Agenda Item 3-A

Revisions to Fee-related Provisions of the Code — Remaining Issues and Task Force Proposals

Note to IESBA Meeting Participants

This agenda paper should be read in conjunction with:

- **Agenda Item 3-B** (revised proposed text marked up from the updated October 2020 version)
- **Agenda Item 3-B.1** (revised proposed text marked up from the September 2020 turnaround version)
- **Agenda Item 3-C** (compilation of advance comments from IESBA with the Task Force responses)
- **Agenda Item 3-D** (revised proposed text marked up from the January 2020 Exposure Draft)

Recap of September 2020 IESBA Discussion

1. At its September 2020 meeting, the IESBA received a full analysis of the significant comments from the 64 comments letters respondents provided on the January 2020 Exposure Draft (ED), *Revisions to the Fee-related Provisions of the Code*.[1] Additionally, the Task Force presented proposed changes to the provisions regarding how to address these comments.

2. Based on the Task Force's proposals for the way forward, the IESBA agreed, among others, to the following:

   - Threats created by the client relationship are a broader issue and cannot be fully addressed as part of the Fees project. The Fees project will continue to focus on the matter of threats created by fees paid by an audit client.
   - Despite the prohibition that a firm not allow the audit fee to be influenced by the provision of services other than audit, the proposal should allow, as an exception, firms to consider cost savings achieved as a result of experience derived from the provision of previous services when determining audit fees. However, the proposal should be clear that firms need to be able to demonstrate such cost savings, regardless of the stage of the audit at which such cost saving have been, or will be, realized.
   - With regard to the restrictions to the provision of non-assurance services (NAS) to audit clients which are being addressed separately under the NAS project, a cap or exact threshold regarding the proportion of fees for services other than audit to the audit fee is not considered to be warranted in the Code at a global level.
   - The proposed requirements and thresholds in the case of fee dependency on audit client that are non-PIEs, and audit clients that are PIEs should be retained. In the case of PIE audit clients, the IESBA maintained its position set out in the ED that fee dependency cannot continue indefinitely, as there are no safeguards capable of reducing the threats to an acceptable level after a certain period of time.
   - The project will aim to promote global transparency about fee-related matters to both those

[1] All the comments letters can be accessed here.

charged with governance (TCWG) and to the public. Regarding transparency to the public, the Code should set out a flexible approach for firms to achieve such transparency, in line with the IAASB's approach to communication with external stakeholders in ISQM 1.[2]

- The Task Force will consider whether the Code should include exceptions to disclosure of fee-related information for cases where there is no requirement to consolidate controlled related entities in the group financial statements, such as in case of private equity or other investment company complexes.
- The IESBA will coordinate the effective date of the final Fees pronouncement with the effective dates of the revised provisions from the Public Interest Entity (PIE) and NAS projects. The approach will allow for an appropriate transition period.

3. Taking into consideration (i) the IESBA's comments, and (ii) further input from stakeholders during outreach conducted in Q4, the Task Force developed further revisions to the fee-related proposals. The updated proposals were circulated for the IESBA's consideration and comment in October 2020. For reference, **Agenda Item 3-C** includes a table with the text of the revised proposals (marked-up from the September 2020 Turnaround version), comments from IESBA participants and the Task Force responses. The proposed revisions are presented below.

Revisions to September 2020 Turnaround Version

I. Exceptions to Disclosure of Fee-related Information of Audit Clients that Are PIEs

Related Entities Over Which the Audit Client Has Direct or Indirect Control ("Controlled Entities")

4. In relation to the transparency of fee-related information (i) some commentators[3] to the Fees and NAS EDs, (ii) IESBA members, and (iii) participants of the Forum of Firms and National Standard Setters meetings observed that the proposals could create a significant and undue compliance burden for firms in the case of private equity complexes (or similar investment company complexes). Where a private equity firm is an investment holding entity the portfolio companies are generally not consolidated into the financial statements of the private equity firm. It was also noted that the funds and portfolio companies would generally be subject to corporate governance from a different group of individuals than TCWG of the private equity firm.

5. It was also noted[4] that in some significant jurisdictions, such as the US and EU, law or regulation does not require private equity firms to disclose information about fees paid by their "controlled" portfolio companies (that are not required to be included in the consolidated financial statements). Commentators suggested that the IESBA consider limiting the scope of the requirements regarding fee disclosure (and pre-approval of NAS) to only the PIE audit client and its consolidated controlled entities.

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2 International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

3 Deloitte Touche Tohmatsu Limited (DTTL), Ernst & Young Global Limited, KPMG IFRG Limited, Moore Global Network Limited, US Center for Audit Quality, Accountancy Europe, Institute of Public Accountants (Australia), Institute of Singapore Chartered Accountants

4 DTTL

6. The Task Force acknowledged that those are practical concerns and that there is a need for the requirement to be proportionate, having regard to the principle that only those controlled entities over which TCWG of the audit client have governance responsibility should be captured.

7. Accordingly, the Task Force proposed that in the case of transparency of fees paid for services other than the audit of the financial statements – such as review engagements, audit-related services, other assurance and non-assurance services – the scope of the communication with TCWG or disclosure to the public should extend only to controlled entities that are consolidated in the group financial statements of the PIE. (See paragraphs R410.25 (a) and R 410.31 (b) in **Agenda Item 3-B**.)

8. Nevertheless, the Task Force believes that the Code should not rule out that depending on the facts and circumstances, the fees paid for services other than the audit of the financial statements to controlled entities not consolidated in the group financial statements might also be relevant to the evaluation of the firm's independence. Therefore, the Task Force proposed that the fees paid to such controlled entities for services other than the audit of the financial statements be included based on the firm applying a "knows or has reason to believe" test. (See paragraphs R410.26 and R 410.31 (c) in **Agenda Item 3-B**.)

9. In the case of fees for the audit of the financial statements on which the firm expresses an opinion (which do not comprise fees for review engagements and fees for audits of special purpose financial statements), by definition the firm would only consider controlled entities included in the group financial statements.

10. The Task Force believes that this revised approach strikes an appropriate balance between providing transparency to TCWG and to the public to facilitate their assessments of the threats to the firm's independence created by fees paid to controlled entities, and the compliance burden from gathering the necessary information.

11. The Task Force believes it is important to note that other fee-related proposals – such as in relation to fee dependency and proportion of fees – would continue to require firms to have information about, and consider threats created by, fees for services other than audit paid by controlled entities (i.e., whether or not consolidated), in line with the Code's related entity principle in paragraph R400.20.

Advance Comments and Task Force Response

12. In October, IESBA members who provided comments generally agreed with the proposed exception and the Task Force's approach. It was suggested that it be made clear when it would be relevant to consider fees paid for services other than the audit of the financial statements to controlled entities that are not consolidated in the group financial statements in relation to the evaluation of the firm's independence.

13. Accordingly, the Task Force has developed some guidance regarding factors the firm might consider when determining whether the fees charged for the provision of services by controlled entities which are not included in the group financial statements are relevant to the evaluation of the firm's independence. For the Board's consideration, this guidance is presented in paragraphs 410.26 A1 and 410.31 A2 in **Agenda Item 3-B**.

14. The Task Force has not yet settled on the location of such guidance as it would welcome the Board's views on (a) whether the factors proposed are helpful in facilitating the application of the provision or whether further clarification would be warranted, and (b) if the Board believes the guidance is helpful, whether it might be better positioned as part of the Basis for Conclusions or a non-authoritative Staff

Q&A publication. The Task Force noted that other provisions in the Code setting out a similar "reason to believe" test do not generally include further application material, leaving it to the individual professional accountant or firm to exercise appropriate professional judgment.

Matters for IESBA Consideration

1. Do IESBA members agree with the proposed changes?
2. IESBA members are asked whether they support the guidance presented in paragraphs 410.26 A1 and 410.31 A2, and if so, for views as to whether it would be best included in the Code as application material, in the Basis for Conclusions or in a non-authoritative Staff publication.

Exception to Disclosure in the Case of Certain Subsidiaries and Parent Entities

15. In many jurisdictions, apart from presenting group financial statements, parent entities are required to present financial statements on a standalone entity basis. Subsidiaries may also be subject to the same requirement to present financial statements on a standalone entity or sub-group basis.

16. When the group financial statements and the standalone entity's financial statements are all audited by the firm or a network firm, applying the same requirement to communicate fee-related information to TCWG and to the public could create confusion given the potential for different fee-related information being communicated from the standalone entity's perspective compared to the group perspective. Furthermore, there would be an element of repetition as the fee-related information from the standalone entity's perspective would also be included in the communication of the fee-related information in relation to the group financial statements.

17. To avoid duplication of effort in relation to compiling and communicating the information, the Task Force is therefore proposing an exception to the communication requirement in the case of standalone financial statements of PIE parent entities and wholly-owned entities (subsidiaries) included in consolidated financial statements which are published. The Task Force is not proposing that this exception be extended to PIE controlled entities that are not wholly-owned given the presence of minority shareholders.

18. Furthermore, in the case of communication with TCWG, there is a distinction to be drawn between a parent entity and a wholly-owned subsidiary. For a parent entity, TCWG are, by definition, the same as for the group. Therefore, it is not necessary to provide an explicit exception from the requirement to communicate with TCWG about the fees in the case of parent entities; an exception is only relevant for parent entities as standalone entities with respect to the disclosure to the public. (See paragraphs R410.24, R410.27 and R410.32 in **Agenda Item 3-B**.)

Advance Comments and Task Force Response

19. Based on the comments received from IESBA members and the PIOB, the Task Force is proposing drafting refinements to the exceptions noted in paragraph 16 above to address circumstances where there is more than one PIE within a group. Therefore, instead of using the terms "audit client," the wording refers generically to a parent entity or a wholly-owned entity, as the case may be. (See paragraphs R410.24, R410.27 and R410.32 in **Agenda Item 3-B**.)

20. The PIOB remarked that the exception does not include a provision that the group financial statements themselves disclose the relevant information. The PIOB was concerned the information

might not be disclosed in either the individual financial statements or the group financial statements. The PIOB therefore suggested that if there is a presumption that the group financial statements include disclosure of the relevant fees, this should be explicitly stated in the provisions.

21. The Task Force is of the view that, based on the financial reporting requirements, the fee-related information included in the parent entity's or a wholly-owned entity's financial statements will be included in the group financial statements. As per the proposed requirements in paragraphs R410.30 and R410.31, the firm is required to ensure that the fee-related information – in relation to the group financial statements – is publicly disclosed *either by the client or by the firm itself*. Therefore, the Task Force does not consider it necessary to include this suggestion as a condition to the proposed exception. That said, there is agreement that the group financial statements would include disclosure of the relevant fees.

Matter for IESBA Consideration

3. Do IESBA members agree with the proposed changes?

PIOB's Comments on Proposed Exceptions to Disclosure of Fee-related Information

22. In relation to the October 2020 version of the document, the PIOB commented that "the introduction of so many exceptions creates significant confusion, hinders understandability, and increases the likelihood of differing interpretations of what information should be communicated and publicly disclosed". The PIOB further commented that "readability and understandability are important characteristics underpinning the public interest of a standard."

23. The Task Force acknowledges that the proposed exceptions add some complexity to the proposed requirements. However, the Task Force is of the view that the proposed exceptions will provide for the disclosure of information that is relevant to the firm's independence.

24. Respondents to the ED asked the IESBA to be considerate of the compliance burden created by requiring firms to disclose fee-related information of the client, especially in large groups, and to set out a balanced and reasonable approach accordingly. The Task Force believes that the proposed exceptions are necessary in order to focus on the information that is essential from an independence perspective, while eliminating duplication of the disclosures that would otherwise be required and minimizing the potential for confusion. The Task Force recommends that the Board commission Staff to develop a Questions & Answers (Q&A) publication to provide detailed implementation guidance to facilitate and support consistent application of the requirements.

25. While readability and understandability of the provisions are important objectives, the Task Force believes it is also in the public interest that the Code only require transparency in relation to information that is necessary and important for stakeholders to form a judgment on the firm's independence. Furthermore, the Task Force notes that the impact of any perceived complexity will be relatively short term while the proposals are being implemented, whereas the impact of duplicating the disclosure effort would be permanent.

II. Other Proposed Revisions

Significance of a Third Party Referring the Client

26. In its comment letter on the ED, the Accounting Professional & Ethical Standards Board (APESB) raised the situation where multiple audit clients are referred from one source and the total fees from those clients represent a large proportion of the total fees of the firm expressing the audit opinion. APESB noted that this scenario prompted the audit regulator in Australia to request the APESB to include strengthened provisions in the Australian Code (APES 110) to address the threats that might be created in this situation.

27. On further consideration of the matter, the Task Force agreed that such a situation would merit being addressed as part of the revised provisions. However, the Task Force believes that the consideration should extend beyond the firm to also cover a network firm, or a partner or office of the firm. The Task Force therefore proposes to recognize "the significance of a third party referring the client, for example to the firm, network firm, partner or office" as an example of another factor relevant to evaluating the level of threats created when fees for an audit or any other engagement are paid by the audit client. (See paragraph 410.4 A3 in **Agenda Item 3-B**.)

Type of Review Performed as a Safeguard in the Case of Fee Dependency on PIE Audit Clients

28. The Approved International Standard on Quality Management 2, *Engagement Quality Reviews* (ISQM 2) sets out requirements[5] regarding the planning and timing of an engagement quality review (EQR). Among other matters, ISQM 2 explains that timely review of the engagement documentation by the engagement quality reviewer throughout all stages of the engagement (e.g., planning, performing and reporting) allows matters to be promptly resolved to the engagement quality reviewer's satisfaction, on or before the date of the engagement report.[6]

29. The Task Force considered whether it is possible for firms to consider an EQR (as described under ISQM 2) as a safeguard if they can only determine the fact that the total fees received from an audit client represent or are likely to represent more than 15 percent of the total fees at a later stage of the audit engagement.

30. To avoid the proposed requirement in paragraph R410.18 being inoperable if the review does not meet all the requirements to qualify as an EQR under ISQM 2 because it is not undertaken until a later stage of the audit, the Task Force is proposing a change that would allow more flexibility for firms to determine the timing and extent of the review, provided that the objective of an EQR set out in ISQM 2 is met (i.e., an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon).

31. Taking into account the advance comments from IESBA members in October, the Task Force is proposing that instead of an EQR, the requirement set out the determination whether a review *consistent with the objective of* an EQR would be an appropriate action to reduce threats to an acceptable level. (See paragraph R410.18 in **Agenda Item 3-B**.)

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5 Paragraphs 24 to 26

6 Paragraph A29

Matter for IESBA Consideration

4. Do IESBA members agree with the proposed changes?

PIOB's Public Interest Issues as of October 2020

32. In its letter summarizing public interest issues in relation to the IESBA's projects as of October 2020, the PIOB acknowledged the introduction of requirements for firms to communicate fees to TCWG and to disclose fee-related information publicly. The PIOB highlighted that transparency is fundamental to protect the public interest and to provide clarity and robust information for decision making.

33. The PIOB also noted that the requirement of ending the audit engagement if the total fees from a PIE audit client exceed the threshold of 15% for five consecutive years (subject to some limited exceptions for compelling reasons) sets a strict guideline that is enforceable and can be applied consistently.

Sufficiency of Appropriate Reviewer Safeguard

34. In its letter, the PIOB raised for the IESBA to consider revisiting the sufficiency and effectiveness of having an appropriate reviewer not involved in the engagement as a safeguard to address threats created by fee dependency. The PIOB queried whether additional safeguards and alternatives can be applied when using an appropriate reviewer as a safeguard is not available or when doing so would not be scalable (e.g., in smaller firms, there may not be sufficient personnel available).

35. The Task Force notes that the proposal includes having an appropriate reviewer who is not involved in the audit engagement as a safeguard in the case of fee dependency with respect to a partner or an office of the firm (see paragraph 410.14 A7). In all other cases, the appropriate reviewer is required to be outside of the firm.

36. Furthermore, the provisions on fee dependency relevant to all audit clients (including for fee dependency with respect to a partner or an office of the firm) include other examples of safeguards. Nevertheless, in the case of the requirements in paragraphs R410.15 and R410.18 setting out the thresholds regarding fee dependency for non-PIE and PIE audit clients, respectively, the IESBA was of the view that at such levels of fee dependency, only a review performed by a professional accountant outside of the firm is capable of reducing the threats to an acceptable level.

Enforceability and Clarity of Language

37. The PIOB also raised for the IESBA to consider clarifying certain terms used in the ED, such as "large proportion of fees," "significance," etc. The PIOB was of the view that even if some of these terms have been used previously in the Code, they may not be clear or precise enough in the current context.

38. The Task Force notes that the term "significance" is used in line with the provisions of the extant Code. The term "significant" is used only in two fee-related requirements[7] to which the Task Force proposed no revisions from the extant Code. Apart from those instances, the terms "significant," "large

[7] R410.10 re contingent fees and R410.13 re overdue fees

proportion," and "long period" are only included in application material, mainly in relating to factors for consideration.

39. The Task Force believes that using these terms in the Code's provisions – especially in application material – is in line with the Code's principles-based approach. Facts and circumstances vary, and the Code requires firms to exercise appropriate professional judgement when identifying and evaluating threats. In some special instances, a bright line has been proposed, i.e., an exact threshold. However, the need for specificity is carefully deliberated at the Board, having regard to the particular issue being addressed. This does not detract from the principles basis on which the Code fundamentally rests.

Matter for IESBA Consideration

5. Do IESBA members agree with the Task Force's response to the PIOB's comments.

Due Process Matters

Significant Matters Raised by Respondents

40. The Task Force has carefully considered all significant matters raised by the respondents to the ED, including Monitoring Group members. The Task Force's analysis of the significant matters raised by respondents to the ED and its proposals have also been presented in public agenda papers for the Board's deliberation. In the Task Force's view, there are no significant matters raised by the respondents that have not been brought to the Board's attention.

Need for Further Consultation

41. The Task Force believes that all significant matters have been duly deliberated by the Board. The Task Force has also pursued extensive outreach to stakeholders throughout the life cycle of this project, including meetings with the IESBA Consultative Advisory Group (CAG), members of the regulatory community (including the International Forum of Independent Audit Regulators (IFIAR) and the Committee of European Audit Oversight Bodies (CEAOB)), the Forum of Firms, the IFAC SMP Advisory Group, and national standard setters. Finally, this project has benefited from close coordination with the IAASB.

42. On the basis of the above, the Task Force does not believe there is a need for further consultation with stakeholders.

Consideration of the Need for Re-Exposure

43. The key revisions to the ED are as follows (See **Agenda Item 3-D**):

- Removal of the proposed requirement regarding evaluation and re-evaluation of the threats created by fees paid by an audit client; and inclusion of application material instead that appropriately references to the pre-existing requirements in the conceptual framework.
- Highlighting – through inclusion of factors – that the level of the threats created by fees charged by network firms or pertaining to services delivered to related entities is generally expected to be lower.
- Clarifications regarding the demonstrability of the cost savings achieved as a result of provisions of previous services that firms are allowed to consider when determining audit fees.

- Emphasizing that disclosure of the fee-related information to the public is mainly the responsibility of the client and requiring firms to communicate with TCWG – as a first step – about the benefit of such disclosure.
- The disclosure of fees for the audit of the financial statement includes only fees paid by the firm and network firms; firms are not required to disclose information about fees for other firms outside of the network.
- Providing exceptions from fee disclosure for cases where there is no requirement to consolidate all controlled entities in the group financial statements, e.g., in the case of private equity complexes.
- Providing exceptions from the fee-disclosure in the case of certain subsidiaries and parent entities, to avoid confusion and duplication of effort.
- A more flexible approach for firms to achieve transparency and including more examples of a suitable location for disclosure by the firm. The possible ways of disclosure are in line with the IAASB's approach regarding communication with external parties in ISQM 1.

44. The Task Force considers the changes reflected in the final proposed text post-exposure respond to the feedback received from respondents to the ED and do not fundamentally or substantively change the proposals in the ED. Accordingly, the Task Force is of the view that re-exposure is not warranted.

Matter for IESBA Consideration

6. Do IESBA members agree that the changes to the ED do not warrant re-exposure?

Effective Date

45. Refer to **Agenda Item 4-E** for the discussion of effective date of the final pronouncement and the Planning Committee's recommendation.