

IOSCO Comments on SWP Consultation Paper (CP) and Planning Committee (PC) Responses and Recommendations

IOSCO Comment/Proposal	PC Responses/Recommendations
<p>Focus of the Board</p> <p>Accountants have a duty to act with integrity, objectivity, and high ethical standards in performing independent external audits. Accordingly, we continue to support the focus of the Board on improving the “Code of Ethics for Professional Accountants” (the Code), particularly in relation to auditor independence for public interest entities.</p> <p>We believe the Board’s strategic themes should be focused on enforceability, clarity and appropriateness of the threats and safeguards approach. It is important that the Board gives priority to these areas in an effort to strengthen the Code. We have organized our overarching comments on the Paper around these broad themes of enforceability, clarity and appropriateness of the threats and safeguards approach which we believe the Board should prioritize.</p> <p>In contrast, we believe the Board’s strategic themes as outlined in the Paper could be viewed as an overarching mission statement that seeks to define the remit of the Board. Whereas an overall mission statement is important, a strategic theme provides the lens through which the Board can focus its efforts by considering specific elements of the Code during the next five years. The Board should consider what impact, if any, using such a narrower focus as the strategic theme(s) would have on identifying other elements or projects for the Board to pursue during the strategy period.</p> <p>Also, in the latter part of our letter we have included for the Board’s consideration other important elements of less urgency.</p>	<p>The Board’s proposed strategic themes have been widely supported by the respondents to the CP, as well as by the CAG generally, and national standards setters. Unlike the more specific topics of enforceability, clarity and appropriateness of the threats and safeguards approach, the Board’s proposed strategic themes are appropriately broad to cover the variety of actions the Board plans to undertake in the strategy period to serve the needs of its diverse constituencies. While the regulatory community is an important constituency, it is important for the Board as a global standard setter to be seen to be serving its broad stakeholder base.</p> <p>Notwithstanding the above, the proposed SWP already has recognized the need to address the themes suggested by IOSCO, in particular through the work being done on the Structure of the Code project, and through the proposed new work stream on safeguards.</p> <p>Nevertheless, the PC recommends that the SWP more explicitly recognize enforceability, clarity and appropriateness of the threats and safeguards approach as important objectives under the strategic themes of maintaining a high quality Code, and promoting and facilitating adoption and implementation.</p>
<p>Enforceability</p>	<p>The PC notes that over 120 jurisdictions have adopted or are in the process of adopting the 2009 Code, have based</p>

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<p>As securities regulators, we have concerns with whether the Code is enforceable due to, among other matters, the precision of various requirements throughout the Code and sometimes the breadth of the latitude for auditors in complying. The result of this is that the Code may be seen as needing improvement to be effective for use in the more or most developed capital markets. These points are applicable to any Board project. Thus, we believe the Board should have explicit deliberations about the enforceability of a proposal as it deliberates that proposal's provisions or requirements.</p> <p>We note that "...the Board reaffirms its strong belief that a principles-based Code provides for a robust set of standards that appropriately equips PAs in navigating the ethical landscape in the diverse professional activities they may undertake." While a principles-based Code allows for application in different scenarios, it requires the use of significant judgment in interpreting and applying the Code. Though the use of judgment by the auditor is not in itself objectionable, in enforcing the Code we are concerned that inspections of auditors find that significant judgments and conclusions reached with respect to auditor independence by the auditors may not be supportable by the requirements in the Code and may lead to deficiencies in the performance of the audit.</p> <p>In addition, we often observe that auditors seem to suggest "bright lines" to guide their decisions, as it seems that if the lines are brighter it is easier for the audit firms to put systems in place to assist partners and staff in navigating the requirements of the Code. If the Board continues to set standards that are principles-based, we believe that the principles should be more definitive and be articulated in a way that is crisper so that it leads to the best possible implementation in practice.</p>	<p>their national ethics standards on the Code, or are working to eliminate differences with the Code. Of these, close to 100 have already adopted or have committed to adopt the Code. Importantly, the 25 largest firm networks around the world are required to have their policies and methodologies conform to the Code for transnational audits. These statistics represent a strong endorsement for the Code and its principles-based approach.</p> <p>The Board, however, has launched a project to review the structure of the Code to further enhance compliance and facilitate enforcement. Among other matters, the project will seek to increase the visibility of the requirements of the Code and clarify responsibility for compliance with those requirements.</p>
<p>Clarity</p> <p><i>Structure of the Code</i></p> <p>We believe the "Structure of the Code" initiative is a step in the right direction and has the potential to increase the effectiveness of the Code. To increase the</p>	<p>These comments have been shared with the Structure of the Code Task Force for further consideration.</p>

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<p>prospect of the effectiveness of this initiative we believe the Board should focus its resources in adopting a “clarity” format in the Code. The objectives of the “clarity” format should be as follows:</p> <ol style="list-style-type: none"> 1. To make a clear distinction between requirements and guidance; 2. To clearly identify who specifically within the firm (for example, the firm’s quality control function, firm leadership, the engagement partner or the engagement team) has responsibility for compliance with the Code; and 3. To allow for consistent use of unequivocal language such as “shall” rather than “should” so that the obligations of an auditor or an accountant are clearly communicated. <p>We support this effort, in part, because we continue to observe final Board outputs which in our view do not produce the clarity that would be achieved if the format contained all of these elements.</p> <p>As an example, in responding to the Board’s recently concluded <i>A Breach of a Requirement of the Code</i> we indicated that it was important that when a breach of an independence provision of the Code is uncovered the firm’s assessment and determination of the outcome of the breach should be elevated within the firm to, for example, the firm’s quality control function and/or firm leadership, thus not left solely to members of the audit engagement team or local office management. However, in finalizing the requirements of the Code, the Board stated that “the firm shall evaluate the significance of the breach.” This type of language does not achieve the clarity to appropriately direct the professional accountant in determining who within the firm has the responsibility to assess the breach and the outcome thereof, particularly considering the broad definition of the “Firm” in the Code.¹</p>	

¹ The Code defines the Firm as follows: (a) A sole practitioner, partnership or corporation of professional accountants; (b) An entity that controls such parties, through ownership, management or other means; and (c) An entity controlled by such parties, through ownership management or other means.

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<p><i>Post implementation Review</i></p> <p>We appreciate the Board taking steps to understand the extent of adoption of the Code. Nonetheless, we believe that where the Code has been adopted it is important for the Board to also conduct a post implementation review of its recently implemented standards, including <i>A Breach of a Requirement of the Code</i> (particularly, the independence standards) and the results of current work streams, particularly <i>Responding to Non-Compliance with Laws and Regulations</i>, when it is implemented.</p> <p>Post implementation reviews could enable the Board to determine if the standards are clear and are consistently being understood and implemented. Such a review could also identify whether professional accountants, regulators and other stakeholders are experiencing challenges with the standards that need to be addressed by the Board.</p>	<p>While such a process may provide for a systematic way of gathering input regarding the implementation of standards, there may be practical challenges to implementing it for ethical standards. This is because, unlike other professional or technical standards, ethical standards do not lend themselves well to directly observable outcomes in terms of preventing or averting unethical conduct.</p> <p>The PC nevertheless recommends that the SWP include, as part of ongoing activities and subject to stakeholder feedback, consideration of whether there is a need to gather information from relevant stakeholders such as regulators, firms and those charged with governance regarding how effectively certain revised or new standards are being implemented in practice.</p>
<p>Appropriateness of the Threats and Safeguards Approach</p> <p>We appreciate the Board including in its Paper a review of the appropriateness and effectiveness of the safeguards which we commented upon in our letter to the Board dated 2 May 2013 in response to the IESBA 2014-2016 Strategic Review Survey. In this regard we observe that the Paper states “In response to regulatory input to the strategy survey, the Board plans to undertake a comprehensive review of the safeguards in the Code, particularly in relation to auditor independence. The regulatory concerns revolve around the appropriateness and effectiveness of safeguards in certain areas of the Code.”</p> <p>We commend the Board for proposing a potential project to address safeguards in the Code as we believe this is a very important project that should be given heightened priority particularly relating to auditor independence. However, as the Board deliberates the feedback received on the Paper, we would like to emphasize some key points that we believe the Board should address in any such project. They</p>	<p>The topic of safeguards is included in the proposed SWP. These comments will be further considered as part of a potential project on this topic.</p>

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<p>are as follows:</p> <ol style="list-style-type: none"> 1. The Board should review and update the entire suite of safeguards throughout the Code. Such a process should seek to bring clarity to safeguards that are not clear and eliminate those that are inappropriate; 2. There should be a direct correlation between a safeguard and the threat it is intended to address; and 3. The Board's output should convey the notion that not every risk could be addressed by a safeguard. 	
Other Considerations for the Board	
<p><i>Longstanding associations</i></p> <p>We support the Board undertaking this project as we believe the threat of familiarity with the audit client can undermine the auditor's objectivity. We believe the main issues to be addressed in this work stream should be:</p> <ol style="list-style-type: none"> 1. A comprehensive review of which individuals, including those below the partner level, should be subject to rotation; 2. A review of the length of the cooling-off period for individuals subject to rotation; 3. The permissibility of work in which individuals in the cooling-off period could be engaged; 4. A focus on addressing the familiarity threat by the audit firm engaging fresh individuals; and 5. Whether the threat of familiarity is only a concern when an entity becomes a public interest entity. 	<p>These comments have been shared with the Long Association Task Force for further consideration.</p>

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<p><i>Internal audit services – <u>Direct assistance</u></i></p> <p>The IESBA should further consider how auditors utilize internal auditors as part of the external audit work. Even with review of the internal auditor's work and other safeguards, the internal auditor is an employee of the audited entity.</p> <p>Though some of our member jurisdictions are not opposed to using direct assistance as part of the audit process, some of our members believe employees should not be part of the external audit process. Review of internal audit reports and work as part of the risk assessment and as part of a company's system of internal control is a different matter.</p>	<p>The Board agreed that it will not reconsider the matter of direct assistance at this time as the project to revise the definition of "engagement team" was only finalized in March 2013.</p> <p>With respect to the suggestion that the Board consider how external auditors use internal auditors as part of the external audit work, the Board does not consider that this would be within its remit but a matter for the IAASB to address.</p>
<p><i>Internal audit services – <u>Other matter</u></i></p> <p>The Code should be amended to prohibit the auditor from providing internal audit services where there is any self-review threat, not only where management functions are assumed. Consideration should be given to prohibiting a company's auditor from providing internal audit services despite the provisions in paragraph 290.198, given the remaining self-review threat and the perception of a lack of independence.</p> <p>Further, what constitutes "internal audit" and the distinction from similar other services should be more clearly defined (paragraph 290.195 of the Code). Equivalent services that are not labeled as internal audit services should be treated in an equivalent manner in the Code.</p>	<p>The Board has considered this suggestion in the NAS project. The Board has tentatively concluded that there is no case for reviewing the Code's provisions on internal audit services at this time given that the Code's threats and safeguards approach continues to be appropriate.</p> <p>The Board also noted that in May 2008, it issued a re-exposure draft (i.e., after exposing proposals relating to independence in its July 2007 exposure draft) requesting comment on the proposed restriction on providing internal audit services to PIE audit clients. The re-exposure draft specifically asked respondents whether there should be an exception for immaterial internal audit services. The majority of respondents (21 out of 37) were of the view that an exception should be made for immaterial internal audit services. Respondents commented that this would be consistent with:</p> <p>(a) The framework because immaterial services do not create an unacceptable self-review threat; and</p>

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	<p>(b) Positions taken in the Code on other services (e.g. bookkeeping, IT systems and valuation services).</p> <p>In addition, the Board considered all of the NAS survey responses and Committee 1's suggestion in its deliberations regarding internal audit services. The responses to the surveys did not provide clear cut directions or majority views on how jurisdictions address such services.</p>
<p><i>Breaches</i></p> <p>We appreciate the efforts of the IESBA to review the "inadvertent violation" exemptions in the Code and to introduce a new approach to dealing with breaches. We believe that the IESBA should consider further opportunities to improve the Code in relation to breaches, including:</p> <ol style="list-style-type: none"> 1. Clearly defining what the term "significant" means including what bench mark is to be used to measure the significance of a breach; 2. Clarifying how the auditor is to determine when the significance, impact or type of breach makes it appropriate for an auditor to resign rather than to take action to address the consequences of a breach of the independence requirements; and 	<p>The Board agreed that it will not reconsider these matters at this time as the Breaches project was only finalized in December 2012.</p>
<ol style="list-style-type: none"> 3. Working with the IAASB to determine whether breaches of auditor independence and similar provisions within the Code meet the criteria to be reported as a Key Audit Matter in the auditor's report. If so, how such matters could be presented in a manner that does not confuse a user as to the auditor's objectivity. <p>With respect to (3), above, consideration regarding reporting of these matters becomes even more important if the IAASB continues to pursue within its auditor reporting project the idea that auditors would include in their report a positive</p>	<p>The Board is actively liaising with the IAASB in this area in the context of the IAASB's Auditor Reporting project.</p>

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statement regarding the auditor's independence.	
<p><i>Outsourcing of audit procedures</i></p> <p>We have observed a growing trend among audit firms of assigning certain audit procedures to off-shore centers in an effort to drive efficiency, cost savings or other benefits. We are not sure which Code requirements apply to individuals performing work in such off-shore centers including whether or not they are covered by the definition of engagement team outlined in the Code.</p> <p>We believe the Code should specifically address the ethical requirements, including the independence provisions, for these individuals to preserve the objectivity and independence of the external auditor.</p>	<p>The PC has noted that the issues being raised in this area appear to relate more to ISQC 1² in terms of ensuring that firms that engage third party providers comply with the relevant professional standards in those situations, including the relevant independence and other ethical requirements of the Code. Accordingly, the PC's view is that there is no immediate need to prioritize a standard-setting project in this area.</p> <p>Nevertheless, the PC agreed that the Board should continue to liaise with regulators to further understand the specific issues being raised on this topic, and consider the need to coordinate any potential action with the IAASB. In addition, the PC recommends that the Emerging Issues and Outreach Committee (EIOC) monitor developments in this area.</p>
<p><i>Emergency situations and other exemptions</i></p> <p>The IESBA should consider removing the exemption for providing accounting and bookkeeping services and preparation of tax calculations in "...emergency or other unusual situations when it is impractical for the Audit Client to make other arrangements" in paragraphs 290.172, 290.174, 290.185 and 290.186 of the Code.</p> <p>This exemption creates a self-review threat and undermines the purpose of an independent audit. The exemption is unnecessary given that in most jurisdictions there are relatively large numbers of qualified accountants other than the auditor who could be engaged to provide these services. We have significant concerns with the message sent by such an exemption for any entities and, in particular, public</p>	<p>The emergency situations as they pertain to bookkeeping services and preparation of tax calculations are currently being addressed in the NAS project.</p>

² ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

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<p>interest entities. The Code should be reviewed in detail for other such exemptions that today are no longer necessary.</p>	
<p><i>Business, employment and financial relationships</i></p> <p>The IESBA should consider the need for prohibitions on business, employment and financial relationships between auditors and their audit clients. For example, the safeguards surrounding a guarantee of a loan; the threat of selling financial products on behalf of an audit client for a commission; and jointly developing a software product with an audit client are some areas of concern in which requirements could be strengthened.</p> <p>The IESBA should also consider whether changes should be made to the Code to increase the cooling off period for retiring audit partners that join public interest entity audit clients. In addition, the Board should consider the implications to the standard cooling off period should more than one former partner join the audit client. Also, we believe there are threats to independence if an officer of an audit client becomes a member of the firm who can influence the outcome of the audit regardless of whether they were deemed a member of the engagement team.</p>	<p>The PC believes there is a need to better understand what the issues are and, in particular, whether there is evidence of adverse consequences for audit quality in practice.</p> <p>The PC recommends that the EIOC monitor developments in these areas, particularly with respect to employment relationships (e.g., the increased need for audit committee members to have greater financial literacy will stimulate a trend of former (often retired) partners from the firms joining audit clients).</p> <p>Also, these matters would lend themselves well to benchmarking and consideration of the findings of academic research.</p> <p>The PC further noted that the Code cannot prohibit a former partner of a firm from joining an audit client but only require the firm to withdraw from the audit engagement in the relevant circumstances.</p>
<p><i>Materiality</i></p> <p>The proposed Code applies to material contraventions and should provide guidance on how the auditor is to evaluate materiality.</p>	<p>The Board has chosen not to define materiality in the Code to allow for the exercise of appropriate professional judgment. The Board has noted that the ISAs themselves do not define materiality but provide some guidance that describes the concept in general terms.</p> <p>Also, some staff guidance on materiality has already been provided in the November 2012 Staff Q&A.</p> <p>The Board has concluded that this should not be a priority at this time, especially given that attempting to define</p>

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	materiality or develop detailed guidance on it could be a potentially large and complex endeavor.
<p>The IESBA should consider whether the nature of the following arrangements dictates that they should not be permitted by the Code irrespective of materiality and significance:</p> <ol style="list-style-type: none"> 1. A firm, a member of the audit team, or a member of that individual's immediate family may make or guarantee a loan to an audit client, provided the loan or guarantee is immaterial to the firm or individual and the client (paragraph 290.122); and 2. A firm, or a member of the audit team, or a member of that individual's immediate family may enter into certain business relationships with the audit client or its management and hold a financial interest arising from such relationships provided the financial interest is immaterial and the business relationship is insignificant to the firm and the client or its management (paragraphs 290.124 and 290.125). <p>These exemptions may lead to unnecessarily difficult judgments by auditors.</p>	<p>As these matters appear to be of limited scope and significance, the PC recommends that they not be prioritized at this time.</p>
<p><i>Documentation</i></p> <p>The documentation requirements in paragraph 290.29 of the Code should apply to any threats to independence requiring analysis and not only to those requiring significant analysis. There should be consistency between the general documentation requirement in paragraph 290.29 and the specific documentation requirements in other paragraphs of the proposed Code.</p> <p>For example, in relation to mergers and acquisitions, paragraph 290.38 only requires documentation of certain interests and/or relationships which have not been successfully terminated by the effective date of the merger or acquisition for situations described in paragraphs 290.34 to 290.36. All instances requiring analysis should be documented.</p>	<p>The Board plans to review the consistency of the documentation provisions in the Code as part of its Structure of the Code project.</p>

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<p><i>Management Responsibilities</i></p> <p>Given the continued growth of the non-audit services businesses of audit firms, particularly advisory type services that are provided to both audit and non-audit clients, there is an increased risk of the auditor performing “de facto” management functions for its audit client while performing a “non-audit” service. We believe the requirements in the Code addressing “Management Responsibilities” should be revisited, since the concept of management “taking responsibility for the results of a non-audit service” provided to the audit client does not prevent situations where the auditor could heavily influence management’s decisions, resulting in an unacceptable threat to independence.</p>	<p>The topic of management responsibilities is being addressed in the NAS project.</p>
<p><i>Definition of “Public Interest Entity”</i></p> <p>The IESBA set a minimum definition of "Public Interest Entity", which was to be reviewed for application of the independence requirements in each jurisdiction. Some countries have accepted the minimum definition in the Code without amendment. The Code presumes that regulators can set a definition but in many jurisdictions regulators do not have the power to set a definition. Therefore, the Board should reexamine the definition in light of the fact that in practice it is not just serving as a baseline.</p> <p>One way to reexamine the definition would be to examine the outputs of the IASB's work in this area, particularly the meaning of public accountability that was developed in drawing the dividing line between IFRS and IFRS for SMEs. Consistency in the approaches between the proposed Code and this definition would be simpler and may reduce any possible confusion amongst auditors and audit clients in jurisdictions that use the IASB's standards.</p>	<p>The Board reviewed the Code's definition of a PIE seven years ago under the Independence I project. The Board believes it is important for the definition to be fairly broad to be capable of global application, and that jurisdictions should be aware of the minimum (i.e., listed entities).</p> <p>However, the PC has noted that the Basel Committee on Banking Supervision has also highlighted this as an area for the Board to reconsider from the perspective of banks.</p> <p>The PC recommends that the Board liaise with the regulatory community to better understand the nature of the regulatory concerns and to consider whether there is a need to reexamine the definition.</p>

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<p><i>Developments in Various Jurisdictions</i></p> <p>The prospect of joint audits may increase in prevalence as a result of auditor tenure developments in certain jurisdictions. As such, we suggest the Board should consider whether the Code adequately addresses any ethical issues that may arise as a result of joint audit arrangements. For example, what are the obligations of both auditors with respect to understanding and verifying the independence of the joint auditors from the audit client?</p>	<p>The PC's view is that this topic should not be prioritized at this stage as it is jurisdiction-specific. The PC believes that any international standard setting effort in this area should be driven primarily by the IAASB. Nevertheless, the PC has recommended that the EIOC monitor developments in this area.</p>
<p><i>Undue Fee Pressure</i></p> <p>We believe Section 240 of the Code (namely, Fees and Other Types of Remuneration) does not adequately address the threats and safeguards regarding setting audit fees for the engagement and the potential effect of the fee level on the quality of the audit. Audit firms competing for an audit engagement by using low fees in an attempt to obtain the audit client can have a negative impact on audit quality if that fee level translates into inadequate audit work. As such, the Board should determine the most effective manner for the Code to address the threats and safeguards associated with the negative incentives to carry out inadequate audit procedures as a result of audit fee pressures.</p>	<p>The PC recommends that the Board further study this and the other fee-related issues raised by IOSCO in its submission to the January 2013 strategy survey to determine whether there is a need for further enhancements to the Code or the commissioning of staff guidance.</p>
<p><i>Other assurance engagements</i></p> <p>Some of the comments above may also apply to equivalent sections of the Code dealing with Other Assurance Engagements.</p>	<p>Noted.</p>