International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores
Organización Internacional de Comisiones de Valores

15 May 2017

Technical Director
International Ethics Standards Board for Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017 U.S.A.

Our Ref: 2017/PK/C1/IESBA/19

Subject Line: IESBA's Exposure Draft, *Proposed Revisions Pertaining to Safeguards in the Code—Phase 2 and Related Conforming Amendments*

Dear Sir:

The International Organization of Securities Commissions' Committee on Issuer Accounting, Audit and Disclosure (Committee 1) appreciates the opportunity to comment on the International Ethics Standards Board for Accountants' (the IESBA or the Board) Exposure Draft, *Proposed Revisions Pertaining to Safeguards in the Code—Phase 2 and Related Conforming Amendments* (the Paper). As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through the promotion of high quality accounting, auditing and professional standards, and other pronouncements and statements.

Members of Committee 1 seek to further IOSCO's mission through thoughtful consideration of accounting, disclosure and auditing matters, and pursuit of improved global financial reporting. Unless otherwise noted, the comments we have provided herein reflect a general consensus among the members of Committee 1. Our comments are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

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Overall Comments

We appreciate the Board's continued efforts to examine the Code to clarify the safeguards in the non-assurance services sections therein. We see this project as an opportunity for the Board to promote a more objective and unbiased auditor mindset as well as enhance the effectiveness and enforceability of the Code. The importance of an investor's confidence in the financial reporting process and the independent audit cannot be underestimated.

We have observed an increased trend globally whereby more jurisdictions are including strict prohibitions against the performance of certain non-assurance services rather than a pure "threats and safeguards" approach. While a "bright-line" approach with respect to non-assurance services is not without its shortcomings we believe it can provide increased confidence to investors regarding the auditor's independence both in fact and appearance, given it generally removes the self-interest bias that is more inherent in a threats and safeguards approach in this area. In light of global developments, we believe it would be appropriate and timely for the Board to engage in an effort to analyze the pros and cons of the "threats and safeguards" approach as compared to a "bright-line" approach to auditor independence with respect to non-assurance services to determine which approach is more effective in promoting the auditor's independence and contributing to audit quality.

Substantive Safeguards

As you noted in paragraph 3 of the Paper:

> "Some regulators suggested that the IESBA should:
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> (a) Clarify the safeguards that are not clear in the extant Code and eliminate those that are inappropriate or ineffective;
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> (b) Better correlate a safeguard with the threat it is intended to address; and
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> (c) Clarify that not every threat can be addressed by a safeguard."

While we appreciate the Board's initiative to address the above concerns, we believe the Code should be further revised to apply specific safeguards to address the specific threats

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which they were intended to mitigate. With the cumulative years of experience of the firms and the profession as a whole in mitigating threats to independence we anticipated more substantive and targeted safeguards that addressed specific threats.

Relatedly, we strongly believe that two of the more commonly used safeguards in the Paper are inappropriate. Specifically, where the Board suggests that in instances where there is a threat to the firm's or network firm's compliance with auditor independence requirements, safeguards can include:

- "Using professionals who are not audit team members to perform the accounting and bookkeeping service, and

- If such services are performed by an audit team member, using a partner or senior professional who is not an audit team member, with appropriate expertise to review the work performed."

If the provision of a service creates a threat to the auditor independence requirements of the *firm* or *network firm*, how then can any professional within that firm or network firm be used as an effective safeguard? Since "the firm" performed the service for its audit client, the professional staff member may be incentivized to make judgments that protects the economics and other interest of the firm rather than the public interest and needs of investors. The threats to independence is with respect to the entire firm or network firm therefore other safeguards outside of the firm or network firm would be more effective in mitigating any risk with respect to an audit engagement in those circumstances. We are concerned that the language and implicit message in the Paper would lead the public accountant to conclude that self-interest and self-review threats are only confined to the individuals on an engagement team, rather than to the entire audit and/or network firm itself.

Evaluating a Safeguard

Throughout the Paper the Board provides examples of actions that might be safeguards. This suggests that auditors can also establish their own safeguards to mitigate a threat to the auditor's independence. If auditors are allowed to establish their own safeguards, we believe the Board needs to establish an enhanced and more robust framework that explains to an auditor how to identify and establish a safeguard and evaluate its effectiveness. This must be

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balanced with a resign-first mindset when there is non-compliance with auditor independence requirements.

Use of Auditing Concepts

We noted instances in the Board's approach to auditor independence that seem to borrow from concepts embedded in the audit of financial statements. Two of the more significant issues noted are as follows:

1. The threats and safeguards approach seems to deal with auditor independence similar to how the auditor approaches the audit of the financial statements, namely, *reasonable assurance* about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This suggests that if certain safeguards are applied by the auditor, then the non-assurance service could be performed particularly when it is not strictly prohibited.

2. The concept of materiality has different implications with respect to auditor independence as compared to the audit of financial statements.

The threats and safeguards approach seems to rely on the auditor's judgment and therefore provides the auditor more flexibility in interpreting what is acceptable versus what is not. We believe an auditor is either independent or not independent– it is not a reasonableness test as is used in the audits of financial statements. We also question whether the typical quantitative and qualitative factors used to assess materiality in the financial statement context, are appropriate in determining whether the auditor is independent. We could envision circumstances where the nature, scope and magnitude of a service, although not material to the financial statements, could bear on the auditor's objectivity. For example, the service might be important to the audit firm's local office and/or line of business; therefore, the interests of the firm could impact the objectivity of the auditor. We believe the concept of materiality in assessing auditor independence and the permissibility of non-assurance services should be very limited in, if not totally eliminated from, its use in the Code.

Notwithstanding this, we have observed that where the concept of materiality is used to determine the permissibility of a non-assurance service in the Paper, the language used often implies that where the service is immaterial to the financial statements it is permissible. For example, paragraph R603.5 states:

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> "A firm or a network firm shall not provide a valuation service to an audit client that is not a public interest entity if:
>
> **(a)** The valuation involves a significant degree of subjectivity; and
>
> **(b)** The valuation will have a material effect on the financial statements on which the firm will express an opinion."

In this instance, the Paper suggests that if the valuation service will not have a material effect on the financial statements then the service is permissible. If the Board continues to believe that a very limited use of a materiality concept is necessary, then we believe that even if the effect of a service is not always quantitatively or qualitatively material to the financial statements, the auditor should consider other factors since the performance of that service may in some cases still create a threat to the auditor's independence and must be evaluated accordingly. It may be more appropriate for the Board to structure the language in such sections to indicate that in addition to the material impact of the service on the financial statements there needs to be consideration of broader factors consistent with those outlined above.

List of Services or Exceptions

While we note that requirements generally begin with "shall not" language, we have observed that in some sections, the application material in the Paper often reflects a list of permitted services or exceptions to the requirement. This gives the impression of focusing auditors on ways to enhance revenues or navigate the rules rather than the guidance meant to promote the auditor's objectivity. We believe it would be useful if the application material assisted auditors in understanding more precisely what a requirement means or is intended to cover as this concept is familiar to auditors who use ISAs issued by the IAASB.

Lack of Clarity

We have noted that the content of the Code includes language that is too subjective and not enforceable. For example, paragraph R603.5 and R603.5 A1 states:

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"A firm or a network firm shall not provide a valuation service to an audit client that is not a public interest entity if:

(a) The valuation involves a *significant degree of subjectivity*; and

(b) The valuation will have a *material effect* on the financial statements on which the firm will express an opinion.

Certain valuations do not involve a *significant degree of subjectivity*. This is likely to be the case when the underlying assumptions are either established by law or regulation, or are *widely accepted* and when the techniques and methodologies to be used are based on generally accepted standards or prescribed by law or regulation. In such circumstances, the results of a valuation performed by two or more parties are not likely to be materially different" (emphasis added).

We are not sure how the terms "significant degree of objectivity," "material effect," and "widely accepted" are defined or will be measured. We see a risk of terms such as these not being consistently interpreted or being applied liberally by auditors. Further, due to the lack of clarity, regulators will not have a basis to enforce such standards.

Thank you for the opportunity to comment on the Paper. If you have any questions or would like to further discuss these matters, please contact Doug Niven on ph. +61 2 9911-2079 (email: douglas.niven@asic.gov.au) or Nigel James at ph. + 1 202-551-5300 (email: jamesN@sec.gov).

Sincerely,

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