

October 15-16, 2012 – Conference Call

## **Extract from September 12, 2012 CAG Meeting**

### **Breaches of a Requirement of the Code**

Ms. Munro introduced the topic, summarizing the outcome of the IESBA discussion of the topic at its June 2012 meeting. She noted that subject to the CAG discussion of the topic at this meeting, the Task Force planned to seek final approval of the proposals at the October 15, 2012 IESBA teleconference. To facilitate this, the IESBA had, at its June 2012 meeting, taken a straw poll indicating that subject to additional changes in response to comments from CAG members, the IESBA would support issuing the document in final form. She then briefly recapitulated the significant issues arising on exposure and the Task Force's responses thereto.

Mr. James noted that one of IOSCO's concerns with respect to independence provisions has been the resign-first mentality. He wondered about the IESBA's thought process as to whether the concept of resignation should apply also to other aspects of the Code outside of independence. Ms. Munro noted that a distinction exists. For an audit engagement, independence is essential. Accordingly, a breach of the Code's requirements with respect to independence would make it difficult for the auditor to continue the engagement. In contrast, it would be unclear what a "resign first" mindset would mean in relation to a breach of other requirements of the Code by, for example, a professional accountant in business. She noted that for this reason, the IESBA did not believe that the concept of resignation should apply to a breach of a provision of the Code that does not relate to independence. Mr. Fleck emphasized that the IESBA had carefully considered the issue and had come to the view that the concept cannot be generalized throughout the Code. However, the IESBA was conscious of the need for a rigorous approach with respect to independence.

Ms. Blomme noted that the independence rules of the U.S. Securities and Exchange Commission (SEC) do not require reporting of certain breaches that are created where a family member of a covered person has a financial interest in an audit client. She questioned whether the IESBA had considered whether there should be a similar exemption from disclosure in the Code. Ms. Munro noted that the IESBA had considered this matter early in the project and concluded that all breaches of the Code should be reported. The IESBA recognized that this would go beyond the disclosure required under SEC independence requirements.

In relation to the firm's policies and procedures, Mr. James noted that the proposed documentation requirements do not call for documentation of the firm's conclusion that objectivity had not been compromised and the rationale for that conclusion. Ms. Munro noted that the documentation paragraph did not repeat all of the material which was contained in the paragraph detailing the matters to be discussed with those charged with governance because the IESBA wanted to avoid repetition within the standard. Mr. Fleck noted that one of the first matters to discuss with those charged with governance would be the significance of the breach. Ms. Munro suggested that it might be clearer if the requirement was to document "all" matters discussed with those charged with governance. Mr. James stated that this would be somewhat clearer.

Ms. Munro noted that IESBA was proposing changes to paragraph 290.47 to better target the firm's policies and procedures which would be discussed with those charged with governance.

Ms. Munro explained that the proposed revisions to paragraph 290.42 dealing with notification of a breach of a provision of the Code had been developed by the Task Force but had not yet been considered by the IESBA. She noted that the Task Force had developed this wording to respond to a comment from IOSCO that the firm's assessment and determination of the outcome of the breach should be elevated within the

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firm, for example, to the firm's quality control function and or the firm's leadership. The language developed is consistent with International Standard on Quality Control (ISQC) 1.<sup>1</sup> Mr. James noted that IOSCO continues to have a concern in the area of escalating a breach within the firm. He questioned at what level within the firm the matter would be addressed. Mr. Fleck stated that this would be addressed by ISQC 1.

Mr. Kuramochi stated that a significant concern for IOSCO is to ensure that, when a provision of the Code has been breached, the decision to continue an audit engagement be made at the firm, as opposed to the engagement partner, level. This is because of the significant pressure the engagement partner will experience to continue the engagement. Accordingly, IOSCO was of the view that there is a need to clarify the respective roles of the engagement partner, the firm's quality control department and the firm's leadership in this regard so that the firm can properly address the issue. Mr. Kuramochi noted that this issue relates not only to paragraph 290.42 but also to other paragraphs of the requirements for breaches. Mr. Fleck suggested that a refinement could be made to paragraph 290.42 to clarify that the communication should be made by the individual who has become aware of the breach.

Mr. Kuramochi also stated that it was unclear in paragraph 290.49 in relation to documentation, as well as in other parts of the section, whether the requirement was directed at the engagement partner or the firm. Ms. Munro noted that this issue had been discussed as part the IESBA's consideration of a possible reformatting of the Code and that it is not unique to this section. Pending the IESBA's further consideration of the reformatting of the Code, it would be necessary to retain the current construct. In relation to reporting, Mr. Kuramochi noted that several IOSCO members are of the view that transparency by firms to investors, in terms of disclosure of breaches in the auditor's report, is of great importance, a point that IOSCO had raised in its comment letter. He added that such reporting could be based on an appropriate threshold. Given that the IAASB is now progressing its Auditor Reporting project, some IOSCO members were of the view that the IESBA's project on breaches should be closely linked to the IAASB's project. Ms. Munro noted that the IESBA's view is that the matter of disclosure of breaches is for national regulators to decide, and that the IESBA did not believe the matter would be appropriate in a Code for general application.

Mr. Kuramochi highlighted that some IOSCO members have concerns on the above issues. He drew attention to the fact that pursuant to the recent Monitoring Group review of the IFAC reforms<sup>2</sup>, an individual Monitoring Group member would expect direct feedback from the IESBA regarding the Monitoring Group member's input on a particular issue if it does not appear that the IESBA will take up the input in the final standard. He questioned if the IESBA has a plan to respond to IOSCO on this issue. Ms. Munro noted that she knew about this matter and was under the impression that a mechanism was being developed and, in the meantime, an oral response had been considered to be appropriate. She indicated that she would follow up on the matter and respond accordingly. Mr. Kuramochi expressed his view that it would be important for IOSCO to receive direct feedback from the IESBA regarding the issue..

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<sup>1</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>2</sup> 2003 IFAC Reform proposal states that *"Members of the MG will, if desired, comment on proposed standards. When they do so, the relevant IFAC standard setting board or committee should give strong consideration to such comments, and, if the comment is not to be taken up in the final standard, should explain to the relevant MG member the reasons for that decision."*

Mr. Fleck acknowledged that there are at least two main IOSCO issues that need to be addressed prior to finalizing the document. Mr. Fleck recommended that IOSCO and IESBA Staff resolve these outstanding issues subsequent to CAG meeting.

Regarding the effective date of the proposed changes to the Code, Mr. Fleck questioned whether early adoption would be permitted. Ms. Munro expressed the view that this is a matter that the IESBA should consider at its October 15, 2012 teleconference.