



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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**Agenda Item
2**

Board Ethics Standards Board for Accountants

Meeting Location: CICA, Toronto, Canada

Meeting Date: October 24-26, 2007

Drafting Conventions

Objectives of Agenda Item

1. To discuss and approve the exposure draft.
2. To provide comment on the explanatory memorandum.

Background

At its June 2007 meeting, the IESBA considered the views of the Task Force¹ regarding the implications of the IAASB Clarity project on the Code and certain other matters related to the clarity of the Code.

The Task Force has met once since the June meeting and has had two conference calls to develop the proposed exposure draft and explanatory memorandum. In addition, the Task Force proposals were discussed by the CAG at its September meeting.

Issues

Requirements

The Board discussed the implications of the IAASB Clarity project on the Code. The IAASB Clarity project has 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

¹ Ken Dakdduk (chair), Jean-Luc Doyle, Kariem Hoosain, Peter Hughes and Tim Volkmann

- 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.

The IESBA considered the feasibility of applying the above approach to the Code. The IESBA was of the view that because the structure of the Code and the structure of the ISAs are very different, separately presenting the objective to be achieved, the requirements designed to achieve that objective, and the application material, as in the ISAs, would not improve the clarity of the Code. As currently drafted, Part A of the Code establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles. Parts B and C of the Code illustrate how the conceptual framework is to be applied in specific situations. In all cases, the objective to be achieved, as outlined in the conceptual framework, is to identify threats to compliance with the fundamental principles and apply safeguards to eliminate the threats or reduce them to an acceptable level. This matter was discussed with the CAG. CAG members agreed with the position proposed.

The IESBA discussed the use term “shall” and the following points were noted:

- It was critical to have consistency with the drafting conventions used by the IAASB. Users of the Code who perform assurance engagements will be knowledgeable of the ISAs and using different terms to denote a requirement would be confusing;
- As the clarity of the Code is improved the probability of adoption is increased;
- The term “should” is confusing and can lead to translation difficulties;
- The goal of the project should not be to change the meaning of the Code – rather to clarify what was intended.

The Task Force has reviewed the Code to identify provisions that are intended to convey requirements and re-write these requirements, which are often conveyed by use of the word “should” in the existing Code, using the word “shall.” The intention of the Task Force was not to create any new requirements but, rather, to clarify the original intent.

Clearly Insignificant

The IESBA also considered the use of the term “clearly insignificant” and the requirement to apply safeguards to eliminate a threat or reduce it to an acceptable level. This issue arose during the Task Force’s review of the Code but it had also been raised in the comments to the December 2006 Exposure Draft.

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.”

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.
- 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.”

* See Definitions.

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.

In discussing the issue the IESBA noted the following points:

- It would be useful to reword the requirement such that the professional accountant did not have to deal with and document matters that were clearly trivial. It is not proportionate to cost;
- Care should be taken to ensure that any change does not inappropriately bring the bar too low and weaken the Code. The current construction requires the professional accountant to consider all threats that are not clearly insignificant but only to apply safeguards to the extent necessary to eliminate the threats or reduce them to an acceptable level;
- Professional judgment is required to determine what is an acceptable level; the current starting point of considering all matters that are not both trivial and inconsequential may be too low a threshold;
- It is important that any change maintains the onus on the professional accountant to demonstrate that threats have been adequately considered; and
- The rationale for any change needs to be clearly articulated in the explanatory memorandum.

The IESBA agreed that the Task Force should consider how to eliminate use of the term "clearly insignificant" and to clarify the documentation requirement, but without reducing the accountant's thought process in addressing threats.

The Task Force proposes modifying the guidance by eliminating the reference to clearly insignificant and providing guidance on what is intended by the term "acceptable level." Under the proposal, an acceptable level is a level at which it is likely that a reasonable and informed third party would conclude, weighing all the specific facts and circumstances, that compliance with the fundamental principles is not compromised. A professional accountant would be required to identify threats to compliance with the fundamental principles, evaluate the significance of the threats and, when necessary, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. This proposal emphasizes the importance of the accountant focusing his or her analysis on the threats that are not at an acceptable level because those are the threats that would require the application of safeguards. The Task Force is of the view that this would be a more efficient and effective way of applying the threats and safeguards framework set out in the Code and would eliminate uncertainty about the interplay between the terms "clearly insignificant" and "acceptable level" in the existing guidance.

Consistent with the proposed change above, the Task Force proposal also contains an amendment of the documentation requirements in Sections 290 and 291 (which address

independence requirements). Under the existing Code, 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 along with a description of the threats identified and the safeguards applied to eliminate them or reduce them to an acceptable level. The proposal makes the documentation requirement consistent with the clarification above by calling for documentation of threats in situations in which the application of safeguards are necessary to eliminate a threat or reduce it to an acceptable level. The documentation should describe the nature of the threats and the safeguards that were applied.

This matter was discussed with the CAG. CAG members agreed with the proposal but noted that there is a significant judgment to be made when the auditor concludes that the threats are at an acceptable level. The CAG asked the Task Force to consider expanding the documentation requirements to address this matter.

The Task Force has considered `proposed clarified ISA 220 *Quality Control for Audits of Historical Financial Information* which contains requirements regarding the partner's responsibility for concluding on independence. The requirements in this area are:

10. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- (c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards. The engagement partner shall promptly report to the firm any failure to resolve the matter for appropriate action. (Ref: Para. A3-A4)

26. The engagement partner and, where appropriate, other members of the engagement team, shall document:

- (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

290.27 Given the documentation requirement for a conclusion on independence in the ISA and the position in the Code that documentation is not, in itself, a determinant of whether a firm is independent, the Task Force is of the view that the documentation requirement in the Code should re-enforce the requirement in the ISA. The Task Force, therefore, proposes the following documentation requirement:

“Standards on quality control and auditing standards require documentation that provides a sufficient and appropriate basis for the auditor's report and evidence

~~that the audit was performed in accordance with the applicable standardsof matters important to the audit.~~ Although documentation is not, in itself, a determinant of whether a firm is independent, ~~when threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the audit engagement, the decision should be documented.~~ The documentation should shall include (i) a conclusion that threats to independence are at an acceptable level and (ii) a summary of the relevant decisions that support that conclusion. When threats to independence are identified that require the application of safeguards, the documentation shall also describe the nature of those threats identified and the safeguards applied to eliminate them the threats or reduce them to an acceptable level.

Consider vs evaluate

The Code frequently uses the words “consider” and “consideration”. For example:

“Where a matter involves a conflict with, or within, an organization, a professional accountant should also consider consulting with those charged with governance of the organization, such as the board of directors or the audit committee.” (¶100.18)

“The professional accountant should consider obtaining legal advice to determine whether there is a requirement to report.” (¶100.20)

“Before accepting a new client relationship, a professional accountant in public practice shall consider whether acceptance would create any threats to compliance with the fundamental principles.” (¶210.1)

“The following additional safeguards shall also be considered:” (¶220.4)

“When an entity becomes an audit client during or after the period covered by the financial statements on which the firm will express an opinion, the firm shall consider whether any threats to independence may be created by:” (¶290.29)

In reviewing the Code for Clarity, the Task Force was concerned that in many instances the term consider could be seen by some as being less robust than intended. For example it could be seen as equivalent to “think about” as opposed to “determine whether it is necessary to”.

The Task Force is proposing changes to the Code consistent with the following principles of drafting:

- “Consider’ will be used where the accountant is required to think about several matters – for example ¶100.17 “When initiating either a formal or informal conflict resolution process, a professional accountant shall consider the following, either individually or together with others, as part of the resolution process”

- “Evaluate” will be used when the accountant has to assess and weigh up matters as in “the significance of the threat should be evaluated”
- “Determine” will be used when the accountant has to conclude and make a decision – for example ¶100.20 “The professional accountant shall determine whether to obtain legal advice to ascertain whether there is a requirement to report.”

Other

The Task Force is also proposing some changes to make the language more direct – for example by a greater use of the active voice and by deleting some instances where the Code states that a matter “generally would not”.

Exposure Draft Comment Period

The Task Force considered the appropriate exposure comment period for the exposure draft. The standard comment period for IESBA exposure drafts is three months (except for strategic plans which have a minimum comment period of one month). The IESBA did determine that the independence exposure draft issued in December 2006 (Independence 1) should have a four month comment period. This decision was taken because of the length of the ED and the extensive number of changes (including, for example, splitting existing Section 290 into 290 and 291).

The Task Force recommends a three month comment period for the proposed drafting changes. The Task Force believes this is an appropriate period of time because, while the length of the ED is long, because it contains the complete Code, many of the changes are cumulative.

Material Presented

Agenda Paper 2	This Agenda Paper
Agenda Paper 2-A	Proposed Revised Code
Agenda Paper 2-A Supplement	Proposed revisions to July ED text
Agenda Paper 2-B	Proposed Explanatory Memorandum

Please note that for the purposes of the exposure draft the supplement will be merged with Agenda Paper 2-A and the paragraph number revised accordingly. It is anticipated that this document will be ready for the meeting in Toronto and will be used by the Board on the third day of the meeting when it is planned that the final revised ED will be presented for approval.

Action Requested

1. IESBA members are asked to review and approve for exposure the proposed changes. 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.

