

## **International Ethics Standards Board for Accountants Draft Convergence Program**

### **Objective**

The objective of the IESBA as established in its Terms of Reference, as approved by the PIOB is:

*“To serve the public interest by setting high quality ethical standards for professional accountants and by facilitating the convergence of international and national ethical standards, thereby enhancing the quality and consistency of services provided by professional accountants.”*

The IESBA Strategic and Operational Plan 2008-2009 identifies convergence of international and national ethics standards as a high priority for the IESBA. It states that:

*“The IESBA will develop a program and course of action to promote recognition of the IFAC Code. This will include consultation with interested parties, including regulators and national standard setters, to determine the basis on which progress can be made in establishing the Code as a global benchmark. The consultation will include holding four regional forums or roundtables, as appropriate, in each of the Americas, Europe, Africa and Asia/Pacific.”*

The Plan indicates that the IESBA will, once the course of action is approved, review the progress of implementation at each meeting and periodically review the course of action and update it as necessary.

### **Background**

IESBA's aim of facilitating convergence of international and national ethics standards is set against a background where there has been much progress towards adoption of International Financial Reporting Standards (“IFRS”) as the single set of global accounting standards, with over 100 countries permitting or requiring the use of IFRS. Beginning in 2005, listed companies in a regulated market in the European Union were required to apply IFRS in preparing their consolidated financial statements and beginning in 2008 the US Securities and Exchange Commission (“SEC”) permits foreign private issuers to include financial statements prepared under IFRS, eliminating the reconciliation to US GAAP. Also the SEC may decide to permit US companies to file their financial statements prepared under IFRS as early as 2010.

Furthermore, International Standards on Auditing (“ISAs”) as issued by the International Auditing and Assurance Standards Board (“IAASB”) are used in more than 100 countries – either adopted as written or locally adapted, or the national standards are compared to the ISAs to eliminate the differences. In addition, many of the world's major capital

markets accept the use of ISAs for the audit of financial statements of foreign issuers. An IAASB survey indicates that 20 out of the 23 largest capital markets with overall market capitalisation of 56% of the world total accept ISAs for this purpose, in all but one country outside the US. In addition, a Public Company Accounting Oversight Board (“PCAOB”) Board member has indicated that in 2008 the PCAOB will consider whether investors would be better served if there were less variation on auditing standards.

Convergence of international and national ethics standards is less advanced. Member bodies of IFAC are required by under the Statement of Membership Obligations (“SMOs”) to apply no less rigorous standards than those stated in the Code unless prohibited by law or regulation from complying with certain parts of the Code, in which case it should comply with all other parts of the Code<sup>1</sup>. Member bodies of IFAC completed a self-assessment of compliance with the SMOs. With respect to those member bodies that establish ethical requirements (as opposed to those jurisdictions where ethical requirements are established by law or an external body), 30% of member bodies indicated they were using the 2006 version of the Code, 35% indicated use of the 2004 Code (which includes the updated independence requirements included in Section 8) and 35% indicated use of an earlier version of the Code.

The members of the Forum of Firms agree to meet the Forum’s membership obligations which include, with respect to transnational audits, policies and methodologies which conform to the IFAC Code and national codes of ethics<sup>2</sup>.

There are, also many other bodies that promulgate independence standards or regulations applying to auditors. These bodies include the US Securities and Exchange Commission, the PCAOB, the European Commission, many security regulators and others such as the United Kingdom Financial Reporting Council, under the aegis of which APB sets ethics and independence standards. Some of the independence codes and regulations promulgated by these bodies are broadly similar to the Code in that they are principle-based and follow the threats and safeguards approach with some absolute restrictions as used by IESBA. Others, while devised with principles in mind, are more in the nature of straightforward regulation, with detailed rules.

Although the scope of the independence codes and regulations promulgated by these bodies might be broadly similar to the scope of the independence requirements of the IFAC Code there are a myriad of subtle and not-so-subtle differences which can create significant challenges for compliance with multiple requirements. When developing revisions to the independence requirements the IESBA considered the benchmarking of the proposals against the requirements of some major jurisdictions. The broad similarities concealed often important differences of detail which need to be respected by companies and their auditors and result in considerable complexity in training, monitoring and compliance generally.

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<sup>1</sup> Statement of Membership Obligations 4 paragraph 4.

<sup>2</sup> Forum of Firms Constitution Part 2 paragraph 4d)iii).

## **Meaning of Convergence**

In the discussion of convergence it is important that there is some common understanding of the use of the term. The term can have different meanings in comparing national and global standards, including:

- Standards are fully converged and identical;
- Standards are “harmonized”; (e.g. both use the same approach but the language is different); and
- Standards achieve the same result – “equivalence” (somewhat less than harmonisation but have broadly similar effects).

For the purpose of this document the following meaning has been adopted:

“Convergence is the process of moving towards the same point.”

## **Opportunity for Convergence**

There are two aspects to the opportunity for increased convergence:

- Greater compliance by IFAC member bodies to adopt no less rigorous standard than those contained in the IFAC Code; and
- Increased convergence of independence standards and acceptance by regulators of the independence requirements contained in the IFAC Code, including reliance by regulators on the IFAC Code.

### *Member Body Compliance*

The IFAC Compliance Advisory Panel (“CAP”) has been established to evaluate the quality of IFAC member body’s endeavors to meet the IFAC membership requirements. The Compliance Program includes a self-assessment by member bodies regarding compliance with the SMOs and an action plan to respond to recommendations prepared by IFAC Compliance Staff.

### *Convergence of Independence Standards*

In the EU, the Statutory Audit Directive is in the course of being implemented, including aspects relating to auditing standards, ethics and independence.

Other regulators also keep an active interest in financial reporting and audit quality, including the International Organization of Securities Commissions (“IOSCO”). Other regulators such as the Swiss Oversight Authority and the Japanese Financial Supervisory Agency (“FSA”) are also implementing regulations affecting auditors and their clients.

Much recent audit regulation seeks to extend oversight to foreign auditors of foreign companies with securities listed in financial markets in the country in question. This is true of the US (PCAOB), the EU (Statutory Audit Directive requirement), Japan (recent FSA proposals) and Switzerland (Federal Auditors Oversight Authority). Many of these regulations recognise that it may be possible to rely to a greater or lesser extent on existing national oversight to which the foreign auditors are subject. This requires some assessment of the national system of oversight in the foreign country and for example, the

European Commission in 2007 published a consultation paper on this matter. One element of such assessment is ethics and independence, where the EU raised the possibility of relying on the Code as a reference benchmark.

A further feature of independence requirements established by regulators and others is that often they apply not only to the group auditor of the parent company but also have extraterritorial implications in that they also apply to all auditors of subsidiary and affiliated companies, even if these auditors are in a foreign jurisdiction. The SEC rules on auditor independence are long established. A more recent example is the requirement to apply French auditor independence rules outside France in a broadly similar way.

A further factor to be considered is the extent of detailed regulation and the complexity of auditor independence when fully considered. The Code itself is approximately 135 pages long of which approximately 80 pages address independence matters. Through custom and practice as well as detailed rulemaking, each regulator establishing an independence code can be faced with a myriad of circumstances not originally envisaged in establishing the Code, which require judgment or rulemaking, as necessary, in order to deal with such independence issues arising in practice. These issues can be more difficult to deal with where there are no de-minimis or materiality exemptions, resulting in more numerous enquiries and circumstances requiring attention by the regulators, companies and auditors themselves.

### **The Case for a Single Set of High Quality Independence Standards**

A uniform set of auditor independence standards would clearly provide a consistent understanding among investors, public authorities and others of the independence of auditors. In principle, this should increase confidence in auditors' reports, at least as regards the independence aspects. This is an important element of confidence in financial reporting, which in turn is a vital element of capital markets and public confidence generally.

Differing independence standards may result in:

- Somewhat reduced choice in the audit market arising from the application of multiple independence rules, including extraterritorial reach;
- Potential confusion among investors and other users of audit reports as to what exactly it means to be independent;
- Higher costs for companies, audit committee, regulators and the profession;
- Greater risk of violations occurring as a result of having to apply different standards to clients throughout a network, thus potentially undermining the credibility of the profession; and
- The potential for the loss of confidence in assurance reports because of the "noise" associated with technical violations that do not fundamentally impact independence.

A uniform set of auditor independence standards would bring consistency in practice through more effective training and reduced complexity concerning the varying and

differing impacts of the existing range of standards improved compliance. It should also be more efficient for all parties. Monitoring, quality control and inspection should be more effective and more cost effective.

Audit Committees and company management should find it more straightforward to operate in clear compliance with a single global set of standards on auditor independence and best practice should converge around such standards, facilitating the work of regulators, the profession itself and others.

Regulators should be better able to assess the impact on capital markets of any limitations on choice in the audit market arising out of the application of a single global set of independence rules, including those on non-audit services, and should find the extraterritorial aspect more straightforward to deal with, including when making assessments of foreign oversight regimes.

### **The Case for Short and Medium Term Reliance on the Code by Regulators**

Many regulators are faced with assessment of the regulatory regimes for auditors in foreign jurisdictions, including the oversight regimes. This generally includes consideration of the applicable independence standards. A possible use of the Code by regulators is for the purposes of assessing the independence regimes in foreign jurisdictions. This point has already been raised in the consultation paper by the European Commission. Adoption of this approach would provide a short term step towards convergence and may be helpful to regulators.

A second area where regulators could arguably rely on the Code, if they consider it to be of sufficient quality, is for the purposes of assuring the independence of the auditors of foreign affiliates of the companies they regulate. The APB already is prepared to rely on the existing Code for this purpose<sup>3</sup>.

If other regulators were to adopt a similar policy, rather than seeking to apply their national rules on an extraterritorial basis, it would address many of the matters noted above in the case for a single set of independence standards. If this route were taken, most companies, regulators and auditors would need to deal only with two sets of independence requirements, namely those requirements set in national law or regulation and the Code itself.

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<sup>3</sup> APB Ethical Standard No 1 paragraphs 46 and 47 state:

The group audit engagement partner should be satisfied that other auditors (whether a network firm or another audit firm) involved in the audit of the group financial statements, who are not subject to APB ethical standards are objective and document the rationale for that conclusion.

The group audit engagement partner obtains written confirmation from the other auditors that they have a sufficient understanding of and have complied with the IFAC Code of Ethics for professional accountants, including the independence requirements.

Both of these elements would also be a useful test of the credibility of the Code and would not require such an important decision of principle in the short term as would a general commitment to convergence on the part of each regulator.

### **Member Body Convergence**

As noted above, the IFAC CAP has been established to evaluate the quality of member body compliance with the SMOs. Under the program, member bodies perform a self-assessment of compliance and develop an action plan to respond to recommendations prepared by Compliance staff.

It is therefore apparent that while it is for IESBA to determine a policy as to what constitutes convergence with its code, including any possible intermediate phases to full convergence, compliance with the policy is not the responsibility of IESBA.

### **Convergence of Independence Requirements**

In seeking to promote convergence of independence requirements, IESBA is mindful that existing national requirements of law and regulation are usually time consuming and difficult to change and in particular require public justification, bearing in mind that the laws and regulations were put in place in that jurisdictions to protect the public interest. Many securities regulators and other authorities are mandated to exercise their authority in relation to auditor independence. It is unlikely to be easily possible therefore in the short or medium term for their codes, regulations or rules either to replicate exactly the Code or to commit in advance to adopting any future changes to the Code.

It is, however, possible to anticipate that a regulator or public authority might, over time, as a matter of principle, wish to adhere as far as possible to an established global code, in this case the Code. This would mean that the Code would be to a greater or lesser extent adopted into local regulation or rulemaking or perhaps even recognised in law, for example, at the same time and in the same manner as ISAs. Such an implementation process might in all likelihood result in some adaptation of the Code. It is likely, in particular, that in certain jurisdictions certain long held principles or practices which might be at variance with the Code will nevertheless be maintained, for example the prohibition in France on auditors providing tax services to their audit clients.

For convergence purposes, however, what is important is the direction and speed of travel towards a global code. It should be possible for regulators and others to adapt their codes and rules over time so as to conform to the greatest possible extent (or at least to the extent considered appropriate), to the Code once such a policy is adopted as a matter of principle. Therefore our first aim should be to seek to persuade those responsible that there is indeed merit in their taking good account of the Code when considering matters of auditor independence with a view to aligning their rules with those the Code.

It will take time to make substantial progress in convergence.

## Action Plan

This action plan outlines proposed steps to be taken in the short and longer-term to facilitate:

- Increased IFAC member Body convergence; and
- Increased convergence by regulators and other standard setters.

Proposed Actions	Time Period
IESBA review and approve convergence program and action plan	June and December
Preparation of “toolkit” for independence convergence discussions. Including: <ul style="list-style-type: none"> <li>• Materials outlining the case for convergence <ul style="list-style-type: none"> <li>○ Slide deck with speaking notes</li> <li>○ Articles</li> </ul> </li> </ul>	Q3 2008
Comparison of draft IESBA independence code with a sample of regulatory requirements with a view to identifying significant remaining differences and scope for possible acceptance of the code by regulators.	Q3 2008
Liaison with Compliance Advisory Panel <ul style="list-style-type: none"> <li>• Discussion with CAP to gain an understanding of extent of compliance by member bodies</li> <li>• Gain an understanding of barriers to convergence</li> <li>• Consider whether convergence objective would be advanced if SMO4 was amended to incorporate a member body convergence objective<sup>4</sup></li> <li>• Consider other approaches to further convergence such as whether a phased approach would be beneficial – whereby a member body adopts the “key elements” and then moves to adoption of all of the requirements</li> <li>• Consider a statement of policy on the basis on which a member body is entitled to state that it complies with the IESBA code (2009).</li> </ul>	Q3 and onwards

<sup>4</sup> SMO4 states that member bodies should apply no less stringent standards than those stated in the Code of Ethics. SMO3, however, which addresses obligations with respect to the ISAs states that member bodies should use best endeavours to incorporate ISAs into national standards. It also states that member bodies should, in implementing their obligations of membership, have as a central objective the convergence of national standards with ISAs.

Proposed Actions	Time Period
<p>National Standard Setters Meeting</p> <ul style="list-style-type: none"> <li>• Date established to coincide with IAASB NSS</li> <li>• Possible agenda items: <ul style="list-style-type: none"> <li>○ Discussion of differences from national standards and the Code</li> <li>○ Consideration of need for IESBA equivalent of IAASB policy statement</li> <li>○ Work plans of standard setters</li> <li>○ Seek input on steps that would necessary to facilitate the convergence of international and national ethical standards and achieve greater global acceptance of the Code</li> </ul> </li> </ul>	Q2 2009
<p>Four regional forums to promote the Code and consider steps necessary to facilitate convergence</p> <ul style="list-style-type: none"> <li>• Europe Asia/Pacific</li> <li>• Americas</li> <li>• Africa</li> </ul>	2009/2010
Liaison with European Commission	On going
Liaison with IOSCO Standing Committee 1 and Auditing Subcommittee	On going
Liaison with IFAC Compliance Advisory Panel	On going
Seek out opportunities to speak with other interested parties	On going