

## Agenda Item B-1

The Safeguards Task Force (TF) has used the text of the December 2015 Structure Exposure Draft (ED), *Improving the Structure of the Code of Ethics for Professional Accountants—Phase 1*, as the starting point for developing proposed revisions to pertaining to the application of the conceptual framework to independence.<sup>1</sup>

For ease of reference, this paper includes the full text of Sections 400–404 of the International Independence Standards C1, *Independence – Audit and Review Engagements*. **The TF is not proposing changes to the paragraphs shaded in grey.** Proposed changes pertaining to safeguards are shown in marked text. As further discussed at **Agenda Item B**, the proposed changes build on the requirements set out in the December 2015 Safeguards Exposure Draft, *Proposed Revisions Pertaining to Safeguards in the Code – Phase 1*. **Agenda Item B-1** is a clean version of this document.

**(Marked from Structure ED)**

The Conceptual Framework contained in Section 120 applies in all circumstances

### C1 – INDEPENDENCE – AUDIT AND REVIEW ENGAGEMENTS

#### Section 400

#### Application of Conceptual Framework to Independence for Audits and Review Engagements

##### Introduction

400.1 Independence is a measure of objectivity, both in mind and appearance, which is applied to audit engagements.<sup>2</sup> It enables a firm to express, and be seen to express, an objective conclusion when performing such engagements. It is in the public interest and required by the Code that members of audit teams,<sup>3</sup> firms and network firms be independent of audit clients.<sup>4</sup> C1 sets out requirements and application material on maintaining independence when performing audit engagements. (See also paragraph 400.7 regarding references to “firm.”)

400.2 Independence comprises:

- (a) Independence of mind – the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit

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<sup>1</sup> Paragraphs 290.4–290.11 of the extant Code deals with application of the conceptual framework to independence.

<sup>2</sup> In C1, “audit engagement” includes “review engagement.”

<sup>3</sup> In C1, “audit team” includes “review team.”

<sup>4</sup> In C1, “audit client” includes “review client” and related entities of the audit client – see Glossary for more detail.

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or assurance team's, integrity, objectivity or professional skepticism has been compromised.

400.3 C1 describes facts and circumstances, including professional activities, interests and relationships, that create or might create threats to independence. It describes the potential threats, and safeguards that might be appropriate to address any threats by eliminating them or reducing them to an acceptable level. It identifies situations where no safeguards could reduce the threats to an acceptable level but does not describe all situations that might create a threat.

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400.4 The conceptual framework requires a firm to evaluate the implications of similar, but different, facts and circumstances and determine whether the threat can be addressed by applying safeguards, including the safeguards in 300.2 A10 to eliminate the threats to independence or reduce them to an acceptable level.

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400.5 Independence requirements for assurance engagements that are not audit or review engagements are set out in C2.

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#### Public Interest Entities

400.6 C1 sets out requirements and application material that reflect the extent of public interest in certain entities which are defined to be public interest entities. Firms and member bodies are encouraged to determine whether to treat additional entities, or certain categories of entities, as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered include:

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- The nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders. Examples might include financial institutions, such as banks and insurance companies, and pension funds.
- Size.
- Number of employees.

#### Responsibility

400.7 Firms are required by International Standards on Quality Control (ISQCs) to establish policies and procedures designed to provide them with reasonable assurance that independence is maintained when required by relevant ethical requirements. International Standards on Auditing (ISAs) establish responsibilities for engagement partners and engagement teams. Certain responsibilities within a firm depend on its size, structure and organization. Many of the provisions of C1 do not prescribe the specific responsibility of individuals within the firm for actions related to independence. Although firms and professional accountants within those firms each have responsibilities for compliance, for ease of reference, many of the provisions of C1 refer to "firm," even if the main responsibility rests with an individual within the firm.

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**Reports that Include a Restriction on Use and Distribution**

400.8 An audit report<sup>5</sup> might include a restriction on use and distribution. If it does, the independence requirements in C1 may be modified as provided in Section 800,<sup>6</sup> if the conditions set out in those paragraphs are met. These modifications are not permitted for an audit of financial statements which is required by law or regulation.

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**Requirements and Application Material**

**R400.9** A firm performing an audit engagement shall be independent of the audit client.

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**R400.10** A firm ~~and~~ shall apply the conceptual framework set out in Section 120 when identifying, evaluating and addressing threats to independence in relation to an audit engagement.

400.10.A1 Threats to independence are similar to the threats to compliance with the fundamental principles set out in 120.5A2, and fall into one or more of the following categories: self-interest, self-review, advocacy, familiarity, and intimidation. ~~A~~ Facts and circumstances, including professional activities, interests and relationships, might create more than one threat to independence.

**Reasonable and Informed Third Party**

400.10A2 The reasonable and informed third party test described in 120.4A1 is relevant to the application of the conceptual framework in identifying, evaluating and addressing threats to independence.

**Identifying Threats**

**R400.110** ~~In applying the conceptual framework, a firm shall~~ In deciding whether to accept or continue an audit engagement, or whether an individual may be an audit team member, the firm shall identify threats to independence.

**Evaluating Threats**

**R400.12** When the firm identifies a threat to independence, the firm shall evaluate whether such a threat is at an acceptable level.

~~(a) 400.12A1 When evaluating the significance of threats to independence, take qualitative as well as quantitative factors into account;~~

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~~(b) If a determination has been made that the threats are not at an acceptable level is a level at which a reasonable and informed third party would likely conclude that, and the decision to be made is whether to accept an engagement or include a particular individual a firm, is independent in accordance with this Code. determine whether safeguards are available to eliminate the threats or reduce them to an acceptable level;~~

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<sup>5</sup> In C1, “audit report” includes “review report.”

<sup>6</sup> Section 800 is under development.

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400.12A2 Whether an audit client is a public interest entity might impact the level of a threat to independence. International Independence Standards C1 and C2 include additional requirements and application material for public interest entities.

#### Addressing Threats

~~(c)~~R400.13 If the firm determines that the identified threats to independence are not at an acceptable level, the firm shall address those threats by: ~~decision is whether to continue an audit engagement, determine whether:~~

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~~(a) (i) — Eliminating the circumstances, including interests or relationships, that are creating the threats to independence;~~

~~(b) Any existing Applying safeguards, where available and capable of being applied; and/or will continue to be effective to eliminate the threats or reduce them to an acceptable level;~~

~~(c) (ii) — Other safeguards will need to be applied; or~~

~~(iii) Declining or discontinuing the audit engagement, needs to be ended; and~~

#### Re-evaluating Threats

~~(d)~~R400.14 If the firm becomes aware of ~~Whenever new~~ information or changes in facts and circumstances, including professional activities, interests and relationships, that might impact whether a threat to independence has been eliminated or reduced to an acceptable level, the firm shall re-evaluate and address that threat accordingly. ~~about a threat to independence comes to the attention of the firm during an audit engagement, evaluate the significance of that threat in accordance with the conceptual framework.~~

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#### Overall Assessment

R400.15 The firm shall review judgments made and overall conclusions reached to determine that threats to independence are eliminated or reduced to an acceptable level, and that no further action is needed. The reasonable and informed third party test in 120.4 A1 is relevant to this assessment.

#### Related Entities

R400.146 As defined, an audit client that is a listed entity includes all of its related entities. For all other entities, references to an audit client in C1 include related entities over which the client has direct or indirect control. When the audit team knows, or has reason to believe, that a relationship or circumstance involving any other related entity of the client is relevant to the evaluation of the firm's independence from the client, the audit team shall include that related entity when identifying, and evaluating and addressing threats to independence, and applying appropriate safeguards.

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#### Engagement Period

**R400.172** Independence as required by C1 shall be maintained during both:

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- (a) The engagement period; and
- (b) The period covered by the financial statements.

**R400.183** If an entity becomes an audit client during or after the period covered by the financial statements on which the firm will express an opinion, the firm shall apply the conceptual framework set out in Section 120 to identify, evaluate and address ~~determine whether~~ any threats to independence ~~are~~ created by:

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- (a) Financial or business relationships with the audit client during or after the period covered by the financial statements but before accepting the audit engagement; or
- (b) Previous services provided to the audit client by the firm or network firm.

**R400.194** If a non-assurance service was provided to the audit client during, or after the period covered by the financial statements, but before the audit team begins to perform audit services, and the service would not be permitted during the engagement period, the firm shall apply the conceptual framework set out in Section 120 to identify, evaluate and address any threat to independence created by the service. ~~If a threat is not at an acceptable level, the firm shall only accept the audit engagement if the threat to independence is eliminated or reduced to an acceptable level. safeguards are applied to eliminate any threats or reduce them to an acceptable level.~~

**400.194 A1** A firm might determine that such threats to independence can be addressed by applying safeguards. Safeguards vary depending on the facts and circumstances. The following are examples of actions that in certain circumstances might be safeguards in addressing such threats to independence: Examples of safeguards include:

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- Not including individuals who provided the non-assurance service as ~~members of the~~ audit team members.
- Having a professional accountant review the audit and non-assurance work as appropriate.
- Engaging another firm to evaluate the results of the non-assurance service.
- Having another firm re-perform the non-assurance service to the extent necessary to enable ~~the that~~ other firm to take responsibility for the service.

#### Communication with those Charged with Governance

**R400.2015** A firm shall comply with paragraph R300.3 when communicating with those charged with governance.

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**R400.2115-A1** Even when not required by the Code, applicable professional standards, law or regulation, regular communication is encouraged between the firm and those charged with governance of the client regarding relationships and other matters that might, in the firm's opinion, reasonably bear on independence. Such communication enables those charged with governance to:

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- (a) Consider the firm's judgments in identifying and evaluating threats to the fundamental principles;
- (b) Consider the appropriateness of safeguards applied to eliminate them or reduce them to an acceptable level; and
- (c) Take appropriate action.

Such an approach can be particularly helpful with respect to intimidation and familiarity threats.

## Subsection 401 – Network Firms

### Introduction

401.1 To enhance their ability to provide professional services, firms frequently form larger structures with other firms and entities. Whether these larger structures create a network depends on the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct. A larger structure is a network if it is aimed at co-operation and, for example, the firms share: a common brand name; a common system of quality control; or significant professional resources. Alternatively, a larger structure might be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network.

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### Requirements and Application Material

**R401.2** A network firm shall be independent of the audit clients of the other firms within the network where C1 specifically requires such independence.

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**R401.3** When associated with a larger structure of other firms and entities, a firm shall:

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- (a) Use professional judgment to determine whether a network is created by such a larger structure;
- (b) Consider whether a reasonable and informed third party would be likely to conclude that the other firms and entities in the larger structure are associated in such a way that a network exists; and
- (c) Apply such judgment consistently throughout such a larger structure.

401.3 A1 The independence requirements in C1 that apply to a network firm apply to any entity that meets the definition of a network firm. It is not necessary for the entity also to meet the definition of a firm. For example, a consulting practice or professional law practice might be a network firm but not a firm.

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401.3 A2 Where the larger structure is aimed at co-operation and it is clearly aimed at profit or cost sharing among the entities within the structure, it is a network. However, the sharing of immaterial costs does not in itself create a network. In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals or training courses, this would not in itself create a network. Further, an association between a firm and an otherwise unrelated entity jointly to provide a service or develop a product does not in itself create a network.

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401.3 A3 Where the larger structure is aimed at co-operation and the entities within the structure share common ownership, control or management, it is a network. This could be achieved by contract or other means.

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401.3 A4 Where the larger structure is aimed at co-operation and the entities within the structure share common quality control policies and procedures, it is a network. For this purpose, common quality control policies and procedures are those designed, implemented and monitored across the larger structure.

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401.3 A5 Where the larger structure is aimed at co-operation and the entities within the structure share a common business strategy, it is a network. Sharing a common business strategy involves an agreement by the entities to achieve common strategic objectives. An entity is not a network firm merely because it co-operates with another entity solely to respond jointly to a request for a proposal for the provision of a professional service.

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401.3 A6 Where the larger structure is aimed at co-operation and the entities within the structure share the use of a common brand name, it is a network. A common brand name includes common initials or a common name. A firm is using a common brand name if it includes, for example, the common brand name as part of, or along with, its firm name when a partner of the firm signs an audit report.

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401.3 A7 Even if a firm does not belong to a network and does not use a common brand name as part of its firm name, it might appear to belong to a network if its stationery or promotional materials refer to being a member of an association of firms. Accordingly, if care is not taken in how a firm describes such membership, a perception might be created that the firm belongs to a network.

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401.3 A8 Where the larger structure is aimed at co-operation and the entities within the structure share a significant part of professional resources, it is a network. Professional resources include:

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- Common systems that enable firms to exchange information such as client data, billing and time records.
- Partners and other personnel.
- Technical departments that consult on technical or industry specific issues, transactions or events for assurance engagements.
- Audit methodology or audit manuals.

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- Training courses and facilities.

401.3 A9 Whether the shared professional resources are significant depends on the circumstances. For example:

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- Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be significant. The same applies to a common training endeavor.
- Where the shared resources involve the exchange of personnel or information, such as where personnel are drawn from a shared pool, or a common technical department is created within the larger structure to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

R401.4 If a firm or a network sells a component of its practice, the sales agreement sometimes provides that, for a limited period of time, the sold component might continue to use all or part of the name of the firm or the network, even though it is no longer connected to the firm or the network. In such circumstances, while the two entities might be practicing under a common name, the facts are such that they do not belong to a larger structure aimed at cooperation and are therefore not network firms. Those entities shall determine how to disclose that they are not network firms when presenting themselves to outside parties.

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## Subsection 402 – General Documentation of Independence for Audit and Review Engagements

### Introduction

402.1 Documentation provides evidence of the firm's judgments when forming conclusions regarding compliance with independence requirements.

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### Requirements and Application Material

R402.2 A firm shall document conclusions regarding compliance with independence requirements, and the substance of any relevant discussions that support those conclusions. Accordingly:

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(a) When an independence matter requires significant analysis or consultation, the firm shall document the nature of the matter and the firm's rationale for its conclusions

(a)(b) When safeguards are required to reduce a threat to an acceptable level, the firm shall document the nature of the threat and the safeguards in place or applied that reduce the threat to an acceptable level, ~~and~~

~~When a threat required significant analysis to determine whether safeguards were necessary and the firm concluded that they were not because the threat was already at~~

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~~an acceptable level, the firm shall document the nature of the threat and the rationale for the conclusion.~~

402.2 A1 A lack of documentation does not determine whether a firm considered a particular matter or whether the firm is independent as required by C1.

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## Subsection 403 – Mergers and Acquisitions

### Introduction

403.1 An entity might become a related entity of an audit client because of a merger or acquisition. A threat to independence, and therefore, the ability of a firm to continue an audit engagement might be created by previous or current interests or relationships between a firm or network firm and such a related entity.

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403.2 It might not be reasonable to end an interest or relationship by the effective date of the merger or acquisition. This might be because the firm provides a non-assurance service to the related entity, which the entity is not able to transition in an orderly manner to another provider by that date.

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### Requirements and Application Material

R403.3 (a) In the circumstances set out in paragraph 403.1, the firm shall identify and evaluate previous and current interests and relationships with the related entity that, taking into account available safeguards, could affect its independence and therefore its ability to continue the audit engagement after the effective date of the merger or acquisition.

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(b) In the circumstances set out in paragraph 403.1, the firm shall take steps to end any interests or relationships that are not permitted by the Code by the effective date of the merger or acquisition.

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(c) As an exception to R403.3(b), if the interest or relationship cannot reasonably be ended by the effective date, the firm shall:

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- (i) Evaluate the threat that is created by the interest or relationship; and
- (ii) Discuss with those charged with governance the reasons why the interest or relationship cannot reasonably be ended by the effective date and the evaluation of the significance of the threat.

403.3 A1 The more significant the threat, the more likely the firm's objectivity will be compromised and it will be unable to continue as auditor. The significance of the threat to objectivity might depend upon factors such as:

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- The nature and significance of the interest or relationship.
- The nature and significance of the related entity relationship (for example, whether the related entity is a subsidiary or parent).

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- The length of time until the interest or relationship can reasonably be ended.

**R403.4** If those charged with governance request the firm to continue as the auditor, the firm shall do so only if:

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- (a) The interest or relationship will be ended as soon as reasonably possible but no later than six months after the effective date of the merger or acquisition;
- (b) Any individual who has such an interest or relationship, including one that has arisen through performing a non-assurance service that would not be permitted by C1, will not be a member of the engagement team for the audit or the individual responsible for the engagement quality control review; and
- (c) Transitional measures will be applied, as necessary, and discussed with those charged with governance.

403.4 A1 Examples of transitional measures include:

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- Having a professional accountant review the audit or non-assurance work as appropriate.
- Having a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, perform a review that is equivalent to an engagement quality control review.
- Engaging another firm to evaluate the results of the non-assurance service or having another firm re-perform the non-assurance service to the extent necessary to enable the other firm to take responsibility for the service.

**R403.5** The firm might have completed a significant amount of work on the audit prior to the effective date of the merger or acquisition and might be able to complete the remaining audit procedures within a short period of time. In such circumstances, if those charged with governance request the firm to complete the audit while continuing with an interest or relationship identified in paragraph 403.1, the firm shall only do so if it:

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- (a) Has evaluated the significance of the threat created by such interest or relationship and discussed the evaluation with those charged with governance;
- (b) Complies with the requirements of paragraph R403.4(a) to (c); and
- (c) Ceases to be the auditor no later than the date that the audit report is issued.

**R403.6** When addressing previous and current interests and relationships set out in paragraph 403.1, the firm shall determine whether, even if all the requirements of paragraphs R403.3 to R403.5 could be met, the interests and relationships create threats that would remain so significant that objectivity would be compromised. If so, the firm shall cease to be the auditor.

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**R403.7** The firm shall document:

- (a) Any interests or relationships set out in paragraph 403.1 that will not be ended by the effective date of the merger or acquisition and the reasons why they will not be ended;
- (b) The transitional measures applied;
- (c) The results of the discussion with those charged with governance; and
- (d) The reasons why the previous and current interests and relationships do not create threats that would remain so significant that objectivity would be compromised.

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## Subsection 404 – Breach of an Independence Provision

### Introduction

404.1 A breach of a provision of C1 might occur despite the firm having policies and procedures designed to provide it with reasonable assurance that independence is maintained. It might be necessary to end the audit engagement because of the breach.

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### Requirements and Application Material

#### When a Firm Identifies a Breach

**R404.2** If a firm concludes that a breach of an independence provision of C1 has occurred, the firm shall:

- (a) End, suspend or eliminate the interest or relationship that created the breach and address the consequences of the breach;
- (b) Consider whether any legal or regulatory requirements apply to the breach and, if so:
  - (i) Comply with those requirements; and
  - (ii) Consider reporting the breach to a professional body or regulator if such reporting is common practice or expected in the relevant jurisdiction;
- (c) Promptly communicate the breach in accordance with its policies and procedures to:
  - (i) The engagement partner;
  - (ii) Those with responsibility for the policies and procedures relating to independence;
  - (iii) Other relevant personnel in the firm and, where appropriate, the network; and
  - (iv) Those subject to the independence requirements who need to take appropriate action;
- (d) Evaluate the significance of the breach and its impact on the firm's objectivity and ability to issue an audit report; and
- (e) Depending on the significance of the breach, determine whether:

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- (i) To end the audit engagement; or
- (ii) Whether it might be possible to take action that satisfactorily addresses the consequences of the breach, and whether such action can be taken and is appropriate in the circumstances.

In making this determination, the firm shall exercise professional judgment and take into account whether a reasonable and informed third party would be likely to conclude that the firm's objectivity would be compromised and therefore the firm is unable to issue an audit report.

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404.2 A1 When a breach of the independence requirements set out in C1 is identified, the significance and impact of the breach on the firm's objectivity and ability to issue an audit report will depend on factors such as:

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- The nature and duration of the breach.
- The number and nature of any previous breaches with respect to the current audit engagement.
- Whether an audit team member had knowledge of the interest or relationship that created the breach.
- Whether the individual who created the breach is an audit team member or another individual for whom there are independence requirements.
- If the breach relates to an audit team member, the role of that individual.
- If the breach was created by providing a professional service, the impact of that service, if any, on the accounting records or the amounts recorded in the financial statements on which the firm will express an opinion.
- The extent of the self-interest, advocacy, intimidation or other threats created by the breach.

404.2 A2 Depending upon the significance of the breach, examples of actions that the firm might consider to satisfactorily address the breach include:

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- Removing the relevant individual from the audit team.
- Using different individuals to conduct an additional review of the affected audit work or to re-perform that work to the extent necessary.
- Recommending that the audit client engage another firm to review or re-perform the affected audit work to the extent necessary.
- If the breach relates to a non-assurance service that affects the accounting records or an amount recorded in the financial statements:
  - Engaging another firm to evaluate the results of the non-assurance service.

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- Having another firm re-perform the non-assurance service to the extent necessary to enable the other firm to take responsibility for the service.

**R404.3** If the firm determines that it cannot take action to satisfactorily address the consequences of the breach, the firm shall inform those charged with governance as soon as possible and take the steps necessary to end the audit engagement in compliance with any applicable legal or regulatory requirements. Where ending the engagement is not permitted by law or regulation, the firm shall comply with any reporting or disclosure requirements.

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**R404.4** If the firm determines that it can take action to satisfactorily address the consequences of the breach, the firm shall discuss with those charged with governance:

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- (a) The significance of the breach, including its nature and duration;
- (b) How the breach occurred and how it was identified;
- (c) The action proposed or taken and why the action will satisfactorily address the consequences of the breach and enable the firm to issue an audit report;
- (d) The conclusion that, in the firm's professional judgment, objectivity has not been compromised and the rationale for that conclusion; and
- (e) Any steps proposed or taken by the firm to reduce or avoid the risk of further breaches occurring.

Such discussion shall take place as soon as possible unless an alternative timing is specified by those charged with governance for reporting less significant breaches.

*Communication with Those Charged with Governance – Breaches of an Independence Provision*

**R404.5** The firm shall communicate in writing to those charged with governance:

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- (a) All matters discussed in accordance with paragraphs R404.2 to R404.4 and obtain the concurrence of those charged with governance that action can be, or has been, taken to satisfactorily address the consequences of the breach; and
- (b) A description of the firm's policies and procedures relevant to the breach designed to provide it with reasonable assurance that independence is maintained and any steps that the firm has taken, or proposes to take, to reduce or avoid the risk of further breaches occurring.

**R404.6** If those charged with governance do not concur that the action proposed by the firm in accordance with R404.2(e)(ii) satisfactorily addresses the consequences of the breach, the firm shall take the steps necessary to end the audit engagement in accordance with the provisions set out in paragraph R404.3.

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*Breaches Before the Previous Audit Report Was Issued*

**R404.7** If the breach occurred prior to the issuance of the previous audit report, the firm shall comply with the provisions of C1 in evaluating the significance of the breach and its impact on the firm's objectivity and its ability to issue an audit report in the current period.

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**R404.8** The firm shall also consider the impact of the breach, if any, on the firm's objectivity in relation to any previously issued audit reports, and the possibility of withdrawing such audit reports, and discuss the matter with those charged with governance.

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*Documentation – Breaches of an Independence Provision*

**R404.9** In applying the provisions of R404.1 to R404.8, the firm shall document:

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- (a) The breach;
- (b) The action taken;
- (c) Key decisions made;
- (d) All the matters discussed with those charged with governance; and
- (e) Any discussions with a professional body or regulator.

**R404.10** If the firm continues with the audit engagement, it shall also document the conclusion that, in the firm's professional judgment, objectivity has not been compromised and why the action taken satisfactorily addressed the consequences of the breach so that the firm could issue an audit report.

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