

EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background for, and an explanation of, the proposed changes to the *Code of Ethics for Professional Accountants* (the Code), approved for exposure by the International Ethics Standards Board for Accountants (IESBA or the Board) in October 2007, resulting from the Board's project to improve the clarity of the Code.

The IESBA welcomes comments on these proposed revisions to the Code. Comments should be received by January 31, 2008.

Background

In 2007, the IESBA began a project to improve the clarity of the provisions in its Code. As part of its clarity project, the IESBA considered the results of the International Auditing and Assurance Standards Board's (IAASB) clarity project. The IESBA determined that certain changes being made to the international standards on auditing (ISA) as a result of the IAASB's project would benefit the Code. Accordingly, the IESBA has incorporated certain of those changes into the Code and is requesting comment on the proposed changes.

In December 2006, the IESBA issued an exposure draft proposing revisions to existing Section 290 and proposing a new Section 291 addressing independence requirements for audit and review engagements and other assurance engagements, respectively. The IESBA issued a second exposure draft in July 2007 proposing further changes to these two sections. The comment periods for these exposure drafts have ended and the IESBA is considering the comments received and determining whether any changes to the two proposals are necessary as a result of the feedback.

This exposure draft contains the existing Sections 100 through 280 and 300 through 350 of the Code and the text of proposed revised Section 290 and new Section 291 as contained in the December 2006 and July 2007 exposure drafts. The IESBA is only requesting comment on the proposals noted below that are the result of its clarity project. The exposure draft is presented in mark-up form with additions noted in underline and deletions in ~~strike through~~ to permit readers to focus on the changes stemming from the IESBA's clarity project.

After considering comments it receives on this exposure draft, the IESBA intends to issue the revisions proposed in the exposure draft in mid-2008 simultaneously with the revisions to the Code that were exposed in December 2006 and July 2007.

Proposals

Requirements

The IESBA has considered the implications of the IAASB's clarity project in determining proposed clarity changes to the Code. Under the IAASB's clarity project, each ISA states the objective to be achieved in relation to the subject matter of the ISA. In addition, each ISA specifies the requirements designed to achieve the stated objective and contains separate

application material that provides further explanation and guidance to promote proper application of the standards. The requirements of each ISA 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 an ISA in order to achieve the purpose of that requirement, the accountant is required to document how the alternative procedures performed achieve the purpose of the ISA's requirement and, unless otherwise clear, the reasons for the departure. While the professional accountant has a responsibility to consider the entire text of an ISA in carrying out an engagement, the application material is not intended to impose a requirement on the professional accountant.

The IESBA has considered the feasibility of applying the above approach to the Code. The IESBA is 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.

The IESBA is of the view, however, that identifying a requirement by use of the word “shall” would clarify the Code and bring the language in line with that adopted by the IAASB. Accordingly, the IESBA has reviewed the Code to identify provisions that are intended to convey requirements and has re-written these requirements, which are often conveyed by use of the word “should” in the existing Code, using the word “shall.” The IESBA does not intend to create new requirements as part of this project.

Clearly insignificant

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

The IESBA considered whether the term “clearly insignificant” and its interaction with the term “acceptable level” as part of this guidance is sufficiently clear and, when operating in tandem with the documentation requirements in Sections 290 and 291, whether it results in instances of documentation that are appropriate in all cases. The IESBA has determined that it is appropriate to modify this guidance and proposes to clarify it 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 IESBA believes 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 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, and with the documentation requirements under International Standards on Auditing issued by the International Auditing and Assurance Standards Board, by calling for documentation of a conclusion that threats to independence are at an acceptable level and a summary of the relevant decisions that support that conclusion. In addition when threats to independence are identified that require the application of safeguards the documentation shall also describe the nature of those threats and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

Other changes

The existing Code, in paragraph 100.9, states that Parts B and C of the Code include "examples that are intended to illustrate how the conceptual framework is to be applied." This construction is used elsewhere in the Code, for example, in paragraph 290.100, which states that "The following examples describe specific circumstances and relationships that may create threats to independence." The use of the word "examples" has led some to question whether the material is mandatory. The proposal clarifies that the examples are intended to be mandatory by removing the word "examples."

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

"When initiating either a formal or informal conflict resolution process, a professional accountant should consider the following..." (¶100.17)

"If the threat is not clearly insignificant safeguards should be considered and applied when necessary to eliminate the threat or reduce it to an acceptable level." (¶290.123)

"Before the firm accepts an engagement to provide a non-assurance service to an audit client, consideration should be given to whether providing such a service would create a threat to independence." (¶290.152)

In reviewing the Code for Clarity, the IESBA 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 IESBA 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;
- “Evaluate” will be used when the accountant has to assess and weigh up matters; and
- “Determine” will be used when the accountant has to conclude and make a decision.

Using these conventions the examples provided above would be as follows:

“When initiating either a formal or informal conflict resolution process, a professional accountant ~~should~~shall consider the following...” (¶100.17) *No change to consider*

“~~If the significance of the threat is not clearly insignificant~~shall be evaluated and safeguards ~~should be considered and~~ applied when necessary to eliminate the threat or reduce it to an acceptable level.” (¶290.123) *Consider changed to evaluate*

“Before the firm accepts an engagement to provide a non-assurance service to an audit client, ~~consideration should be given to it~~ shall determine whether providing such a service would create a threat to independence.” (¶290.152) *Evaluate changed to determine*

The proposal also contains some additional 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”.

Guide for Commentators

The IESBA welcomes comments on the proposed revisions. Comments are most helpful when they refer to specific paragraphs, include the reason for the comments and, where appropriate, make specific suggestions for any proposed changes to wording to enable the IESBA to fully appreciate the respondent’s position. Where a respondent agrees with proposals in the exposure draft (especially those calling for a change in current practice), it will be helpful for the IESBA to be made aware of this view.

Recognizing that the proposed revised Code will apply to all professional accountants in public practice that perform assurance engagements, the IESBA is also interested in comments on matters set out below.

Request for Specific Comments

1. The IESBA is of the view that the clarity of the Code would not be improved by separately presenting the objective to be achieved, the requirements designed to achieve that objective, and the application guidance as in the ISAs. Do you agree? If you do not agree please provide an explanation.
2. The IESBA is of the view that identifying a requirement by the use of the word “shall” clarifies the Code and appropriately brings the language in line with that adopted by the IAASB. Do you agree? If you do not agree please provide an explanation.

Comments on Other Matters

Special Considerations on Application in Audit of Small Entities

Respondents are asked to comment on whether, in their opinion, considerations regarding the audit of small entities have been dealt with appropriately in the proposed revisions to the Code. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Developing Nations

The IESBA welcomes comments on any foreseeable difficulties in applying the proposed provisions in a developing nation environment. Reasons should be provided, as well as suggestions for alternative or additional guidance.

Translations

The IESBA welcomes comments from respondents on potential translation issues noted in reviewing this exposure draft.