



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

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# Agenda Item 2

Board International Ethics Standards Board for Accountants

**Meeting Location:** Marriott Marble Arch, London, UK

**Meeting Date:** December 10-12, 2008

## Independence II

### Objectives of Agenda Item

1. To discuss comments received on issues re-exposed for comment.
2. To agree on changes to address comments received.

### Background

In May 2008, the IESBA issued a re-exposure draft requesting comment on only three specific areas:

- The proposed restriction on providing internal audit services to public interest audit clients;
- Whether there should be an exception for immaterial internal audit services; and
- The required frequency of the application of the pre- or post-issuance review safeguard and the requirement to determine whether a pre-issuance review is required when total fees significantly exceed 15%.

The explanatory memorandum stressed that the IESBA was seeking views on only these matters was not seeking repetition of comments previously made.

The exposure period was three months and ended on August 30, 2008. Comments were received from the following:

Member Bodies of IFAC	19
Firms	7
Regulators and Authorities	2
Other Professional Organizations	4
Standard Setters	1
Others	4
Total Responses	37

The comment letters have been posted on the IFAC website and may be downloaded at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0112>.

The Task Force met on October 21, 2008 to address the comments received on re-exposure. The CAG meets on November 24, 2008 and the content of this agenda paper will be discussed with the CAG members.

## Discussion

### *Internal Audit*

The exposure draft contained two questions related to internal audit services. These questions are presented below, together with an overview of comments received, followed by the Task Force's proposal to address both questions.

***ED Question 1*** *Views on whether the proposed restriction on providing internal audit services to public interest entities is appropriate.*

### *ED Responses*

The majority of respondents supported the proposal to prohibit firms from providing certain internal audit services to audit clients that are public interest entities.

	Member Bodies	Firms	Others
Support	KICPA, CICA, MIA, ICAS, ICPAS, SAICA, HKICPA, ICPAK	RSM, GTI, NASBA, RSMI,	AIA, APESB, NJCPA
Support but prohibition should be more tightly worded		E&Y, PWC	
Support but do not allow non-recurring			IAA, Basel, Mazars
Support and apply to non PIEs	ICANZ		
Support but not for small PIEs			CARB
Against – unless there is a materiality exception	WpK, JICPA	DTT	
Against – goes too far	ICJCE, NIVRA, ACCA, CNCC	KPMG	
Against – different approach suggested			APB
Encouraged IESBA to reconsider reasons for prohibiting services	AICPA		
Lack of clarity in what services are prohibited			IOSCO

Illustrative arguments in favour of the approach are:

- “when the external audit client is an entity of public interest, we believe that the self-review threat or management threat in cases where the audit firm is providing both external and internal audit services would be so high that no safeguards could be implemented to mitigate the threat” (Basel)
- “In principle, we agree with the IESBA’s view that it is appropriate to impose a more restrictive requirement for audit clients that are public interest entities. In this regard, we are supportive of the IESBA’s proposal that a firm should not provide internal audit services that relate to the internal accounting controls, financial systems or financial statements to public interest audit clients.”(KICPA)

One respondent (ICANZ) supported the approach but felt that the prohibition should be extended to non PIE audit clients as well. Another respondent felt that the prohibition should not apply to small PIE audit clients. These are both minority view points and are not recommended.

One respondent (PwC) supported the approach but noted that the prohibition and the description of internal audit services should be more tightly worded. The respondent noted that the provision of advice to clients on internal controls and financial systems is a core competency of many accounting firms and such advice is often expected by clients.

Three respondents did not agree with the approach unless there was an exception for immaterial services. This is discussed in more detail under the responses to question 2.

Five respondents (ICJCE, NIVRA, ACCA, CNCC and KPMG) were against the approach noting that it went too far. Comments included:

- The explanatory memo does not make the case for the need for the prohibition;
- ISA 610 specifies procedures that must be performed before reliance can be placed on the work of internal audit and this would address the threat;
- The position taken in the exposure draft (to permit internal audit services provided threats were reduced to an acceptable level) was appropriate and a logical flow from the application of the conceptual framework approach; and
- If it is necessary to strengthen the position, this could be done by requiring a professional accountant who was not involved in the internal audit work or the audit to review the internal audit work and the way it was relied on in the audit.

Four respondents (IAA, Basel, APB and Mazars) expressed that there should not be an exception for non-recurring internal audit services. The arguments for this were:

- There could be a substantial self-review threat if non-recurring material services were permitted; and
- There is no definition of non-recurring services – and even if there was a definition it could be difficult to apply and enforce.

It was also noted that this is only place where the Code permits an otherwise prohibited service solely because it is non-recurring in nature.

One respondent (APB) expressed the view that the approach was inappropriate. The respondent stated that there should be no exemption for non-recurring services but rather there should be an exception for immaterial internal audit services. In addition, the respondent felt that the prohibition on “internal audit services that relate to the internal accounting controls, financial systems or financial statements” was not appropriate. The respondent expressed the view that because there was no definition of these types of internal audit services it could lead to inconsistent application of the standard. The respondent also stated that it may omit other internal audit services that could impact audit judgments – for example, it could be argued that, internal audit work on compliance with laws and regulations would be outside of the prohibition. The respondent suggested two alternative ways to address the issue:

“In the case of an audit client that is a public interest entity, a firm should not provide internal audit services where internal audit work is likely to be relied upon in making audit judgments related to matters that are, separately or in aggregate, material to the financial statements.”

Or

“In the case of an audit client that is a public interest entity, a firm should not provide internal audit services that relate to the internal accounting controls, financial systems or financial statements where these services relate to matters that are likely to be relied upon in making audit judgments that are, separately or in aggregate, material to the financial statements.”

One respondent (IOSCO) noted that the description of internal audit services was unclear and, as a consequence, the prohibition for public interest entity audit clients was unclear.

***Question 2*** Views as to whether there should be an exception for immaterial internal audit services provided to a PIE audit client.

***ED Responses***

The majority (21) of respondents expressed the view that there should be an exception for immaterial internal audit services.

	Member Bodies	Firms	Others
Against exception	CICA, ICPAS, MIA, HKICPA, AIA, SAICA, ICAS		NJCPA, IIA, IOSCOA
In favour of exception	ACCA, NIVRA, WpK, IDW, FAR, KICPA, ICPAK, JICPA, CNCC	RSMI, Mazars, PwC, GTI, E&Y, KPMG, D&T	CARB, NASBA, SMP, Basel, APB
Other			Maresca

Illustrative comments from those who stated that there should be no exception included:

- The definition of what would comprise an immaterial internal audit service is problematic and may lead to different interpretation (NJCPA);
- The term “immaterial” could be unclear; for example, does it mean that the results of internal audit service do not materially affect the audit opinion, or that the fees from internal audit service is immaterial with respect to the fees received from the financial statement audit (IIA); and
- We do not support the use of exceptions to the Code’s general principles and stated prohibitions as we believe that stating exceptions in the Code increases the likelihood that the principle underlying the reason for the prohibition will be undermined and compromised (IOSCO).

Illustrative comments from those who stated there should be an exception included:

- An exception based on materiality is consistent with the conceptual framework approach and consistent with the approach taken with other non-audit services such as bookkeeping, IT systems services and valuation services (D&T, CARB, NIVRA, IDW, FAR, PwC, KICPA, E&Y, CNCC);
- While agreeing with an exception for immaterial internal audit services the provision of such services would be expected to be unusual (NASBA); and
- Without such an exception the costs would exceed the benefits.

#### *Task Force Proposal*

The Task Force considered the comments received and concluded that while the majority of respondents expressed support for a prohibition on providing certain internal audit services to public interest audit clients, there were differing views on the nature of the services that should be prohibited.

- Description of internal audit services - Some noted that it was it clear what was meant by “internal audit services that relate to the internal accounting controls, financial systems or financial statements” (¶290.200).
- Many expressed the view that “immaterial” internal audit services should not be prohibited, noting that elsewhere the Code distinguishes between material and immaterial services (for example bookkeeping, valuation services and IT systems

services). Allowing such services is also consistent with the threats and safeguards approach – if the threat created is a self-review threat, providing immaterial services will not create an unacceptable threat.

- Non-recurring internal audit services – several noted that this is the only place in the Code where an otherwise prohibited service would be permitted merely because it is not recurring.

The Task Force considered these comments and proposes to address the points raised by replacing paragraphs 290.200 and 201 with the following:

In the case of an audit client that is a public interest entity, a firm should not provide internal audit services that relate to:

- (a) Significant internal controls over financial reporting;
- (b) Financial systems that generate information that is significant to the client's accounting records or to the financial statements on which the firm will express an opinion; or
- (c) Amounts or disclosures that are, separately or in the aggregate, material to the financial statements on which the firm will express an opinion.

The Task Force is of the view that the proposed change clarifies the prohibition and notes that parts (a) and (b) are aligned with the IT systems services prohibition. In addition, because the prohibition is linked to significance or materiality there is no need for a separate exemption for immaterial internal audit services.

#### **IESBA Question**

IESBA members are asked to consider the comments received on internal audit services and determine whether they believe the Task Force's proposal is appropriate.

**Question 3** *Views on appropriateness of the required frequency of the application of the safeguard and the requirement to determine whether a pre-issuance review is required when fees significantly exceed 15%.*

#### **ED Responses**

The majority of the respondents were supportive of the frequency of application, with several stating that a pre-issuance review should be required in certain situations, with others stating that a post-issuance review was sufficient.

	Member Bodies	Firms	Others
Support frequency of application	AICPA, SAICA, MIA, NIVRA, ICAS, AIA, ICANZ, KICPA	PwC, RSML, GTI, Mazars; E&Y, DTT	CARB, NJCPA, APESB, Basel

Against frequency of application	CICA, WpK(2), CNCC, JICPA		
Safeguard necessary in 1st year fees expected to exceed 15%			NASBA
Safeguards only necessary if fees exceed 15% for five years	ICPAK		
Should strongly encourage –pre-issuance if fees exceed 15%		RSMI	
Should require pre-issuance if fees exceed 15%		E&Y	
Should encourage a post-issuance review	ICPAK		
Disagree necessary consider pre-issuance review if fees significantly exceed 15%	JICPA		
Support requirement to consider pre-issuance if fees significantly exceed 15%	AICPA, WpK, KICPA		CARB
If fees significantly exceed 15% should require pre-issuance review	NIVRA, ICAS(2), AIA(?)	GTI, Mazars	NJCPA, Maresca
If fees significantly exceed 15% consider whether it is necessary to withdraw from engagement	ICANZ		
If fees significantly exceed 15% withdraw from engagement	MIA, ICAS(1)		
Disagree with any fixed percentage	HKICPA, ICPAS, WpK(1), CNCC(1)		
Establish threshold of economic dependence - require resignation if exceeded			APB(1)

Illustrative comments from those who did not support the frequency of application of the safeguard included:

- There will be difficulty in some jurisdictions in finding an accountant from outside of the firm to perform the review – which would, in effect, create a prohibition. (JICPA);
- It is unclear to us how the professional accountant will be in a position to know either the total fees of the firm or the fees for the particular audit client for the second year in time to know whether to apply the safeguard described in the second bullet of proposed paragraph 290.215. We do not believe that a bright line test should be based on an estimate of fees that may turn out to be very inaccurate (CICA); and
- We recommend that the safeguard be implemented not less than once every three years as a minimum. In other words, even if the total fees exceed 15% every year, the auditor should decide whether the review is necessary every year by taking into consideration surrounding factors, including the degree of threat of

impairment to auditors' independence and other regulatory frameworks with which auditors should comply (JICPA).

In addition, some (CARB; HKICPA, RSMI, CICA, APESB, E&Y); commented that the Code should provide guidance on what is meant by “significantly” exceed 15%.

#### *Task Force Proposal*

The Task Force considered the comments received, noting that while the majority of respondents supported the frequency of application, some felt the safeguard should be strengthened (by requiring a pre-issuance review) and others felt a post-issuance review was appropriate. The Task Force concluded that the position in the re-exposure draft struck the appropriate balance.

In considering whether a pre-issuance review should be required if the fees significantly exceed 15%, the Task Force was of the view that if the Code were to contain such a requirement it would be necessary to establish an additional bright-line percentage (i.e. a fixed percentage above the 15% threshold). The Task Force did not think this was appropriate and was of the view that the position in the re-ED was appropriate – the additional consideration should be a matter of professional judgment.

The Task Force is, therefore, proposing only editorial changes to the section addressing fees.

#### **IESBA Question**

IESBA members are asked to consider the comments received on internal audit services and determine whether they believe the Task Force's proposal is appropriate.

#### **Material Presented**

Agenda Paper 2	This Agenda Paper
Agenda Paper 2-A	Detailed cut and paste of comments
Agenda Paper 2-B	Re-exposure Draft
Agenda Paper 2-C	Revised text (mark-up)

#### **Action Requested**

1. IESBA members are asked to consider the questions contained in this agenda paper.

## Appendix

The content of the comment letters received is included in the detailed cut and paste of comments which is included in Agenda Paper 2-A.

### Respondents Legend

ACCA	Association of Chartered Certified Accountants
AIA	Association of International Accountants
AICPA	American Institute of Certified Public Accountants
APB	Auditing Practices Board (UK)
APESB	Accounting Professional and Ethical Standards Board – Australia
Basel	Basel Committee on Banking Supervision
CARB	Chartered Accountants Regulatory Board – Ireland
CICA	Canadian Institute of Chartered Accountants
CICPA	Chinese Institute of Certified Public Accountants
CNCC	Compagnie Nationale des Commissaires aux Comptes
DTT	Deloitte Touche Tohmatsu
E&Y	Ernst & Young
FAR	The Institute for the Accountancy Profession in Sweden
GTI	Grant Thornton International
HKICPA	Hong Kong Institute of Chartered Accountants
ICANZ	Institute of Chartered Accountants of New Zealand
ICAS	Institute of Chartered Accountants of Scotland
ICJCE	Instituto de Censores Jurados de Cuentas de España
ICPAK	Institute of Certified Public Accountants of Kenya
ICPAS	Institute of Public Accountants in Singapore
IDW	Institut der Wirtschaftsprüfer (Germany)
IIA	Institute of Internal Auditors
IOSCO	International Organization of Securities Commissions
JICPA	Japanese Institute of Certified Public Accountants
KICPA	Korean Institute of Certified Public Accountants
KPMG	KPMG
Maresca	Joseph Maresca
Mazars	Mazars and Guérard
MIA	Malaysian Institute of Accountants
NASBA	National Association of State Boards of Accountancy
NIVRA	Nederlands Instituut Van Registeraccountants (Netherlands)
NJCPA	New Jersey Society of Public Accountants
PwC	PricewaterhouseCoopers
RSM	RSM International
SAICA	South African Institute of Chartered Accountants
SMP	IFAC Small and Medium Practices Committee
Wpk	Wirtschaftsprüferkammer