

## Safeguards Phase 1—Issues and Task Force Proposals

### How the Project Serves the Public Interest

This project addresses the clarity, appropriateness and effectiveness of safeguards in the extant Code. Phase 1 of the project includes revisions to safeguards in Section 100<sup>1</sup> and Section 200<sup>2</sup> of the extant Code.<sup>3</sup> Phase 2 of the project deals with safeguards that pertain to non–assurance services (NAS) in Section 290<sup>4</sup> and other conforming changes to the extant Code that are deemed necessary.<sup>5</sup>

Varying views exist about what constitutes a safeguard, as well as on the effectiveness and appropriateness of the examples of safeguards within the Code whether they are appropriate to eliminate threats to independence and compliance with the fundamental principles or reduce them to an acceptable level.

Enhanced requirements and application material about how to identify, evaluate and address threats to compliance with the fundamental principles and threats to independence (i.e., apply the conceptual framework (CF)), will support PAs (PAs) in fulfilling their responsibility to act in the public interest, and with respect to audits of financial statements, contribute to supporting audit quality.

### Introduction

- At its June 2016 meeting, the IESBA considered a [summary of significant issues](#) raised by respondents to the December 2015 Exposure Draft (ED), [Proposed Revisions Pertaining to Safeguards in the Code—Phase 1](#) (Safeguards ED-1) and the Task Force (TF's) proposed revisions.<sup>6</sup>

### Recap of IESBA Discussions

- The IESBA broadly supported the direction of the TF's proposed revisions to Safeguards ED-1 in the light of the feedback from respondents, and provided input on those revisions taking into account the input received from the June 2016 IESBA National Standards Setters meeting and the June 20, 2016 IESBA Consultative Group teleconference. The IESBA asked that the TF further consider:
  - Refinements to its proposed revisions to clarify the various stages in the CF set out in Section 120, in particular, the requirements for PAs to re-evaluate new information or changes in facts and circumstances, and to form overall conclusions about whether threats are addressed.
  - Consider whether changes are needed to the description of familiarity threats in light of near-final

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

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

<sup>3</sup> Phase 1 of the Safeguards project includes proposed revisions to paragraphs 100.12–100.16 and paragraphs 200.3–200.15 of the extant Code.

<sup>4</sup> Extant Section 290, *Independence – Audit and Review Engagements*

<sup>5</sup> Phase 2 of the Safeguards project will explore proposals to revise:

- Paragraphs 290.100 to 290.101 of the extant Code, titled *Application of the Conceptual Framework Approach to Independence*.
- Paragraphs 290.154 to 290.216, *Provision of Non-Assurance Services to an Audit Client*.
- Conforming changes to other sections of the Code, including Section 291. The TF plans to consider conforming amendments to Section 291 pertaining to NAS and independence in the context of other assurance engagements at its October 2016 meeting.

<sup>6</sup> The IESBA noted that as of June 2016, the TF had considered the feedback from all except two respondents to Safeguards ED-1 – International Forum of Independent Audit Regulators (IFIAR) and International Organizations of Securities Commissions (IOSCO).

Long Association (LA) proposals.

- Clarify the description of the reasonable and informed third party test. The IESBA was of the view that the TF should describe in a simple manner what the test involves, as well as, the characteristics of the person who would be performing the test (i.e., the reasonable and informed third party). Some IESBA members also asked that the TF consider wording that describe similar concepts at the jurisdictional level.
- How best to emphasize in the Code that there are situations when there can be no safeguards to eliminate threats or reduce them to an acceptable level.
- The appropriateness of the description of safeguards in light of the feedback received from late respondents – IFIAR and IOSCO.
- How to respond to concerns raised about Section 300 (e.g., clarify its purpose and consider how to improve the examples of safeguards) contained herein.

### Overview of Paper

3. The purpose of this paper is to summarize the significant revisions made to the June 2016 IESBA meeting draft of Safeguards ED-1 and explain the TF's rationale for those revisions. The paper is organized as follows:
  - Matters related to clarifying the CF (Section 120);
    - Description of reasonable and informed third party
    - Description of acceptable level
    - Description of safeguards, including conditions, policies and procedures
  - Matters pertaining to the revision of proposed Section 300<sup>7</sup>; and
  - Other matters.

## Issues and TF Proposals

### Matters Related to Clarifying the CF (Section 120)

4. The TF noted IESBA's general support for its revised proposals and agreed to retain its approach. As explained in the Structure TF agenda materials, several structural revisions have been made to Section 120 and to clarify the interaction between the CF and the rest of the Code. For example, the CF set out in Section 120 in paragraphs 120.10 A1–120.10 A2 of **Agenda Item 2-B**, include new guidance under a heading titled *Considerations for Audits, Reviews and Other Assurance Engagements* which:
  - (a) State that PAs in public practice are required to be independent when performing audits, reviews or other assurance engagements.
  - (b) Explain that independence is linked to the fundamental principles of objectivity and integrity and restates the extant description of independence.

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<sup>7</sup> Section 300, *Applying the Conceptual Framework – Professional Accountants in Public Practice*

- (c) State that the CF set out in Section 120 to identify, evaluate and address threats to compliance with the fundamental principles applies in the same way to compliance with independence requirements.
- (d) Refer to the requirements and application material in Parts 4A—*Independence for Audits and Reviews* and 4B—*Independence for Other Assurance Engagements* of the restructured Code for requirements and application material that explain how to apply the CF to maintain independence when performing audits, reviews or other assurance engagements, as the case may be.
- (e) Explain that the categories of threats to compliance with the fundamental principles described in paragraph 120.5 A3 (i.e., self-interest, self-review, advocacy, familiarity and intimidation) also apply to threats to compliance with independence.

5. The revisions described above were developed by the Structure TF.

#### The CF – A Three Stage Approach

6. The TF continues to be of the view that the simple three stage approach described in the CF set out in Section 120 is appropriate. The TF's revised proposals in **Agenda Item 2-B** include several refinements to clarify the three stages in the CF. With the use of new subheading titles, the TF's proposals clarify that the timing for applying the requirement to:
- Consider new information or changes in facts and circumstances, formerly titled "Re-evaluating Threats" should be as part of evaluating threats. The new subheading titled "Consideration of New Information or Changes in Facts and Circumstances" positioned under the main heading "Evaluating Threats" is intended to clarify that the requirement to re-evaluate threats is not an additional stage per se, but rather forms part of the PA's responsibility to properly evaluate threats to compliance with the fundamental principles.
  - Perform the overall assessment, formerly titled "Overall Assessment" should be as part of addressing threats. The new subheading titled "Consideration of Significant Judgments Made and Overall Conclusions Reached" positioned under the main heading "Addressing Threats" is intended to clarify that the requirement to perform an overall assessment is not an additional stage per se, but rather forms part of the PA's responsibility to properly address threats to compliance with the fundamental principles.

#### Threats

7. The TF continues to believe that it is important to require that PAs identify threats to compliance with the fundamental principles. Accordingly, it believes that the requirement to identify threats to compliance with the fundamental principles and the supporting application material that:
- Explain that understanding the facts and circumstances, including professional activities, interests and relationships that might compromise compliance with the fundamental principles enables the PA to identify threats;
  - Indicate that threats to compliance with the fundamental principles might be created by a broad range of facts and circumstances, the description of which, are not all possible;
  - Describe the various categories of threats to compliance with the fundamental principles; and

- Explain that the existence of certain conditions, policies and procedures established by the profession, legislation, regulation, the firm or employing organization might assist in the identification of threats to compliance with the fundamental principles.

should be retained. See paragraphs R120.5–120.5 A5.

8. The TF also affirmed its view that the categories and description of threats in the extant Code that were brought forward to Safeguards ED-1, including the definition of familiarity threat, continue to be complete and appropriate. (See further discussion with respect to the definition of familiarity threat in **Agenda Item 5-A.**)

#### Addressing Threats

9. Safeguards ED-1 included new application material that states “There are some situations where the threat created would be so significant that no safeguards could reduce the threat to an acceptable level.” As noted in the June 2016 IESBA meeting agenda materials, the aim behind the statement was supported, but a number of respondents were of the view that this application material should be stated more explicitly to indicate that there are situations in which no safeguards are possible.
10. The TF further reflected on the following suggestions made by respondents with respect to paragraph 120.7 A1 of Safeguards ED-1 which asked that the IESBA consider:
  - Elevating the application material to a requirement that clarifies that there are no safeguards available, the PA is required to decline or discontinue the service “unless precluded from doing so by law or regulation”.
  - Repositioning the application material and elevate so that it appears before R120.3 in Safeguards ED-1 (i.e., the first requirement in Section 120).
  - Clarify what is meant by last sentence in the paragraph.

#### TF proposal

11. Taking into account the input from the June 2016 IESBA discussion, the TF agreed to retain the ordering of paragraphs 120.7 A1 and 120.7 A2 as presented in the June 2016 IESBA meeting materials.
12. The TF has further refined the wording in 120.7 A1 of Safeguards ED-1 to state that: “There are some situations in which the circumstances creating the threats cannot be eliminated and there are no safeguards to eliminate the threats created or reduce them to an acceptable level. In such situations, the PA is required to decline or end the specific professional activity” (see paragraph 120.8 A2).
13. The last sentence of 120.7 A2 of Safeguards ED-1 has been deleted.

#### Re-evaluating Threats and Overall Assessment

14. As highlighted in the June 2016 IESBA meeting agenda materials, some respondents, in particular regulators, were of the view that the PA’s re-evaluation of threats should not be restricted to the emergence of new information or changes in facts and circumstances, but rather the PA should maintain a constant state of awareness and engage in periodic re-evaluation of threats throughout the duration of the professional activity.

15. The TF further reflected on some respondents' requests for more guidance relating to the re-evaluating threats and for performing an overall assessment provisions, including the:
- Calls for clarification about the timing for applying the new requirement for performing an overall assessment.
  - Suggestion that the application material related to performing the overall assessment in Section 300 be dropped since it is required in the CF set out in Section 120.

TF proposal

16. As discussed in paragraph 6, the TF's revised proposals include revisions to clarify the timing for the PA's re-evaluation of threats and for performing the overall assessment.
17. The TF's proposals in paragraphs R120.7–120.7 A1 also include revisions to clarify that the overall assessment is a consideration of significant judgments made and overall conclusions reached. It:
- Requires that the PA, and in the case of audits, reviews and other assurance engagements, the firm, form an overall conclusion about whether the actions that the accountant takes, or intends to take to address the threats created will eliminate those threats or reduce them to an acceptable level.
  - Explains that as part of forming this overall conclusion, it is necessary to review the significant judgments that have been made or conclusions reached, taking into account the reasonable and informed third party test.
18. The application material in Safeguards ED-1 has been refined to clarify what is meant by remaining alert. Paragraph 120.7 A1 clarifies that remaining alert throughout the professional activity assists the PA 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 PA's conclusions about whether safeguards applied continue to be appropriate to address identified threats.
19. The introductory material in Section 300 clarifies that all the requirements and application material in Section 120 apply to PAs in public practice and accordingly do not need to be repeated. Accordingly, the TF has reaffirmed its decision to drop the application material in paragraph 300.2 A12 of Safeguards ED-1 relating to the overall assessment.

**Matters for IESBA Consideration**

1. Do IESBA members agree with the TF's proposed revisions to clarify the various stages of the CF, including the revisions made to explain the timing for re-evaluating threats and performing the overall assessments?

*Description of Reasonable and Informed Third Party Concept*

20. At its June 2016 meeting, the IESBA asked that the TF clarify the description of the reasonable and informed third party test. As noted above, the IESBA was of the view that the TF should describe in a simply manner:

- What the test involves; and
- The characteristics of the person who would be performing the test (i.e., the reasonable and informed third party).

Some IESBA members also asked that the TF consider wording that describe similar concepts at the jurisdictional level.

21. The June 2016 IESBA agenda materials included the heading “Reasonable and Informed Third Party Test”. The TF has revised the title of the heading “Reasonable and Informed Third Party Test” to be “Reasonable and Informed Third Party Concept”. This new heading allows the TF the flexibility to describe both the “reasonable and informed third party test” and a “reasonable and informed third party” in the same paragraph. The TF also notes that the term “reasonable and informed third party” rather than “reasonable and informed third party test” is used many instances in the extant Code, including the recently released *Responding to Non-Compliance with Laws & Regulations* pronouncement.
22. The TF’s revisions related to the description of the reasonable and informed third party concept make it clear that the test is performed by the PA. It explains that the test involves the PA’s consideration of whether the same conclusions would likely be reached by another person. The TF is of the view that this other person effectively meets the description of a reasonable an informed third party. Such a person, the reasonable and informed third party, would possess sufficient knowledge and experience to objectively evaluate the appropriateness of the accountant’s conclusions, and weigh all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions were made (see 120.4 A1).
23. The TF agrees that although the PA performs the test, it is done from the “objective lens” of a person who may not necessarily be a PA, but rather knows enough about a PA’s work to understand and challenge the PA’s judgments made and conclusions reached.
24. The TF continues to believe that the focus of this test should be on what the PA is required to do based on the relevant facts and circumstances that the PA knows, or could reasonably be expected to know, at the time that the PA’s judgments and conclusions were made, but not when the test is performed. The TF has dropped:
  - The word “skills” to avoid the notion that the reasonable and informed third party has to have the same skills as another PA.
  - The words “...to determine whether the accountant complies with the fundamental principles...” in an effort to keep the description of the term sufficiently general for it to be used elsewhere in the Code, and not just in the context of compliance with the fundamental principles. The TF believes that these words are picked up in the description of acceptable level.
  - The word “hypothetical” in response to concerns raised about translation challenges. The TF believes that the revised description, even without the word “hypothetical” clarifies that the test is performed by the PA from the perspective of another person, rather than by another real person.

**Matters for IESBA Consideration**

2. Do IESBA agree with the TF's proposed revisions to clarify the description of reasonable and informed third party?

*Description of Acceptable Level*

25. The June 2016 IESBA agenda meeting materials noted that some respondents to Safeguards ED-1 are of the view that the affirmative description of acceptable level is more prescriptive. This view was expressed by some participants in the June 2016 NSS meeting.
26. The TF continues to believe that describing "acceptable level" in an affirmative manner clarifies the description in the extant Code. However, as a counterbalance to the comments above, the TF has made some refinements in paragraph 120.6 A3 of **Agenda Item 2-B** to emphasize that the determination of whether a threat is at an acceptable level is determined by the PA. The TF continues to believe that the application of the reasonable and informed third party test is relevant to this determination.
27. The TF has noted some merit to the suggestion to avoid the use of the term "acceptable level" but has agreed to retain the concept because it is used pervasively throughout the extant Code and is well understood.
28. The TF has agreed to include a subheading titled "Acceptable Level" above paragraph 120.6 A3 as a way of making the term "acceptable level" more prominent. It is also included in the glossary.

**Matters for IESBA Consideration**

3. Do IESBA agree with the TF's conclusions about how the term acceptable level should be described in the proposed restructured Code?

*Description of Safeguards and Conditions, Policies and Procedures*

29. As the majority of respondents were supportive of the enhancements to the description of safeguards, the TF has reaffirmed its proposals with respect to the description of safeguards. No revisions have been made. However, the revised proposals make it more explicit that there are some situations in which the circumstances creating the threats cannot be eliminated and there are no safeguards to eliminate the threats created or reduce them to an acceptable level. The revised proposals also explain that in such situations, the PA is required to decline or end the specific professional activity (see paragraphs 120.8 A1 and 120.8 A2).
30. With respect to the suggestions to have additional application material and in some cases examples of safeguards in the CF (i.e. in Section 120), the TF is of the view that it is important for the CF to establish the overarching and more general provisions. The TF believes that subsequent sections of the Code should build on the provisions in the CF, including where appropriate, provide more specific application material and examples that are based on specific facts and circumstances.

*Conditions, Policies and Procedures*

31. The TF agreed to retain the proposal to withdraw the terms "safeguards created by the profession or legislation", "safeguards in the work environment" and "safeguards implemented by the entity" (e.g., firm-specific safeguards). These terms were formerly characterized as safeguards in the extant Code.

32. Responsive to some respondents' suggestions, the TF has reinstated some the wording from the extant Code to clarify the importance of those conditions, policies and procedures in the identification and evaluation of threats. The TF has also taken on some of respondents' other suggestions to clarify the related application material in paragraphs 120.5 A4, 120.6 A3 and 300.2 A1 of Safeguards ED-1 (see revised paragraphs 120.5 A5, 120.6 A2 and 300.5 A1 in **Agenda Item 2-B**).

#### **Matters for IESBA Consideration**

4. IESBA members are asked to consider the feedback on Safeguards ED-1 and indicate whether they agree with the TF's conclusions to:
- (a) Make no change to the description of "safeguards" in Safeguards ED-1.
  - (b) Retain proposals to withdraw certain activities (e.g., firm-specific safeguards) which were formerly characterized as safeguards in the extant Code.

#### **Matters Pertaining to the Revision of Proposed Section 300**

33. New introductory material has been included in Section 300 to better explain the interaction between the requirements for PAs in public practice in Section 300 and those for all PAs in Section 120. This new material was developed by the Structure TF, and it explains that Section 300 describes the requirements and application material for PAs in public practice when they apply the CF set out in Section 120. It also clarifies that the provisions in Section 300 apply to both PAs and firms.
34. The TF has reviewed the examples of safeguards in Section 300 of Safeguards ED-1 and believes that they are appropriate (see paragraph 300.7 A1 of **Agenda Item 2-B**). In response to feedback from the June 2016 IESBA meeting, the TF has dropped as an example of safeguard "consulting or seeking approval from those charged with governance or an independent third party..."
35. The TF also made several editorials and refinements to Section 300 to:
- Align to the revisions made in the CF set out in Section 120; and
  - Incorporate, when appropriate, respondents' suggested revisions.

#### **Other Matters**

36. The revisions to the proposals in Safeguards ED-1 also reflect changes to align to the updated format and drafting conventions used by the Structure TF in response to Structure ED-1. For example, the use of the word "might" or "may" and "PA" versus "accountant".

#### *Documentation*

37. The TF further considered respondents' suggestions with respect to documentation and concluded that a consideration of documentation requirements with respect to the Code should be done on a holistic basis, and in coordination with the IAASB. The TF believes that the documentation requirements in the extant Code apply to the enhanced requirements and application material in Sections 120 and 300. The TF is of the view that the development of additional documentation requirements at this stage go beyond the scope of the Safeguards project and is a matter for future IESBA consideration.

*Consideration of Other Jurisdictional Initiatives*

38. In developing Safeguards ED-1, the TF and IESBA considered the initiatives and developments in local jurisdictions (e.g., European Union Audit Reforms) that are aimed at meeting similar objectives as the Safeguards project to determine whether they might be appropriate for global implementation.

*Timing*

39. The TF further reflected on respondents' views with respect to timing. The TF continues to be of the view that the timing of the Safeguards project should be aligned to the Structure of the Code project.

*Small and Medium Practice (SMPs) Considerations*

40. The TF has carefully considered the feedback from SMP respondents has made revisions as appropriate. The TF continues to welcome input from the Ethics Committee of the SMPC as it progresses its revised proposals.

*Principles versus Rules Based Provisions*

41. A few respondents cautioned that the proposed revisions to the CF would result in the Code being prescriptive.
42. The TF is of the view that the enhanced CF and the other provisions in Safeguards ED-1 continue to be principles-based. The TF believes that the enhanced proposals are clearer and include more specific requirements and application material which make Sections 120 and 300 more robust, but not necessarily more prescriptive.

**Matters for IESBA Consideration**

5. IESBA members are asked for views about the TF's proposed revisions to Section 300, *Applying the Conceptual Framework – PAs in Public Practice*.
6. IESBA members are asked to share any further comments on matters relevant to Safeguards Phase 1.