

Section 290 of the Code of Ethics

Independence—Audit and Review Engagements



**International Federation
of Accountants**

REQUEST FOR COMMENTS

The International Ethics Standards Board for Accountants (IESBA), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the release of the exposure draft, *Code of Ethics for Professional Accountants for publication* in April 2008. These proposed revisions to the Code may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **August 31, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of this exposure draft may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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CONTENTS

	Page
Explanatory Memorandum	4
Proposed Code of Ethics for Professional Accountants	
Section 290: Independence—Audit and Review Engagements.....	9

EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, the proposed changes to the *Code of Ethics for Professional Accountants* (the Code), approved for re-exposure by the International Ethics Standards Board for Accountants (IESBA or the Board) in April 2008.

Background

In July 2007, the IESBA published proposed changes to Section 290 Independence – Audit and Review Engagements and Section 291 Independence – Other Assurance Engagements. The comment period ended on October 15, 2007. The comments on that exposure draft have been posted on the IFAC website and may be downloaded at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0085>.

The following summarizes the more significant issues raised by respondents and how the IESBA addressed them. The IESBA concluded that re-exposure of the proposals relating to internal audit services and the frequency of the application of safeguards when the relative size of fees from a public interest audit client exceeds 15%, is necessary because the changes made to the July 2007 exposure draft, as a result of responding to the comments received on exposure, are significant and substantive.

Significant Issues and Related Proposals

Internal Audit

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 July 2007 position

The IESBA proposed, amending Section 290 to clarify the wide range of services that comprise internal audit services. The IESBA was of the view 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 be reviewing its own work. The IESBA was also of the view 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 proposed changes also required 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 was expected to create a self-review threat because it was likely to be relied upon in the making of significant audit judgments related to a matter that is material to the financial statements.

The IESBA considered whether there should be a more restrictive requirement for an audit client that is an entity of significant public interest. The IESBA was of the view 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 were done as part of an internal audit service was unnecessary as long as the procedures did not entail the performance by the firm of management functions. The IESBA was, therefore, of the view that internal audit services could be provided as long as the firm did not perform management functions and eliminated or reduced to an acceptable level any remaining threat that was not clearly insignificant. Therefore, the IESBA was of the view that it was not appropriate to have a more restrictive requirement for audit clients that are entities of significant public interest.

IESBA's Response to the ED comments

The majority of respondents to the exposure draft agreed, expressly or implicitly, with the proposal to permit the provision of internal audit services provided that certain conditions are met. Several respondents were, however, not supportive of the approach with respect to public interest entities. These respondents were of the view that the proposals were not sufficiently robust. It was noted that where an auditor was likely to place significant reliance on the internal audit work performed by the audit firm, the self-review threat would be unacceptably high and, therefore, such services should be prohibited, rather than allowing safeguards to be applied.

In considering the comments, the IESBA noted that the majority of regulators and independent standard setters responding to the exposure draft were of the view that there should be a restriction on providing internal audit services to entities of public interest. The IESBA concluded that it was appropriate to prohibit firms from providing internal audit services that relate to the internal accounting controls, financial systems or financial statements to an audit client that was a public interest entity. A firm will not, however, be precluded from providing a non-recurring internal audit service to evaluate a specific matter that relates to the internal accounting controls, financial systems or financial statements providing specified conditions are met and the facts and circumstances related to the service are discussed with those charged with governance. The IESBA considered whether, consistent with the position taken with bookkeeping services and valuation services, it was appropriate to permit “immaterial” internal audit services for public interest audit clients. The IESBA concluded that, because of the nature of internal audit services, this would not be appropriate other than as a non-recurring service.

The IESBA is seeking views on these revised proposals.

Fees—Relative Size

The July 2007 position

The proposed revisions provided additional guidance with respect to the relative size of fees from an audit client that is an entity of significant public interest. The IESBA was of the view that when, for two consecutive years, the total fees from such a client represented more than 15% of the total fees received by the firm the self-interest threat created would be too significant unless disclosure was made to those charged with governance of the client and one of the following safeguards was 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 (“a pre-issuance review”).

IESBA’s Response to ED comments

Respondents to the exposure draft were mixed in their views as to whether it was appropriate to have a fixed percentage threshold after which safeguards were mandatory. Approximately half of the respondents expressed the view that it was inappropriate for the Code to have such a “bright-line” threshold. These respondents expressed the views that a fixed percentage was inconsistent with a conceptual framework approach, might have a disproportionate impact on smaller audit firms and might have a negative impact on concentration and choice in the audit market. The respondents who expressed support for the proposal indicated that a specific percentage was necessary for consistent application and was an appropriate threshold given that once the threshold was exceeded mandatory safeguards were necessary. A minority of respondents expressed the view that the proposals were too permissive noting that either the threshold should apply to all audit clients or there should be a specific threshold which, if exceeded, would create a threat that was so significant it could not be addressed by safeguards.

The IESBA considered the comments and concluded that the proposals were appropriate and that it was appropriate to require mandatory safeguards once the total fees from a public interest entity client represent more than 15% of the total fees received by the firm. The IESBA is not seeking further comment on this matter.

The proposed revisions in the July 2007 exposure draft provided that, once the 15% threshold was exceeded, in subsequent years, in determining which of the safeguards should be applied, and the frequency of their application, consideration should be given to the significance of the relative size of the fee. However, at a minimum a post-issuance review should be performed not less than once every three years. The respondents expressed mixed views. Some expressed support for the approach, others stated that only a pre-issuance review would be effective, others commented that neither safeguard was practical and others were of the view that neither safeguard would be effective to reduce the threat to an acceptable level. The IESBA considered the comments and is of the view that the guidance should be strengthened in two respects. Firstly, to require either a pre-issuance or a post-issuance review of the second audit opinion and in each subsequent year when the fees continue to exceed 15%, and secondly, to indicate that when total fees significantly exceed 15%, the firm should determine whether the significance of the threat is such that a post-issuance review would not be sufficient and, therefore, a pre-issuance review is required. The IESBA is seeking comment on these two proposed revisions.

Guide for Commentators

The IESBA has carefully considered the responses to the initial proposals contained in the July 2007 exposure draft. It is, therefore, **seeking comments only on the three questions noted below and is not seeking repetition of comments previously made.** However, to ensure that

respondents can understand the questions in this memorandum in the appropriate context, the whole text of the Code relevant to Internal Audit Services and Fees – Relative Size is reproduced in this re-exposure draft.

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

Internal Audit Services

The proposals prohibit, except as noted, a firm from providing internal audit services that relate to the internal accounting controls, financial systems or financial statements to an audit client that is a public interest entity. A firm would not, however, be precluded from providing a non-recurring internal audit service to evaluate a specific matter that relates to the internal accounting controls, financial systems or financial statements provided specified conditions are met and the facts and circumstances related to the service are discussed with those charged with governance.

Question 1: Respondents are asked for their views on whether the proposed restriction on providing internal audit services to public interest audit clients is appropriate.

Question 2: Respondents are asked for their views as to whether there should an exception for immaterial internal audit services provided to an audit client that is a public interest entity.

Fees Relative Size

The proposals require application of safeguards when, for two consecutive years, the total fees from a public interest audit client exceed 15% of the total fees received by the firm. When the 15% threshold is exceeded, the proposals would require a pre-issuance or post issuance review by a professional accountant who is not a member of the firm for the second and subsequent audit opinions (if the threshold continues to be exceeded). The proposals also indicate that when the total fees from a public interest audit client significantly exceed 15%, the firm should determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review should be performed.

Question 3: Respondents are asked for their views on the appropriateness of the required frequency of the application of the safeguard and the requirement to determine whether a pre-issuance review is required in those instances when the total fees significantly exceed 15%.

Comments on Other Matters

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

Special Considerations on Application in Audit of Small Entities

Respondents are asked to comment on whether, in their opinion, given the proposed changes apply to public interest entities, considerations regarding the audit of small entities have been dealt with appropriately in these 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.

REVISION OF SECTION 290

INDEPENDENCE—AUDIT AND REVIEW ENGAGEMENTS

Paragraphs 290.1-290.194 of the updated Section 290 will be unchanged and paragraphs 290.195-290.-200 will be deleted and replaced with the following paragraphs.

Internal Audit Services

General Provisions

290.195 The scope and objectives of internal audit activities vary widely and depend on the size and structure of the entity and the requirements of management and those charged with governance. Internal audit activities may include:

- (a) Monitoring of internal control – reviewing controls, monitoring their operation and recommending improvements thereto;
- (b) Examination of financial and operating information – reviewing the means used to identify, measure, classify and report financial and operating information, and specific inquiry into individual items including detailed testing of transactions, balances and procedures;
- (c) Review of the economy, efficiency and effectiveness of operating activities including non-financial activities of an entity; and
- (d) Review of compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

290.196 Internal audit services involve assisting the audit client in the performance of its internal audit activities. The provision of internal audit services to an audit client creates a self-review threat to independence if the firm uses the internal audit work in the course of a subsequent external audit. Assisting an audit client in the performance of a significant part of the client's internal audit activities increases the possibility that firm personnel providing internal audit services will assume a management responsibility. If the firm's personnel assume a management responsibility when providing internal audit services to an audit client, the threat created would be so significant that no safeguards could reduce the threat to an acceptable level. Accordingly, a firm should ensure that its personnel do not assume a management responsibility when providing internal audit services to an audit client.

290.197 Examples of internal audit services that involve assuming management responsibilities include:

- (a) Setting internal audit policies or the strategic direction of internal audit activities;
- (b) Directing and taking responsibility for the actions of the entity's internal audit employees;
- (c) Deciding which recommendations resulting from internal audit activities should be implemented;
- (d) Reporting the results of the internal audit activities to those charged with governance on behalf of management;

- (e) Performing procedures that form part of the internal control, such as reviewing and approving changes to employee data access privileges;
- (f) Taking responsibility for designing, implementing and maintaining internal control; and
- (g) Performing outsourced internal audit services, comprising all or a substantial portion of the internal audit function, where the firm is responsible for determining the scope of the internal audit work and may have responsibility for one of more of the matters noted in (a) – (f).

290.198 To ensure that, in performing internal audit services, the firm does not assume a management responsibility, the firm should only provide internal audit services to an audit client if all of the following conditions are met:

- (a) The client designates an appropriate and competent resource, preferably within senior management, to be responsible at all times for internal audit activities and to acknowledge responsibility for designing, implementing, and maintaining internal control;
- (b) The client's management or those charged with governance reviews, assesses and approves the scope, risk and frequency of the internal audit services;
- (c) The client's management evaluates the adequacy of the internal audit services and the findings resulting from their performance;
- (d) The client's management evaluates and determines which recommendations resulting from internal audit services to implement and manages the implementation process; and
- (e) The client's management reports to those charged with governance the significant findings and recommendations resulting from the internal audit services.

290.199 When a firm uses the work of an internal audit function, international standards on auditing require the performance of procedures to evaluate the adequacy of that work. When a firm accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the external audit, a self-review threat is created because of the possibility that the audit team will use the results of the internal audit service without appropriately evaluating those results or exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. The significance of the threat will depend on factors such as:

- The materiality of the related financial statement amounts;
- The risk of misstatement of the assertions related to those financial statement amounts; and
- The degree of reliance that will be placed on the internal audit service.

The significance of the threat should be evaluated and, if the threat is not clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include using

professionals who are not members of the audit team to perform the internal audit service.

Audit Clients that are Public Interest Entities

290.200 In the case of an audit client that is a public interest entity, a firm should not provide internal audit services that relate to the internal accounting controls, financial systems or financial statements.

290.201 A firm is not, however, precluded from providing to an audit client that is a public interest entity a non-recurring internal audit service to evaluate a specific matter that relates to the internal accounting controls, financial systems or financial statements provided the conditions in paragraph 290.189 are met, the facts and circumstances related to the service are discussed with those charged with governance, the service would otherwise be permitted under Section 290, and safeguards are applied as necessary to reduce any threat that is not clearly insignificant to an acceptable level.

Paragraphs 290.192-290.212 of the updated Section 290 will be unchanged and paragraphs 290.213-290.219 will be deleted and replaced with the following paragraphs:

Fees

Fees—Relative Size

290.213 When the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, the dependence on that client and concern about losing the client may create a self-interest threat. The significance of the threat will depend on factors such as:

- The operating structure of the firm;
- Whether the firm is well established or new; and
- The significance of the client qualitatively and/or quantitatively to the firm.

The significance of the threat should be evaluated and, 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. Such safeguards might include:

- Reducing the dependency on the audit client;
- External quality control reviews; or
- Consulting a third party, such as a professional regulatory body or another professional accountant, on key audit judgments.

290.214 A self-interest threat may also be created when the fees generated from an audit client represent a large proportion of the revenue from an individual partner's clients or a large proportion of the revenue of an individual office of the firm. The significance of the threat will depend upon factors such as:

- The significance of the client qualitatively and/or quantitatively to the partner or office; and

- The extent to which the remuneration of the partner, or the partners in the office, is dependent upon the fees generated from the client.

The significance of the threat should be evaluated and, 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. Such safeguards might include:

- Reducing the dependency on the audit client;
- Having an additional professional accountant review the work or otherwise advise as necessary; or
- Regular independent internal or external quality reviews of the engagement.

Audit Clients that are Public Interest Entities

290.215 In the case of an audit client that is a public interest entity when, for two consecutive years, the total fees from the client and its related entities (subject to the considerations in paragraph 290.24) 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 would be too significant unless the firm discloses to those charged with governance of the audit client the fact that the total of such fees represents more than 15% of the total fees received by the firm and discusses which of the safeguards below will be applied to reduce the threat to an acceptable level:

- After the audit opinion on the second year's financial statements has been issued, and before the issuance of the audit opinion on the third year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, or a professional regulatory body 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 on the second year's financial statements, 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 or a professional regulatory body performs a review that is equivalent to an engagement quality control review ("a pre-issuance review")

When the total fees significantly exceed 15%, the firm should determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review is required. In such circumstances a pre-issuance review should be performed.

Thereafter, when the fees continue to exceed 15%, each year, the disclosure to and discussion with those charged with governance should occur and one of the above safeguards should be applied. If the fees significantly exceed 15%, the firm should determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review is required. In such circumstances a pre-issuance review should be performed.



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