



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

545 Fifth Avenue, 14th Floor  
New York, New York 10017  
Internet: <http://www.ifac.org>

Tel: +1 (212) 286-9344  
Fax: +1 (212) 856-9420

**Agenda Item**

**2**

**Board** International Ethics Standards Board for Accountants

**Meeting Location:** Millennium Hotel, New York, USA

**Meeting Date:** April 27-28, 2009

**Drafting Conventions**

**Objective of Agenda Item**

To consider and approve the revisions to the Code resulting from the July 2008 exposure draft and subsequent Board deliberations.

**Background**

In July 2008, the IESBA issued an exposure draft proposing revisions to improve the drafting conventions of the Code. The explanatory memorandum stressed that the IESBA was seeking comments only on the proposed changes to the Code that were the result of the drafting conventions project. The exposure period was three months and ended on October 15, 2008.

At the February 2009 meeting, the IESBA considered a draft of a revised document. The document contained revisions to address recurring issues raised in comment letters and also individual comments that, while only raised by a small number of respondents, were deemed by the Task Force to be substantive in nature. The Task Force met directly after the February IESBA meeting to discuss comments received from the IESBA and to collectively discuss all remaining comments received on the exposure draft.

A revised draft of the Code reflecting the Board and Task Force's deliberations to date was presented to the CAG at its meeting on March 11, 2009. The Task Force met on March 25, 2009 to discuss and respond to comments received from CAG members.

This paper discusses the significant issues considered by the Task Force since the February IESBA meeting and its recommendations to the Board. The Task Force's proposed changes to the exposure draft are presented in Agenda Papers 2-A and 2-B (mark-up and clean respectively).

## **Discussion**

### **Mergers and Acquisition Clause**

At the February 2009 meeting, the IESBA agreed that the Code should address independence issues arising from client mergers and acquisitions and discussed a draft clause.

The IESBA agreed that the guidance should:

- Stress the importance of the firm taking the steps that are necessary to bring it into compliance with the Code by the effective date of the merger or acquisition;
- Recognize that sometimes it will not be reasonably possible to terminate all relevant interests and relationships by the effective date and, in such circumstances, require:
  - The interest or relationship to be terminated as soon as reasonably possible and, in all cases, within six months of the merger or acquisition;
  - Members of the engagement team and the individual responsible for the engagement quality control review to be free of such interests or relationships, and also not to be involved with a continuing prohibited non-assurance service; and
  - Application of transitional measures as necessary.
- Recognize that those charged with governance might request the firm to continue as auditor for a short period of time and only until the next audit report is issued and, in such circumstances, require:
  - Members of the engagement team and the individual responsible for the engagement quality control review to be free of such interests or relationships, and also not to be involved with a continuing prohibited non-assurance service; and
  - Application of transitional measures as necessary.
- Require discussion with those charged with governance and documentation.
- Require the firm to consider whether, even if all the requirements set out in the clause could be met, the threats created by previous and current interests and relationships are so significant that the firm cannot remain as auditor.

After discussion at the IESBA meeting, the Task Force revised the guidance it had developed. This was discussed with the CAG at its March 2009 meeting.

CAG members were supportive of the Code addressing independence issues created by client mergers and acquisitions.

Some CAG members questioned the drafting of the clause. They questioned whether it would permit a firm to choose not to dispose of an interest or relationship before the effective date provided that it was disposed of within six months of the effective date. The Task Force has made some editorial changes to ¶290.34 to make it clear that the firm shall take steps necessary to terminate, by the effective date of the merger or acquisition, any current interests that are not permitted under Section 290.

Some CAG members questioned what was meant by “cannot reasonably be terminated.” The Task Force discussed this matter and was of the view that this could best be explained by an example. Proposed ¶290.34, therefore, now includes the following example “because the related entity is unable by the effective date to effect an orderly transition to a qualified service provider of a non-assurance service provided by the firm”.

The version of the Code the CAG received referred to a "short period" when describing the remaining term of a firm that will be terminated as the client's auditor (i.e., either the auditor of the acquirer or acquiree) upon completing the audit for the current year. Some CAG members questioned what was meant by a “short period” and the discussion suggested that there is a potential for "short period" to be interpreted as any period that does not consist of one full year. To reduce the potential for "short period" to be interpreted as a label for anything less than a full twelve months, the Task Force recommends that the language be changed to "short period of time." ¶290.36 now states that those charged with governance may request the firm to continue as auditor only for a *short period of time* while continuing with an interest or relationship that would not be permitted under Section 290. The Task Force considered whether additional guidance should be provided and whether, for example, there should be greater specificity on what period of time would constitute a short period of time, for example, by stating that it should be no more than six months (which would be consistent with the period of time used in the case of a continuing auditor). Although a “short period of time” could be subject to differing interpretations, the Task Force did not think that it was appropriate to specify an absolute period of time. The Task Force was of the view that the critical point is that when the auditor has already begun working on the audit of the year in which the acquisition becomes effective and the client believes it makes sense for the auditor to finish the audit for the remainder of that year, the firm remains as auditor only until it issues the next audit report. The Task Force notes that ¶290.36 sets this out as one of the required conditions. The Task Force did not want to introduce an absolute time restriction which, if violated by one day (e.g., because the firm is waiting for a piece of audit evidence to be received from a third party or a client representation letter in order to sign the final audit report), would put the client in a position where it would need to have the period re-audited by another auditor.

The guidance requires the auditor to discuss with those charged with governance:

- In cases where the interest or relationship cannot reasonably be terminated by the effective date of the merger or acquisition, the reasons why and the evaluation of the significance of the threat (¶290.34);
- In cases where the firm will continue as auditor only for a short period of time while continuing with an interest or relationship, the evaluation of the significance of the threat created by the interest or relationship (¶290.36); and
- Any transitional measures that will be applied (¶290.35).

The Task Force considered stipulating in this clause why such matters should be discussed with those charged with governance. ¶290.28 already provides the rationale for why matters are communicated to those charged with governance (“Such communication

enables those charged with governance to (a) consider the firm’s judgments in identifying and evaluating threats to independence, (b) consider the appropriateness of safeguards applied to eliminate them or reduce them to an acceptable level, and (c) take appropriate action.”). A majority of the Task Force concluded that it is not necessary to repeat this in the mergers and acquisitions clause.

The Task Force considered the positioning of the mergers and acquisitions paragraphs. The Task Force is of the view that the paragraphs are best placed immediately after the discussion of engagement period. Although the mergers and acquisitions clause deals with situations where the firm involuntarily acquires a new client, both the engagement period guidance and the proposed mergers and acquisitions guidance deal with situations where the firm needs to become independent of a new client. And, although certain parts of the proposed mergers and acquisitions guidance are more restrictive than the engagement period guidance, the two pieces of guidance are largely consistent. Accordingly, the Task force concluded that the proposed mergers and acquisitions guidance is more closely aligned with the engagement period guidance than the guidance on related entities in ¶290.27.

#### **IESBA Question**

IESBA members are asked to consider whether they agree with the Task Force’s proposed drafting of the mergers and acquisitions paragraphs and their positioning.

#### **Consultation Clause**

At the February 2009 meeting, the IESBA agreed that the Code should contain a clause recommending consultation with a member body or relevant regulator in situations where application of a specific requirement would result in a disproportionate outcome or an outcome that may not be in the public interest.

The clause was discussed with the CAG. CAG members were supportive of the Code containing such a clause, though some CAG members questioned whether the meaning of a disproportionate outcome was clear and whether it would be clearer if the clause referred to, for example, “unintended consequences.”

The Task Force has carefully considered these comments and concluded that it is appropriate to refer to a “disproportionate outcome.” The Task Force is of the view that a professional accountant will be able to determine when an outcome is disproportionate. In addition, the clause will enable a discussion with a member body or a relevant regulator. Consequently, the member body or regulator would be involved in the discussion as to whether the outcome was, or was not, disproportionate in the circumstances. The Task Force also recognized that what is disproportionate may vary from jurisdiction to jurisdiction and it would not, therefore, be appropriate to try and define disproportionate. Also, the clause applies to the whole Code and, therefore, what might be disproportionate

in the case of a professional accountant in business may differ from what might be disproportionate for a professional accountant in public practice.

Some CAG members commented that the ending of this clause (i.e., "the professional accountant is recommended to consult . . .") seemed awkward. The Task Force considered this comment when reconsidering the wording of the clause and proposes the following (the text is shown in mark-up from the text discussed by the Board in February 2009):

When a professional accountant encounters unusual circumstances ~~that are so unusual that~~ in which the application of a specific requirement of the Code would result in a disproportionate outcome or an outcome that may not be in the public interest, it is recommended that the professional accountant ~~is recommended to~~ consult with a member body or the relevant regulator.

The Task Force considered the positioning of the consultation clause. The Task Force is of the view that it should be placed after the description of the conceptual framework approach and, therefore, proposes that it be placed after ¶100.11.

#### **IESBA Question**

IESBA members are asked to consider the content and positioning of the consultation clause.

#### **Documentation**

At the February 2009 meeting, the IESBA discussed the objective of having a documentation requirement that results in documentation of threats that are “at the margin.” The Task Force had proposed some changes in response to respondents' comments to strengthen the requirements and, in particular, to make it clearer that documentation of threats that are “at the margin” is the objective. Some CAG members were unsure whether the proposed wording might result in threats below the margin also being documented. On balance, however, the CAG members thought that the proposed wording would accomplish the Board's objective.

The IESBA agreed that the documentation should also include the rationale for the conclusion in situations where the threat was such that the accountant considered whether safeguards were necessary and concluded that they were not because the threat was already at an acceptable level. The Task Force has considered the Board's direction and CAG member's comments and proposes the following (the text is shown in mark-up from the text discussed by the Board in February 2009):

290.35 Documentation provides evidence of the professional accountant's judgments in forming conclusions regarding compliance with independence requirements; it is not a determinant of whether a firm is independent.

The professional accountant shall document conclusions regarding compliance with independence requirements, and the substance of any relevant discussions that support those conclusions. Accordingly:

- When a threat requires safeguards to reduce the threat to an acceptable level, the documentation shall include the nature of the threat and the safeguards in place or applied that reduce the threat to an acceptable level; and
- When a threat is such that the professional accountant ~~considered~~ applied significant professional judgment in determining whether safeguards were necessary and concluded that they were not because the threat was already at an acceptable level, the documentation shall ~~include that conclusion and~~ describe the nature of the threat and the rationale for the conclusion.

#### **IESBA Question**

IESBA members are asked to consider whether they agree with the Task Force's proposed change to the documentation clause.

#### **Effective Date**

At the February 2009 meeting, the IESBA discussed the effective date of the Code and agreed that the effective date and transitional provisions would be as follows:

- The revised Code shall be effective on January 1, 2011;
- Early adoption will be permitted and language stating that early adoption is encouraged will not be included;
- Entities that are now public interest entities under the revised Code (but not the old Code) will be subject to the more restrictive public interest entity independence requirements on January 1, 2012;
- Non-assurance services contracted before January 1, 2011 that would be permitted under the old Code but not under the revised Code shall be completed by July 1, 2011;
- Individuals now subject to the rotation requirements shall be required to rotate for fiscal periods beginning after December 15, 2011 if they had served as a key audit partner for seven or more years. So, for example, a key audit partner for whom the calendar year-end 2011 audit is the seventh year on the audit would rotate off the engagement team after the 2011 audit is completed;
- The requirement for a pre- or post-issuance review when total fees from a public interest entity audit client exceed 15% of the total fees of the firm for more than

two consecutive years shall be effective if the fees for the first and second fiscal years beginning after December 15, 2011 exceed 15% of the total fees of the firm.

**IESBA Question**

IESBA members are asked to confirm that they agree with the effective date and transitional provisions.

**Re-exposure**

The IESBA Terms of Reference require 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.

At the February meeting, the IESBA had a preliminary discussion on whether the changes to the document warrant re-exposure. This preliminary discussion was necessary so that in the March CAG meeting, CAG members could have the benefit of Board members' preliminary thinking on this issue and therefore a more informed view on matter.

The IESBA noted that exposure draft respondents were supportive of the proposed change from “should” to “shall” and retaining the current structure of the Code. Respondents were also generally supportive of the elimination of the concept of threats that were “other than clearly insignificant” and the definition of an acceptable level.

The area that generated the most comments from respondents was the proposed general exception clause. The exposure draft contained a provision that would have permitted a temporary departure from a requirement in the Code provided that certain conditions were met. The departure would have been permitted in exceptional and unforeseen circumstances that were outside of the control of the professional accountant, the firm or employing organization and the client. While a majority of the respondents to the exposure draft were supportive of the approach proposed, a significant minority of respondents disagreed with the exception clause, expressing the view that it would weaken the Code and undermine its requirements. The exposure draft asked respondents whether there were any other circumstances where departure from a requirement in the Code would be acceptable. Thirteen of forty-seven respondents responded to this question by expressing the view that the Code should address independence issues created by client mergers and acquisitions.

After considering exposure draft comments and input from CAG members, the IESBA concluded, as discussed above, that the Code should not contain a clause permitting a temporary departure. It should, however, address the independence implications of a client merger or acquisition. It also should contain a recommendation that an accountant consult with a member body or relevant regulator if faced with an unusual circumstance.

The IESBA's preliminary discussion on whether re-exposure is warranted focused on the new mergers and acquisition clause. Several Board members expressed the view that re-exposure is not warranted for the following reasons:

- Many respondents to the exposure draft expressed the view that the Code should address mergers and acquisitions, and the Board has been responsive to that request;
- The proposal provides pragmatic guidance for situations that are often faced by firms and in many cases codifies existing best practice. Thus, the extent to which the proposed guidance will change practice is expected to be limited; and
- The IESBA's understanding is that in most cases firms are able to terminate relevant interests and relationships by the effective date, and the proposed guidance will reinforce the requirement to do that; therefore, it is expected that in many mergers and acquisitions the clause will not be used.

No Board member expressed the view that re-exposure is warranted.

The matter was thoroughly discussed by CAG members and, with the exception of IOSCO, all CAG members expressed the view that re-exposure was not warranted. The IOSCO representatives noted that while there had not been a full discussion at IOSCO, some form of re-exposure was desirable.

The Task Force has considered the matter further and is of the view, for the reasons noted in the preliminary discussion in February, that re-exposure is not warranted.

## **Material Presented**

Agenda Paper 2	This Agenda Paper
Agenda Paper 2-A	Proposed changes to exposure draft (mark-up)
Agenda Paper 2-B	Proposed changes to exposure draft (clean)
Agenda Paper 2-C	Detailed cut and paste of comments

*Please note that Agenda Paper 2-A containing the mark-up will be used in the meeting for the detailed read of the Code.*

### **Actions Requested**

1. IESBA members are asked to consider the questions contained in the agenda paper.
2. IESBA members are asked to approve the revised Code.