

Meeting: IESBA CAG

Meeting Location: New York

Meeting Date: September 14, 2015

Agenda Item

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Emerging Issues—Report-Back and Issues

Objectives of Agenda Item

1. To note the report-back on the September 2014 CAG discussion.
2. To consider recent developments internationally that may merit IESBA attention.
3. To reflect on whether there are other developments internationally that should be considered by the IESBA.

Activities Since Last CAG Discussion

4. Since the September 2014 CAG meeting, the Emerging Issues and Outreach Committee (EIOC) has met four times via teleconference and three times in person to consider external developments and to discuss matters to bring to the Board's and CAG's attention.

Report-Back on September 2014 CAG Discussion

5. Below are extracts from the minutes of the September 2014 CAG meeting,¹ and an indication of how the EIOC or IESBA has responded to CAG Representatives' comments.

Matters Raised	EIOC/IESBA Response
EXTERNAL DEVELOPMENTS	
<p>Ms. Sucher highlighted a recent case in the U.S. where a large firm was engaged to provide a regulatory consulting service to a banking client relating to controls over transactions with sanctioned countries. The firm was found by the financial regulator to have shown a lack of independence and integrity by "sanitizing" its report to make it less damaging as a result of pressure from the client. Based on this finding, the firm was sanctioned by the regulator. She was of the view that cases such as this bring the profession into</p>	<p>Mr. Kwok responded that the case is one of certain individuals in the firm allegedly acting improperly. He highlighted acting with integrity as one of the fundamental principles in the Code and that this places an obligation on the professional accountant (PA) to act honestly. He also highlighted that one of the Board's current projects is addressing the issue of pressure on PAs to act unethically and that the Board would be considering a proposed exposure draft in this regard at its October 2014 meeting.</p>

¹ The minutes were approved at the November 2014 IESBA CAG teleconference.

Matters Raised	EIOC/IESBA Response
disrepute. She wondered whether this would have been addressed by the Code and whether there were any lessons to be drawn.	
GLOBAL ADOPTION OF THE CODE	
<p>Mr. Fukushima expressed a view that there was a need to have a clear definition of the terms “adoption” and “convergence” as these relate to the Code. He noted that the term “adoption” when referring to IFRSs can be more readily understood but less so when referring to the Code, in respect of which he felt it has a broader meaning. Mr. Fukushima wondered whether it would be appropriate to classify Japan in the Adopted category as he believed that the Japanese Institute of Certified Public Accountants (JICPA) translates and incorporates the Code into its code of ethics in a way that is other than complete adoption.</p>	<p>Mr. Kwok agreed that it would be beneficial to have clear definitions of the various categories of adoption, and outlined a possible approach to these.</p> <p>Point accepted. IESBA staff will endeavor to clarify the definition of adoption with respect to the Code. Resources permitting, staff will present refinements to the adoption data in due course.</p>
<p>Mr. Ahmed was of the view that the relevant issue is consistency across countries and that the Board should define adoption to mean the same thing everywhere. However, he acknowledged that this may not be achievable given the diversity of approaches to adoption and the wide variation in legal and regulatory frameworks around the world. Nevertheless, he encouraged the Board as part of its long-term goal to champion global adoption of the Code and to assist jurisdictions in overcoming the challenges to adoption. He also observed that the Asia/Oceania region comprises a good mix of common law and civil code jurisdictions. He wondered if the IESBA assisted the latter in adopting the Code.</p> <p>Ms. Diplock drew an analogy to cross border adoption of securities market principles, which entailed a complex process of methodology and measurement of adoption around the world. She noted that this would be a huge exercise if it were to be done in a credible way. Apart from the definitional issue, she noted that there would be a practical question of support and measurement to</p>	<p>In response to the various comments, Mr. Kwok outlined the background to why the Board was undertaking this exercise, noting the direct link to the strategic themes in the Strategy and Work Plan, 2014-2018 (SWP).</p> <p>On the issue of granularity, he noted that it would be impossible to document the nature and extent of differences with the Code for all jurisdictions. However, the Board would plan to focus on the G20 and the major financial centers around the world, starting with presentations of the status of adoption in Canada and the U.S. at the October 2014 Board meeting.</p> <p>With respect to Mr. Ahmed’s point about consistency, he noted that it would not be possible to have the Code implemented in the same way in all jurisdictions because of unique national circumstances. He highlighted that the Code deals with more than just independence matters and the provision of services. He hoped that jurisdictions would find the Code relevant and useful as a basis for developing their own ethical standards. In this regard, he noted that</p>

Matters Raised	EIOC/IESBA Response
<p>establish whether the standards have indeed been adopted. She felt that this would be a complex process that would need clear conceptual outlines.</p> <p>Ms. Blomme agreed with the above comments. She reflected on the experience in the EU when the ISAs were being considered for adoption. She noted the detailed reviews that were carried out then at the European Commission's request to understand which member states had adopted the ISAs. She noted that this required a detailed understanding of the pluses and minuses at the member state level. She was of the view that beyond the broad adoption label, the picture may not be as rosy. She felt that carrying out a similar review for the Code would be time consuming and not straightforward.</p> <p>Ms. Blomme also noted that circumstances have now changed with the finalization of the new audit regulation in the EU. She felt that this would lead to increasing divergence between the approach for audits of PIEs and that for audits of non-PIEs. She was of the view that there was little hope that the Code would be adopted in the EU for the former. For the latter, however, she felt that the Code with its threats and safeguards approach was perfectly valid and adoptable. Given that there may be some hesitation now with the new audit regulation, she suggested that the Board identify appropriate targets for outreach in the EU where it believes it would have the greatest likelihood of success. She added that while member states will be busy in the next two years implementing the new regulation, there would be an opportunity for the Board to provide helpful guidance to them based on the Code as the regulation does not explain how a number of its provisions should be implemented.</p> <p>Mr. James noted that different versions of the Code may have been adopted by different jurisdictions. This would add another dimension to consider in terms of the version of the Code intended when auditors refer to the IESBA Code in their reports.</p>	<p>there has been initial contact with INTOSAI about its considering using the IESBA Code as a basis for revising its own code of ethics. In addition, he noted that the largest 25 networks of firms around the world have committed to having their policies and methodologies conform to the Code for transnational audits.</p>

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<p>Ms. Lang shared Ms. Blomme's and Mr. James's views, adding that the data referred to the adoption of the 2009 Code even though changes had been made to the Code since then. She wondered if the adopting jurisdictions have processes in place to adopt subsequent revisions to the Code. She also noted that while the perfect end would be to have all jurisdictions fully adopting the Code, it might perhaps be better to aim to help those at the bottom rise up to a given level first, which would have the bigger impact for the public interest globally. Overall, however, she felt it was a positive surprise to see the extent of global adoption of the Code.</p>	
<p>Mr. Ahmed acknowledged that while there would be difficulties in achieving a consistent application of the Code globally, operational consistency at some level should be a goal. He was of the view that the fact that something is difficult to achieve should not affect its desirability or relevance. He felt that in the long term this would fundamentally enhance the value of the Code. Accordingly, he suggested that this be made an operational part of the SWP.</p>	<p>Mr. Kwok emphasized the need to be realistic as it would be impossible to have the strictest provisions in some jurisdictions (e.g. the inclusion of non-financially dependent grandparents in the definition of immediate family members) apply equally everywhere else. He noted that it would be acceptable to have no less stringent differences as compared to the Code at the national level provided there are good reasons for them.</p>
<p>Mr. Dalkin noted from his experience working with supreme audit institutions around the world that the process of adopting universal auditing standards was relatively easy in comparison to adopting ethical standards. He suggested that one approach could be to develop a ratchet system for adoption of ethical standards whereby jurisdictions could move up one level at a time as they progressed towards full adoption over time. He felt that this would be a long journey. Nevertheless, he was pleased to see from the data that jurisdictions have been making good progress towards adoption.</p>	<p>Suggestion noted. Such a system may, however, not be capable of being readily implemented for a variety of reasons. These include the fact that IESBA does not have the power to compel jurisdictions to adopt the Code. In addition, responsibility for the promulgation of ethical standards in a particular jurisdiction may not rest with only one body.</p>
<p>Mr. Hansen noted that in the U.S., the code of ethics (excluding independence requirements for audits of listed entities) is for the most part the IESBA Code, with a few differences.</p>	<p>Point noted.</p>

Matters Raised	EIOC/IESBA Response
<p>Mr. Koltvedgaard noted that there are two ways to adoption, i.e., a legal process or pressure from the investor community such as through calling for a reference to the IESBA Code in the auditor's report. He felt that the latter approach could send a strong signal and wondered whether it could be a way forward. Ms. de Beer expressed skepticism that investors could drive the adoption of the Code as they did not have the force of law behind them.</p>	<p>Mr. Kwok agreed with Ms. de Beer, noting as an example that in Singapore there is a proposal to adopt the latest IESBA Code as a regulation.</p>
<p>Mr. Waldron expressed a view that the Board should aim for the Code to be the highest standard. Ms. de Beer noted that she understood that local circumstances could justify additions to the Code. However, if the trend is that jurisdictions are adding significantly to the Code, the Board should seek to understand what these are. The risk otherwise would be for the Code to become the lowest common denominator. Ms. Lopez agreed with Ms. de Beer, adding that the Code should be the standard to which jurisdictions should aspire. Ms. Lopez felt that it would be important to analyze what is missing in the Code so that it will be clear how the bar can be raised.</p>	<p>Mr. Kwok explained that the Code is an instrument for global application that needed to be operable across a large number of jurisdictions. He emphasized that while the Code is still the gold standard to which many jurisdictions are aspiring, some jurisdictions might have certain unique situations that they might want to address beyond the Code, and that this would be acceptable.</p>
<p>Mr. Waldron disagreed, noting his view that the Board should aim for the Code to be the highest standard.</p> <p>Mr. Dalkin noted differences can be expected. As an analogy, the U.S. had always had ISA+, where there are requirements additional to those in the ISAs to cater to needs in the US. Mr. Hansen indicated that this has also been the case for ethics standards. Mr. Ahmed noted that as jurisdictions in South East Asia were adopting IOSCO's harmonized standards for cross-border issuers, they were allowed national add-ons, so the resulting standards became IOSCO+. The intention, however, was that over time jurisdictions would move to fully harmonized standards.</p>	<p>Points noted. While the board aims for the highest quality standards, global operability must be an important consideration. For example, it would not be appropriate to call for the Code to impose 3-year mandatory audit firm rotation for listed audits (as is currently required in Argentina) without considering whether this would be capable of being operationalized in Europe, North America and everywhere else in the world.</p>

Matters Raised	EIOC/IESBA Response
<p>Mr. James noted that, as expressed in previous IOSCO comment letters, there is a perception that the Code is a lowest common denominator and not the highest standard. He expressed a view that a mindset change was needed as the explanation he often hears is that the Code is a global Code to help jurisdictions adopt. Without such a change, he felt that the Board would run the risk of continuing to be perceived as setting lowest common denominator standards as opposed to raising the bar for those at the bottom. Ms. Lang and Mr. Fukushima agreed with Mr. James.</p> <p>Ms. Sucher noted that the BCBS view would be to go for the highest standards. However, she acknowledged that the issue is not so simple, especially when considering the wide diversity around the world in the area of independence. However, she agreed that there is a perception issue. She felt that if the goal was to have the maximum number of jurisdictions adopting the Code, there would be a risk that the advanced jurisdictions will disregard the Code if the Board does not go for the highest standards. Mr. Thompson agreed with Ms. Sucher's concern relating to the perception issue, but noted that there will always be countries that will wish to go beyond the highest common denominator. As an example, he noted that France has more stringent independence standards than the UK.</p> <p>Mr. Hansen was of the view that it is one thing to have the highest standards, but another to have compliance with them. Mr. Dalkin noted from his experience working on the ethics standards for INTOSAI that if those standards are set too high, they are simply ignored. Accordingly, he felt that there was a balance to be struck to achieve acceptance.</p> <p>Mr. Bluhm noted that he had never viewed the Code as being a lowest common denominator, just as he had never considered the ISAs as being the lowest common denominator. He did not believe</p>	<p>Mr. Kwok reiterated his views – and views the late chair of the Board, Mr. Holmquist, had stated at a previous CAG meeting – that the Code is not a lowest common denominator but it is a high quality Code. He highlighted that many jurisdictions around the world are still struggling, in practice, to reach the standards in the Code.</p>

Matters Raised	EIOC/IESBA Response
that the concept of high quality standards equated to lowest common denominator.	
RECENT REGULATORY INSPECTION REPORTS	
<p>Mr. Harris highlighted the key trends in the profession that the Investor Advisory Group he chairs at the International Forum of Independent Audit Regulators (IFIAR) was currently monitoring. These include:</p> <ul style="list-style-type: none"> • An increase in the level of advisory/consulting services provided by the firms and the implications for audit quality. • The implications of the increasing commoditization of the audit. • The relevance and value of the audit, and auditors' ability to detect fraud. • The trend in big data and whether that has a positive impact on audit quality and investor protection. • Competition in the audit market and firm governance. <p>He acknowledged that the key issue is how to ensure independence is safeguarded and conflicts of interest adequately addressed. With respect to the banking sector, he noted that the key issue is how to ensure that Chinese walls are not breached.</p>	<p>Points noted. The EIOC is monitoring these developments.</p>
<p>Ms. de Beer wondered whether there was any interaction between IFIAR and the Board.</p>	<p>Mr. Kwok responded in the affirmative, noting that he and Mr. Siong would be attending the October 2014 IFIAR meeting. He noted that the Board was endeavoring to strengthen its working relationship with IFIAR.</p>
<p>Mr. Harris extended an open invitation for the Board to visit the U.S. PCAOB also, noting that he would bring the Board's interest in further liaison to the attention of the new chairs of the investor advisory groups at both IFIAR and PCAOB.</p>	<p>Mr. Kwok noted that the Board will discuss a more proactive outreach strategy at its October 2014 meeting.</p>

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Mr. Gunn highlighted that IFIAR had now established a protocol to provide formal comments to the IAASB on its exposure drafts and consultation papers. Mr. Harris acknowledged that this engagement had already started.	Points noted.

Recent International Developments

A. THE RISE OF ADVISORY SERVICES IN AUDIT FIRMS

6. In a speech at the Practising Law Institute 12th Annual Directors' Institute on Corporate Governance in New York in November 2014, U.S. PCAOB member Steven Harris elaborated on some of the investor concerns he conveyed at the September 2014 CAG meeting. These concerns relate to the largest accounting firms' expansion into increasing lines of business activity (including a variety of consulting and advisory services), and consequential investor concerns about the future direction of audit quality.
7. Mr. Harris's speech can be accessed [here](#). For convenience, it is also included in Agenda Item F-1. He chairs the PCAOB Investor Advisory Group and also the IFIAR Investor and Other Stakeholders Working Group.

B. INITIAL FINDINGS REGARDING THE EFFECTS OF MANDATORY AUDIT FIRM ROTATION IN EUROPE

8. In December 2014, an [Accounting Today article](#) reported that the PCAOB had been finding that the push toward mandatory audit firm retendering and rotation was leading to lower audit fees in Europe, triggering audit quality concerns.
9. In a speech at a Financial Executives International's Current Financial Reporting Issues Conference in New York in November 2014, PCAOB member and IFIAR Chairman Lewis Ferguson noted that the PCAOB and other audit firm regulators abroad had been noticing some disturbing trends in Europe since the European Parliament approved mandatory audit firm rotation in April 2014. In particular, one of the findings was that audit fees seemed to drop between 20 and 40 percent in cases of rotation in the majority of European countries, with the exception being the UK.
10. Mr. Ferguson also noted that the new rules seemed to be creating serious labor problems for auditors. As an example, he noted that in the European oil industry, there are four big oil companies, but only one in each country. When a firm rotates off the audit of an oil company, it will have excess staff that would need to be redeployed. However, given poor European labor mobility this often does not happen. Firms may not be licensed in other countries, so even if they obtained a petroleum audit in another country, they might not be able to move the staff.
11. He also noted that the European mandatory firm rotation program was primarily aimed at increasing competition and not for audit quality reasons. He indicated, however, that in practice rotation appeared to be increasing concentration, rather than decreasing it, as clients move to an audit firm that already has the number one or number two market share. He noted that this seemed to be doing exactly the opposite of what the measure was intended to do as a pro-competitive mechanism.

12. The PCAOB had been considering the idea of requiring mandatory audit firm rotation in the US and issued a concept release in 2011 suggesting the proposal. However, after members of the House of Representatives overwhelmingly voted in favor of a bill that would prohibit the PCAOB from requiring listed entities to change their audit firms, the PCAOB shelved the idea.

C. CURRENT TRENDS IN THE AUDIT INDUSTRY

13. In April 2015, members of IFIAR met in Chinese Taipei to consider issues relating to audit quality. IFIAR members considered how changes in the economic environment and in the market for audit services have affected the audit industry. The intention of the meeting was to assist stakeholders in better understanding the potential implications of the matters under consideration (such as mandatory tendering and rotation requirements, which some regulators hope will strengthen auditor independence) on audit quality and investor protection.
14. A background paper to the meeting setting out the issues and related considerations is included in Agenda Item F-3.

D. TOSHIBA ACCOUNTING SCANDAL

15. The Toshiba Corporation has been embroiled in an accounting scandal since May 2015. The company's chief executive, two previous CEOs (who retained company posts) and several other senior staff have resigned as a result of the scandal. The resignations come after an independent investigation showed that top executives set unrealistic profit targets that systematically led to flawed accounting. The scandal brings into the foreground the issue of pressure on professional accountants in business (PAIBs) to breach the fundamental principles in the Code. It also raises questions about the effectiveness of the corporate governance code recently adopted in Japan.
16. The investigation report can be accessed [here](#). For convenience, a summary of the main elements of the case is included in Agenda Item F-2.

E. RECENT AUDIT INSPECTION REPORTS

I. *Canadian Public Accountability Board (CPAB) Big Four Public Report 2014*

17. In early 2015, CPAB released its first [annual inspections report](#) focused on Canada's Big Four audit firms. It noted that historically, the nature of findings in Big Four firms is consistent with its findings in all other firms.
18. The Big Four report noted that 2014 inspection results had improved over 2013 across the Big Four firms. Firms with significant audit deficiencies had declined overall by more than two-thirds since 2011.
19. While no new audit quality themes emerged in 2014, the report noted that challenges persist in a number of areas. Challenges noted that are of most relevance to ethics and independence include:
 - Applying professional judgment and professional skepticism
 - Areas requiring the most professional judgment and the most experienced auditors featured prominently in the 2014 inspection findings. CPAB's inspections also continued to identify a need for firms to enhance the professional skepticism of their staff, ensuring their people appreciate its importance and embedding appropriate processes and behaviors into their methodologies and cultures.

- Findings indicated that in many cases, up to 80 per cent of the audit work is conducted by staff with fewer than five years' audit experience. It noted that this lack of experience needs to be complemented with appropriate involvement of engagement leadership to ensure the delivery of a quality audit.
20. For information, the report also noted a number of challenges relating to areas more specific to the auditing process, including:
- Auditing complex accounting estimates
 - Estimates relating to impairment, and going concern evaluations in particular, often involve cash flow forecasts and frequently involve specialists. CPAB noted that auditors need a strong experience base from which to consider the appropriateness of the forecasts being made. This can be challenging since such forecasts are based on both past experience and future expectations. Similarly, CPAB noted that firms can face challenges in evaluating the work of external experts and in integrating their own internal experts into the audit process.
 - Auditing in foreign jurisdictions
 - CPAB noted that it had seen the Big Four firms increase their focus in this area, including defining procedures for this kind of audit work, resulting in improved execution and better quality audits. It also noted that it continues to face limitations when it comes to accessing and evaluating component auditor work in certain jurisdictions, and that it is actively engaging with the relevant regulators to achieve appropriate access.
 - Understanding and evaluating internal controls
 - CPAB's inspections identified many cases where internal controls work had not been well done, which could bring into question both how internal controls are tested and the effectiveness of the audit. It noted that considerable experience is necessary to effectively execute an internal controls-based audit.
21. The report also noted that the most effective plans to rectify the deficiencies focus on:
- Tone at the top
 - Creating a culture of shared accountability
 - Encouraging consultation
 - Changing audit leadership to support the right culture
 - Moving technical support into the practice offices
 - Developing and concentrating expertise
 - Rebalancing workloads/realigning staff
 - Recognizing audit quality in performance reviews
 - Improving tools to drive consistency

The Role of Audit Committees

22. CPAB noted that audit committees can create an environment where they, management and the auditors can engage in an effective dialogue to enhance and sustain audit quality. It observed that audit committees are in a unique position to assess the effectiveness of the auditor/ management relationship, including the degree of professional skepticism demonstrated by the auditor.
23. CPAB noted that audit committees should engage with their auditors to ensure their use of component auditors of foreign operations is more transparent so the audit committees better understand the work done by component auditors, including how it was overseen by the group auditor.
24. CPAB believes audit committees could enhance their oversight of the auditor by moving along a continuum from pure compliance (approval of financial statements, periodic/quarterly meetings with the auditor, etc.) to a stronger governance role (understanding key audit risks, oversight of management and the auditor, etc).

II. Netherlands Authority for the Financial Markets (AFM) 2014 Report

25. The AFM's [2014 report](#) summarizes the results of inspections of the quality of statutory audits conducted by Big Four firms in the country.
26. At each of the four firms, the AFM reviewed 10 statutory audits from the period 2012/2013 and classified a number of them as “inadequate:”
 - Deloitte – Four
 - EY – Three
 - KPMG – Seven
 - PwC – Four
27. Overall, the AFM qualified the quality of 18 of the 40 (45 percent) reviewed statutory audits as “inadequate.” For these audits, the AFM was of the view that the auditors did not obtain sufficient and/or appropriate audit evidence to justify their opinion on the financial statements being audited.
28. The most commonly occurring deficiencies concern:
 - Tests of controls.
 - Substantive analytical procedures.
 - Critical evaluation of the audit evidence obtained.
29. The AFM found that the root causes for the deficiencies identified by the Big Four firms varied considerably and were not completely clear. The AFM noted that the remedial measures announced by the Big Four firms were greater in number, as well as more inclusive and extensive, than the measures taken in response to its September 2010 report.
30. The measures announced focus mainly on the quality control procedures of the audit firms, though remedial measures for other areas have also been announced, such as organizational culture, executive board, internal supervision and relationship with other audit firms.
31. The AFM has requested the four firms to further deepen their analyses of root causes and reasons underlying the deficiencies found. Should they identify additional causes, they would be expected to

assess whether the measures being taken to address these causes are effective, and take different or additional measures if necessary. The AFM noted its expectation that the four firms make the root cause analyses part of their quality control procedures.

32. The AFM recommended that the firms implement remedial measures while constantly focusing on the public interest involved in statutory audits above all other interests. It also recommended that the firms give special attention and priority to the following matters:
- Strengthening of governance
 - Creating a quality-oriented culture
 - Embedding statutory quality standards
 - Increasing transparency with respect to quality
33. Based on the results of the inspections, the AFM noted that it saw reason to advise the legislator to make the following additions to the law:
- Suitability tests to be conducted by the AFM
 - The AFM to submit findings and conclusions from suitability tests directly to the bodies responsible for governance
 - Mandatory implementation of corrective and improvement measures
 - Introduction of additional categories for PIEs
 - Mandatory supervisory boards

Matters for CAG Consideration

1. Representatives are asked for:
- (a) Reactions to the developments and trends noted in Sections A-C above from an ethical perspective, and views on actions the IESBA could contemplate in the light of such developments and trends;
 - (b) Reactions to the Toshiba Accounting Scandal from an ethical perspective;
 - (c) Views on whether there are any particular themes or issues from the inspection findings and other developments highlighted in Section E that the IESBA should further consider; and
 - (d) Views on any other significant developments internationally that may warrant consideration by the Board.

(To facilitate this discussion, Representatives are asked to email comments on any significant developments not otherwise noted in the agenda material to Kaushal Gandhi (kaushalgandhi@ethicsboard.org) in advance of the meeting.)

Material Presented – CAG Reference Papers

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| Agenda Item F-1 | November 2014 Speech by PCAOB Member Steven Harris – The Rise of Advisory Services in Audit Firms |
| Agenda Item F-2 | Toshiba Accounting Scandal |
| Agenda Item F-3 | Background Paper for Panel Session at April 2015 IFIAR Plenary Meeting, “Current Trends in the Audit Industry” |