

**Meeting:** IESBA CAG

**Meeting Location:** New York

**Meeting Date:** September 14, 2015

## Agenda Item

# E

### Safeguards—Report-Back and Issues

#### Objectives of Agenda Item

1. To note the report-back on the March 2015 CAG discussion.
2. To obtain CAG Representatives' views on the matters identified by the Task Force.

#### Project Status and Timeline

3. At its January 2015 meeting, the Board approved a project to review the safeguards in the Code. The project's initial focus is on the clarity, appropriateness and effectiveness of the safeguards in Sections 100<sup>1</sup> and 200<sup>2</sup> of the Code.
4. The Project Proposal addressed the need to consider revisions to the provisions in Section 290<sup>3</sup> of the Code addressing non-assurance services (NAS) to audit clients. Because the revisions to Sections 100 and 200 are likely to impact the nature and extent of the changes to the NAS provisions in Section 290, the Task Force is recommending that consideration of potential revisions to those NAS provisions be progressed in Phase II of the project. Also, the Task Force is of the view that similar to the approach being taken by the Structure Task Force, the consideration of revisions to Part C<sup>4</sup> of the Code with respect to safeguards should be deferred pending the completion of the Part C project.
5. The Task Force is therefore envisaging that the December 2015 IESBA meeting would be the first opportunity for the Board to consider the Task Force's proposals regarding Section 290. The Task Force anticipates Board consideration of the ED of Phase II with a view to approval in the second half of 2016.
6. This project is being coordinated with the project to improve the structure of the Code given the pervasiveness of safeguards in the Code and the need to review them for clarity. The aim will be for the Board to consider drafts of the restructured Code and any revised provisions on safeguards with a view to approving them for exposure in December 2015.
7. The Appendix to this paper provides a project history, including links to the relevant CAG documentation.

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<sup>1</sup> Section 100, *Introduction and Fundamental Principles*

<sup>2</sup> Section 200, *Introduction* (Part B – Professional Accountants in Public Practice)

<sup>3</sup> Section 290, *Independence – Audit and Review Engagements*

<sup>4</sup> Part C addressing Professional Accountant in Business (PAIB)

## March 2015 CAG Discussion

8. Below are extracts from the minutes of the March 2015 CAG meeting,<sup>5</sup> and an indication of how the project Task Force or IESBA has responded to CAG Representatives' comments.

Matters Raised	Task Force/IESBA Response
REPRESENTATIVES' FEEDBACK ON PROJECT PROPOSALS	
<p>Mr. Koktvedgaard noted it would be important to consider what CAG Representatives would view as the success outcomes of the project.</p>	<p>Point accepted.</p> <p>Engaging with the CAG is an important part of IESBA's due process. The Task Force plans to discuss significant issues with the CAG throughout the project to obtain CAG Representatives' input.</p>
<p>Mr. Fukushima noted that International Organization of Security Commissions (IOSCO) is very interested in this project as it could help, together with the restructuring of the Code, to enhance the enforceability of the Code. He indicated that he was at first surprised that the scope of the safeguards project seemed to be limited to NAS but reassured to hear that this would only be a first phase. He suggested clarifying the scope in the project proposal. He also indicated that IOSCO was interested in fee-dependency issues.</p>	<p>Point accepted.</p> <p>Mr. Hannaford responded that the Board understood that the project in the longer term would need to extend beyond safeguards pertaining to NAS. However, he noted that the need to align the project with the Structure project means that not everything is possible in the short term. He explained that initially the Task Force intends to review the conceptual framework and the most pervasive area, i.e., NAS. Other areas where improvements might be needed could form a phase II later. He confirmed that a separate project addressing fee-related issues is included within the Board's Strategy and Work Plan, 2014-2018.</p> <p><i>See also Section A of this paper and Agenda Item E-1.</i></p>
<p>Mr. Fukushima noted that IOSCO had suggested that the Board consider clarifying the notion that not every threat can be addressed by safeguards. He noted as an example the holding of financial interests in an audit client by engagement team members. He felt that the project proposal was unclear in this respect and suggested that the Board address the matter.</p>	<p>Point accepted.</p> <p>Mr. Hannaford confirmed that the Task Force understands and accepts that there may be circumstances where no safeguards can eliminate or reduce a threat to an acceptable level. The Task Force's is of the view that the proposed revisions to Section 100 of the Code makes this point clearer.</p> <p><i>See also Section A, in particular paragraphs 22–24 of this paper, and Agenda Item E-1.</i></p>

<sup>5</sup> The March 2015 CAG minutes will be approved at September 2015 IESBA CAG meeting.

Matters Raised	Task Force/IESBA Response
REPRESENTATIVES' VIEWS ON PRELIMINARY ISSUES FOR CONSIDERATION	
<p>Mr. Dalkin noted that International Organisation of Supreme Audit Institutions (INTOSAI) considers the threats and safeguards approach as principles-based and subject to professional judgment. In some jurisdictions, however, such an approach could represent quite a significant change as they tend to be rules-based. One of the matters INTOSAI considered was the possibility of two firms reaching different conclusions when facing the same situation. He gave the example that in some jurisdictions, bookkeeping is by definition a NAS and a firm would therefore need to apply the conceptual framework. In practice, a firm may conclude that safeguards can be applied in this situation whereas another firm may conclude that such a service cannot be safeguarded. He noted that the natural reaction is therefore to move to a rules-based approach, adding that it would be important for Board to consider this matter.</p>	<p>Point noted.</p> <p>Mr. Hannaford noted that respondents to the November 2014 Consultation Paper <a href="#">Improving the Structure of the Code of Ethics for Professional Accountants</a> had emphasized the importance of the principles-based approach.</p> <p>This point will be further considered as the Task Force undertakes its work on NAS.</p> <p><i>See also Section D of this paper.</i></p>
<p>Mr. Dalkin noted that the other challenge is in the area of materiality. He highlighted the risk of moving from a prohibited NAS to a permissible one if not material. He therefore cautioned against unintended consequences.</p> <p>Mr. Fukushima acknowledged the Board's intention to review the concept of "reducing a threat to an acceptable level" but felt that this would be very challenging. He noted that materiality relates not only to quantitative measures but also to perception.</p>	<p>Points accepted.</p> <p>Mr. Hannaford responded that the Task Force is aware of the sensitivities in this area but that it is also aiming to enhance a principled-based Code. The Task Force plans to further consider how the concept of materiality is addressed in the context of its work in proposing revisions to sections of the Code relating to safeguards in the context of NAS.</p> <p>The Code defines an "acceptable level" as "a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant (PA) at that time, that compliance with the fundamental principles is not compromised."</p> <p>The concept of a reasonable and informed third party is fundamental to assessing whether the safeguards applied are effective in eliminating or reducing the threat to an acceptable level. As a result, the Task Force is of the view that a clarification of what is</p>

Matters Raised	Task Force/IESBA Response
	<p>meant by the reasonable and informed third party is warranted.</p> <p><i>See also section B and paragraphs 18-19 of this paper for the discussion of the Task Force's proposals relating to the concepts of "reasonable and informed third party" and "materiality," and Agenda Item E-1.</i></p>
<p>Ms. Miller noted that in the US, the audit committee appoints the independent auditor and must report on the auditor's independence to all of those charged with governance (TCWG). She therefore believes that the role of the audit committee is an important safeguard with respect to auditor independence. She commented that the Code currently mentions reporting to TCWG but does not particularly emphasize this matter. She suggested it would be better if the Code could establish obligations with respect to audit committees in that regard. Mr. Koktvedgaard noted that under the new EU audit legislation, the audit committee will have its own responsibility to assess the independence of the auditor and will not be able to rely solely on the auditor's report on its independence. Accordingly, he suggested considering how safeguards could flow in that context.</p>	<p>Points taken into account.</p> <p>Mr. Hannaford indicated that while the Task Force understands the important role of audit committees, it is not within the Board's remit to set standards for TCWG. However, the Task Force could consider their roles and responsibilities with respect to auditor independence.</p> <p><i>See also section D of this paper for the Task Force's proposals with respect to communications with TCWG.</i></p>
<p>Ms. de Beer agreed that it is not within the Board's remit to place requirements on TCWG. However, she was of the view that auditors should be given greater responsibility to communicate to TCWG, similar to the approach taken with respect to communication of key audit matters to TCWG under the revised auditor reporting ISAs. Doing so would then prompt TCWG to address the issue. Mr. Koktvedgaard noted that public expectations have changed since the introduction of the threats and safeguards approach in the Code. Accordingly, the Board should consider how to improve communication with TCWG.</p>	<p>Points taken into account.</p> <p>Mr. Hannaford noted that the leaderships of the IAASB and IESBA had met the previous day to consider a number of crossover issues and they had agreed to monitor potential crossover issues as the safeguards project develops.</p> <p>The Task Force plans to continue to explore whether revisions can be made to the Code to enhance communications with TCWG, in particular as part of its work on NAS.</p> <p><i>See also section D of this paper for the Task Force's proposals with respect to communications with TCWG.</i></p>

Matters Raised	Task Force/IESBA Response
<p>Mr. Koktvedgaard highlighted the need to pay attention to smaller entity considerations.</p>	<p>Point accepted.</p> <p>As noted in section D, paragraph 50 of this paper, the Task Force plans to continue to consider the challenges faced by the SMP/ SME community as it progresses its work on the project. The Task Force Chair has scheduled a meeting with representatives of the SMPC in advance of the September 2015 IESBA meeting to obtain their specific viewpoints.</p>
<p>Mr. Dalkin suggested that it would be important to consider the definition of a NAS. He gave a number of examples of services that may be considered NAS. He noted some basic questions which arise in applying the conceptual framework such as: whether preparing financial statements is a part of the audit or a NAS; and whether providing technical advice with respect to preparation of notes to the financial statements when management does not have the technical expertise would constitute a NAS.</p>	<p>Point noted.</p> <p>As noted in Section D of this paper, this point will be further considered as the Task Force undertakes its work on NAS.</p>
<p>Mr. Greene suggested considering addressing the impact of the cumulative effect of NAS provided to an audit client on independence.</p>	<p>Point noted.</p> <p>Ms. Soulier noted that this matter is already addressed under the Code. However, as noted in Section D of this paper, the Task Force will further consider this point as it undertakes its work on NAS.</p>
<p>REPRESENTATIVES' VIEWS ON EXPOSURE OF PROPOSED REVISIONS</p>	
<p>With respect to the planned timing of the Safeguards ED, Mr. Bradbury believed the two obvious options were outlined in the issues paper. He wondered whether both could be presented.</p>	<p>Point accepted.</p> <p>The Task Force continues to liaise closely with the Structure Task Force in progressing its work, and in determining the user-friendly way of presenting proposed revisions in the Safeguards ED.</p> <p><i>See also paragraph 5 of this paper for a further discussion on timing.</i></p>
<p>Ms. Lang felt that she could only comment on the approach if she were able to see the nature of the issues addressed and the proposed changes being contemplated. She noted a risk that in exposing two documents at the same time, respondents may</p>	<p>Point accepted.</p> <p>Mr. Hannaford explained that one of the reasons to coordinate the two projects is to enable stakeholders to see how the revised provisions on safeguards would fit in the restructured Code. He commented</p>

Matters Raised	Task Force/IESBA Response
choose to respond to only one. She wondered how the Board was expecting respondents to comment on the two exposure drafts.	that in an ideal world, the Board would issue the safeguards exposure draft first but this may not be physically possible.  <i>See also paragraph 5 of this paper for a further discussion on timing.</i>

## Matters for CAG Consideration

9. This paper summarizes the Task Forces proposals to-date, and is organized as follows:
- Section A: Clarifying the conceptual framework (CF) (including establishing a revised description of the term “safeguards”)
  - Section B: Clarifying what is meant by the threshold of “acceptable level” relative to reduction of a threat, and the concept of a “reasonable and informed third party”
  - Section C: Proposed revisions to Section 200, including types of threats and safeguards
  - Section D: Other issues for future Task Force consideration
  - Section E: Alignment and coordination with the Structure Task Force and others

**Agenda Item E-1** reflects the Task Force’s proposals in the light of the June/July Board discussion, and addresses proposed revisions to Sections 100 and 200 of the extant Code.

### A. Clarifying the CF

#### *Format and Layout*

10. The Task Force recognizes that Section 100 of the Code addresses responsibilities that all PAs should fulfill and fundamental principles to which they should all adhere. The Task Force further notes that other sections of the Code (e.g., Section 200 in the case of PAs in public practice, and Section 290 in the case of auditors) build on Section 100 to provide more engagement-specific or service-specific requirements and guidance. Consequently, the Task Force agreed to retain in Section 100 only the requirements and guidance that it believes should be applicable to all PAs. The Task Force agreed to relocate guidance such as the latter part of the last sentence in extant 100.9 that relate only to PA in public practice to Section 200.<sup>6</sup>
11. At the June/July 2015 meeting, the Board generally agreed to align the CF approach to the extent appropriate with the approach to dealing with risks of material misstatement of the financial statements established in the International Auditing and Assurance Standards Board’s (IAASB’s) International Standards on Auditing (ISAs). Specifically, the ISAs require auditors to identify and assess risks of material misstatement of the financial statements; design responses to the assessed risks of material misstatement; and evaluate the sufficiency and appropriateness of the audit

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<sup>6</sup> The last sentence in extant Section 100.9 states “In such situations, the professional accountant shall decline or discontinue the specific professional activity or service involved or, when necessary, resign from the engagement (in the case of a professional accountant in public practice) or the employing organization (in the case of a professional accountant in business).”

evidence obtained.<sup>7</sup> To adopt a similar approach in the Code for threats, the Task Force sought to re-organize the content of extant Section 100 in accordance with the following outline which was generally agreed to by the Board at its June/ July 2015 meeting.

- Introduction and Fundamental Principles
    - Introduction
    - Fundamental Principles
  - Conceptual Framework
    - Requirements and Application Material
    - Reasonable and Informed Third Party
    - Identifying Threats
    - Evaluating Threats
    - Addressing Threats
    - Re-evaluation of Threats
12. The Task Force is of the view that the inclusion of the above subheadings in the Code would serve to assist PAs better understand how the CF approach should be applied, thereby enhancing its overall usefulness.
13. In proposing the revised layout and format of Sections 100 and 200, the Task Force deemed it appropriate to enhance the flow of the Code by re-positioning certain paragraphs without necessarily changing the text of those paragraphs. These paragraphs are presented in shaded grey text in **Agenda Item E-1**. With respect to those paragraphs, IESBA members are asked to comment on their positioning only.

#### *Revision of Content*

##### Overview

14. In developing proposed revisions to extant Section 100, the Task Force has endeavored to:
- (a) Reduce the ambiguities regarding the objective of the CF. Specifically, the Task Force is hoping to shift the focus to be on “the elimination or reduction of threats to compliance with the fundamental principles” rather than on “the application of safeguards.” In doing so, the Task Force has re-characterized the discussion of the CF approach in the Code to more explicitly link it to a discussion of the PA’s responsibility to eliminate or reduce threats to compliance with the fundamental principles (see paragraphs 100.6–100.20 of **Agenda Item E-1**).
  - (b) Retain a general description of the fundamental principles, and the explanation of the PA’s responsibility to comply with those fundamental principles, by applying the CF that was in paragraphs 100.1–100.5 of the extant Code (see paragraphs 100.1–100.5 **Agenda Item E-1**).

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<sup>7</sup> See ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* and ISA 330, *The Auditor’s Response to Assessed Risks*

- (c) Enhance the guidance in paragraph 100.6 of the extant Code to better explain the purpose of the CF and the PA's responsibility to apply the CF to comply with the fundamental principles.
- (d) Prominently articulate, overarching requirements and guidance in Section 100 of the Code for the PA to apply the CF (see paragraphs 100.8–100.9 of **Agenda Item E-1**). The Task Force is of the view that the PA should be required to:
  - (i) Exercise professional judgement when applying the Code; and
  - (ii) Take into account whether a reasonable and informed third party would likely conclude that compliance with the fundamental principles is not compromised.

To support the latter, the Task Force has developed a proposed description of the concept of a “reasonable and informed third party” (see further discussion of reasonable and informed third party in section B of this paper).

- (e) Establish improved guidance in support of the overarching requirement described above to assist PAs appropriately apply the CF to:
  - (i) Identify threats to compliance with the fundamental principles (see paragraphs 100.11–100.13 of **Agenda Item E-1**),
  - (ii) Evaluate those threats (see paragraphs 100.14–100.16 of **Agenda Item E-1**), and
  - (iii) Address them (see paragraphs 100.17–100.19 of **Agenda Item E-1**).
- (f) Establish a more robust description of the term “safeguards” (see paragraphs 23-24 of this paper below and paragraph 100.19 of **Agenda Item E-1**).
- (g) Develop new guidance to better and more clearly explain that a re-evaluation of threats and safeguards is necessary when facts and circumstances change, i.e., establishment of a “step-back” requirement (see paragraph 100.20 of **Agenda Item E-1**).

#### *New and Revised Guidance Relating to Identifying, Evaluating and Addressing Threats*

##### **Identifying Threats**

- 15. As part of its guidance relating to the identification of threats, the Task Force proposes to include a general discussion about threats in Section 100 of the Code, drawing from extant paragraphs 100.8 and 100.12 of the Code that describe how a PA would identify threats. The revised paragraphs also describe the factors that may threaten compliance with the fundamental principles, and more clearly articulate that the identification of threats supports compliance with the fundamental principles.
- 16. To inform its work on safeguards, the Task Force reviewed the threats appearing in other ethics codes and regulations, and concluded that the categories of threats in the extant Code remain appropriate.

##### **Evaluating Threats**

- 17. By expanding on paragraphs 100.8, 100.9, 100.14 and 100.16 of the extant Code, the Task Force has described a process by which PAs should evaluate threats. In conjunction with its work in revising



paragraph 200.12, the Task Force is also proposing changes to the bulleted list in paragraph 100.14 of the extant Code to clarify and update the guidance presented.

#### Materiality and significance

18. The Task Force observed that terminology that is consistent with the auditing concept of materiality is used throughout the Code. It is used to explain how the PA evaluates threats identified. For example, the Code gives some guidance regarding the application of materiality to financial interests, loans, guarantees and business relationships.<sup>8</sup>
19. In revising Sections 100 and 200, the Task Force has avoided the use of the term “material” and “significant” or “significance.” The Task Force is of the view that the terms may be relevant in the context of more specific requirements relating to NAS, but believes that those terms are not appropriate in establishing overarching requirements and principles about threats and safeguards.

#### Conditions that may impact the level of a threat

20. The Task Force accepts that there are conditions that are established by the profession, legislation, regulation, the firm or employing organization that may impact the level of a threat to compliance with the fundamental principles, which can affect the likelihood of identifying or deterring unethical behavior.
21. However, the Task Force concluded that these conditions should not be characterized as “safeguards” in the Code. The Task Force is of the view that the determination of a safeguard should be made at the engagement level so that the PA is able to appropriately weigh the facts and circumstances relevant to the engagement or activity.

#### Addressing Threats

22. The Task Force is proposing new guidance in paragraph 100.17 of **Agenda Item E-1** to explain that if a PA determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the application of the CF calls for the identification and application of safeguards to eliminate those threats or reduce them to an acceptable level.

#### Description of safeguards

23. The new guidance regarding addressing threats includes a revised description of safeguards. The Task Force observed inconsistencies in how the term “safeguards” is used in the extant Code. Specifically, the Task Force noted that there are instances where the term safeguards is intended to have a broad and conceptual meaning, while in other instances the term is used to more narrowly describe actions or measures that PAs undertake to address threats to compliance with the fundamental principles.
24. The Task Force is of the view that having a more robust definition of the term “safeguards” addresses some of the concerns that have been raised by some stakeholders, in particular regulators, regarding the effectiveness and appropriateness of safeguards in the Code. Accordingly, the Task Force

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<sup>8</sup> Paragraph 290.101. In addition, the November 2012 IESBA Staff Questions and Answers, [Implementing the Code of Ethics – Part II](#) includes reference to the International Auditing and Assurance Standards Board’s (IAASB’s) International Standard on Auditing (ISA) 320, *Materiality in Planning and Performing an Audit* with respect to the meaning of materiality when the Code refers to a NAS having a material effect on the client’s financial statements.

proposes the following as a new description of the term “safeguards,” taking into account the input received at the June/July Board meeting:

Specific actions or measures that the professional accountant takes to effectively eliminate identified threats to the fundamental principles or reduce them to an acceptable level. Safeguards, which may be individual or a combination of specific actions or other measures, are effective when they eliminate or reduce the level of the threat to an acceptable level, such that the fundamental principles are not compromised, or are not likely to be compromised.

25. The revised description clarifies that safeguards:
  - Must be effective to address specific threats to compliance with the fundamental principles.
  - May be an individual or a combination of specific actions or measures.
  - Are effective when they eliminate or reduce the level of the threat such that the fundamental principles are not compromised, or are likely to be compromised.
26. The Task Force is of the view that with the proposed revised description of safeguards together with the proposed clarifications made to the CF, the linkage among “safeguards,” “threats” and the “fundamental principles” is stronger. The Task Force proposes to discontinue using the term “safeguards” in its broader context, using instead the term “conditions” or simply “actions or measures” as appropriate.
27. The Task Force is of the view that the PA would need to exercise professional judgement to determine whether an action or measure is appropriate and effective enough to be a safeguard that is responsive to the identified threat. As noted in paragraph 14(g) above, the Task Force believes that the PA should re-evaluate whether a safeguard remains effective whenever new information arises during an engagement.
28. Additionally, the content in paragraph 100.9 of the extant Code relating to when the PA declines or discontinues a specific professional activity or service has been retained, but re-characterized as guidance for PAs. The Task Force is of the view that the appropriate application of the CF would result in the PA declining or discontinuing the specific professional activity or service involved, if the safeguards are not available, or cannot be applied.

#### *Establishment of a Step-back Requirement*

29. The Task Force is also of the view that the identification, evaluation and addressing of threats could be an iterative process that may be ongoing based on the nature and extent of the engagement or activity. Accordingly, the Task Force agreed to introduce new guidance in paragraph 100.20 of **Agenda Item E-1** that explains that the CF calls for a re-evaluation of threats and safeguards if information about threats and safeguards changes, or if new information indicates an inconsistency with the PA’s original identification and evaluation of threats. In doing so, the Task Force aims to respond to specific feedback on the matter from a regulatory respondent<sup>9</sup> to the Structure of the Code consultation paper.

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<sup>9</sup> International Organization of Securities Commissions note in their January 20, 2015 letter, that:

“In practice, on more than an infrequent basis, auditor oversight and securities regulators have encountered auditors who attempt to justify their actions by indicating compliance with the requirements without stepping back to determine

### **Matters for CAG Consideration**

1. Representatives are asked for views on the Task Force's proposals relating to Section 100 of the extant Code in particular:
  - (a) The proposed revisions to the CF, including the new guidance relating to the identification, evaluation and addressing of threats in paragraphs 100.6–100.20 of **Agenda Item E-1**
  - (b) The description of the term “safeguards” in paragraph 100.18 of **Agenda Item E-1**.

### **B. Determination of An Acceptable Level and Reasonable and Informed Third Party**

30. When applying the CF, a PA is required to determine whether the safeguards applied are effective at eliminating or reducing threats to an acceptable level. Questions have been raised, including from the IESBA Consultative Advisory Group (CAG), about what constitutes “an acceptable level” in the context of reducing threats to compliance with the fundamental principles. The extant Code defines an “acceptable level” as follows:

A level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant at that time, that compliance with the fundamental principles is not compromised.

31. The Task Force is of the view that establishing a description of what is meant by the term “reasonable and informed third party” would help address some of the concerns that have been raised. The concept of a reasonable and informed third party is fundamental to the PA's evaluation of whether the safeguards applied are effective in eliminating or reducing the threat to an acceptable level.
32. The Task Force believes that the “reasonable and informed third party” test is intended to be an important and objective test which requires the PA to “step back” to consider whether compliance with the fundamental principles is compromised. Retaining the principles in paragraphs 100.2 and 100.8 of the extant Code, the Task Force proposes the reasonable and informed third party be described as:

A conceptual person who possesses suitable skills, knowledge and experience to evaluate the appropriateness of the professional accountant's conclusions. This evaluation entails weighing all the specific facts and circumstances that the professional accountant knows, or could reasonably be expected to know, at the time, to objectively determine whether the relevant threats to compliance with the fundamental principles will be eliminated or reduced to an acceptable level.

33. In coming to a view on how the concept of a “reasonable and informed third party” should be described, the Task Force concluded that:

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if the facts and circumstances suggest that the fundamental principles may be violated though the requirements were achieved.

The fundamental principles are not simply background information but are overarching objectives that auditors must meet whereas the standards-specific requirements capture specific areas identified by the Board to which auditors must comply. We believe greater emphasis should be placed on the need for auditors to step back after complying with the standards-specific requirements to determine if, based on the facts and circumstances, the auditor is independent with respect to the fundamental principles.”

- There is a public interest benefit to be derived from the reasonable and informed third party test. However, the test is not intended to represent the views of any one individual or stakeholder group.
- Having a simple and easy to understand description of the concept in the Code would better assist PAs in determining whether safeguards have been appropriately applied to eliminate or reduce threats to an acceptable level.

**Matters for CAG Consideration**

2. Representatives are asked for views on the proposed description of the concept of a “reasonable and informed third party” (see paragraph 100.10 of **Agenda Item E-1**).

**C. Revisions to Section 200, Including Types of Threats and Safeguards**

*Background*

34. The Task Force observed that the extant Code includes several examples of conditions, actions or measures that are described as safeguards. They are distinguished as:
- (a) Safeguards established by the profession, legislation or regulation, firm or an employing organization;<sup>10</sup>
  - (b) Safeguards in the work environment which could either be: firm-wide,<sup>11</sup> or engagement-specific safeguards;<sup>12</sup>
  - (c) Safeguards that the client has implemented.<sup>13</sup>
35. As discussed above, the Task Force has established a revised description for the term safeguards. Only the matters described as engagement-specific safeguards constitute a safeguard under the Task Force’s enhanced description of a safeguard. The Task Force believes that other examples do not meet its proposed description of a safeguard because they are not expressly designed and implemented to respond to the threats that the PA has identified.

*Conditions in a Work Environment*

36. The Task Force accepts that conditions may exist in a work environment that are conducive to compliance with the fundamental principles. For example, continuing professional development requirements created by the profession directly support compliance with the fundamental principle of professional competence and due care. While such factors would not reduce a threat to compliance with the fundamental principles, the significance of a threat may increase if such factors are not present. The Task Force is of the view that these factors also support the application of engagement-specific safeguards. Thus, the Task Force is proposing that these conditions be included as factors for the PA to consider when evaluating threats.

<sup>10</sup> Paragraphs 100.14 and 100.16 of the extant Code

<sup>11</sup> Paragraph 200.12 of the extant Code

<sup>12</sup> Paragraph 200.13 of the extant Code

<sup>13</sup> Paragraph 200.14–200.15 of the extant Code

*Application of the CF Approach by PAs in Public Practice*

37. The Task Force is of the view that it would be helpful for section 200 to follow the same format, and build on the content of Section 100, with more specific requirements and guidance for PAs in public practice. The Task Force is also of the view that doing so would clarify the linkage between the two sections, thereby strengthening the foundational requirements and principles related to compliance with the fundamental principles of the Code (see paragraphs 200.3, 200.4, 200.6, 201.12 and 200.15 of **Agenda Item E-1**).

*Streamlining the Examples of Threats and Conditions that May Reduce Potential Threats*

Threats

38. With a new lead-in, the inclusions of sub-headings, as well as a revised presentation of the format, the Task Force has streamlined and clarified the examples of threats in paragraphs 200.4–200.8 of the extant Code (see 200.5 of **Agenda Item E-1**). The Task Force is of the view that doing so eliminates some duplication that currently exists in the Code, thereby making it easier to understand.

*Conditions that May Reduce Potential Threats*

39. In responding to criticisms that have been raised about the examples of conditions (characterized as firm-wide safeguards in extant Section 200 of the Code), the Task Force has also streamlined and updated the listing of matters in paragraph 200.12 of the extant Code (see paragraph 200.9 of **Agenda Item E-1**). In doing so, the Task Force considered certain requirements in ISQC 1<sup>14</sup> as well as similar requirements and best practices of national standard setters.
40. The Task Force considered including a reference to the requirements of ISQC 1 in the Code, but acknowledged that:
- (a) ISQC 1 applies only to firms of PAs that perform audits and reviews of financial statements, and other assurance and related services engagements. Thus, the requirements of ISQC 1 do not apply to PAs in public practice who do not provide these types of engagements.
  - (b) ISQC 1 may not be adopted by firms who adopt the Code, but do not comply with IAASB standards for some or all of their engagements.
  - (c) The IAASB has an ongoing Quality Control project which is likely to result in revisions to certain requirements in ISQC 1.<sup>15</sup>
41. However, the Task Force agreed that PAs would benefit most from having examples in the Code that draw from the key principles and guidelines in best practices and existing standards (e.g., ISQC 1).

**Matter for CAG Consideration**

3. Do Representatives agree the proposed revisions to Section 200 of the extant Code?

<sup>14</sup> International Standard on Quality Control (ISQC 1), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraphs 21 – 25

<sup>15</sup> See [IAASB 2015-2016 Work Plan](#).

#### **D. Other Issues for Future Consideration by the Task Force**

##### *Communications with TCWG, Including Audit Committee Members*

##### Required Communications with TCWG

42. The extant Code explicitly requires communication with TCWG in the following circumstances:
- When an entity becomes a related entity of an audit client as a result of a merger or acquisition, and interests or relationships that would not be permitted under the Code cannot reasonably be terminated by the date of the merger or acquisition.<sup>16</sup>
  - When a breach of a provision in Section 290 or 291 occurs.<sup>17</sup>
  - When an audit client is a public interest entity (PIE) and for two consecutive years the total fees from the client and its related entities represent more than 15 percent of the total fees of the audit firm.<sup>18</sup>
  - When an entity becomes an assurance client during or after the period covered by the subject matter information and the firm provided NAS that would not be permitted during the period of the engagement.<sup>19</sup>
43. ISA 260 (Revised) requires auditors of listed entities to communicate the following with TCWG:<sup>20</sup>
- A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and
    - All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist TCWG in assessing the effect of services on the independence of the auditor; and
    - The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.
44. Specific to safeguards, the application material in ISA 260 (Revised) notes that:<sup>21</sup>
- The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:
    - Threats to independence, which may be categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

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<sup>16</sup> Paragraphs 290.34 - 36

<sup>17</sup> Paragraphs 290.45 – 48, and Section 291, *Independence – Other Assurance Engagements*, paragraphs 35 – 36

<sup>18</sup> Paragraph 290.219

<sup>19</sup> Paragraph 291.32

<sup>20</sup> ISA 260 (Revised), *Communication with Those Charged With Governance*, paragraph 17

<sup>21</sup> ISA 260 (Revised), paragraphs A30 and A49

- Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.
  - Timely communication throughout the audit contributes to the achievement of robust two-way dialogue between TCWG and the auditor.
45. ISA 260 (Revised) further explains that the appropriate timing for communications with TCWG will vary with the circumstances of the engagement, and that relevant circumstances include the significance and nature of the matter, and the action expected to be taken by TCWG (e.g., communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion).
46. The application material in ISA 260 (Revised)<sup>22</sup> also explains that communication requirements relating to auditor independence that apply in the case of listed entities may also be appropriate in the case of some other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business.

#### Calls for Enhancing PAs' and Firms' Communications with TCWG

47. Some CAG Representatives<sup>23</sup> were of the view that the Code should establish provisions to encourage further engagement between PAs and TCWG, in particular audit committee members. It was noted that although paragraph 100.25 of the extant Code mentions the PA's or firm's responsibility to communicate with TCWG, it does not emphasize it. Those CAG Representatives also suggested that the Task Force explore whether communication with TCWG could be characterized as a safeguard.

#### Task Force's Views

48. The Task Force believes that communication with TCWG increases transparency around the identification and evaluation of threats to compliance with the fundamental principles, and the actions or measures taken to eliminate or reduce those threats to an acceptable level.
49. Accordingly, the Task Force will be vigilant as it reviews the Code to consider how and whether requirements or guidance in the Code can be strengthened or clarified to encourage PAs and firms, in particular auditors, to communicate with TCWG. The Task Force is of the view that this aspect of its work will be dealt with in its proposals relating to NAS, and that coordination with the IAASB may be necessary.

#### Other Issues

50. Beyond considering Sections 100 and 200 of the Code, the Task Force plans to:
- (a) Consider the clarity, appropriateness and effectiveness of safeguards that pertain to NAS in Section 290 of the Code.

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<sup>22</sup> ISA 260 (Revised), paragraph A32

<sup>23</sup> See CAG March 2015 CAG Public Session Meeting minutes available at:  
[http://www.ethicsboard.org/system/files/meetings/files/Agenda\\_Item\\_A\\_-\\_Draft\\_March\\_2015\\_IESBA\\_CAG\\_Minutes\\_Mark-Up.pdf](http://www.ethicsboard.org/system/files/meetings/files/Agenda_Item_A_-_Draft_March_2015_IESBA_CAG_Minutes_Mark-Up.pdf)

- (b) Consider whether the extant Code includes sufficient and appropriate documentation requirements related to safeguards, and whether there is a need for alignment to the requirements and application material in ISA 220.<sup>24</sup>
- (c) Consider whether additional guidance is needed in the Code to explain the differences between the evaluation of the significance of the threat and the acceptable level for a PIE and a non-PIE.
- (d) Continue to consider the challenges faced by the SMP sector in employing safeguards involving the segregation of duties.

#### **E. Alignment and Coordination with the Structure Task Force and Others**

- 51. The Task Force continues to work in close coordination with the Structure Task Force. The Task Force believes that the revisions relating to safeguards in **Agenda E-1** are drafted in the format and language of the restructured Code.

##### *The CF Approach to Independence*

- 52. The Structure Task Force has put forth proposals for revising paragraphs 290.4–290.12<sup>25</sup> of the extant Code (see **Agenda Items D**). While the project scope in the Safeguards Project Proposal does not include those paragraphs, the Safeguards Task Force is of the view that in light of the nature of its proposals relating to Sections 100 and 200, it may be necessary to consider further changes to paragraphs 290.4–290.12 of the extant Code that are of conforming or consequential in nature.
- 53. The Safeguards Task Force plans to work closely with the Structure Task Force, and take into account the outcome of the September 2015 CAG and Board meeting discussions, in progressing future work relating to paragraphs 290.4–290.12 of the extant Code.

##### *Other Matters*

- 54. The Task Force is continuing to consider options for presenting the proposed changes in the ED so that respondents can easily identify and understand the proposed changes relating to safeguards.
- 55. The Task Force is of the view that proposed revisions should be exposed in the format and language of the draft restructured Code, supported by a detailed explanatory memorandum explaining the changes being proposed along with the rationale for the changes.
- 56. The Task Force anticipates that there will be a need for conforming amendments throughout the Code, and plans to liaise with other Task Forces as needed. The Task Force plans to conduct this work after the September 2015 IESBA meeting.
- 57. Depending on the nature and extent of the changes being proposed, it may also be necessary to liaise with the IAASB and its staff to determine whether conforming amendments are needed to the ISAs or ISQC 1.

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<sup>24</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

<sup>25</sup> Section 290.14 – 290.12, *The Conceptual Framework Approach to Independence*



**Matter for CAG Consideration**

4. Representatives are asked to share any further comments on matters relevant to the Safeguards project.

**Material Presented – CAG Papers**

Agenda Item E-1      Safeguards – Proposed Revisions to Sections 100 and 200

## Appendix

### Project History

#### Project: Safeguards

##### Summary

	CAG Meeting	IESBA Meeting
Project commencement		January 2015
Development of proposed international pronouncement (up to exposure)	March 2015	April 2015 June/July 2015

##### CAG Discussions: Detailed References

<b>Project Commencement</b>	<u>March 2015</u> See IESBA CAG meeting material <a href="#">here</a> (see Agenda Items D, D-1, D-2, D-3 and D-4) and CAG meeting <a href="#">minutes</a> (see section D).
<b>Development of proposed international pronouncement (up to exposure)</b>	<u>September 2015</u> See also Agenda Item E-1