in the client and insufficient objective testing of his representations.

— *Intimidation threat*: covers the possibility that the auditor may be deterred from acting objectively by threats or by fear of, for example, an influential or overbearing client.

The significance of a particular threat depends on a variety of (quantifiable and non-quantifiable) factors such as its force, the status of the person(s) involved, the nature of the matter causing the threat, and the overall audit environment. When evaluating the significance of a threat the Statutory Auditor also has to consider that different kinds of threats may arise in one set of circumstances. With regard to one certain set of circumstances a threat can be considered significant if, considering all of its quantitative

and qualitative aspects, both alone and in combination with others, it increases the level of independence risk to an unacceptably high level.

#### 4. SYSTEMS OF SAFEGUARDS

Where threats to statutory auditors independence exist, the Statutory Auditor should always consider and document whether safeguards are appropriately applied to negate or reduce the significance of threats to acceptable levels. The safeguards to be recognised relate to different responsibilities in the audit environment, including the governance structure of the Audit Client (see A. 4.1), the entire system of self-regulation, public regulation and oversight of the audit profession including disciplinary sanctions (see A. 4.2), and the Statutory Auditor's system of internal quality control (see A. 4.3).

##### Level of independence risk

The level of independence risk can be expressed as a point on a continuum that ranges from 'no independence risk' to 'maximum independence risk.' Although it cannot be measured precisely, the level of independence risk for any specific activity, relationship, or other circumstance that may pose a threat to a Statutory Auditor's independence can be described as being within, or at one of the endpoints, on the independence risk continuum.

The Statutory Auditor and any other person involved in a decision concerning the independence of the Statutory Auditor in relation to his client (e.g., regulatory bodies, other statutory auditors who are consulted for advice) need to evaluate the acceptability of the level of independence risk that arises from specific activities, relationships, and other circumstances. That evaluation requires these independence decision makers to judge whether existing safeguards eliminate or adequately mitigate threats to independence posed by those activities, relationships, or other circumstances. If they do not, a further decision has to be made on which additional safeguard (including prohibition) or combination of safeguards would reduce independence risk, and the corresponding likelihood of compromised objectivity, to an acceptably low level.

#### **Extract from APB**

##### **ES 1**

27 Auditors identify and assess the circumstances, which could adversely affect the auditors' objectivity ('threats'), including any perceived loss of independence, and apply procedures ('safeguards'), which will either:

- (a) eliminate the threat (for example, by eliminating the circumstances, such as removing an individual from the engagement team or disposing of a financial interest in the audit client); or
- (b) reduce the threat to an acceptable level, that is a level at which it is not probable that a reasonable and informed third party would conclude that the auditors' objectivity is impaired or is likely to be impaired (for example, by having the audit work reviewed by another partner or by another audit firm).

When considering safeguards, where the audit engagement partner chooses to reduce rather than to eliminate a threat to objectivity and independence, he or she

- recognises that this judgment may not be shared by users of the financial statements and that he or she may be required to justify the decision.
- 32 The audit firm should establish policies and procedures to require the audit engagement partner to identify and assess the significant or threats to the auditors' objectivity, including any perceived loss of independence:
- (a) when considering whether to accept or retain an audit engagement;
  - (b) when planning the audit;
  - (c) when forming an opinion on the financial statements;
  - (d) when considering whether to accept or retain an engagement to provide non-audit services to an audit client; and
  - (e) when potential threats are reported to him or her.
- 36 If the audit engagement partner identifies threats to the auditors' objectivity, including any perceived loss of independence, he or she should identify and assess the effectiveness of the available safeguards and apply such safeguards as are sufficient to eliminate the threats or reduce them to an acceptable level.
- 37 The nature and extent of safeguards to be applied depend on the significance of the threats. Where a threat is clearly insignificant, no safeguards are needed.
- 39 The audit engagement partner should not accept or should not continue an audit engagement if he or she concludes that any threats to the auditors' objectivity and independence cannot be reduced to an acceptable level.