

Basis for Conclusions
Prepared by the Staff of the IESBA
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*International Ethics Standards Board for
Accountants*

Changes to the Code of Ethics for Professional Accountants Related to Provisions Addressing a Breach of a Requirement of the Code

IESBA

International
Ethics Standards
Board for Accountants

This document was prepared by the Staff of the International Ethics Standards Board for Accountants (IESBA).

The IESBA is an independent standard-setting board that develops and issues high-quality ethical standards and other pronouncements for professional accountants worldwide. Through its activities, the IESBA develops the *Code of Ethics for Professional Accountants*, which establishes ethical requirements for professional accountants.

The objective of the IESBA is to serve the public interest by setting high-quality ethical standards for professional accountants and by facilitating the convergence of international and national ethical standards, including auditor independence requirements, through the development of a robust, internationally appropriate code of ethics.

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BASIS FOR CONCLUSIONS: CHANGES TO THE CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS RELATED TO PROVISIONS ADDRESSING A BREACH OF A REQUIREMENT OF THE CODE

This Basis for Conclusions has been prepared by staff of the International Ethics Standards Board for Accountants (IESBA). It relates to, but does not form part of, the changes to the *Code of Ethics for Professional Accountants* (the Code) related to provisions addressing a breach of a requirement of the Code. These changes were approved by the IESBA in December 2012 with the affirmative votes of 16 out of 16 IESBA members present.

Background

1. The Code contains several paragraphs that address an inadvertent violation of a provision of the Code. Those paragraphs were commented on in a letter submitted to the IESBA by the International Organization of Securities Commissions (IOSCO) in response to an IESBA Exposure Draft issued in July 2008, which proposed new drafting conventions for the Code. IOSCO expressed concern that the paragraphs could be read to imply that all inadvertent violations can be corrected through the application of any necessary safeguards. This, in turn, might encourage unscrupulous behavior and potential abuse in complying with the Code. It also might reduce a firm's motivation to establish robust preventive controls to properly identify threats to independence.
2. The IESBA published its proposals in an exposure draft (ED) in October 2011. The comment period for the ED closed on January 23, 2012. Forty six comment letters were received from various respondents, including regulators and oversight bodies, national standard setters, IFAC member bodies, other professional bodies, and firms. This Basis for Conclusions explains the more significant issues raised by respondents to the ED, and how the IESBA has addressed them.
3. The IESBA has also discussed this project with its Consultative Advisory Group (CAG) on five separate occasions, including: at the project commencement stage; prior to the issuance of the ED; and prior to the finalization of the standard.

The Need for Provisions to Address a Breach of a Requirement of the Code

4. In developing the ED, the IESBA took the view that in respect of breaches of independence requirements, it is in the public interest for there to be a robust framework that can be applied across all jurisdictions to assist those charged with governance, auditors, and regulators in (a) evaluating the impact of a breach of an independence requirement, and (b) determining whether such a breach should result in the auditor resigning from the engagement or whether actions can be taken to satisfactorily address the consequences of the breach. The IESBA was of the view that the public interest would not be well served if the automatic response to any breach of an independence requirement is that the firm must resign, regardless of the magnitude of the breach and its impact on the firm's objectivity.
5. A number of regulatory and public authorities have adopted provisions in their standards and regulations that set out mandatory processes for dealing with breaches. Not every jurisdiction, however, has a regulator that is able to deal with breaches and not all regulators have a regulatory process for dealing with them. In those situations, those charged with governance and audit firms are left to address breaches on an ad hoc basis as there is no guidance on the steps that must be

taken if the firm has identified a breach. The IESBA therefore took the view that the Code should provide such a framework to promote consistent analysis and outcomes. Accordingly, the ED proposed provisions to address a breach of an independence requirement as well as a general provision to promote ethical behavior by professional accountants if a breach of other requirements in the Code occurs.

6. All respondents, except three, expressed support for the Code to contain provisions that address a breach of a requirement of the Code. Of the three who did not support such a proposal, two expressed the view that the Code should not include such provisions because addressing the consequences of a breach of the Code is within the purview of those who enforce the Code (such as professional bodies and regulators). The third respondent who disagreed felt that there should be no further amendments to the Code at this time because of the demands on IFAC member bodies with respect to implementation and regulation.

IESBA Decision

7. Given support from the overwhelming majority of the respondents, the IESBA concluded that the Code should contain such provisions.

Scope, Timing and Threshold for Reporting Breaches

8. The ED proposed to require a firm to discuss all breaches with those charged with governance because a *de minimis* test whereby insignificant breaches are not disclosed to those charged with governance would entail too much subjectivity as to whether or not a breach was significant, and thus whether it was necessary to report the breach. The IESBA took the view that requiring disclosure of all breaches would address the perceived self-interest that some may believe a firm may have in not reporting a breach.
9. The majority of the respondents expressed support for all breaches to be communicated to those charged with governance, although a number of them suggested additional considerations including the following:
 - Minor breaches should be communicated to the chair of the audit committee.
 - Insignificant breaches need not be reported as soon as possible or could be reported in accordance with a timetable agreed with those charged with governance.
 - To be consistent with ISA 260,¹ communication should be on a timely basis rather than as soon as possible.
 - The significance of the breach should affect the timing of the communication.
10. A significant minority of respondents, however, expressed the view that breaches that are not significant need not be communicated to those charged with governance. A number of other respondents expressed the view that those charged with governance should be permitted to establish a threshold below which insignificant breaches would not be communicated.
11. A few other respondents suggested that the breach could be reported to a regulator and/or investors in certain circumstances, such as when such reporting is encouraged in the jurisdiction. In

¹ ISA 260, *Communication with Those Charged with Governance*

this regard, a respondent was of the view that to achieve transparency to investors in the context of an audit of financial statements, disclosure of the breach in the auditor's report would be important.

IESBA Decisions

12. In considering the diversity of responses, and the number of comments regarding whether all breaches should be reported and the timing of reporting, the IESBA considered whether it would be appropriate to permit the timing of the reporting of less significant breaches to be established by those charged with governance. Such an approach would have the benefit of balancing the views of those respondents who believe that less significant breaches should not be reported and those who support the reporting of all breaches.
13. Representatives of the IESBA CAG generally expressed support for communicating all breaches, although there were differing views on the timing of the communication.
14. To obtain additional views from those charged with governance regarding whether they wish to hear about all breaches, irrespective of significance, and the timing of such reporting, the IESBA conducted a survey of audit committee chairs and directors. Over 500 responses were received. The majority (88%) agreed that all breaches should be reported. With respect to timing, 67% expressed support for some form of flexibility and 51% felt that the form of communication should be verbal, as soon as possible and followed by written communication.
15. In the light of the ED responses, CAG input and survey findings, the IESBA determined that all breaches should be reported to those charged with governance to maintain transparency and reduce subjectivity. The IESBA also determined that all breaches should be discussed with those charged with governance as soon as possible, unless those charged with governance have specified an alternative timing for reporting less significant breaches (see paragraph 290.46). The IESBA believes that the introduction of this flexibility in timing appropriately recognizes the importance of bringing all breaches to the attention of those charged with governance while at the same time allowing for the fact that not all breaches will necessarily be of the same severity and therefore call for the same urgency of communication.
16. In addition to the above change, the IESBA determined that there should be a requirement for the firm to communicate in writing with those charged with governance all matters discussed with them regarding the breach to enable their concurrence to be obtained (see paragraph 290.47).
17. The IESBA considered whether the provisions should include a requirement or an expectation for the firm to report to appropriate regulators. The IESBA noted that in many jurisdictions, there is no specific regulation for audits of entities that are not public interest entities and professional rules are applicable that may not include such a reporting requirement. The IESBA is of the view that it would be inappropriate to require public reporting in a code of ethics for global application and that if a regulator in a particular jurisdiction believes that reporting to the regulator and/or investors is appropriate in that jurisdiction, the regulator should require such reporting. In addition, the IESBA noted that it is within the remit of the International Auditing and Assurance Standards Board (IAASB) to establish requirements regarding the content of the auditor's report and that the IAASB was already undertaking a project to improve such report. Nevertheless, the IESBA concluded that, subject to compliance with any applicable legal or regulatory requirements, the firm should be required to consider reporting a breach to a member body, relevant regulator, or oversight authority if such reporting is common practice or is expected in the particular jurisdiction (see paragraph 290.41).

18. With respect to a breach of a provision of Section 291, the IESBA determined on further reflection in the light of the ED responses that the timing of the discussion of the breach with the party that engaged the firm or those charged with governance need not be as prescriptive as for audit engagements. Accordingly, the IESBA determined that the firm's discussion of the breach and the proposed action should be on a timely basis as opposed to as soon as possible (see paragraph 291.35).

Agreement of Those Charged with Governance Regarding Whether Action Can be Taken to Satisfactorily Address the Consequences of a Breach

19. The ED proposed an approach that provides a robust, transparent mechanism for addressing breaches. This included a proposed requirement for the firm to determine whether termination of the audit engagement is necessary when a breach is identified or whether action can be taken to satisfactorily address the consequences of the breach such that the firm can still issue an audit opinion. When a breach of an independence provision is identified, the ED proposed that the firm be required to, amongst other things, communicate with those charged with governance and obtain their agreement with the proposed course of action.
20. A number of respondents did not support the proposal that the firm could continue with the audit engagement only if those charged with governance agree that action can be taken to satisfactorily address the consequences of the breach. The respondents expressed concern that this suggested that the auditor could delegate responsibility for making the continuance decision to those charged with governance.

IESBA Decision

21. The IESBA noted that the proposal was not intended to enable the auditor to abdicate the auditor's responsibility to make the requisite judgment about the impact of the breach on the auditor's objectivity and the adequacy of any safeguards. The IESBA also noted that the proposal did not intend that the agreement would involve a negotiation between the auditor and those charged with governance. Rather, the message that was intended was that it is appropriate to engage with those charged with governance when the auditor believes that action can be taken to satisfactorily address the consequences of the breach.
22. The IESBA noted that 75% of the respondents to the survey of audit committee chairs and directors had agreed that the firm should seek the concurrence of those charged with governance that action can be taken to satisfactorily address the consequences of the breach. In the light of this input, and to better recognize the element of dialogue that is envisaged, the IESBA decided to replace the provision that the firm may continue the engagement only if those charged with governance agree that action can be taken to satisfactorily address the consequences of the breach with a requirement for the firm to *obtain the concurrence* of those charged with governance that such action can be, or has been, taken (see paragraph 290.47). The IESBA believes that this change helps avoid the suggestion that the communication is a negotiation or that those charged with governance should determine whether the engagement should continue.
23. The IESBA also agreed to delete the phrase "may continue with the audit engagement" from that proposed provision to eliminate the perception that audit activity must be suspended until agreement is obtained from those charged with governance.

Reasonable and Informed Third Party Test

24. The ED proposed that in determining whether action can be taken to satisfactorily address the consequences of a breach, the firm should take into account whether, even if such action could be taken, 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 would be unable to issue an audit report. The IESBA believed that this is an appropriately high threshold for making the determination and is consistent with the general thrust of the Code, which requires an accountant's judgments to take into account the views of a reasonable and informed third party.
25. All but a few respondents agreed that the reasonable and informed third party test is appropriate in determining whether an action satisfactorily addresses the consequences of a breach of an independence requirement. The few who did not support the use of the test expressed varying views as follows:
- It would be difficult for a firm to determine what a reasonable and informed third party would likely conclude to be an appropriate course of action for addressing a breach of the independence requirements, and the impact of that action on independence and objectivity.
 - It would be preferable to obtain an impartial opinion from another professional accountant (not within the firm or a network firm) or from a lawyer.
 - The test is appropriate in the general principles in the Code but unnecessary when considering breaches.
 - The test should be based on the views of a reasonable and informed investor and not those of an auditor.

IESBA Decisions

26. In view of the overwhelming support from respondents, the IESBA reaffirmed its decision to require use of the reasonable and informed third party test as proposed in the ED.
27. The IESBA has noted comments from respondents to its December 2011 exposure draft regarding changes to the Code addressing conflicts of interest to the effect that the reasonable and informed third party test is subjective and a matter of judgment, and cultural differences may result in inconsistent application of the test. The IESBA has noted that this matter could be addressed in a future project and, if so, it would take into account as part of that project relevant comments made by those respondents above who did not support use of the test in the context of a breach of a requirement of the Code.

Matters that Should be Discussed with Those Charged with Governance

28. The ED proposed certain matters that should be included when discussing a breach with those charged with governance.
29. All but two respondents expressed general support for the matters that should be discussed. The two respondents who had concerns expressed the following views:
- The firm should be able to exercise judgment as to whether to discuss these matters with those charged with governance.

- It would not be appropriate to include amongst the matters for discussion a description of the firm's relevant policies and procedures designed to provide it with reasonable assurance that independence is maintained. As such policies and procedures are designed to provide reasonable but not 100% assurance, breaches may well occur. Thus, breaches will not always indicate that the policies and procedures were at fault.
30. A respondent expressed the view that there should be written communication of the matters discussed with those charged with governance.

IESBA Decisions

31. Given the overwhelming support for the proposal in the ED, the IESBA determined that no significant changes should be made. Regarding the matter of whether there should be written communication with those charged with governance, the IESBA determined that specific input on the matter should be sought via the survey of audit committees and directors.
32. The IESBA found that the majority of the survey respondents supported a written communication requirement. On that basis, the IESBA determined that the firm should be required to communicate in writing the matters discussed with those charged with governance. In introducing this requirement, the IESBA also determined that the written communication should include a description of the firm's independence policies and procedures relevant to the breach and any steps the firm has taken, or proposes to take, to reduce or avoid the risk of recurrence (see paragraph 290.47).

Reporting Within the Firm

33. A respondent expressed the view that the firm's assessment and determination of the outcome of a breach should be elevated within the firm, for example, to the firm's quality control function and or the firm's leadership.

IESBA Decision

34. The IESBA accepted that greater clarity should be provided regarding the reporting of a breach within the firm. Accordingly, the IESBA amended the proposals to require that when a breach is identified, the firm, in accordance with its policies and procedures, promptly communicate the breach to the engagement partner, those with responsibility for the policies and procedures relating to independence, other relevant personnel in the firm, and, where appropriate, the network, and those subject to the independence requirements who need to take appropriate action (see paragraph 290.42).
35. The IESBA believes that this requirement is consistent with, and does not go beyond, the requirements in ISQC 1.²

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

Additional Guidance on How to Judge the Significance of a Breach

36. The ED referred to the “significance” of a breach in relation to the evaluation of the breach, the reasonable and informed third party test, and matters that should be discussed with those charged with governance.
37. A respondent suggested that additional guidance could be provided on how to evaluate the significance of a breach. It was also noted in particular that the guidance did not indicate the reference point or denominator against which the significance of a breach should be judged.

IESBA Decision

38. The IESBA is of the view that significance is contextual. The proposals in particular contain a detailed list of factors that will influence the significance of the breach (see paragraph 290.42):
- The nature and duration of the breach.
 - The number and nature of any previous breaches with respect to the current audit engagement.
 - Whether a member of the audit team had knowledge of the interest or relationship that caused the breach.
 - Whether the individual who caused the breach is a member of the audit team or another individual for whom there are independence requirements.
 - If the breach relates to a member of the audit team, the role of that individual.
 - If the breach was caused by the provision of a professional service, the impact of that service, if any, on the accounting records or the amounts recorded in the financial statements on which the firm will express an opinion.
 - The extent of the self-interest, advocacy, intimidation or other threats created by the breach.
39. The IESBA believes that it is implicit that the significance of a breach is to be evaluated relative to independence. The drafting of the proposals is consistent with the conceptual framework of the Code which requires the identification of threats to compliance with the fundamental principles, the evaluation of the significance of the threats identified, and the application of safeguards. The IESBA therefore determined that further guidance in this respect was unnecessary and no changes were made in this regard.

Additional Guidance on When Resignation is Necessary

40. A respondent suggested that additional guidance could be provided on when resignation is necessary. The respondent noted that the proposals do not indicate that even when the consequences of a breach are highly significant, resignation is needed.

IESBA Decision

41. The IESBA noted that in a number of places in the proposals, it had been indicated that resignation may be necessary. The IESBA believes that whether resignation is necessary is dependent upon an evaluation of both the significance of the breach and whether action can be taken to satisfactorily address the consequences of the breach. The IESBA, therefore, does not believe that

it is possible to categorically describe a fact pattern as to when resignation would always be necessary. Accordingly, no changes were made in this regard.

Definition of Those Charged with Governance

42. A respondent noted that the definition of “those charged with governance” in the Code is not consistent with the definition of the term in ISA 260.

IESBA Decision

43. The IESBA acknowledged the inconsistency. While the IESBA recognized that the use of the term “those charged with governance” in the ED is consistent with the rest of the Code, it noted that the definition in the Code tends to point the requirement to communicate breaches to encompass the entire board of an entity. The IESBA noted that it may in fact be more appropriate for the firm to report to the “audit committee” or even a delegate of the audit committee of the entity.
44. While a revision of the definition of those charged with governance was not originally contemplated as part of this project, the IESBA nevertheless agreed to undertake a separate project to address the matter.

Effectiveness of Those Charged with Governance

45. Those charged with governance play an important role in the proposals. They receive the communication of any breaches, and their concurrence is sought as to whether action can be, or has been, taken to satisfactorily address the consequences of the breach.
46. A respondent noted that those charged with governance may have an interest in finding a solution to a breach so as to avoid a change in auditor. The respondent also noted that in some jurisdictions, those charged with governance might not be as effective as in other jurisdictions.

IESBA Decision

47. The IESBA determined that no changes would be necessary to the proposals. In many jurisdictions, those charged with governance have legal responsibilities regarding the need for an independent audit. The IESBA also noted that the extensive documentation requirements provide an appropriate level of transparency by providing an audit trail for any identified breaches and actions taken, if any, to address such breaches. Finally, the IESBA noted that it would not be appropriate for it to set standards on the basis of a perceived inadequacy in the quality or effectiveness of those charged with governance. Rather, if national regulators wished to amend corporate governance rules, it would be within their remit to do so.

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