International Ethics Standards Board for Accountants

Exposure Draft

July 2007

Comments are requested by October 15, 2007

Section 290 of the Code of Ethics

Independence – Audit and Review Engagements

Section 291 of the Code of Ethics

Independence – Other Assurance Engagements

International Federation of Accountants

REQUEST FOR COMMENTS

The International Ethics Standards Board for Accountants (IESBA), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the release of this exposure draft, *Code of Ethics for Professional Accountants* on June 25, 2007. These proposed revisions to the Code may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **October 15, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:

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545 Fifth Avenue, 14th Floor
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Email responses should be sent to: Edcomments@ifac.org

Copies of this exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, the proposed changes to the *Code of Ethics for Professional Accountants* (the Code), approved for exposure by the International Ethics Standards Board for Accountants (IESBA or the Board) in June 2007.

The IESBA welcomes comments on these proposed revisions to Section 290 and the Section 291. Comments should be received by October 15, 2007.

Background

In December 2006 the IESBA issued an exposure draft proposing revisions to existing Section 290 and a new Section 291. The comment period ended on April 30, 2007. The comment period on that exposure draft has ended and the IESBA has commenced its deliberation of the comment received. All comments received have been posted on the IFAC website.

In the December 2006 exposure draft the IESBA indicated that there were three additional areas that would be considered. This exposure draft proposes changes to address these three areas. The IESBA is now requesting comments on the changes proposed in this exposure draft.

Significant Proposals

Internal Audit

Existing Section 290 states that a self-review threat may be created when a firm provides internal audit services to an audit client. It also states that a firm should not provide any internal audit services to an audit client unless the client takes certain specified actions and the findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance.

The IESBA proposes amending the guidance of internal audit services to clarify the wide range of services that comprise internal audit services. The IESBA is of the view that depending on the nature of the services a threat to independence may be created if the services involve the firm performing management functions or are such that it would review its own work.

The IESBA is also of the view that assisting an audit client in the performance of a significant part of the client's internal audit activities increases the risk that firm personnel providing the service may perform a management function. The proposed changes, therefore, state that before accepting such an engagement the firm should be satisfied that the client has designated appropriate resources to the activity.

Certain services, such as the outsourcing of all or a portion of the internal audit function whereby the firm is responsible for determining the scope of the work and the recommendations that should be implemented and performing procedures that firm parts of the internal controls of the audit client, involve management functions. The IESBA is of the view that a firm should not provide such services.

The IESBA is of the view that, to ensure the firm does not perform management functions, the firm should only provide assistance to an audit client's internal audit function if specified conditions are in place including that the findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance.

The proposed revisions require a firm, prior to accepting an engagement to provide internal audit services to an audit client, to consider the scope and objective of the proposed engagement and whether the assignment is expected to create a self-review threat because it is likely to be relied upon in the making of significant audit judgments related to a matter that is material to the financial statements.

The IESBA considered whether there should be a more restrictive requirement for an audit client that is an entity of significant public interest. The IESBA concluded that procedures performed as part of internal audit services and procedures performed during an audit conducted in accordance with International Standards on Auditing can be similar and that prohibiting procedures simply because they are done as part of an internal audit service is unnecessary as long as the procedures do not entail the performance by the firm of management functions. Accordingly, the IESBA is of the view that internal audit services can be provided as long as the firm does not perform management functions and eliminates or reduces to an acceptable level any remaining threat that is not clearly insignificant. Therefore, the IESBA is of the view that it is not appropriate to have a more restrictive requirement for audit clients that are entities of significant public interest.

Fees – Relative Size

The proposed revisions to Section 290 provide additional guidance with respect to the relative size of fees from an audit client that is an entity of significant public interest. The IESBA is of the view that when, for two consecutive years, the total fees from such a client represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client the self-interest threat created would be too significant unless disclosure is made to those charged with governance of the client and one of the following safeguards is applied:

- After the audit opinion has been issued a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs a review that is equivalent to an engagement quality control review ("a post issuance review"); or
- Prior to the issuance of the audit opinion a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs an engagement quality control review.

In subsequent years, in determining which of these safeguards should be applied, and the frequency of their application, consideration should be given to the significance of the relative size of the fee. The IESBA is of the view that at a minimum a post-issuance review should be performed not less than once every three years to reduce the threat to an acceptable level.

The IESBA is of the view that the professional accountant who performs the engagement quality control review (or equivalent) may be a member of a network firm.

The IESBA considered whether there should be a threshold of relative size which, if exceeded, would indicate that the threat created was so significant that no safeguard could adequately address the threat and therefore the firm should either not act as auditor for the client or take

steps to reduce the relative size of the fee below the threshold. The IESBA is of the view that such an absolute threshold is not appropriate in a global code.

Contingent Fees

The proposed revisions to Sections 290 and 291 provide additional guidance with respect to contingent fees. Under the proposed revisions a firm should not perform a non-assurance service for an audit client if either the fee is material, or expected to be material, to the firm or the fee is dependent upon the outcome of a future or contemporary judgment related to the audit of a material amount in the financial statements. In the case of a non-assurance service provided to an assurance client that is not an audit client a firm should not provide a non-assurance service for a contingent fee if the amount of the fee is dependent on the result of the assurance engagement.

Guide for Commentators

The IESBA welcomes comments on the proposed revisions. Comments are most helpful when they refer to specific paragraphs, include the reason for the comments and, where appropriate, make specific suggestions for any proposed changes to wording to enable the IESBA to fully appreciate the respondent's position. Where a respondent agrees with proposals in the exposure draft (especially those calling for a change in current practice), it will be helpful for the IESBA to be made aware of this view.

Request for Specific Comments

The proposals state that in the case of audit clients that are entities of significant public interest if the total fees from that client exceed a specified percentage of the total fees of the firm one of two alternative safeguards should be applied. Is it appropriate to establish such a threshold, and if so is 15% the appropriate threshold?

When such a threshold is exceeded:

- Is it appropriate to require disclosure to those charged with governance?
- Are the alternative mandatory safeguards of a pre-issuance or a post issuance review appropriate and practical?
- If not are there any other alternative safeguards that would adequately address the threat to independence?

Comments on Other Matters

Recognizing that the proposed revised Code will apply to all professional accountants in public practice that perform assurance engagements, the IESBA is also interested in comments on matters set out below.

Special Considerations on Application in Audit of Small Entities

Respondents are asked to comment on whether, in their opinion, considerations regarding the audit of small entities have been dealt with appropriately in the proposed revisions to the Code. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Developing Nations

The IESBA welcomes comments on any foreseeable difficulties in applying the proposed provisions in a developing nation environment. Reasons should be provided, as well as suggestions for alternative or additional guidance.

Translations

The IESBA welcomes comments from respondents on potential translation issues noted in reviewing this exposure draft.

The following revisions are proposed to the exposure draft that was issued by the IESBA in December 2006 ("the December ED").

REVISION OF SECTION 290

INDEPENDENCE – AUDIT AND REVIEW ENGAGEMENTS

Paragraphs 290.1-290.185 of the December ED will be unchanged and paragraphs 290.186-191 will be deleted and replaced with the following paragraphs.

Internal Audit Services

290.186 Internal audit functions comprise a wide range of activities, for example:

(a) reviewing and testing of internal controls over financial reporting;

(b) performing procedures that form part of the internal controls;

(c) conducting operational internal audit activities unrelated to internal controls over financial reporting; and

(d) performing fraud investigations.

290.187 Depending on the nature of the service, the provision of internal audit services to an audit client may create a threat to independence if such services involve the firm performing management functions or reviewing its own work in the course of a subsequent audit.

290.188 Assisting an audit client in the performance of a significant part of the client's internal audit function increases the risk that firm personnel providing the internal audit service will become part of the client's internal controls or will take management decisions Accordingly, before accepting an engagement to perform a significant part of an audit client's internal audit functions, the firm should be satisfied that the client has designated appropriate resources to the activity to take responsibility for the matters detailed in paragraph 290.190.

290.189 If a firm performs management functions for an audit client, no safeguards could reduce the threats to an acceptable level. Accordingly, a firm should ensure that it does not perform management functions when providing internal audit services to an audit client. Examples of internal audit services that entail the performance of management functions include:

(a) performing outsourced internal audit services, comprising all or a portion of the internal audit function, whereby the firm is responsible for determining the scope of the work and which recommendations should be implemented;

(b) performing procedures that form part of the internal controls, such as reviewing and approving changes to employee data access privileges.

290.190 To ensure that performing internal audit services does not threaten independence the firm should only provide internal audit services to an audit client if all of the following conditions are met:

(a) The client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the internal controls;

(b) The client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;

(c) The client or those charged with governance approve the scope, risk and frequency of internal audit work;

(d) The client is responsible for evaluating and determining which recommendations of the firm to implement;

(e) The client evaluates the adequacy of the internal audit procedures and the findings resulting from their performance by, among other things, obtaining and acting on reports from the firm; and

(f) The findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance.

290.191 Before the firm accepts an engagement to provide internal audit services to an audit client, consideration should be given to the scope and objective of the proposed engagement and whether the work to be undertaken is expected to create a self-review threat because it is likely to be relied upon in the making of a significant audit judgment related to a matter that is material to the financial statements. If the self-review threat is not clearly insignificant, safeguards should be considered and applied when necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Using professionals who are not members of the audit team to perform the internal audit services; and
- Having an additional professional accountant review the work or otherwise advise as necessary.

Paragraphs 290.192-290.212 of the December ED will be unchanged and paragraphs 290.213-290.219 will be deleted and replaced with the following paragraphs:

Fees

Fees – Relative Size

290.213 When the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, the dependence on that client and concern about losing the client may create a self-interest threat. The significance of the threat will depend on factors such as:

- The operating structure of the firm;
- Whether the firm is well established or new; and
- The significance of the client qualitatively and/or quantitatively to the firm.

The significance of the threat should be evaluated and, if the threat is not clearly insignificant, safeguards should be considered and applied when necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- External quality control reviews; or
- Consulting a third party, such as a professional regulatory body or another professional accountant, on key audit judgments.

290.214 A self-interest threat may also be created when the fees generated from an audit client represent a large proportion of the revenue from an individual partner's clients. The significance of the threat should be evaluated and, if the threat is not clearly insignificant, safeguards should be considered and applied when necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include having an additional professional accountant review the work or otherwise advise as necessary.

Audit Clients that are Entities of Significant Public Interest

290.215 In the case of an audit client that is an entity of significant public interest when, for two consecutive years, the total fees from the client and its related entities (subject to the considerations in paragraph 290.24) represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client, the self-interest threat would be too significant unless the firm discloses to those charged with governance of the audit client the fact that the total of such fees represents more than 15% of the total fees received by the firm and one of the following safeguards are applied to the following year's audit:

- After the audit opinion has been issued a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs a review that is equivalent to an engagement quality control review ("a post-issuance review"); or
- Prior to the issuance of the audit opinion a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs an engagement quality control review

Thereafter, in determining which of these safeguards should be applied and the frequency of their application, consideration should be given to the extent to which the relative size of the fees from the audit client in relation to the firm's total fees is greater than 15%. At a minimum a post-issuance review should be performed not less than once every three years commencing with year 3.

Fees – Overdue

290.216 A self-interest threat may be created if fees due from an audit client remain unpaid for a long time, especially if a significant part is not paid before the issue of the audit report for the following year. Generally the firm should require payment of such fees before the audit report is issued. If the fee remains unpaid after the report has been issued, the significance of the threat should be evaluated. If the threat is not clearly insignificant, safeguards should be considered and applied when necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include having an additional professional accountant who did not take part in the audit engagement, provide advice, or review the work performed. The firm should also consider whether the overdue fees

might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

Contingent Fees

290.217 **Contingent fees**[*] are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them or is required to approve them.

290.218 A contingent fee charged by a firm in respect of an audit engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by applying any safeguard. Accordingly, a firm should not enter into any such fee arrangement.

290.219 A contingent fee charged by a firm in respect of a non-assurance service provided to an audit client may also create self-interest and advocacy threats. No safeguards can reduce the threats to an acceptable level if the amount of the fee is either: (a) material or expected to be material to the firm expressing the opinion on the financial statements; or (b) dependent upon the outcome of a future or contemporary judgment related to the audit of a material amount in the financial statements. Accordingly, such arrangements should not be accepted.

290.220 For other types of contingent fee arrangements charged by a firm for a non-assurance service to an audit client, the significance of the threats will depend on factors such as:

- The range of possible fee amounts;
- The nature of the service; and
- The effect of the event or transaction on the financial statements.

The significance of the threats should be evaluated and, if the threats are not clearly insignificant, safeguards should be considered and applied when necessary to eliminate the threats or reduce them to an acceptable level. Such safeguards might include:

- Review or determination of the final fee by an unrelated third party; or
- Quality control policies and procedures for the non-assurance service.

Paragraphs 290.220-290.223 of the December ED will be unchanged and will be renumbered 290.221-290.224 respectively.

[*] See Definitions.

REVISION OF SECTION 291

INDEPENDENCE – OTHER ASSURANCE ENGAGEMENTS

Paragraphs 291.1-291.150 of the December ED will be unchanged and paragraphs 290.151-154 will be deleted and replaced with the following paragraphs.

Contingent Fees

291.151 Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them or is required to approve them.

291.152 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by applying any safeguard. Accordingly, a firm should not enter into any such fee arrangement.

291.153 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. If the amount of the fee for a non-assurance engagement is dependent on the result of the assurance engagement no safeguards can reduce the threat to an acceptable level. Accordingly, such arrangements should not be accepted.

291.154 For other types of contingent fee arrangements charged by a firm for a non-assurance service to an assurance client, the significance of the threats will depend on factors such as:

- The range of possible fee amounts;
- The nature of the service; and
- The effect of the event or transaction on the financial statements.

The significance of the threats should be evaluated and, if the threats are not clearly insignificant, safeguards should be considered and applied when necessary to eliminate the threats or reduce them to an acceptable level. Such safeguards might include:

- Review or determination of the final fee by an unrelated third party; or
- Quality control policies and procedures for the non-assurance service.

Paragraphs 291.155-156 of the December ED will be unchanged.

Definitions

The definition of contingent fee in the December ED will be deleted and replaced with the following definition:

Contingent fee	A fee calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. A fee that is established or required to be approved by a court or other public authority is not a contingent fee.

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