

Agenda Item 2



Meeting Location: Hilton, 1335 Avenue of the Americas, New York, United States

Meeting Date: October 17-19, 2011

Breach of an Independence Requirement

Objective of Agenda Item

1. To approve for exposure proposals to address a breach of requirement of the Code of the Code.

Background to the Project

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.

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.

The IESBA discussed a draft exposure draft at its June 2011 meeting and met again by conference call in July 2011 to discuss proposed Task Force¹ changes to respond to input received from the IESBA. The Task Force revised the document based upon input received on the conference call and the revised document was discussed by the CAG at its meeting in September 2011. The Task Force met on Sept 30th and Oct 1st, to consider input from CAG members and to finalize the documents.

Overview of Approach Proposed

The proposal is to delete the paragraphs in the Code addressing an inadvertent violation of a provision of the Code and replace them paragraphs with provisions in Section 290 *Independence – Audit and Review Engagements* and Section 291 *Independence – Other Assurance Engagements* addressing a breach of an independence requirement of the

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

Code. The proposal would also introduce a new paragraph 100.10 to provide guidance to an accountant if a breach of any other provision of the Code is identified.

The proposed guidance would require a firm to take the following actions if a breach is identified:

- Communicate the breach with those charged with governance and terminate, suspend or eliminate the breach;
- Consider whether there are any applicable legal or regulatory requirements that apply with respect to the breach and, if so, comply with those requirements;
- Evaluate the significance of the breach and its impact on the firm's objectivity and ability to issue the audit report;
- Determine whether action can be taken to satisfactorily address the consequences of the breach. In making this determination the firm shall consider whether a reasonable and informed third party weighing the significance of the breach would be likely to conclude that the firm's objectivity would be compromised such that the firm is unable to issue an audit report;
- If the firm determines that action cannot be taken to satisfactorily address the consequences of the breach, after discussion with those charged with governance, the firm shall take the steps necessary to terminate the audit engagement in compliance with any legal or regulatory requirements;
- If the firm determines that action can be taken to satisfactorily address the consequences of the breach, discuss the breach with those charged with governance as soon as possible and if those charged with governance agree, ensure the actions are implemented. If those charged with governance do not agree take the steps necessary to terminate the audit engagement in compliance with any legal or regulatory requirements; and
- Document the actions taken and all the matters discussed with those charged with governance and, if applicable relevant regulators.

A similar approach is taken in Section 291.

The Task Force has also developed an overall provision to be included in Section 100 which provides general guidance for a professional accountant who identifies a breach of any other provision of the Code.

The proposed text is contained in Agenda Paper 2-A which shows a mark-up from the document discussed on the July 2011 conference call and Agenda Paper 2-B which shows the clean version.

Matters for Discussion

Cumulative Effect of Breaches

At the March 2011 CAG meeting, a CAG member noted that when considering the significance of a breach of an independence provision it was important to consider the aggregate effect of any breaches. The Task Force was of the view that this consideration would be an implicit part of preparing to discuss all breaches, regardless of magnitude,

with those charged with governance, along with any steps taken to reduce or avoid the risk of reoccurrence. At the September 2011 CAG meeting, a CAG member raised the point again, noting that the implicit nature of the consideration was unclear.

The Task Force has reconsidered the matters and proposes a clarification to make it explicit that the significance of the breach will depend upon, *inter alia*, the number and nature of previous breaches with respect to the client, if any, relevant to the current audit report.

Focus on a Breach of an Independence Requirement

At its June meeting and on the July conference call the IESBA was of the view that the provisions should apply only to the independence requirements of the Code. The rationale for this approach is that a distinguishing feature of the independence provisions is the *consequences* of the violation – if an independence requirement is violated and the firm cannot issue an opinion, there is a potential for harm to, for example, third parties who are planning certain activities upon receiving the audited financial statements and may be working within tight time constraints. If the impact of the violation was trivial or inconsequential, the consequences of a firm resignation would thus be disproportionate to the violation. In the case of the other provisions in the Code, there are not the same consequences to the public.

This approach was discussed with the CAG at its September meeting. CAG members generally agreed that the focus of a robust framework for dealing with breaches should be on a breach of an independence provision of the Code. They noted, however, that it would be useful if the Code contained some general guidance on the steps an accountant would take if a breach of another provision of the Code was identified. The matter was also raised by the PIOB during its consideration of the due process followed by the IESBA in its development of the 2011-2012 Strategy and Work Plan.

At its first meeting the Task Force reviewed all the requirements of the Code to consider whether the breaches provisions should address all of the Code or should be focused on independence. The Task Force has reviewed these provisions and re-considered the matter to determine what approach should be taken if there is to be guidance addressing a breach of other provisions of the Code. Task Force considered the matter and has developed a general paragraph that provides guidance to a professional accountant on how to apply the overarching principles in the framework for a breach of an independence provision to a breach of any other provision in the Code. The guidance would be contained in new paragraph 100.10 and is as follows:

“Sections 290 and 291 contain provision with which a professional accountant shall comply if the professional accountant identifies a breach of an independence provision of the Code. If a professional accountant identifies a breach of any other provision of this Code, the professional accountant shall take steps as soon as possible, if any are available, to terminate or eliminate the circumstances or relationship that caused the breach. The professional accountant shall evaluate the significance of the breach and determine whether there are any actions that can be

taken to address the consequences of the breach, including reporting the breach to those who may have been affected by the breach. The professional accountant shall comply with any duty to report a breach of a provision of this Code.

Action Requested

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

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.

Effective date – The Task Force has considered the effective date. The Task Force is of the view that the proposals do not call for any changes in systems; what is required is increased transparency through reporting to those charged with governance and through documentation. The Task Force, therefore, recommends a relatively short transition period and assuming approval by the IESBA in June 2012, that the proposals become effective January 1, 2013.

Exposure process – an IESBA exposure draft is issued with a press release which is sent to the media, member bodies, members of PIACs, members of IFAC Boards and Committee and individuals who have subscribed to the Ethics E-news. The exposure draft is also posted on the website. Historically, the IESBA receives comments on exposure draft from member bodies, firms, a few standard setters, a few regulators and a few individuals. The IESBA does not commonly receive comment from members of those charged with governance such as audit committees. Given the role of those charged with governance in the proposed framework, the Task Force believes that it would be appropriate to target such individuals to obtain their comment. The Task Force, is, therefore, developing a short document highlighting the provisions in the exposure draft and the effect on, for example, audit committees that the provisions would have if approved in final form. This short document will be mailed directly to members of audit committees to solicit input on the proposals.

Action Requested

IESBA members are asked to review the proposed text in Agenda Paper 2-B and provide comment on any matters to be addressed before approving the proposed changes for release as 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 October 17-19, 2011 meeting.

Material Presented

Agenda Paper 2	This Agenda Paper
Agenda Paper 2-A	Breaches – proposed wording (mark-up from July conference call)
Agenda Paper 2-B	Breaches – proposed wording (clean)
Agenda Paper 2-C	Basis for Conclusions

Action Requested

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