

Note to Readers

This Explanatory Memorandum has been drafted to reflect the position presented in Agenda Paper 2. It will be updated to reflect the IESBA's decisions at the meeting.

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), which were approved for exposure by the International Ethics Standards Board for Accountants (IESBA or the Board) in June 2008 and resulted from the Board's project to improve the drafting conventions of the Code, (the "drafting conventions project").

The IESBA welcomes comments on these proposed revisions to the Code. Comments should be received by September 30, 2008.

Background

In 2007, the IESBA began a project to improve the drafting conventions used in the Code with the objective of enhancing the clarity and understandability of the provisions in the Code. As part of its drafting conventions 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, which are described later, into the Code and is requesting comment on those proposed changes.

In January 2008, the IESBA approved revisions to existing Section 290, which now sets out independence requirements only for audit and review engagements, and approved the adoption of a new Section 291 addressing independence requirements for other assurance engagements. The IESBA issued an exposure draft in July 2007 proposing further changes to these two sections. In April 2008, the Board approved changes based on that exposure draft and decided to expose for comment two new proposed changes, one that would prohibit the rendering of internal audit services to public interest entity audit clients and another that would require the application of specified safeguards on a more frequent basis than previously proposed when the relative size of fees from a public interest entity audit client exceeds 15% of the total fees of the firm. The accompanying exposure draft contains proposed drafting convention changes in various provisions throughout the Code, including revised Section 290 and new Section 291, and the parts of Section 290 that contain proposed changes to the provisions on internal audit service and relative size of fees.

The IESBA is requesting comments only on the proposed changes to the Code that are the result of its drafting conventions project. The exposure draft is presented in mark-up form with additions noted in underline and deletions in ~~striketrough~~ to assist readers in focusing on these proposed changes. In addition, the exposure draft includes a clean version of the Code that reflects all of the proposed drafting convention changes to enable respondents to read a clean copy with all changes accepted.

After considering the comments it receives on the drafting convention changes in this exposure draft, the IESBA intends to approve and issue a revised Code that reflects some or all of the proposed drafting conventions.

Drafting Proposals

Wording to Indicate Requirements

The IESBA considered the outcome of the IAASB's clarity project in determining proposed drafting convention 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 by performing alternative audit procedures to achieve the aim of that requirement, the accountant is required to document how alternative procedures performed achieve the aim of the ISA's requirement and 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 considered the feasibility of applying the above approach to the Code. The IESBA is of the view that because the structure of the Code is very different from the structure of the ISAs, 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 complying with those principles. Parts B and C of the Code describe 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 for the professional accountant to comply with the fundamental principles. In doing so, the professional accountant will either take the actions prescribed in the Code to eliminate the circumstance or relationship that creates a threat to compliance with the fundamental principles or, when the Code does not require that action, identify and evaluate threats to compliance with the fundamental principles and, if the threats are not at an acceptable level, 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 requirements of the Code, and bring the language in the Code in line with that adopted by the IAASB in the ISAs. 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 revised Code would require professional accountants to comply with all provisions denoted by the word “shall,” unless compliance is prohibited by law or regulation or an exception is permitted by the Code. The IESBA does not intend to use the word “shall” to create new requirements as part of this project. Rather it is used to remove any ambiguity from the wording in the existing Code.

The IESBA recognizes that it is impossible to anticipate all circumstances in which a requirement denoted by “shall” would apply and acknowledges that there may be exceptional circumstances in which compliance with such a requirement would not best serve the public interest. Accordingly, the IESBA has provided that in exceptional circumstances a departure from a requirement may better serve the public interest. Before the departure can occur, the professional accountant would be required to:

- Determine that the departure is expected to be non-recurring;
- Determine that the departure will not compromise the professional accountant’s compliance with the fundamental principles;
- Discuss the matter, including any safeguards that will be applied, with those charged with governance, or with the relevant regulatory authority; and
- Document how, in the accountant’s professional judgment, the public interest is better served by a departure from a requirement in the Code, any safeguards that will be applied, the nature of the discussion with those charged with governance or the relevant regulatory authority and the rationale for concluding that the accountant’s compliance with the fundamental principles is not compromised.

In all cases where a departure will occur and compliance with the requirement can be subsequently achieved, the professional accountant shall comply with the requirement as soon as possible.

The IESBA is of the view that a departure should only occur in exceptional (i.e., rare and unusual) circumstances. For example, the IESBA considered the requirement that a key audit partner on a public interest entity audit client rotate off the audit engagement team after seven years. The Code further provides that a partner whose continuity is especially important to audit quality may be permitted an additional year on the audit team. The IESBA is of the view that in exceptional circumstances the public interest might be better served if a key audit partner was permitted to remain on the team for a period longer than one year. Such might be the case if a planned rotation did not occur because of the unexpected death of the successor partner and the incumbent partner needed to remain on the team for an additional year. The firm then took steps to identify another successor and make the necessary arrangements for the partner to take over as a key audit partner, including things such as obtaining a visa and a license to practice in the particular jurisdiction, all of which took one year to achieve. However, before the second

successor partner assumed the key audit partner position, the partner unexpectedly left the firm. In that circumstance, in the absence of a departure from a strict requirement, the only alternative is for the firm to resign from the audit. Such a resignation could result in significant difficulties for the client and might lead to its failure to meet regulatory reporting requirements. The IESBA is of the view that in such circumstances the public interest is better served if the incumbent key audit partner is permitted to remain temporarily on the audit team until the firm is able to install another individual to serve as the key audit partner.

The IESBA also considered a situation in which subsequent to the partner ceasing to be a key audit partner for a public interest entity audit client, the partner joins the client as a director or officer. The Code provides that no safeguards could reduce the threat to an acceptable level unless the client had issued audited financial statements covering a period of not less than twelve months and the partner was not a member of the audit team with respect to that audit. The IESBA is of the view that in exceptional circumstances the public interest might be better served if the firm were permitted to remain as auditor in that situation. Such might be the case if the lead audit partner left the firm to join a non-client but one week before the public interest entity audit client issues its audited financial statements covering the subsequent twelve months for which the partner was not a member of the audit team, the partner joined the client as a director. In that circumstance, in the absence of a departure from a strict requirement, the only alternative might be for the firm to resign from the audit. Such a resignation could result in significant difficulties for the client and might lead to its failure to meet regulatory reporting requirements. The IESBA is of the view that in such circumstances the public interest is better served if the firm is permitted to remain as auditor of the entity.

Threats

The Code identifies five categories of threats to compliance with the fundamental principles and provides examples of situations in which those threats might be created, but does not describe in general how a threat might be created and what its ramifications are. The IESBA concluded that the clarity of the Code and the application of the conceptual framework approach to complying with the fundamental principles would be improved if the Code contained a revised description of a threat and revised descriptions of each of the five categories of threats. The IESBA, therefore, proposes to amend the Code to indicate that threats may be created by a broad range of relationships and circumstances that could compromise, or be perceived to compromise, compliance with the fundamental principles. This revision, which is reflected in the accompanying exposure draft, makes clear what the consequences of a threat may be (i.e., compliance with the fundamental principles could be compromised) and that a threat includes both actual and perceived compromises of an accountant's compliance with the fundamental principles. The IESBA also proposes to refine the description of each category of threat.

In some cases the Code states that a particular relationship or circumstance *may* create a threat, but that statement is followed by a statement that the significance of *the* threat should be evaluated. The IESBA concluded that if a matter may create a threat, it would be more appropriate to state that the significance of *any* threat shall be evaluated. In addition, in some cases the Code states that a relationship or circumstance *may* create a threat, but in the view of

the IESBA, the particular relationship or circumstance *does* create a threat. The IESBA has, therefore, reviewed the Code to determine whether a matter may create a threat or does create a threat and is proposing to eliminate use of the word "may" where appropriate.

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."

In response to comments received on the Board's December 2006 exposure draft of proposed changes to Section 290 and creation of a new Section 291, the IESBA considered whether the term "clearly insignificant" and its intended interaction with the term "acceptable level" as part of applying the conceptual framework approach to complying with the fundamental principles is sufficiently clear. The Board also considered whether, when operating in tandem with the documentation requirements for independence purposes in Sections 290 and 291, the instances in which the use of the "clearly insignificant" threshold results in documentation are appropriate and whether the level of threats that are documented are appropriate.

The IESBA determined that a threat that is "clearly insignificant" is at a level that is below a threat that is at an "acceptable level." Under the conceptual framework, a threat that has not been eliminated is required to be reduced to an acceptable level (but not to a clearly insignificant level) in order for the professional accountant to comply with the fundamental principles. Accordingly, the Board concluded that it is appropriate to modify the guidance in the Code that refers to "clearly insignificant" as part of applying the conceptual framework and make it consistent with the conceptual framework. The IESBA, thus, eliminated the reference to "clearly insignificant" in favor of "acceptable level" and provided guidance on what is intended by the term "acceptable level."

Under the proposal, an acceptable level is a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances that were available to the professional accountant at that time, that compliance with the fundamental principles is not compromised. A professional accountant should therefore be required to identify threats to compliance with the fundamental principles, evaluate the significance of the threats identified and, when the threats are not at a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances that were available to the professional accountant at that time, that compliance with the fundamental principles is not compromised, apply safeguards to eliminate the threats or reduce them to an acceptable level. Accordingly, the proposal emphasizes that the threats that need to be identified are those that are not at an acceptable level because those are the threats that require action by the professional accountant. The IESBA believes this is a more efficient and effective way of applying the threats and safeguards analysis set out in the conceptual framework and eliminates uncertainty about the interplay between the terms "clearly insignificant" and "acceptable level" in the existing Code.

Consistent with this proposed change, the proposal also contains an amendment of the documentation requirement in Section 290 and proposes a similar documentation requirement in Section 291. Under the existing Code, when threats to independence that are not clearly insignificant are identified and the firm decides to accept or continue the assurance engagement, that decision should be documented along with a description of the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

The proposal calls for documentation of a conclusion about compliance with independence requirements and any relevant discussions that support that conclusion. This documentation requirement applies to all professional accountants when conducting an audit or review engagement. When documentation of those matters is prepared to meet the requirements of ISA 220, *Quality Control for Audits of Historical Financial Information*, it will satisfy the requirement of this Code to document conclusions about compliance with independence requirements and any relevant discussions that support that conclusion. Thus, the amended documentation requirement does not mean that professional accountants who comply with ISA 220 are required to prepare duplicate documentation, one to meet ISA 220 and one to meet the requirements of the Code. In all cases, however, when threats to independence are identified that require the application of safeguards, the nature of those threats and the safeguards applied to eliminate the threats or reduce them to an acceptable level shall be included as part of the documentation required by this Code.

Conceptual Framework Approach

In light of the proposed clarity changes discussed above, the IESBA is proposing clarifications to the description of the conceptual framework approach contained in the Code. The proposed changes note that the conceptual framework accommodates many variations in circumstances that create threats to compliance with the fundamental principles. The changes also emphasize the need for a professional accountant to apply the framework in any situation that is not explicitly addressed in Parts B and C of the Code.

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 existing Code, for example, in paragraph 290.100, which states “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 existing Code, issued in June 2005, 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 created is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.” (¶290.134)

“Before the firm accepts an engagement to provide a non-assurance service to an audit client, consideration should be given to whether provision of such a service would create a threat to independence.” (¶290.164)

The IESBA believes 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 the significance of a matter; and
- “Determine” will be used when the accountant has to conclude and make a decision.

These conventions are consistent with the definitions of those words found in standard dictionaries.

Using these conventions, the examples above would read as follows:

“When initiating either a formal or informal conflict resolution process, a professional accountant shall consider the following...” (ED¶100.18) *No change to "consider"*

“The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.” (ED¶290.126) *“Consider” changed to “evaluate”*

“Before the firm accepts an engagement to provide a non-assurance service to an audit client, a determination shall be made as to whether providing such a service would create a threat to independence.” (ED¶290.158) *“Consideration” changed to “determination”*

The appendix to this explanatory memo contains a chart that identifies the paragraphs that have been changed as discussed above.

The proposal also contains some additional changes to make the language more direct – for example by a greater use of the active voice and changes to improve the consistency of the drafting in the Code.

Effective Date

The IESBA proposes that the revised Code be effective December 15, 2010 which will be approximately 18 months after the planned issuance of the document. In determining the appropriate effective date, the IESBA balanced the need for providing firms and member bodies with appropriate time to implement the new standards and effecting change as soon as possible.

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.

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.
3. Do you believe that the proposed drafting convention changes achieve the objective of improving the understandability of the Code?
4. The IESBA is of the view that the proposed modification to focus the application of the conceptual framework throughout the Code, and the related documentation requirements in Section 290 and 291, on threats that are not at an acceptable level will result in a more efficient and effective application of the framework approach. Do you agree? If you do not agree, please provide an explanation.
5. The IESBA is of the view that the effective date provides the appropriate balance between providing firms and member bodies with appropriate time to implement the new standards and effecting change as soon as possible. Do you agree? If you do not agree please provide an explanation.

Comments on Other Matters Related to the Proposed Drafting Convention Changes

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.

Appendix

(To be double checked against final document)

Section No	Consider ¹	Evaluate ²	Determine ³
100	18(2), 21(2)	2, 6, 8, 9, 11, 12	7(2), 18, 19, 21, 22
110	-	-	-
120	-	-	-
130	-	-	-
140	8	-	8
150	-	-	-
200	10(2)	1, 4, 11(2)	10
210	8, 9	3, 7, 10, 17	1, 6, 8, 9
220	-	2(2)	4
230	-	2	3
240	-	2, 4	3
250	2	-	-
260	2	3	-
270	3(2)	-	-
280	-	4	1
290	26, 28(2), 33*, 105, 154, 158, 163, 169, 223, 224	7, 8, 9, 10, 11, 25, 27(2), 28, 30, 32(2), 100, 105, 107, 113, 115, 124, 126, 127, 129, 130, 131, 132, 136, 137, 138, 142, 143, 145(2), 148, 150, 153, 157, 158, 166, 171, 176, 189, 191(2), 192, 198(2), 199(3), 201, 203, 205, 206, 209, 211, 213, 215, 217, 218, 221, 222, 224, 228, 229*, 229(4), 230, 232, 501, 506(2), 507, 509, 510, 513	10(2), 22, 24, 26, 29, 31, 33, 100, 101, 103, 109, 113, 115, 116, 117, 154, 158, 167, 169, 171, 176, 188, 192, 193, 197, 198, 206, 218, 223(2), 228(2), 509
291	33*, 107, 142, 144, 148*, 153	2, 3(3), 6, 7, 8, 9, 10, 12, 13(3), 15, 16(2), 17, 19, 20, 21, 25, 27, 30, 32(2), 100, 101, 107, 110, 119, 120, 121, 123, 124, 125, 126, 129, 130, 131, 132, 134(2), 137, 139, 141, 142, 147, 148, 149, 150, 151, 152, 153, 157, 159	9(2), 17, 25, 28(2), 29, 31, 33, 100, 103, 105, 110, 112, 142, 148, 157(2)
IT 2005-01	4 instances	9 instances	9 instances
300	16	6	9
310	-	3	1
320	6(2)	5	6(3)
330	-	3	4(2)
340	-	2(2), 3	2, 3

¹ Includes the words “consider”, “considered”, “considering” and “consideration”.

² Includes the words “evaluate”, “evaluates”, “evaluated”, “evaluating” and “evaluation”.

³ Includes the words “determine”, “determines”, “determining”, “determinant” and “determination”.

350	3, 4, 18(2), 21(2)	2, 4(2)	4
Definitions	-	2 instances	-

* Word is included in a heading.