



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

545 Fifth Avenue, 14th Floor  
New York, New York 10017  
Internet: <http://www.ifac.org>

Tel: +1 (212) 286-9344  
Fax: +1 (212) 856-9420

**Agenda Item**

**D**

**Committee** IESBA Consultative Advisory Group

**Meeting Location:** Toronto, Canada

**Meeting Date:** September 13, 2006

**Independence**

**Objectives of Agenda Item**

To solicit further views of the CAG on the direction taken by IESBA in revising Section 290 of the Code dealing with independence for assurance engagements.

**Project Status**

At its September meeting, the Ethics Committee (now IESBA) approved a project to consider whether any parts of Section 290 should be revised. A public forum was held in October 2005 to solicit feedback on the project. After the forum, the IESBA discussed the way forward and concluded that it was important to “benchmark” the existing Section 290 against other jurisdictions and prepare position papers for key subject areas.

The Task Force prepared several positions papers which were presented to the IESBA at its February 20-23, 2006 meeting. These position papers and the proposals of the IESBA were discussed with the CAG at its April 3, 2006 meeting.

At the June IESBA meeting, the Task Force presented a first draft of revised Sections 290 and 291 and obtained feedback from the IESBA on key issues. The draft was presented as illustrative wording and the IESBA did not discuss the wording in detail. The Task Force has met twice since the June 13-14, 2006 IESBA meeting and will meet again three times between the CAG meeting and the IESBA meeting in October (for a total of eight days). The Task Force will consider input received from the CAG at its next meeting before revising the document for presentation to IESBA in October.

It is hoped that the exposure draft will be approved by the IESBA at its October meeting. The IESBA has scheduled an additional meeting in December, if needed, so that the exposure draft can be approved in 2006.

### **Matters for IESBA CAG's Consideration**

As noted above, the draft Section 290 presented is still a working draft. A previous draft was discussed by the TF at its August meeting, this draft reflects changes discussed at that meeting but it has not yet been reviewed or discussed by the TF.

Any comments from the IESBA CAG are welcome but, in particular, comment is solicited on the matters noted below. These matters are presented in the order in which they appear in the proposed revised Section 290 (Agenda Item D.2).

#### *Responsibility*

A respondent to the Network Firm ED indicated that the Code was not always clear as to whether the responsibility for a particular requirement rested with the firm or an individual and, if an individual, which individual.

The Task Force is of the view that the responsibility for a particular action may differ depending upon the size, structure and organization of the firm. Therefore the Task Force proposes that the Code (Agenda Paper D.2 ¶290.5) state that firms should have policies and procedures, appropriately documented and communicated, to assign responsibility for identifying and evaluating threats to independence and applying appropriate safeguards to eliminate threats or reduce them to an acceptable level.

### **Matters for IESBA CAG's Consideration**

The IESBA CAG is asked for its views on the proposals with respect to responsibility.

#### *Entities of Significant Public Interest*

The existing Code states that certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. It further requires that consideration should be given to the application of the framework in relation to the financial statement audit of listed entities to other financial statement audit clients that may be of significant public interest.

The Task Force proposes to strengthen the guidance in this area. It is of the view that it is not possible to establish a workable global definition of a public interest entity. The benchmarking exercise indicated that jurisdictions which had adopted a definition of a public interest entity had used widely differing size tests.

The approach proposed by the Task Force is to give the strongest guidance possible while still recognizing that there needs to be flexibility to address the particular circumstances in a jurisdiction. Therefore the Task Force has drafted guidance (Agenda Item D.2 ¶290.23) which states the following:

- If the scope of all public interest entities for independence purposes is defined by statute or regulation that definition should be used.
- In the absence of such a definition, member bodies should determine the types of entity that will be considered to be of significant public interest. Such entities:
  - Will always include listed entities;
  - Will normally include banks, governments, insurance companies and other regulated financial institutions; and
  - May, depending upon their size, include pension funds, government-agencies, government-owned entities and not-for-profit entities.

The Task Force is of the view that this provides consistent guidance while still maintaining a necessary degree of flexibility.

The Task Force has also included, in the proposed revised section 290, an explanation of why there are additional independence requirements for entities of significant public interest (Agenda Item D.2 ¶290.24 -25). These paragraphs, which are still being debated by the Task Force meeting, state:

“Entities of significant public interest have a large number and wide range of stakeholders, including in many instances governmental agencies or similar bodies who provide regulatory oversight. These stakeholders typically have little or no direct contact with management and usually are less familiar with the management, operation, and finances of the business than stakeholders of other entities. Accordingly, the requirement to maintain independence in appearance is greater in an audit of an entity of significant public interest.

As a result of the greater importance to maintain independence in appearance for entities of significant public interest the evaluation of the significance of threats to independence and the safeguards necessary to reduce them to an acceptable level takes into account the extent of the public interest. Consequently, in connection with an audit client that is an entity of significant public interest, certain provisions of this section require firms, members of the audit team, and others who are covered by this section to comply with more restrictive safeguards, including in certain situations to refrain from activities or relationships which may be permissible with an audit client that is not an entity of significant public interest.”

The Task Force is of the view that because of the wider range and larger number of stakeholders, additional independence requirements are necessary.

#### **Matters for IESBA CAG’s Consideration**

The IESBA CAG is asked for its views on the proposals with respect to entities of significant public interest.

*Government Program – Benefits*

The Members in Government Task Force was charged with considering whether any additional guidance was needed to address audit engagements of government entities and government agencies.

That Task Force proposes an additional section addressing receiving a benefit from a government benefit program. For example, a government audit office might be engaged to audit a particular government program (government pension, a program which funds special education needs, veterans benefit programs etc). Consideration should be given to whether members of the audit team, or their immediate or close family members obtain a benefit from the program which they are auditing. The guidance (Agenda Item D.2 ¶290.125) takes a threats and safeguards approach noting that the significance of the threat will depend upon:

- The role of the professional on the audit team;
- Whether the benefit has general application, such as would be the case in a government retirement benefit program where the benefit is available to all individuals who have achieved a certain age, or specific application, such as would be the case in a disability benefit program where the benefit is available only to individuals with a specific disability;
- The degree of judgment in assessing and establishing the nature and amount of the benefit; and
- The materiality of the benefit to the individual receiving the benefit.

**Matters for IESBA CAG's Consideration**

The IESBA CAG is asked for its views on the proposals with respect to entities of receiving a benefit from a government program.

*Cooling-off Period*

The existing Code states that independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement has been a member of the assurance team or a partner of the firm. The Code provides guidance on matters which will influence the significance of any threat created, requires the significance of the threat to be evaluated and, if other than clearly insignificant, requires that safeguards be applied to eliminate the threat or reduce it to an acceptable level. The Code does not contain any differential requirements for audit clients that are entities of significant public interest.

The proposed approach (Agenda Item D.2 ¶290.138 – 140) indicates:

“If a key audit partner joins an audit client that an entity of significant public interest as a director or an officer of the audit client, or an employee in a position to exert significant influence over the preparation of the accounting records or the financial statements on which the firm will express an opinion, the self-interest, familiarity and intimidation threats created would be so significant no safeguards would be available to reduce the threat to an acceptable level unless audited financial statements covering a period of not less than twelve months, for which the partner was not a member of the audit team, have been issued.”

A key audit partner is defined as:

“The engagement partner, the individual responsible for the engagement quality control review, and other partners on the engagement team involved at the group level who are responsible for key decisions or judgments on significant matters with respect to the audit engagement.”

The guidance contains an exception if a former partner becomes a director/officer or employee as a result of a business combination provided:

- The position was not taken in contemplation of the business combination;
- Any benefits or payments due to the partner from the firm have been settled in full, unless these are made in accordance with fixed pre-determined arrangements and any amount owed to the partner is not material to the firm;
- The partner does not continue to participate or appear to participate in the firm’s business or professional activities; and
- The position taken by the partner with the audit client is discussed with those charged with governance.

The guidance also states that if a senior partner of the firm joins an audit client that is an entity of significant public interest a threat might be created and therefore the significance of any threat should be evaluated and if the threat is other than clearly insignificant safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

#### **Matters for IESBA CAG’s Consideration**

The IESBA CAG is asked for its views on the proposals with respect to the cooling off-period before joining an audit client that is an entity of significant public interest.

#### *Partner Rotation*

The IESBA has considered the existing partner rotation provisions in the Code which, for audit clients which are listed entities, require the engagement partner and the individual

responsible for the engagement quality control review to rotate after seven years and not participate in the audit engagement until a further two years have elapsed. The Code also provides flexibility over timing of rotation in certain circumstances. These circumstances are when the person's continuity is especially important to the financial statement audit client and when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard. If rotation does not take place, the Code requires that equivalent safeguards be applied to reduce any threats to an acceptable level.

The Task Force proposes (Agenda Item D.2 ¶290.150 – 154):

- The partner rotation requirements apply to all audit clients that are entities of significant public interest;
- Removal of extant ¶290.157 which states that when a firm has only a few people with the necessary knowledge and experience to serve as engagement partner or individual responsible for the engagement quality control review rotation may not be an appropriate safeguard;
- No change to the existing position that the engagement partner and the individual responsible for the engagement quality control review be rotated after seven years;
- Other key audit partners should generally be rotated after seven years;
- Providing some limited flexibility on rotation of other key audit partners if the individual's continuity is important to audit quality (flexibility is limited to one additional year on the audit team);
- After rotation individuals should not be a member of the audit team for two years;
- Requiring an evaluation of the threats created by long service of partners other than key audit partners. The significance of the threat will depend upon factors such as:
  - The length of time the individual has been a member of the audit team;
  - The role of the individual on the audit team; and
  - The nature, frequency and extent of the individual's interactions with the board or those charged with governance.

<b>Matters for IESBA CAG's Consideration</b>
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The IESBA CAG is asked for its views on the proposals with respect to partner rotation.
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*Management Functions*

The existing Code does not make specific reference to acting as management or acting in a management role. There are, however, several references direct or indirect to this issue.

The Task Force proposes that the revised Code explicitly address management functions (Agenda Item D.2 ¶290.157-161) as follows:

- State that a firm should not perform management functions for an audit client because it would create self-review, self-interest and familiarity threats that are so significant safeguards would not be available to address the threat;
- State that management functions involve leading and directing an entity including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources;
- Provide the following examples of management functions:
  - Setting policies and strategic direction;
  - Preparing and fairly presenting the financial statements in accordance with the applicable financial reporting framework;
  - Designing, implementing and maintaining internal control;
  - Deciding which recommendations of the firm or other third parties should be implemented; and
  - Authorizing transactions.
- State that some activities may not be management functions because they are routine and administrative, involve matters that are insignificant or do not otherwise represent a management responsibility. For example:
  - Executing an insignificant transaction that has been authorized by management or monitoring the dates for filing statutory returns and advising an audit client of such forthcoming dates would not be considered management functions; and
  - Providing advice and recommendations to assist management in performing its functions or providing elements of a client's internal training program would not be considered a management function.
- Require the firm to be satisfied that a member of management of the client has been designated to make all significant judgments and decisions connected with the performance of the services and accept responsibility for the results of the service received. This reduces the risk of the firm inadvertently making any significant judgment or decision. The risk is further reduced when the firm gives the client the opportunity to make judgments and decisions on the basis of an objective and transparent analysis and presentation of the issues.

#### **Matters for IESBA CAG's Consideration**

The IESBA CAG is asked for its views on the proposals with respect to management functions.

#### *Non-audit Services*

As reported at the April CAG meeting, the IESBA reviewed the benchmarking to other jurisdictions and based on input from IESBA the Task Force is proposing certain changes to guidance on the provision of non-audit services the more significant of which are:

- *Valuation services* – Providing guidance on what is meant by significant subjectivity with respect to a valuation service (Agenda Item D.2 ¶290.175) and restricting firms from providing valuations services to audit clients that are entities of significant

public interest if the valuation would have a material effect on the financial statements (Agenda Item D.2 ¶290.177);

- *Taxation services* – Providing additional guidance on the provision of taxation services which are considered under the following broad headings:
  - *Tax Return Preparation* (Agenda Item D.2 ¶290.180) which explains that the provision of such services does not generally threaten the firm's independence because the services are generally based upon historical information, principally involve analysis and presentation of such historical information based upon the constraints of existing tax law and the returns are subject to whatever review or approval process the tax authority considers appropriate;
  - *Preparation of tax calculation to be used as the basis for the accounting entries in the financial statements* – (Agenda Item D.2 ¶290.181 – 182) recognizes that such services may create a self-review threat. The proposal indicates that, for audit clients that are entities of significant public interest, a firm should not provide such services if the entries are material to the financial statements.
  - *Tax Planning and Other Tax Advisory Services* – (Agenda Item D.2 ¶290.183-187) recognizes that such services may create a self-review threat. The proposal indicates that firms should not provide tax advice to an audit client when the effectiveness of the tax advice depends upon a particular accounting treatment and there is reasonable doubt as to the appropriateness of the related accounting treatment and the outcome or consequences of the tax advice will have a material impact on the financial statements.
  - *Assistance in Resolution of Tax Disputes* – (Agenda Item D.2 ¶290.187 – 190) recognizes that acting for an audit client in the resolution of a tax matters before a public tribunal or court may create an advocacy threat. What constitutes a “public tribunal or court” should be determined according to how tax proceedings are heard in the particular jurisdiction. If the matters involved are material to the financial statements the threat created would be so significant safeguards could not address the threat and accordingly firms should not provide such services for their audit clients. If the matters are not material the firm should assess the significance of the threat and apply safeguards.
- *IT Systems Services* – (Agenda Item D.2 ¶290.197 – 202) For audit clients that are entities of significant public interest restricting firms from designing or implementing IT systems that form a significant part of the accounting systems or generate significant financial information used in the preparation of the financial statements.
- *Litigation Support Services* – (Agenda Item D.2 ¶290.203 – 209) restricting firm from providing litigation support services involving the estimates of damages if the estimation involves a significant degree of subjectivity and the amounts are material to the financial statements. For audit clients that are entities of significant public interest restricting the firm from providing such services if the amount is material to the financial statements. This aligns the guidance with the position taken on valuation services.
- *Recruiting Senior Management* - (Agenda Item D.2 ¶215 – 216) for audit clients that are entities of significant public interest restricting a firm from recruiting senior management in a position to exert significant influence over the preparation of the accounting records or the financial statements.



- *Corporate Finance Services* – (Agenda Item D.2 ¶217 – 222) providing additional guidance in the area of corporate finance service and aligning it to the position with respect to providing tax advice i.e. restricting a firm from providing corporate finance advice when the effectiveness of the advice depends on a particular accounting and there is reasonable doubt as to the appropriateness of the related accounting treatment and the outcome or consequences of the corporate finance advice will have a material impact on the financial statements.

**Matters for IESBA CAG's Consideration**

The IESBA CAG is asked for its views on the proposals with respect to non-audit services.

*Compensation Policies*

The existing Code does not address any threat to independence that might be created by partner remuneration schemes.

The Task Force proposes to include guidance in this area (Agenda Paper D.2 ¶290.229 – 230) which indicates that a key audit partner should not be evaluated on or compensated for the selling of non-assurance services to his or her audit client. The guidance also indicates that compensating other members of the audit team for selling non-assurance services to their audit clients might create a threat.

**Matters for IESBA CAG's Consideration**

The IESBA CAG is asked for its views on the proposals with respect to compensation policies.

*Other Matters*

The IESBA has determined that certain items while important are not of a priority nature and will be addressed in the future. The IESBA took this decision recognizing that if the scope of the revisions was expanded this would significantly delay the issuance of the revised Section 290. Some of the issues which will be considered in the next phase of changes are:

- *Independence for Compilation and Agreed upon Procedures Engagements* – the IESBA recognizes that the Code does not contain guidance on independence standards for such engagements. Under standards issued by the IAASB a practitioner performing such engagements is required to assess their independence by reference to the Code and if he/she is not independent disclose this fact. The IESBA is of the view that this is not a priority matter and does not propose to address it at this time (see Agenda Item B.11);
- *Auditor indemnification*;

- *Financial interests held in trust;*
- *Mutual funds;*
- *Significant influence and control;*
- *Definition of listed entity;*
- *Internal audit services.*

The IESBA has split Section 290 into two sections – Section 290 will address independence requirements for audit and review engagements and Section 291 will address independence requirements for all other assurance engagements. The changes to Section 290 will be reflected in the new Section 291

### **Material Presented**

Agenda Item D.1	Revised Section 290 – mark-up
Agenda Item D.2	Revised Section 290 - clean
Agenda Item D.3	Comments received at April 2006 CAG