



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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**Agenda Item
D**

Board Ethics Consultative Advisory Group
Meeting Location: Thistle Royal Horseguards, London, UK
Meeting Date: September 19, 2007

Clarity

Objectives of Agenda Item

1. To discuss and provide input on the proposed revisions to clarify the Code.

Background

At its June 2007 meeting, the IESBA considered the views of the Task Force¹ regarding the implications of the IAASB Clarity project on the Code.

Requirements

The Board has discussed the implications of the IAASB Clarity project on the Code. The IAASB Clarity project has adopted four conventions:

- Each ISA will state the objective to be achieved in relation to the subject matter of the ISA;
- Each ISA will specify requirements designed to achieve the stated objective. The requirements are to be applied in all cases, where they are relevant to the circumstances of the engagement, and are identified by the word “shall”. In exceptional circumstances where the professional accountant judges it necessary to depart from a requirement in order to achieve the purpose of that requirement the accountant will be required to document how the alternative procedures performed achieve the purpose of the requirement, and, unless otherwise clear, the reasons for the departure;
- The present tense will no longer be used in ISAs to describe actions taken or procedures performed by the professional accountant;
- Each ISA will contain application material which provides further explanation and guidance supporting proper application of the standards. While the professional accountant has a responsibility to consider the entire text of a standard in carrying out an engagement the application material is not intended to impose a requirement for the professional accountant.

¹ Ken Dakdduk (chair), Jean-Luc Doyle, Kariem Hoosain, Peter Hughes and Tim Volkmann

The IESBA has considered the feasibility of applying the above approach to the Code. The IESBA is of the view that because the structure of the Code and the structure of the ISAs are very different, separately presenting the objective to be achieved, the requirements designed to achieve that objective, and the application material, as in the ISAs, would not improve the clarity of the Code. As currently drafted, Part A of the Code establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles. Parts B and C of the Code illustrate how the conceptual framework is to be applied in specific situations. In all cases, the objective to be achieved, as outlined in the conceptual framework, is to identify threats to compliance with the fundamental principles and apply safeguards to eliminate the threats or reduce them to an acceptable level.

The IESBA discussed the use term “shall” and the following points were noted:

- It was critical to have consistency with the drafting conventions used by the IAASB. Users of the Code who perform assurance engagements will be knowledgeable of the ISAs and using different terms to denote a requirement would be confusing;
- As the clarity of the Code is improved the probability of adoption is increased;
- The term “should” is confusing and can lead to translation difficulties;
- The goal of the project should not be to change the meaning of the Code – rather to clarify what was intended.

Accordingly, the IESBA asked the Task Force to review the Code to identify provisions that are intended to convey requirements and re-write these requirements, which are often conveyed by use of the word "should" in the existing Code, using the word “shall.” The Task Force has carried out this request (Agenda Paper D.1 and D.1 Supplement). The Task Force did not intend to create any new requirements as a result of this re-write.

Clearly Insignificant

The IESBA has also considered the use of the term “clearly insignificant” and the requirement to apply safeguards to eliminate a threat or reduce it to an acceptable level. This issue arose during the Task Force’s review of the Code but it had also been raised in the comments to the December 2006 Exposure Draft.

The term "clearly insignificant" is used throughout the Code. The first instance where the term is used is in paragraph 100.2, which states:

“Professional accountants are required to apply this conceptual framework to identify threats to compliance with the fundamental principles, to evaluate their significance and, if such threats are other than **clearly insignificant*** to apply safeguards to eliminate them or reduce them to an acceptable level such that compliance with the fundamental principles is not compromised.”

* See Definitions.

The issue can be summarized as follows. The Code requires identification of threats to compliance with the fundamental principles, evaluation of the significance of those threats and, if such threat are not clearly insignificant, the application of safeguards to eliminate the threat or reduce it to an acceptable level. “Clearly insignificant” is defined in the Code as “A matter that is deemed to be both trivial and inconsequential.”

This raises the following matters:

- Is “clearly insignificant” the same as an “acceptable level”? While “clearly insignificant” is defined, “acceptable level” is not. A reader of the Code would likely conclude that there is a difference between the two terms because presumably the different terms are meant to convey different meanings;
- Given the definition of “clearly insignificant” it would seem unlikely that “acceptable level” is lower than “clearly insignificant”;
- If “clearly insignificant” is a lower level than “acceptable,” this would presumably mean that if a threat is not “clearly insignificant” but is at an “acceptable level” no safeguards need to be applied. This concept could be seen as implicit in, for example 210.3 which states:

“The significance of any threats should be evaluated. If identified threats are other than clearly significant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.”

The “as necessary” could be interpreted to mean either:

- To the extent necessary; or
 - The appropriate safeguards should be applied.
- The documentation requirement and some of the new language in the Section 290 exposure draft further complicate the matter. ED 290.26 requires the following documentation:

“...when threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the engagement, the decision should be documented. The documentation should describe the threats identified and the safeguards applied to eliminate them or reduce them to an acceptable level.”

This raises the question of what documentation would be required if a threat was not clearly insignificant but was acceptable such that no safeguards needed to be applied. Further, if documentation were required in that circumstance, there is a question of how that documentation serves to protect the public interest.

In discussing the issue the IESBA noted the following points:

- It would be useful to reword the requirement such that the professional accountant did not have to deal with and document matters that were clearly trivial. It is not proportionate to cost;
- Care should be taken to ensure that any change does not inappropriately bring the bar too low and weaken the Code. The current construction requires the professional accountant to consider all threats that are not clearly insignificant but only to apply safeguards to the extent necessary to eliminate the threats or reduce them to an acceptable level;
- Professional judgment is required to determine what is an acceptable level; the current starting point of considering all matters that are not both trivial and inconsequential may be too low a threshold;
- It is important that any change maintains the onus on the professional accountant to demonstrate that threats have been adequately considered; and
- The rationale for any change needs to be clearly articulated in the explanatory memorandum.

The IESBA agreed that the Task Force should consider how to eliminate use of the term "clearly insignificant" and to clarify the documentation requirement, but without reducing the accountant's thought process in addressing threats.

Since the June IESBA meeting, the Task Force has met and is proposing to modify the guidance by eliminating the reference to clearly insignificant and providing guidance on what is intended by the term "acceptable level." Under the proposal, an acceptable level is a level at which it is likely that a reasonable and informed third party would conclude, weighing all the specific facts and circumstances, that compliance with the fundamental principles is not compromised. A professional accountant would be required to identify threats to compliance with the fundamental principles, evaluate the significance of the threats and, when necessary, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. This proposal emphasizes the importance of the accountant focusing his or her analysis on the threats that are not at an acceptable level because those are the threats that would require the application of safeguards. The Task Force is of the view that this would be a more efficient and effective way of applying the threats and safeguards framework set out in the Code and would eliminate uncertainty about the interplay between the terms "clearly insignificant" and "acceptable level" in the existing guidance.

Consistent with the proposed change above, the Task Force proposal also contains an amendment of the documentation requirements in Sections 290 and 291 (which address independence requirements). Under the existing Code, when threats to independence that are not clearly insignificant are identified and the firm decides to accept or continue the engagement, the decision should be documented along with a description of the threats identified and the safeguards applied to eliminate them or reduce them to an acceptable level. The proposal makes the documentation requirement consistent with the

clarification above by calling for documentation of threats in situations in which the application of safeguards are necessary to eliminate a threat or reduce it to an acceptable level. The documentation should describe the nature of the threats and the safeguards that were applied.

Consider vs evaluate

The Code frequently uses the words “consider” and “consideration”. For example:

“Where a matter involves a conflict with, or within, an organization, a professional accountant should also consider consulting with those charged with governance of the organization, such as the board of directors or the audit committee.” (¶100.18)

“The professional accountant should consider obtaining legal advice to determine whether there is a requirement to report.” (¶100.20)

“Before accepting a new client relationship, a professional accountant in public practice shall consider whether acceptance would create any threats to compliance with the fundamental principles.” (¶210.1)

“The following additional safeguards shall also be considered:” (¶220.4)

“When an entity becomes an audit client during or after the period covered by the financial statements on which the firm will express an opinion, the firm shall consider whether any threats to independence may be created by:” (¶290.29)

In reviewing the Code for Clarity, the Task Force was concerned that in many instances the term consider could be seen by some as being less robust than intended. For example it could be seen as equivalent to “think about” as opposed to “determine whether it is necessary to”.

The Task Force is proposing changes to the Code consistent with the following principles of drafting:

- “Consider” will be used where the accountant is required to think about several matters – for example ¶100.17 “When initiating either a formal or informal conflict resolution process, a professional accountant shall consider the following, either individually or together with others, as part of the resolution process”
- “Evaluate” will be used when the accountant has to assess and weigh up matters as in “the significance of the threat should be evaluated”
- “Determine” will be used when the accountant has to conclude and make a decision – for example ¶100.20 “The professional accountant shall determine whether to obtain legal advice to ascertain whether there is a requirement to report.”

Other

The Task Force is also proposing some changes to make the language more direct – for example by a greater use of the active voice.

Material Presented

Agenda Paper D	This Agenda Paper
Agenda Paper D.1	Proposed Revised Code
Agenda Paper D.1 Supplement	Proposed revisions to July ED text
Agenda Paper D.2	Proposed Explanatory Memorandum

Action Requested

1. CAG members are asked to consider the direction of the IESBA and the recommendations of the Task Force.