

Meeting: IESBA CAG
Meeting Location: Marriott, Prague, Czech Republic
Meeting Date: September 14, 2011

Breach of an Independence Requirement

Objective of Agenda Item

To seek input from CAG members on the proposals to address a breach of an independence provision of the Code.

Background to the Project

The Code contains several paragraphs that address an inadvertent violation of a provision of the Code. Those paragraphs were commented on by the International Organization of Securities Commissions (“IOSCO”) in its response to the IESBA’s Drafting Conventions Exposure Draft, issued in July 2008. Appendix A contains the text of their comments.

The IESBA recognized the concern expressed by IOSCO. The issues raised were beyond the scope of that ED and needed to be considered separately. In 2010, the IESBA concluded that a project should be undertaken to reconsider the inadvertent violation provisions, starting with determining whether the provisions are needed and, if so, how the provisions can be enhanced with regard to scope and application.

The CAG discussed proposals to address the issue at its March 2011 meeting. The IESBA discussed a draft exposure draft at its June 2011 meeting and met again by conference call in July 2011 to discuss proposed Task Force¹ changes to respond to input received from the IESBA.

The Task Force will meet on Sept 30th and Oct 1st to consider input from CAG members and to finalize the proposals. The proposals will be presented to the IESBA for approval as an exposure draft at its October 17th-19th meeting.

¹ Kate Spargo (chair), Wui San Kwok, Alice McCleary and Marisa Orbea

Overview of Approach Proposed

The IESBA is expected to propose deleting all of the paragraphs in the Code addressing an inadvertent violation of a provision of the Code and replacing them with revised provisions in Section 290 *Independence – Audit and Review Engagements* and Section 291 *Independence – Other Assurance Engagements* addressing a breach of an independence requirement of the Code.

The proposed guidance would require a firm to take the following actions if a breach is identified:

- Take steps as soon as possible to suspend or eliminate the breach;
- Consider whether there are any applicable legal or regulatory requirements in relation to how a breach is to be addressed and, if so, take the steps necessary to comply with those requirements;
- Evaluate the significance of the breach and its impact on the firm's objectivity and ability to issue the audit report;
- Determine whether action can be taken to satisfactorily address the consequences of the breach. In making this determination the firm shall consider whether a reasonable and informed third party weighing the significance of the breach would be likely to conclude that objectivity would be compromised such that the firm is unable to issue an audit report;
- If the firm determines that action cannot be taken, it shall discuss this with those charged with governance and take the steps necessary to terminate the audit engagement;
- If the firm determines action can be taken, it shall discuss the breach with those charged with governance as soon as possible and if those charged with governance agree, ensure the actions are implemented; and
- Document the actions taken and all the matters discussed with those charged with governance and, if applicable, relevant regulators.

A similar approach is taken in Section 291.

The proposed text of the requirements in Sections 290 and 291 are contained in Agenda Paper E-1.

Matters for Discussion

The IESBA welcomes comments from CAG members on any aspect of the proposals but in particular seeks the views of CAG members on the two matters that follow.

Focus on a Breach of an Independence Requirement

The IESBA is of the view that the provisions should apply only to the independence requirements of the Code. A distinguishing feature of the independence provisions is the consequences of the violation – if an independence requirement is violated and the firm cannot issue an opinion, there is a potential for harm to, for example, third parties who are planning certain activities upon receiving the audited financial statements and may be working within tight time constraints. Switching auditors could, depending upon the

timing, result in the company having difficulty meeting its filing requirements, missing a market opportunity, and delaying a planned transaction. It also could impact public perceptions about the company and the condition of its financial accounts, and raise doubt about management's stewardship of company assets and the company's compliance culture. If the impact of the violation was trivial or inconsequential, the consequences of a firm resignation would thus be disproportionate to the violation. In the case of the other provisions in the Code, there are not the same consequences to the public.

Action Requested:

CAG members are asked for their views on whether the provisions should address only the independence requirements in the Code.

Timing of Reporting a Breach

The IESBA considered three alternatives regarding the timing of discussions with those charged with governance:

- As soon as possible, and
- On a timely basis.

In determining which timing was appropriate, the IESBA considered the following arguments in favor of each approach:

- As soon as possible
 - Those charged with governance are responsible for overseeing the financial reporting process of the entity and, in many jurisdictions are responsible for reviewing and monitoring the independence of the external audit. It is therefore appropriate that any breaches be communicated as soon as possible. This would mean that the firm has evaluated the breach and made a determination of whether actions can be taken to satisfactorily address the consequences of the breach; and
 - Those charged with governance have a role to play in determining whether action can be taken to satisfactorily address the consequences of the breach. Any breach should be communicated as soon as possible so that those charged with governance can determine whether the actions are satisfactory.
- On a timely basis
 - The significance of a breach and its impact on the firm's objectivity, and thus its ability to issue an audit report, depend in large part on the nature of the breach; the timing of the reporting of the breach should, therefore, be based on the significance of the breach. For example, a breach would be created if the spouse of a partner in the office of the engagement partner purchased 10 shares in the audit client. The impact of such a breach would be less significant than if a network firm provided a prohibited non assurance service to a significant related entity of the audit client.

Accordingly, "on a timely basis" would promote a quicker reporting of the second breach than the first breach.

After consideration, the IESBA concluded that the breach should be reported as soon as possible.

Action Requested

CAG members are asked for their views on when a breach should be communicated to those charged with governance.

Material Presented

Agenda Paper E	This Agenda Paper
Agenda Paper E-1	Breach of an Independence Requirement – proposed wording
Agenda Paper E-2	March 2011 Feedback Statement - Breaches

Action Requested

CAG members are asked to

1. Address the specific questions set out in the agenda paper, and
2. Raise any other matters that they believe should be considered by the IESBA prior to the exposure draft being approved for publication.