



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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**Agenda Item
D**

Board Ethics Consultative Advisory Group

Meeting Location: Hilton Basel, Switzerland

Meeting Date: March 5-6, 2008

Drafting Conventions

Objectives of Agenda Item

1. To discuss the proposals and provide feedback to the Task Force.

Background

At its January 2008 meeting, the IESBA considered the proposals of the Task Force charged with recommending new drafting conventions for the Code that would improve its clarity, including considering the implications of the IAASB's Clarity project on the Code and other matters related to the clarity of the Code.

The matters addressed by the Task Force are:

- Implications of the IAASB Clarity project on the Code;
- The use of the term “clearly insignificant” and its implications on the Code including the documentation requirements in Sections 290 and 291;
- The use of the word “consider”;
- Use of the words “examples” and “illustrates”; and
- How threats should be described in the Code.

The Task Force will meet again before the CAG meeting to continue to develop the exposure draft. The CAG will be provided with an oral report of decisions taken at the Task Force meeting.

The IESBA plans to approve an exposure draft at its April 2008 meeting. This exposure draft will contain the Code and the output from the Independence I and II projects, re-drafted using the proposed drafting conventions. The Board plans to issue the Code in final form, after considering the comments on exposure at the end of 2008.

Issues

Implications of IAASB Clarity Project

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; and
- Each ISA will contain application material that 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 on the professional accountant.

The IESBA has considered the feasibility of applying the above approach to 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 is compliance with the fundamental principles described in paragraph 100.4 of the Code. The conceptual framework approach to complying with those principles calls for accountants to identify threats to compliance with the fundamental principles and, when necessary, apply safeguards to eliminate the threats or reduce them to an acceptable level. The IESBA concluded 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.

The IESBA has discussed the use of the term “shall” and concluded the following:

- It would be helpful if the Code contained drafting conventions that are consistent with the drafting conventions used by the IAASB. Users of the Code who perform assurance engagements using ISAs 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 in certain territories;
- The goal of the project should not be to change the meaning of the Code – rather to clarify what was intended.

The Code has been reviewed to identify provisions that are intended to convey requirements and the IESBA has re-written many of those requirements, which are often conveyed by use of the word “should” in the existing Code, using the word “shall.” The

intention was not to create any new requirements but, rather, to clarify the original intent. Some illustrative examples of these changes are:

“In acting in the public interest a professional accountant shall observe and comply with the ethical requirements of this Code.” (¶ 100.1)

“A professional accountant shall be straightforward and honest in all professional and business relationships.” (¶100.4)

“A professional accountant shall not be associated with reports, returns, communications or other information where he or she believes that the information . . .” (¶110.2)

“A firm shall not provide valuation services to an audit client that is a public interest entity if the valuations would have a material effect, separately or in the aggregate, on the financial statements on which the firm will express opinion.” (290.180)

CAG members are asked whether they agree with the proposals to replace “should” with “shall”.

Clearly Insignificant

The IESBA has also considered whether the term “clearly insignificant” as it is used in the requirement that when a threat is not clearly insignificant, safeguards should be applied to eliminate the threat or reduce it to an acceptable level, is appropriate. While this issue arose during the Task Force’s review of the Code, it was also 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.”

“Clearly insignificant” is defined in the Code as “A matter that is deemed to be both trivial and inconsequential.”

The IESBA considered the following issues:

- Is “clearly insignificant” the same as an “acceptable level”? While “clearly insignificant” is defined, “acceptable level” is not. The Task Force believes there is a difference between the two terms because if they were intended to mean the same thing, the requirement would be to reduce the threat to a clearly insignificant level, rather than an acceptable level. Given the definition of “clearly insignificant,” it seems unlikely that “acceptable level” is lower than “clearly insignificant”;
- If “clearly insignificant” is a lower level than “acceptable level,” does this mean that if a threat is not “clearly insignificant” but is at an “acceptable level,” no safeguards need to be applied? The Task Force believes so. 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 IESBA believes “as necessary” means that if the threat is already at an acceptable level, the application of safeguards is not necessary, even though the threat is greater than clearly insignificant.

- The documentation requirement in ED 290.26 provides:

“...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.”

The IESBA considered what documentation would be required if a threat was not clearly insignificant but was acceptable such that no safeguards needed to be applied. 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 reached the following conclusions:

- It would be useful to reword the documentation requirement of the Code to clarify that under the Code the professional accountant does not have to document threats that are already at an acceptable level; doing so would not be proportionate to cost;
- Care should be taken to ensure that any change does not inappropriately reduce the rigor of the required evaluation of threats and thereby weaken the Code. The current construction requires the professional accountant to consider all threats that are not clearly insignificant but apply safeguards only 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 in the documentation requirement needs to be clearly articulated in the explanatory memorandum.

The IESBA agreed that the use of the term "clearly insignificant" should be eliminated and the documentation requirement clarified. It was, however, important that these changes not reduce the rigor required in the accountant's thought process in addressing threats.

The IESBA agreed that with the following definition of acceptable level was appropriate for the Code:

"An acceptable level is a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that compliance with the fundamental principles is not compromised."

The IESBA also agreed that the documentation requirement in Section 290 would be as follows:

"Documentation is not, in itself, a determinant of whether a firm is independent. International auditing standards require documentation of (i) conclusions regarding compliance with independence requirements and (ii) any relevant discussions that support those conclusions. When threats to independence are identified that require the application of safeguards, the documentation shall also describe the nature of those threats and the safeguards applied to eliminate the threats or reduce them to an acceptable level."

CAG members are asked whether they agree with the proposed revisions to include a definition of an acceptable level and revise the documentation requirements.

Consider

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 IESBA noted that in many instances the word “consider” has been used in the Code to convey a requirement that the accountant make a decision. Because “consider” could be seen by some as conveying something short of a requirement to decide or conclude on a matter, the IESBA proposes 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 matters as in “the significance of the threat should be evaluated” – for example ¶100.6 “A professional accountant shall take qualitative as well as quantitative factors into account when *evaluating* the significant of a threat.”
- “Determine” will be used when the accountant has to conclude and make a decision – for example ¶290.216 “The firm shall also determine whether the overdue fees might be regarded as being equivalent to a loan to the client . . .”

CAG members are asked whether they agree with the proposed revisions.

Threats

At its October 2007 meeting, the IESBA noted that the Code is not clear in how it describes threats. In some cases, it states that a particular relationship *may* create a threat and then states that the significance of *the* threat should be evaluated. It was noted that if a matter *may* create a threat, it would be more logical to then determine whether a threat is created and, if so, require the significance of *the* threat to be evaluated. In addition, in some instances, the Code states that a particular matter may create a threat, but in the view of some IESBA members the particular matter does create a threat and, therefore, stating that a threat may be created in those situations is not correct and potentially weakens the Code. Other IESBA members were of the view that it was important to state that a threat may be created because this requires the professional accountant to think

about whether a threat is created. IOSCO raised this matter in its response to the 2006 exposure draft. The IESBA asked the Task Force to consider this matter and present a proposal for discussion at the January 2008 meeting.

While the Code describes the different categories of threats (for example, self-review, self-interest, etc.) it does not describe what is meant by a “threat” or how a threat is created. The Task Force believes that to clarify when a threat is or may be created, it would be helpful to address the question of “what creates a threat.” The Task Force considered the matter and developed the following description of a threat for the consideration of the IESBA at the January meeting:

“Threats are created by relationships or other circumstances that could compromise a professional accountant’s ability to comply with the fundamental principles.”

This proposed description would require an evaluation by the accountant in each situation in which the Code says that a given relationship or circumstance creates a threat. That evaluation would center on the significance of the threat and whether the relationship or circumstance that *could* compromise the accountant's ability to comply with the fundamental principles actually *would* compromise his or her ability.

If a threat is described in this manner (i.e., created by relationships or other circumstances that *could* compromise a professional accountant’s ability to comply with the fundamental principles), many of the relationships and circumstances described in the Code would create a threat, the significance of which would need to be evaluated. Accordingly, if this description is used, the Task Force proposed that the word “may”, which presently appears in the following paragraphs before the word “create” in the current Code, be deleted:

200.4 Examples of circumstances that create self-interest threats for a professional accountant in public practice include:

- A member of the audit team having a direct **financial interest**^{*} in an audit client.
- Undue dependence on total fees from a client.
- Having a significant business relationship with a client.
- Concern about the possibility of losing a client.
- Potential employment with a client.
- **Contingent fees**^{*} relating to an **assurance engagement**.
- The discovery of a significant error in the performance of a re-evaluation of a professional services engagement.

200.5 Examples of circumstances that create self-review threats include:

- Reporting on the operation of financial systems after involvement with their design or implementation.
- Having prepared the original data used to generate records that are the subject matter of the engagement.
- A member of the **assurance team*** being, or having recently been, a **director or officer*** of that client.
- A member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement.
- Performing a service for a client that directly affects the subject matter of the assurance engagement.

200.6 Examples of circumstances that create advocacy threats include:

- Promoting shares in a **listed entity*** when that entity is a financial statement audit client.
- Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

200.7 Examples of circumstances that create familiarity threats include:

- A member of the engagement team having a close or immediate family relationship with a director or officer of the client.
- A member of the engagement team having a close or immediate family relationship with an employee of the client who is in a position to exert direct and significant influence over the subject matter of the engagement.
- A director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement was recently a partner of the firm.
- Accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.
- Long association of senior personnel with the assurance client.

200.8 Examples of circumstances that create intimidation threats include:

- Being threatened with dismissal or replacement in relation to a client engagement.
- Being threatened with litigation by the client.
- Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

The Task Force also presented a mark-up of the Code (Agenda Paper D.1) which reflected changes as per the above conventions.

The IESBA considered the proposal of the Task Force and the following comments were made:

- It was important that the re-drafting eliminate some of the perceived softness in the Code;
- The Task Force should guard against placing significant weight on the word "could" in the description of a threat – for example, saying that the holding of a financial interest in an audit client creates a threat would mean that the situation could compromise compliance with the fundamental principles. But that is not always true because whether a threat is created depends upon factors such as the materiality of the financial interest, whether it is direct or indirect, and who is holding the financial interest. An immaterial indirect financial interest held by an immediate family member of someone who is not on the audit team also would not automatically create a threat to independence. Saying that those situations create a threat would then require the accountant to decide whether compliance with the fundamental principles would be (as opposed to "could be") compromised by the situation, which seems unnecessary.
- It might be better to refer to an "incentive not to comply with the fundamental principles" rather than an "ability to comply with the fundamental principles";
- While some IESBA members noted that it might not be necessary to explain what is meant by a threat because it might be self-evident by the word itself, others expressed the view that it could be interpreted differently and therefore additional guidance would be useful; and
- The IESBA asked the Task Force to consider whether the description of a threat might be better categorized as "relationships and other circumstances that could provide an incentive for a professional accountant not to comply with the fundamental principles and could otherwise compromise the professional accountant's compliance with the fundamental principles".

The IESBA asked the Task Force to consider the above input when developing the proposal further. The Task Force will meet before the CAG meeting and will provide an update on the progress it makes.

CAG members are asked to consider the direction of the Task Force and the differing views expressed on the description/definition of a threat.

Five Categories of Threats

The Task Force also considered the descriptions of the five categories of threats. The conceptual framework approach was first incorporated into the Code in November 2001 in relation to independence (Section 8 as it then was). The threats were, therefore, described in terms of threats to independence (see extract in Appendix paragraphs 8.29-8.33). The description in the current Code of the categories of threats is shorter and more general, crafted to address the more general application of threats to compliance with all

of the fundamental principles (see Appendix paragraph 100.10). The Task Force believes the clarity of the Code and the understandability of each of the threats would be improved by refining the description of each of the five categories of threats. The Task Force, therefore, developed the following proposal for the IESBA's consideration:

100.10 Threats are created by relationships or other circumstances that could compromise a professional accountant's ability to comply with the fundamental principles. Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

- (a) Self-interest threat - the threat that a professional accountant will act in his or her own best interest, or in the best interest of a member of his or her immediate or **close family**^{*}, because of a potential benefit from a financial interest in or other relationship with a client or employer ;
- (b) Self-review threat - the threat that a professional accountant will not appropriately evaluate the results of a previous service that he or she will rely upon in forming a judgment as part of providing a current service because he or she, or others within his or her firm or organization, performed the previous service;
- (c) Advocacy threat - the threat that a professional accountant who promotes a client's or employer's position may do so to the point that his or her objectivity is compromised;
- (d) Familiarity threat - the threat that a professional accountant will become too sympathetic to the interests of a client or employer or will not appropriately evaluate work performed by the client or employer because the work (i) involves issues that are familiar to the professional accountant or (ii) was performed by an individual familiar to the professional accountant; and
- (e) Intimidation threat - the threat that a professional accountant will subordinate his or her judgment to that of a client or employer because of their reputation or because of their attempts to exercise excessive influence over him or her.

Parts B and C of this Code explain how these threats may be created for professional accountants in public practice and professional accountants in business, respectively. Professional accountants in public practice may also find Part C relevant to their particular circumstances.

100.11 Safeguards are processes or procedures that eliminate or reduce threats to an acceptable level. They fall into two broad categories:

The IESBA considered the proposal of the Task Force regarding the definitions of the five categories of threats and the examples of circumstances that could create these threats

* See Definitions.

for professional accountants in public practice (¶200.4-8 Agenda Paper D.1) and the following comments/suggestions were made:

- Self-interest threat – there are other circumstances that could create a threat – for example fear of losing a client that should be captured in ¶200.4;
- Self-interest threat – the definition should try to capture the concept that the threat is to act in a manner that is not acceptable;
- Self-review threat – the definition should perhaps refer to “another” service as opposed to a “previous” service;
- Familiarity threat – the definition should perhaps refer to the length of the relationship;
- Familiarity threat – whether the definition should refer only to long association with people and not long association with an issue;
- Intimidation threat – whether the definition should include the concept of perception; and
- The Task Force should review all of the proposed definitions for symmetry between the definitions – for example reference to appropriateness.

The IESBA asked the Task Force to consider the above input when developing the proposal further. The Task Force will meet before the CAG meeting and will provide an update on the progress it makes.

CAG members are asked to consider the direction of the Task Force and the differing views expressed on the descriptions of the five categories of threat.

Material Presented

Agenda Paper D
Agenda Paper D.1

This Agenda Paper
Draft Revised Code

Action Requested

1. CAG members are asked to review the proposals and the questions outlined in the paper and provide direction to the Task Force.

Appendix
Extract from the November 2001 Code
Description of threats

8.29 “Self-Interest Threat” occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client. Examples of circumstances that may create this threat include, but are not limited to:

- A direct financial interest or material indirect financial interest in an assurance client;
- A loan or guarantee to or from an assurance client or any of its **directors or officers**;^{*}
- Undue dependence on total fees from an assurance client;
- Concern about the possibility of losing the engagement;
- Having a close business relationship with an assurance client;
- Potential employment with an assurance client; and
- Contingent fees relating to assurance engagements.

8.30 “Self-Review Threat” occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or (2) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement. Examples of circumstances that may create this threat include, but are not limited to:

- A member of the assurance team being, or having recently been, a director or officer of the assurance client;
- A member of the assurance team being, or having recently been, an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- Performing services for an assurance client that directly affect the subject matter of the assurance engagement; and
- Preparation of original data used to generate financial statements or preparation of other records that are the subject matter of the assurance engagement.

8.31 “Advocacy Threat” occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client’s position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgment to that of the client. Examples of circumstances that may create this threat include, but are not limited to:

- Dealing in, or being a promoter of, shares or other securities in an assurance client; and
- Acting as an advocate on behalf of an assurance client in litigation or in resolving disputes with third parties.

8.32 “Familiarity Threat” occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client’s interests. Examples of circumstances that may create this threat include, but are not limited to:

- A member of the assurance team having an **immediate family*** member or close family member who is a director or officer of the assurance client;
- A member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- A former partner of the firm being a director, officer of the assurance client or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- Long association of a senior member of the assurance team
- Acceptance of gifts or hospitality, unless the value is clearly insignificant, from the assurance client, its directors, officers or employees.

8.33 “Intimidation Threat” occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client. Examples of circumstances that may create this threat include, but are not limited to:

- Threat of replacement over a disagreement with the application of an accounting principle; and
- Pressure to reduce inappropriately the extent of work performed in order to reduce fees.

Extract from 2007 Code
Description of threats

100.10 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

- (f) Self-interest threats, which may occur as a result of the financial or other interests of a professional accountant or of an immediate or **close family*** member;
- (g) Self-review threats, which may occur when a previous judgment needs to be re-evaluated by the professional accountant responsible for that judgment;
- (h) Advocacy threats, which may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised;
- (i) Familiarity threats, which may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others; and
- (j) Intimidation threats, which may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived.

* See Definitions.