



Meeting Location: Sofitel Warsaw Victoria, Warsaw, Poland

Meeting Date: June 15-17, 2011

Breach of an Independence Requirement

Objective of Agenda Item

1. To approve for exposure, proposed changes to the Code to address a breach of an independence requirement.

Background

The Code contains several paragraphs that address an inadvertent violation of a provision of the Code. The Code's inadvertent violations provisions were commented on by the International Organization of Securities Commissions ("IOSCO") in its response to the IESBA's Drafting Conventions Exposure Draft, issued in July 2008. Appendix A contains the text of their comments. The IESBA recognized the concern expressed by IOSCO but concluded that the issues raised were beyond the scope of that ED and would, therefore, need to be considered separately.

In 2010, the IESBA assessed the provisions in the Code that address an inadvertent violation and concluded that a project should be undertaken to reconsider those provisions, including determining whether the provisions are needed and, if so, how the guidance can be enhanced with regard to scope and application. At its November 2010 meeting, the IESBA approved a project proposal to address this matter. At its February 2011 meeting, the IESBA discussed and provided input on the proposal of the Task Force¹.

The proposals, and IESBA input was discussed by the CAG at its March 2011 meeting and by the IESBA-National Standard Setters (IESBA-NSS) at its meeting in April 2011.

The Task Force met on April 9-10, 2011 and May 7-8, 2011 and by conference call on May 30, 2011 to consider the feedback received and to develop proposed wording for the exposure draft.

¹ Kate Spargo (chair), Wui San Kwok, Alice McCleary and Marisa Orbea

Discussion

Overview

At the February meeting, the Task Force proposed, and the IESBA agreed, that:

- The Code should contain provisions to address a violation of a requirement;
- The provisions should address only independence requirements, because without such guidance users of the Code could assume that the intention is that any violation should result in the firm's resignation, regardless of the magnitude of the violation which may not be in the public interest; and
- The cause of the violation, intentional or inadvertent is less significant than the potential impact on the company and consequently those affected. It is the violation that gives rise to the issue, regardless of its nature, the term "inadvertent" should, therefore, be dropped.

The proposals were discussed with the CAG and with the IESBA-NSS.

CAG members expressed different views with respect to the need for such provisions. Some CAG members agreed with the IESBA's view that the Code should contain such provisions; others felt that the Code should not contain such provisions noting that regulators would have processes to deal with such matters. With respect to dealing with all types of violations, those CAG members who expressed support for the Code containing such provisions agreed that the provisions should address all violations and should only address independence.

All IESBA-NSS participants agreed with the IESBA view that the Code should address such matters, it should be limited to independence violations and the reference to inadvertent should be removed.

Violation vs Breach

The Task Force has considered whether the matter should be referred to as a "violation". The Task Force noted that the Code currently uses the term "violation" when discussing an inadvertent violation of a provision of the Code but in other instances the Code refers to a breach. For example:

- An explicitly stated duty to report breaches of ethical requirements (§100.16)
- The professional accountant generally can obtain guidance on ethical issues without breaching the fundamental principle of confidentiality if the matter is discussed with the relevant professional body on an anonymous basis (§100.21);
- The firm has established policies and procedures that require prompt notification to the firm of any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the audit client. (§290.117);
- The firm has established policies and procedures that require prompt notification to the firm of any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence. (§290.133).

The Task Force is of the view that "breach" is a better description would improve the

consistency in the Code and has, therefore, adopted this term.

Action Requested

IESBA members are asked to consider whether they agree with the proposed change.

Actions to be Taken

The IESBA discussed the Task Force's recommendation at the February 2011 meeting and while broadly agreeing with the actions to be taken, provided the following direction to the Task Force:

- All violations should be disclosed to those charged with governance irrespective of magnitude or who committed the violation;
- It was not clear what was meant by “resolve the situation”;
- The drafting should not imply that all violations could be rectified such that the audit could continue. It may be useful to make it clear that in some cases resignation may be necessary;
- The drafting should not convey the impression that the aim is to continue the audit at all costs and it may be preferable for the drafting to expressly state that resignation would be necessary unless certain conditions could be met.

Several of these comments were echoed by CAG members and IESBA-NSS participants who noted that:

- Establishing a de minimis threshold below which reporting to those charged with governance was not necessary might discourage firms from establishing robust systems of internal control;
- The drafting should not imply that irrespective of the violation, the firm could continue the audit;
- Those charged with governance would want to know how the violation has occurred; and
- It should be very clear that if there is a regulatory mechanism for reporting and resolving such matters, this should take precedence.

The Task Force carefully considered all the input from the IESBA, CAG members and IESBA-NSS participants and has revised the drafting to address the comments as follows:

- Developing an introductory paragraph which explicitly stating that it may be necessary to terminate the audit engagement and also stating that reporting to a regulator or other body might be required;
- Requiring the auditor to discuss all breaches with those charged with governance;
- Requiring the firm to evaluate the significance of the breach and its impact on the firm's objectivity and ability to issue an audit report;
- Eliminating the phrase “resolve the situation:” and introducing a requirement for the firm to determine whether action can be taken to address the consequences of the breach and requiring the firm to exercise professional judgment taking into account whether a reasonable and informed third party, weighing the significance

of the breach and the action to be taken, would be likely to conclude that the firm can still issue an audit opinion;

The Task Force has also developed a paragraph addressing a breach that occurred prior to the issuance of the previous audit opinion.

Action Requested

IESBA members are asked to consider and provide comment on the proposed wording in Agenda Paper 2-A.

IESBA members are asked to approve the proposed changes for release as an exposure draft. Due process requires the IESBA to expose changes for a period of no less than 90 days. The Task Force is of the view that the standard period of exposure is appropriate.

An affirmative vote of two-third of IESBA members (twelve) is necessary to approve an exposure draft.

Explanatory Memorandum

Each exposure draft is accompanied by an explanatory memo. The IESBA does not vote on this memo but it is provided to Board members for comment and input. This document, which will include the impact analysis, will be circulated to Board members shortly before the Warsaw meeting.

Material Presented

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| Agenda Paper 2 | This Agenda Paper |
| Agenda Paper 2-A | Breach of an Independence Requirement – proposed wording |
| Agenda Paper 2-B | Explanatory Memo (to follow) |

Action Requested

1. IESBA members are asked to address the questions set out in the agenda paper.