

Safeguards Phase 1 – Proposed Revisions to ED-1 (Sections 120 and 300)

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Section 120**The Conceptual Framework****Introduction**

- 120.1 The circumstances in which professional accountants operate might create threats to compliance with the fundamental principles. The conceptual framework sets out requirements and application material to assist the professional accountant in complying with the fundamental principles and meeting their responsibility to act in the public interest. It also accommodates the wide range of facts and circumstances, including the various professional activities, interests and relationships that create threats to compliance with the fundamental principles, and deters an accountant from concluding that a situation is permitted if it is not specifically prohibited by this Code.
- 120.2 The conceptual framework specifies an approach for the professional accountant to:
- (a) Identify threats to compliance with the fundamental principles.
 - (b) Evaluate the threats identified and, when applicable, re-evaluate those threats.
 - (c) Address the threats by eliminating or reducing them to an acceptable level. This includes performing an overall assessment about whether identified threats to the fundamental principles are appropriately addressed.

Requirements and Application Material

- R120.3** The professional accountant shall apply the conceptual framework to identify, evaluate and address threats to compliance with the fundamental principles set out in Section 100.
- 120.3 A1 Additional requirements and application material that are relevant to the application of the conceptual framework are set out in:
- Part B, *Professional Accountants in Business*; and
 - Part C, *Professional Accountants in Public Practice*. Part C includes the International Independence Standards in C1 and C2.
- R120.4** When applying the conceptual framework, the professional accountant shall:
- (a) Exercise professional judgment,
 - (b) Remain alert for new information and to changes in facts and circumstances, and
 - (c) Take into account the reasonable and informed third party test as described in paragraph 120.4 A1 below.

The Conceptual Framework contained in Section 120 applies in all circumstances

Reasonable and Informed Third Party Test

- 120.4 A1 The reasonable and informed third party test involves a consideration by the professional accountant about whether an objective person who possesses skills, knowledge and experience to evaluate the appropriateness of the professional accountant's judgments and conclusions would likely reach the same conclusions. This test entails that objective person weighing all the relevant facts and circumstances that the professional accountant knows, or could reasonably be expected to know, at the time that the professional accountant's judgments and conclusions were made.

Identifying Threats

- R120.5** The professional accountant shall identify threats to compliance with the fundamental principles.
- 120.5 A1 An understanding of the facts and circumstances, including professional activities, interests and relationships, that might compromise compliance with the fundamental principles is a prerequisite to the accountant's identification of threats to such compliance.
- 120.5 A2 Threats to compliance with the fundamental principles might be created by a broad range of facts and circumstances. It is not possible to define every situation that creates threats. In addition, the nature of engagements and work assignments might differ and, consequently, different types of threats might be created.
- 120.5 A3 Threats to compliance with the fundamental principles fall into one or more of the following categories:
- (a) Self-interest threat – the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior;
 - (b) Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made, or activity or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the professional accountant will rely when forming a judgment as part of performing a current activity or providing a current service;
 - (c) Advocacy threat – the threat that a professional accountant will promote a client's or employer's position to the point that the accountant's objectivity is compromised;
 - (d) Familiarity threat – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
 - (e) Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.
- 120.5 A4 A circumstance might create more than one threat, and a threat might affect compliance with more than one fundamental principle.

The Conceptual Framework contained in Section 120 applies in all circumstances

120.5 A5 Certain conditions, policies and procedures established by the profession, legislation, regulation, the firm or the employing organization might act as a deterrent to unethical behavior. They may also enhance the professional accountant's ability to identify threats. Examples of such conditions, policies and procedures include:

- Corporate governance requirements.
- Educational, training and experience requirements for the profession.
- Effective complaint systems which enable the professional accountant and the general public to draw attention to unethical behavior.
- An explicitly stated duty to report breaches of ethical requirements.
- Professional or regulatory monitoring and disciplinary procedures.

Evaluating Threats

R120.6 When the professional accountant identifies a threat to compliance with the fundamental principles, the professional accountant shall evaluate whether such a threat is at an acceptable level.

120.6 A1 The consideration of qualitative as well as quantitative factors is relevant to the professional accountant's evaluation of threats, as is the combined effect of multiple threats, if applicable.

120.6 A2 The existence of conditions, policies and procedures discussed in paragraph 120.5 A5 above might also impact the professional accountant's evaluation of the level of threats to compliance with the fundamental principles.

Acceptable Level

120.6 A3 An acceptable level is a level at which a reasonable and informed third party would likely conclude that the professional accountant complies with the fundamental principles.

Consideration of New Information or Changes in Facts and Circumstances

R120.7 If the professional accountant becomes aware of new information or changes in facts and circumstances that might impact whether a threat has been eliminated or reduced to an acceptable level, the accountant shall re-evaluate and address that threat accordingly.

120.7 A1 Remaining alert throughout the professional activity or service assists the professional accountant in determining whether new information has emerged or changes in facts and circumstances have occurred that:

- (a) Impact the level of a threat; or
- (b) Affect the professional accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats.

The Conceptual Framework contained in Section 120 applies in all circumstances

Addressing Threats

- R120.8** If the professional accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the professional accountant shall address the threats by eliminating or reducing them to an acceptable level. The professional accountant shall do so by:
- (a) Eliminating the circumstances, including interests or relationships, that are creating the threats;
 - (b) Applying safeguards, where available and capable of being applied; or
 - (c) Declining or discontinuing the specific professional activity or service involved.

Safeguards

- 120.8 A1 Safeguards are actions, individually or in combination, that the professional accountant takes that effectively eliminate threats to compliance with the fundamental principles or reduce them to an acceptable level.
- 120.8 A2 There are some situations when safeguards will not be capable of reducing threats to compliance with the fundamental principles to an acceptable level. For example, the International Independence Standards set out in Part C1 and C2 of the Code include a further discussion of, and provide examples of, those situations.

Consideration of Significant Judgments Made and Overall Conclusions Reached

- R120.9** As part of forming an overall conclusion about whether threats to the fundamental principles are appropriately addressed the professional accountant shall review significant judgments made and overall conclusions reached. The reasonable and informed third party test described in paragraph 120.4 A1 is relevant to the professional accountant's ultimate conclusion about whether threats to compliance with the fundamental principles are eliminated or reduced to an acceptable level.
- 120.9 A2 If the professional accountant identifies a new threat either as part of applying the requirements in paragraphs R120.7 or R120.9, the application of the conceptual framework requires that the professional accountant evaluate the level of, and address, this new threat in accordance with paragraphs R120.5–120.6 A3 and R120.8–120.8 A2.

[Note to CAG: The material presented in shaded text below has been developed by the Structure Task Force. Views from CAG Representatives on the Structure Task Force's proposal will be sought during the September 2016 CAG meeting.]

Considerations for Audits, Reviews and Other Assurance Engagements

- 120.10 The Code requires all professional accountants to comply with the fundamental principles. Professional accountants in public practice who perform audits, reviews, or other assurance engagements, are also required to comply with International Independence Standards set out in C1 and C2.

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R120.11 When performing engagements that require the professional accountant in public practice to be independent, the professional accountant in public practice shall apply the requirements and application material set out in the conceptual framework (see paragraphs 120.1–R120.9 above), to identify, evaluate and address threats to compliance with the International Independence Standards in C1 and C2.

120.11 A1 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 an audit team member's integrity, objectivity or professional skepticism has been compromised."

Independence is linked to the fundamental principles of objectivity and integrity.

120.11 A2 The categories of threats to compliance with the fundamental principles and to compliance with the International Independence Standards in C1 and C2 as described in paragraph 120.5 A3 are the same. Therefore, the conceptual framework to identify, evaluate and address those categories of threats applies to compliance with the fundamental principles as it does to compliance with independence standards.

120.11 A3 As explained in paragraph 400.7, although firms and professional accountants within those firms each have responsibilities for compliance with International Independence Standards, many of the provisions in C1 refer to 'firm' for ease of reference, even if the main responsibility rests with an individual within the firm.

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SECTION 300 PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE

Section 300

Application of the Conceptual Framework Approach by Professional Accountants in Public Practice

Introduction

300.1 This Part of the Code describes considerations for professional accountants in public practice to apply the conceptual framework set out in Section 120. It does not describe all of the facts and circumstances, including professional services, interests and relationships, that could be encountered by professional accountants¹ which create or might create threats to compliance with the fundamental principles. Therefore, professional accountants are required to be alert for such facts and circumstances.

300.2 [Placeholder for words to be developed by the Structure Task Force with input from the Safeguards Task Force to:

- Explain the applicability of the provisions in Section 120, Section 400 [and Part B] to professional accountants in public practice; and
- Indicate that threats to compliance with the fundamental principles in the case of assurance engagements should also be threats to independence.]

Requirements and Application Material

R300.3 A professional accountant shall comply with each of the fundamental principles set out in Section 100 and apply the conceptual framework set out in Section 120 to eliminate threats to compliance with those fundamental principles or to reduce them to an acceptable level.

Identifying Threats

300.4 A1 Compliance with the fundamental principles might be threatened by a broad range of facts and circumstances. The categories of threats are described in paragraph 120.5 A3. The following are examples of facts and circumstances within each of those categories of threats that might create threats for a professional accountant who is undertaking a professional activity or providing a professional service:

(a) Self-interest Threats

- A professional accountant having a direct financial interest in a client.
- A professional accountant or firm having undue dependence on total fees from a client or the possibility of losing a significant client.

¹ Within Section 300, in Part C and in C1 and C2, the term “professional accountant” refers to professional accountants in public practice and firms of professional accountants in practice.

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- A professional accountant having a significant close business relationship with a client.
 - A member of the audit team entering into employment negotiation with the audit client.
- (b) Self-review Threats
- A professional accountant issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
 - A professional accountant having prepared the original data used to generate records that are the subject matter of the assurance engagement.
 - A professional accountant being, or having recently been, a director or officer of the client, or having recently been employed by the client in a position to exert significant influence over the subject matter of the engagement.
 - The firm performing a service for an assurance client that directly affects the subject matter information of the assurance engagement.
- (c) Advocacy Threats
- The professional accountant promoting the interests of, or shares in a client's stock.
 - A professional accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties
- (d) Familiarity Threats
- A member of the engagement team having a close or immediate family member who is a director or officer of the client, or is an employee of the client and is in a position to exert significant influence over the subject matter of the engagement.
 - A director or officer of the client, or an employee in a position to exert undue influence over the subject matter of the engagement, having recently served as the engagement partner.
 - Senior personnel having a long close association with the assurance client.
- (e) Intimidation Threats
- A professional accountant or firm being threatened with dismissal from a client engagement.
 - A professional accountant feeling pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.
 - A professional accountant being informed by the firm or the employing organization that a planned promotion will not occur unless the professional accountant agrees with an audit client's inappropriate accounting treatment.

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Evaluating Threats

300.5 A1 Conditions, policies and procedures established by the profession, legislation, regulation, the firm or the employing organization that might enhance the professional accountant's identification of threats and also impact the evaluation of whether a threat to compliance with the fundamental principles is at an acceptable level include the nature of:

- (a) The client and its operating environment;
- (b) The professional service being provided; and
- (c) The firm and its operating environment.

The Client and its Operating Environment

300.5 A2 The professional accountant's evaluation of the level of a threat may be impacted by the following:

- (a) An audit client and whether the audit client is a public interest entity;
- (b) An assurance client that is not an audit client; or
- (c) A non-assurance client.

For example, providing a service to an audit client might be perceived to result in a higher level of threat to the fundamental principle of objectivity. Such a threat might be further increased when the audit client is a public interest entity.

300.5 A3 The corporate governance structure, including the leadership of a client can influence a professional accountant's compliance with the fundamental principles. Accordingly, a professional accountant's evaluation of the level of the threat might also be impacted by a client's operating environment. For example:

- The client requires appropriate persons other than management to ratify or approve the appointment of a firm to perform an engagement.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that facilitate objective choices in tendering non-assurance engagements.
- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

The Professional Service Being Provided

300.5 A4 The professional accountant's evaluation of the level of a threat is impacted by the nature and scope of the professional service. Examples of professional services, the threats that might

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arise as a result, and how a professional accountant may address those threats are discussed in International Independence Standards C1 and C2.

The Firm and its Operating Environment

300.5 A5 A professional accountant's evaluation of the level of a threat might be impacted by the work environment within a firm and its operating environment. For example:

- Leadership of the firm that promotes compliance with the fundamental principles and establishes the expectation that members of the assurance team will act in the public interest.
- Conditions, policies or procedures for establishing and monitoring compliance with the fundamental principles by all personnel.
- Compensation, performance appraisal and disciplinary policies and procedures that promote compliance with the fundamental principles.
- Management of the reliance on revenue received from a single client.
- The engagement partner having authority within the firm for decisions concerning compliance with the fundamental principles, including decisions about accepting or providing non-assurance services to an audit client.
- Educational, training and experience requirements.
- Processes to facilitate and address internal and external concerns or complaints.

Consideration of New Information or Changes in Facts and Circumstances

300.5 A6 New information or changes in facts and circumstances might

- (a) Impact the level of a threat; or
- (b) Affect the professional accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats.

300.5 A7 Examples of new information or changes in facts and circumstances that might impact the level of a threat include:

- When the scope of a professional service is expanded.
- When the client becomes a listed entity or acquires another business unit.
- When the firm merges with another firm.
- Where a member of the engagement team's immediate family member is recently employed by the client.

In the situations described above, actions that were already implemented as safeguards might no longer be effective in addressing threats. Accordingly, the application of the conceptual framework requires that the professional accountant assess the need to re-evaluate and address any new threats and address them accordingly (see paragraph R120.8).

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Addressing Threats

Examples of Safeguards

300.6 A1 Paragraphs R120.8–120.8 A2 includes requirements and application for addressing threats. Safeguards vary depending on the facts and circumstances. Below are examples of actions that in certain circumstances might be safeguards in addressing threats:

- Having a professional accountant who was not involved with the non-assurance service provided to an audit client review the non-assurance work performed, or advise as necessary might address a self-review threat.
- Having a professional accountant who was not a member of the team review the work performed or advise as necessary may address a self-review threats.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client may address self-review and familiarity threats.
- Consulting or seeking approval from those charged with governance or an independent third party, including a committee of independent directors, a professional regulatory body or another professional accountant might address advocacy or intimidation threats.
- Involving another firm to perform or re-perform part of the engagement might address self-interest, self-review, advocacy or familiarity threats.
- Rotating assurance team personnel might address self-interest and familiarity threats.

Consideration of Significant Judgments Made and Overall Conclusions Reached

300.6 A2 As part of forming conclusions about whether identified threats to the fundamental principles are appropriately addressed, Section 120 requires that the professional accountant review significant judgments made and overall conclusions reached. The reasonable and informed third party test described in paragraph 120.4 A1 is relevant to this to the professional accountant's ultimate conclusion about whether threats to compliance with the fundamental principles are eliminated or reduced to an acceptable level.