

## **INADVERTENT VIOLATION OF THE CODE**

### **DRAFT IESBA PROJECT PROPOSAL**

#### **I. Subject**

1. This project will reconsider the paragraphs in the Code that address an inadvertent violation of the Code.

#### **II. Background**

2. The Code contains several paragraphs addressing an inadvertent violation of a provision in the Code. The overall provision, contained in paragraph 100.10, states that a professional accountant may inadvertently violate a provision of the Code. It indicates that, depending upon the nature and significance of the matter, such an inadvertent violation may be deemed not to compromise compliance with the fundamental principles provided, once the violation is discovered, the violation is corrected promptly and any necessary safeguards are applied.
3. Sections 290 and 291 contain a general paragraph stating that if an inadvertent violation occurs, it generally will be deemed not to compromise independence provided the firm has appropriate quality control policies and procedures in place, equivalent to those required by International Standards on Quality Control to maintain independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied to eliminate any threat or reduce it to an acceptable level. The paragraphs also require the firm to determine whether the matter should be discussed with those charged with governance. Separate paragraphs address inadvertent violations of the Code's provisions related to financial interests, family relationships, and non-assurance services.
4. The Code's inadvertent violations provisions were commented on by the International Organization of Securities Commissions ("IOSCO") in its response to the IESBA's Drafting Conventions Exposure Draft, issued in July 2008. The IESBA recognized the concern expressed by IOSCO but concluded that the issues raised were beyond the scope of that ED and would need to be considered separately.
5. The IESBA has assessed the provisions in the Code that address an inadvertent violation and concluded that a project should be undertaken to reconsider those provisions, including determining whether the provisions are needed and, if so, how the guidance can be enhanced with regard to scope and application.

#### **III. Project Objective and How It Serves the Public Interest**

##### **A. Project Objective**

6. The objective of the project is to reconsider the provisions in the Code that address an inadvertent violation of the Code.

##### **B. How the Project Objective Serves the Public Interest**

7. Reconsidering the inadvertent violation provisions in the Code serves the public interest because it will give the Board the opportunity to assess whether the provisions encourage

less compliance rigor by professional accountants and consider how the provisions can provide the public with increased comfort that professional accountants have a clear understanding of the implications of an inadvertent violation of the Code, which can promote more consistent behavior that is appropriate and expected under the Code. It also gives the Board an opportunity to determine whether and how the provisions operate in the public interest.

## **IV. Outline of the Project**

### **A. Project Scope**

8. The scope of this project is to reconsider the provisions in the Code addressing an inadvertent violation of the Code. The Board will consider whether the Code should contain such provisions and, if so, how the provisions can best serve to protect the public interest. If the Board concludes the Code should contain such provisions it will assess whether they should apply with respect to all of the Code or should be restricted to certain parts of the Code.

### **B. Major Problems and Key Issues that Will Be Addressed**

9. The Board will consider the following matters:
  - *Need for Provisions Addressing an Inadvertent Violation* – At an early stage in the project, the Board will define the purpose of an inadvertent violation provision and determine whether the Code should address an inadvertent violation or whether it should be left to the discretion of those who enforce the Code in a particular jurisdiction. The ethical and independence requirements in some jurisdictions contain explicit provisions addressing an inadvertent violation. Other jurisdictions do not include such provisions.

The matters that follow will be considered by the Board if it concludes that the Code should explicitly address an inadvertent violation of the Code.

- *Scope of Coverage* – The Board will consider whether the provisions should apply to all of the Code or only to the independence provisions of the Code. In addressing this matter, the Board will consider the objective of providing explicit guidance on an inadvertent provision of the Code. The Code states that a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. The Board will consider how the public interest is protected by the inadvertent violation provisions. The Board will consider specific requirements in the Code to determine whether the inadvertent violation provisions should apply to all of the provisions in the Code, only the independence provisions, or only some of the independence provisions. The Board may develop illustrations of situations that give rise to an inadvertent violation to support its proposal.
- *“Inadvertent”* – The Board will consider whether “inadvertent” is the appropriate descriptor and, if so, whether guidance should be given on the meaning of inadvertent. The consideration will include the following matters (i) whether an awareness of the requirements of the Code is a factor that should be taken into account in determining whether the violation is inadvertent and whether any other factors should be taken in

account in making that determination and (ii) whether there is a difference if the action creating the violation is taken by the professional accountant or taken by a person other than the professional accountant (for example, in the case of a purchase of shares by an accountant's broker).

- *Consequences of a violation* – The Board will consider whether there are some violations that are of such magnitude that, even if the action creating the violation was inadvertent, compliance with the fundamental principles would still be compromised. In considering this matter, the Board will take into account the harm to the public as a consequence of the violation. For example, if the consequence of an audit team member owning a share of stock in the audit client is that the audit firm has to resign from the audit, the company would need to find another audit firm; depending upon the size of the company and the time of year, this could result in a failure to meet regulatory reporting requirements. Whether that result is appropriate for any inadvertent violation will be considered.
- *Quality Control Policies and Procedures in Place* – The inadvertent violation provisions in the Code addressing independence require the firm to have appropriate quality control policies and procedures in place equivalent to this required by International Standards on Quality Control. The Board will consider whether this requirement continues to be appropriate or whether additional guidance is required. The Board will consider whether the expectations would be the same for a small firm as for a large firm. The Board will also consider whether there are some violations that are so significant it would indicate that the firm did not have appropriate quality control policies and procedures in place.
- *Safeguards* – The Code requires any necessary safeguards to be applied when a professional accountant deals with an inadvertent violation. The Board will consider whether any additional guidance should be given, including, the types of safeguards that might be appropriate.
- *Discussion with Those Charged with Governance* - The Code requires the firm to determine whether to discuss an inadvertent violation of a provision related to independence with those charged with governance. The Board will consider whether a discussion should be required. If the Board concludes there should be a discussion, it will consider the timing of the discussion and whether all violations should be reported, regardless of magnitude.
- *Documentation* – The Board will consider the role that documentation should play in addressing an inadvertent violation and whether guidance should be given regarding the matters that should be documented.
- *Implications of an inadvertent violation* – The Code indicates that, provided the necessary actions are taken, an inadvertent violation may “be deemed not to compromise compliance with the fundamental principles” (paragraph 100.10) and “generally will be deemed not to compromise independence.” The Board will consider whether this is appropriate or whether, for example, the Code should indicate that, provided the criteria are met, no enforcement action need be taken or that the violation would not impact the firm’s ability to issue the audit opinion.

## **V. Implications for Any Specific Persons or Groups**

10. The project has particular implications for the following:
- (a) Professional accountants in public practice;
  - (b) Professional accountants in business;
  - (c) Regulatory bodies;
  - (d) National standard setters.

## **VI. Development Process, Public Consultation, Project Timetable and Project Output**

11. The project will follow due process for the development of a pronouncement. The project may include consultations with regulators and members bodies to determine how they deal with inadvertent violations. This consultation will include both jurisdictions that have explicit provisions to address this matter and jurisdictions where there is no such explicit provision.
12. Specific consideration will be given to the need to hold focus groups or roundtables to ensure relevant feedback is obtained as necessary.

### **A. Project Timetable**

<b>Project Stage</b>	<b>Timing</b>
Approval of project proposal by IESBA	Q4 2010
Discussion of issues and exposure draft first read	Q1 2011
Exposure draft approval	Q2 2011
Review exposure draft comments and first read of final standard	Q4 2011
Final standard approval	Q1 2012

### **B. Project Outputs**

13. Revisions to the inadvertent provisions in the Code.

## **VII. Impact Analysis**

14. The Board will assess the cost associated with having inadvertent violation provisions in terms of the added time and expense it may require of the professional accountant and those charged with governance to address the implications of violations. The Board also will assess the primary benefits of such provisions, which it believes includes providing clarity on the implications of an inadvertent violation of a provision in the Code and assessing the degree to which such provisions can provide the public with greater comfort that the professional accountant has a clear framework with which to address such matters.

### **VIII. Resources Required**

15. A project task force consisting initially of 4 individuals, including a member of the IESBA as chair.
16. IESBA technical staff will provide staff support to the task force.

### **IX. Relevant Sources of Information that Address the Matter Being Proposed**

17. Relevant sources of information include the following:
  - Auditing Practices Board Ethical Standard 1; and
  - US Securities and Exchange Commission Rule 2-01(d).