



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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**Agenda Item
2**

Task Force International Standards Board for Accountants

Meeting Location: AICPA, New York, United States

Meeting Date: April 15-17, 2008

Independence II

Objective of Agenda Item

1. To approve changes made in response to the Independence ED issued in July 2007.

Background

In July 2007, the IESBA issued an exposure draft (ED) proposing revisions to Sections 290 and 291 addressing the areas of internal audit services, relative size of fees and contingent fees. The exposure period was three months and ended on October 15, 2007.

Comments were received from the following:

Member Bodies of IFAC	24
Firms	5
Regulators	2
Government Organizations	1
Other	12
Total Responses	44

All of the comment letters received have been posted on the IFAC website and may be downloaded at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0085>.

The IESBA discussed responses to the exposure draft at its January 2008 meeting and reviewed a first draft of revisions to address the comments raised. The Task Force¹ revised the draft in response to direction received from the IESBA. The CAG discussed the revised draft at its March 5-6, 2008 meeting. The draft CAG minutes are presented in Agenda Paper 1-B.

¹ Dave Winetroub (chair), Heather Briers, Ken Dakdduk, Barbara Majoor, Michael Niehues, Andrew Pinkney and Sylvie Soulier

Internal Audit Services

Background

As noted in the explanatory memorandum, existing Section 290 states that a self-review threat may be created when a firm provides internal audit services to an audit client. It also states that a firm should not provide any internal audit services to an audit client unless the client takes certain specified actions and the findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance. The exposure draft proposed amending the guidance of internal audit services to clarify the wide range of services that comprise internal audit services. The exposure draft also stated that depending on the nature of the services a threat to independence may be created if the services involve the firm performing management functions or are such that it would review its own work. The exposure draft further indicated that assisting an audit client in the performance of a significant part of the client's internal audit activities increases the risk that firm personnel providing the service may perform a management function. The proposed changes, therefore, stated that before accepting such an engagement the firm should be satisfied that the client has designated appropriate resources to the activity.

The exposure draft indicated that certain services, such as the outsourcing of all or a portion of the internal audit function whereby the firm is responsible for determining the scope of the work and the recommendations that should be implemented and performing procedures that firm parts of the internal controls of the audit client, involve management functions. The exposure draft therefore indicated that the auditor should not provide such services.

The exposure draft indicated that to ensure the firm does not perform management functions, the firm should only provide assistance to an audit client's internal audit function if specified conditions are in place including that the findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance.

The proposed revisions require a firm, prior to accepting an engagement to provide internal audit services to an audit client, to consider the scope and objective of the proposed engagement and whether the assignment is expected to create a self-review threat because it is likely to be relied upon in the making of significant audit judgments related to a matter that is material to the financial statements.

As noted in explanatory memorandum, IESBA considered whether there should be a more restrictive requirement for an audit client that is an entity of significant public interest. The IESBA concluded that procedures performed as part of internal audit services and procedures performed during an audit conducted in accordance with International Standards on Auditing can be similar and that prohibiting procedures simply because they are done as part of an internal audit service is unnecessary as long as the procedures do not entail the performance by the firm of management functions. Accordingly, the IESBA was of the view that internal audit services can be provided as long as the firm does not perform management functions and eliminates or reduces to an acceptable level any remaining

threat that is not clearly insignificant. Therefore, the IESBA was of the view that it is not appropriate to have a more restrictive requirement for audit clients that are entities of significant public interest.

Responses

The majority of respondents either expressly (16 respondents) or implicitly (21 respondents) agreed with the proposal to permit the provision of internal audit services provided that certain specified conditions are met.

Eight respondents were not supportive of or questioned the overall approach. Two respondents (NASBA and IIA) were of the view that a firm that provides financial audit services should not also provide internal audit services to the same client. Three respondents (CICA, Basel and Mazars) expressed the view that an audit firm should not provide internal audit services for a public interest entity. One respondent (APB) expressed the view that where the auditor is likely to place significant reliance on the internal audit work performed by the audit firm, the self-review threat would be unacceptably high and such services should be prohibited, rather than allowing safeguards to be applied. One respondent (ICAS) stated that they did not believe the proposed changes to the provision of internal audit services to audit clients by audit firms were sufficiently restrictive – no further detail was provided. One respondent (IOSCO) expressed the view that the safeguards provided are not sufficiently robust and that the Code should contain a statement that not all self-review threats can be mitigated with safeguards and that a firm may need to decline to perform certain non-audit services.

IESBA January Discussion

The IESBA considered these comments and, in light of the respondents who were concerned with the approach, and the probable effect that the proposal would have on convergence, concluded that it was appropriate to adopt a more restrictive approach regarding the provision of internal audit services to public interest audit clients. The IESBA, therefore, directed the Task Force to develop an appropriate prohibition for internal audit services to public interest audit clients.

The Task Force has considered the matter and has developed a proposal that would restrict firms from providing internal audit services that relate to the internal accounting controls, financial systems or financial statements to a public interest audit client (Agenda Paper 2-B ¶290.191). Firms would not be precluded from providing non-recurring internal audit services to evaluate a specific matter (such as assisting the client in an investigation of a suspected fraud) (Agenda Paper 2-B ¶290.192). The Task Force has deleted the detailed discussion of the procedures required under ISAs when the firm uses the work of an internal audit function (Agenda Paper 2-B 290.190) and has expanded the guidance on the evaluation of the significance of the threats for audit clients that are not public interest entities (Agenda Paper 2-B 290.190).

CAG March Discussion

The proposed approach was discussed with the CAG at its meeting in March 2008. Several CAG members expressed support for the approach and, in particular, the more

stringent approach to restrict firms from providing internal audit services that relate to the internal accounting controls, financial systems or financial statements to a public interest audit client.

A few editorial suggestions were made and these have been reflected in Agenda Paper 2-B.

Fees – Relative Size

Background

The proposed revisions to Section 290 provided additional guidance with respect to the relative size of fees from an audit client that is an entity of significant public interest. As proposed in the exposure draft when, for two consecutive years, the total fees from such a client represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client the self-interest threat created would be too significant unless disclosure is made to those charged with governance of the client and one of the following safeguards is applied:

- After the audit opinion has been issued a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs a review that is equivalent to an engagement quality control review (“a post issuance review”); or
- Prior to the issuance of the audit opinion a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs an engagement quality control review.

In subsequent years, in determining which of these safeguards should be applied, and the frequency of their application, consideration should be given to the significance of the relative size of the fee. The exposure draft stated that at a minimum a post-issuance review should be performed not less than once every three years to reduce the threat to an acceptable level.

The professional accountant who performs the engagement quality control review (or equivalent) may be a member of a network firm. As noted in the explanatory memorandum the IESBA considered whether there should be a threshold of relative size which, if exceeded, would indicate that the threat created was so significant that no safeguard could adequately address the threat and therefore the firm should either not act as auditor for the client or take steps to reduce the relative size of the fee below the threshold. The IESBA was of the view that such an absolute threshold is not appropriate in a global Code.

Responses

Respondents were mixed in their views as whether should be a specific percentage threshold after which safeguards were mandatory. Eleven respondents expressed either support for the approach or noted that they did not disagree with the proposal. 14 respondents expressed the view that it was inappropriate for the Code to have a bright-line 15% test. Four respondents expressed the view that the proposals were too

permissive. Two respondents (Mazars and ICANZ) expressed the view that the 15% threshold should not be limited to public interest entities but should apply to all audit clients. One respondent (RM) expressed the view that the threshold should be 10% and one respondent (APB) expressed the view that there should be a threshold over which no safeguards could address the threat. This respondent felt this threshold was 10% for audit clients that were listed entities and 15% for other audit client. One respondent indicated that the Committee was unable to reach consensus as to whether a 15% threshold was appropriate.

The exposure draft proposed that after the 15% threshold had been reached this fact should be disclosed to those charged with governance. A small majority of those who commented on this area were supportive of the need to disclose to those charged with governance. Those who disagreed expressed the view that a potential intimidation threat that may arise where information regarding the financial stability of the individual partner and the firm is disclosed.

The exposure draft proposed that after the 15% threshold had been reached there should be a periodic pre-issuance or post-issuance review. Nine respondents expressed support for this approach. Four respondents expressed the view that a pre-issuance review should be conducted and not a post-issuance review. One respondent expressed the view that a post-issuance review was the only appropriate safeguard. One respondent stated that neither pre-issuance nor post-issuance reviews were practical. One respondent stated that the safeguards were insufficient to reduce the self-interest threat to an acceptable level.

IESBA Discussion January 2008

The IESBA considered the comments on a fixed threshold percentage and concluded that is necessary to ensure consistent application. The IESBA is not, therefore, proposing to change the threshold requirement.

The IESBA considered the comments on disclosure to those charged with governance and concluded it is appropriate. The IESBA was also of the view that the discussion with those charged with governance should include a discussion the safeguard the firm will put in place to address the threat.

The IESBA has considered the comments on safeguards and was of the view that the guidance should be strengthened to require the application of safeguards to the second audit opinion that is issued after the fees reach the 15% threshold. The ISEBA also concluded that a pre or post issuance review conducted by a professional regulatory body could be an effective safeguard.

One respondent commented that the guidance regarding fees that represent a large proportion of the revenue from an individual partner's clients should be expanded. There respondent further indicated that there was also an issue when the revenue from one client represents a large proportion of the revenue of an individual office. The IESBA considered this comment and directed the Task Force to develop additional guidance in this area. The Task Force has considered the matter and has developed guidance on the

factors that would influence the significance of the threat and examples of safeguards (Agenda Paper 2-B ¶290.214).

CAG March Discussion

The proposed approach was discussed with the CAG at its meeting in March 2008. CAG members did not suggest any changes to the proposed approach.

Contingent Fees

Background

The exposure draft provided additional guidance with respect to contingent fees. Under the proposed revisions a firm should not perform a non-assurance service for an audit client if either the fee is material, or expected to be material, to the firm or the fee is dependent upon the outcome of a future or contemporary judgment related to the audit of a material amount in the financial statements. In the case of a non-assurance service provided to an assurance client that is not an audit client a firm should not provide a non-assurance service for a contingent fee if the amount of the fee is dependent on the result of the assurance engagement.

Responses

Eleven respondents indicated that they were generally supportive of the approach taken in this area (subject to some specific comments). Four respondents (CNCC, AGNZ, Mazars and IIA) expressed the view that for audit clients no fees whether received on other assurance or non-assurance engagement should ever be contingent, since they would lead the statutory auditor to enter into a position of having to negotiate its fees with the client based on the result of its work.

Two respondents (GTI and CICA) recommended that the guidance be expanded to include a prohibition of contingent fee arrangements between a firm and third parties where an outcome is dependent on the audited financial statements of the firms' audit client.

One respondent expressed the view that the guidance should address contingent fees charged by network firms.

Eight respondents noted that the guidance related to a contingent fee for an assurance engagement in Section 291 is not aligned with the guidance in Section 290.

IESBA January Discussion

The IESBA asked the Task Force to consider contingent fees charged by a network firm. The Task Force has considered the matter and proposes that if a network firm that participates in a significant part of the audit charges a contingent fee that is material to the network firm the threat created would be too significant.

The Task Force has also considered the guidance in the exposure draft that a firm should not charge a contingent fee if the amount of the fee is dependent upon the outcome of a future or contemporary judgment related to the audit of a material amount in the financial

statements. The Task Force is of the view that the wording does not quite capture what was intended in that it is not the amount of the fee that is dependent upon the outcome of a future or contemporary audit judgment – rather a contingent fee should not be charged if the resulting amounts from the transaction are material to the financial statements and the firm will audit those amounts. Therefore, the Task Force proposes to amend the guidance such that firm should not charge a contingent fee if the non-assurance service has a material effect on the financial statements and that effect will be the subject of a significant or future or contemporary audit judgment.

The ISEBA has revised the guidance to align it with Section 290.

CAG March Discussion

The proposed approach was discussed with the CAG at its meeting in March 2008. CAG members did not suggest any changes to the proposed approach.

Approval

IESBA Terms of Reference requires the affirmative vote of at least two-third of members present at a meeting in person or by simultaneous telecommunications link or by proxy, but not less than twelve.

IESBA Terms of Reference requires that, after approving the revised content of an exposure draft, the IESBA assesses whether there has been substantive change to the exposed document that may warrant re-exposure. Situations that constitute potential grounds for a decision to re-expose may include, for example, substantial change to a proposal arising from matters not aired in the exposure draft such that commentators have not had an opportunity to make their views known to the IESBA before it reaches a final conclusion, substantial changes arising from matters not previously deliberated by the IESBA, or substantial change to the substance of a proposed pronouncement.

The Task Force is of the view that there has not been substantial change to the sections on the relative size of fees and contingent fees. The IESBA has, however, made a substantial change in the restriction on providing certain internal audit services to audit clients that are public interest entities. The Task Force, therefore, is of the view that this portion of the exposure draft should be re-exposed.

Material Presented

Agenda Paper 2	This Agenda Paper
Agenda Paper 2-A	Revised paragraphs (clean)
Agenda Paper 2-B	Revised paragraphs (mark-up)

Please note that Agenda Paper 2-B will be used in the discussion.

Action Requested

1. Members are asked to consider and approve the proposed changes.
2. Members are asked to consider the need for re-exposure.