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30 January 2012

Deputy Director
International Ethics Standards Board for Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Our Ref: 2012/JE/TCSC1/IESBA/5

Subject Line: IESBA's Exposure Draft, *Proposed Changes to the Code of Ethics for Professional Accountants Related to Provisions Addressing a Breach of a Requirement of the Code*

Dear Madam:

The International Organization of Securities Commissions Standing Committee No. 1 on Multinational Disclosure and Accounting (SC 1) appreciates the opportunity to comment on the IESBA's Exposure Draft, *Proposed Changes to the Code of Ethics for Professional Accountants Related to Provisions Addressing a Breach of a Requirement of the Code* (the Paper). As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing and professional standards, other pronouncements and statements.

Members of SC 1 seek to further IOSCO's mission through thoughtful consideration of accounting, auditing and disclosure concerns, and pursuit of improved global financial reporting. Our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1; however, they are not intended to include all comments that might be provided by individual members on behalf of their respective jurisdictions.



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Purpose of the Project

We welcome the Board's efforts to re-examine a fundamental subject that underpins the entire audit process and the results thereof. Auditor independence is critical to an auditor's objectivity, which is a key to providing reliable audited financial statements and promoting investor confidence in the capital markets. To be credible, the auditor's work effort must be objective, must be performed with integrity and must be absent of any undue influences from the audit client, management or its owners. Public confidence in the audited financial statements will be eroded by evidence of, or a perception that, the auditor was lacking objectivity due to a lack of independence.

We appreciate the Board undertaking this project in response to concerns we previously expressed on certain provisions of the Code. We see the Board's efforts as a significant step in the right direction to promote independence and objectivity by professional accountants. Specifically, we recognize the Board's move away from the notion of an "inadvertent violation" and inclusion of a requirement that if the audit firm concludes that a breach has occurred, then the firm shall assess the consequences (presumably on the firm's objectivity), communicate the matter to those charged with governance of the audit client and document the matter's resolution. We do, however, appreciate the challenges facing the Board particularly in writing a Code of Conduct to be applied in various jurisdictions. We have tried to consider those in offering our comments on the Board's proposed Section 290, which applies to audits and reviews of financial statements.

Context for the Project: Regulatory Building Blocks

As securities regulators, we believe investors should have access to relevant and accurate information that is cost effective and meaningful to an investment decision. We believe that a breach of an independence provision creates a risk that the auditor's objectivity was impaired, a risk that generally should be made transparent to investors—via reporting to their corporate governance representatives or to their regulatory advocates or to the investors themselves—in some manner. Such transparency may provide additional incentives for audit firms to implement and maintain good quality control systems that limit the occurrence of independence breaches. Transparency via reporting to investors themselves could further encourage auditors and those charged with governance to make the appropriate decisions with respect to resigning or continuing with the audit engagement, as the auditor's reasoning and conclusion would be subject to public scrutiny.

We believe that a securities regulatory model setting forth requirements to address a breach of an auditor independence provision would involve the following building blocks:



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1. The external auditor promptly identifying the breach and assessing it against the applicable securities laws and regulations. Assessment of the breach and the resolution thereof would be elevated within the firm to, for example, the firm's quality control function and/or firm leadership.
2. The external auditor terminating the audit engagement if objectivity has been compromised. This includes, but is not limited to, those situations in which the very nature of the breach is such that it is likely not credible to conclude that the firm's objectivity was not impaired.
3. The external auditor communicating to those charged with governance of the issuer the occurrence and nature of the breach and the auditor's conclusion of the effect on the auditor's objectivity with respect to the audit of the issuer's financial statements.
4. Those charged with governance of the issuer evaluating and concluding on the auditor retention based on communications with the external auditor and consideration of the specific facts and circumstances and applicable laws and regulations governing the breach.
5. The issuer and/or external auditor promptly reporting the breach and the resolution thereof to the regulator in jurisdictions where such reporting is either required or encouraged under the capital markets regulatory regime.
6. Where objectivity was deemed not to be compromised, the issuer and/or external auditor reporting to investors via proxy, auditor's report or other public document, as appropriate, the occurrence and nature of the breach and the impact on the auditor's objectivity in jurisdictions where such reporting is either required or encouraged under the capital markets regulatory regime.
7. Administration of sanctions, enforcement actions and other remedial actions based on the severity of the breach.

We recognize that writing requirements to fulfill a mandate of establishing and enforcing securities laws is not the goal of the Board as that mandate rests with regulators. In contrast, improving the Board's Code of Conduct is to promote and guide appropriate behavior and best practices among practitioners in IFAC member bodies, especially among those who may be subject only to self-regulation. We see the objectives for the Code of Conduct as overlapping with, yet somewhat different from, a regulator establishing requirements as part of a regulatory regime to foster fair and orderly capital markets and to promote investor protection. Nonetheless, we believe that the



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regulatory building blocks presented above can serve the Board as it considers improvements to its Code taking into consideration the purpose of the Code and the boundaries of the Board's remit.

Overall Tone of the Code's Provisions

We believe that all breaches of an independence provision should be regarded with utmost severity such that the auditor's first inclination is that its objectivity has been affected, there are no actions that can restore that objectivity, and thus the appropriate action is to resign from the audit engagement. We believe that such a mental attitude can promote compliance with auditor independence requirements, not just in the letter of the law but in the spirit of the rules. We suggest that the tone of paragraph 290.39 reflect such a termination-first mindset and within our comments we include related suggestions that would apply to paragraph 290.43.

We further note that the firm/professional accountant would be utilizing this section of the Code in circumstances involving heightened pressures because there is an actual or potential breach. As a result, we have concerns that those for whom the Code is intended may be incentivized to have a self-interest bias which may be at odds with the public interest. Under such pressures the effectiveness of the Code may depend on:

1. the effectiveness of the audit firm's quality control system which includes setting the right tone at the top together with tangible, self imposed disciplinary mechanisms;
2. the competence and engagement of those charged with issuer governance in providing an additional voice with respect to the audit firm's conclusions;
3. the development of the corporate governance structure in the jurisdiction which can provide context to, or shape the mindset of, those charged with governance; and
4. the possibility of any disciplinary measures by accounting bodies or regulatory review by securities regulators and/or audit oversight bodies.

We offer some comments on these matters in the remainder of our letter, but also suggest the Board discuss these matters in finalizing the Code.

Overall Perspective of the Reasonable and Informed Investor

We observe that the "reasonable and informed third party" consideration within the Paper is currently mentioned in paragraph 290.43 with respect to the audit firm determining whether it may be possible



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to take action that satisfactorily addresses the consequences of the breach. We believe the Board should make clear that the views of a reasonable and informed *investor* – not the auditor – weighing all the specific facts and circumstances, are applicable not only in paragraph 290.43 but elsewhere. For example, see paragraph 290.40 which summarizes the overall model, paragraph 290.42 which describes assessing whether a breach has affected objectivity, and paragraph 290.49 which describes assessing the effect of a breach, if any, on previously issued auditors' reports.

The Audit Firm's Assessment of the Effects of a Breach

Who is Involved in the Assessment

When a breach of an independence provision is uncovered we believe that the firm's assessment and determination of the outcome of the breach should be elevated within the firm to, for example, the firm's quality control function and/or firm leadership, thus not left solely to members of the audit engagement team or local office management. This approach can provide a fresh perspective on the issue at hand, promote consistency of application and can help minimize what may be the engagement team's bias for continuing the audit engagement. We suggest that such a consultation requirement be included in the Code.

Nature of the Analysis

Paragraph 290.42 states that "When a breach is identified, the firm shall evaluate the significance of that breach and its impact on the firm's objectivity and ability to issue an audit report." We agree with the focus on objectivity, however, we believe the sentence should be strengthened and clarified by rephrasing it to state "...the firm shall evaluate the nature and severity of the breach in the context of the firm's objectivity." This will help make clear that there is a single focus on objectivity and, further, that "insignificance" of a breach does not lead to a different approach for handling it.

Factors to Consider

We believe that if the audit firm has established a culture of compliance together with effective quality control policies and procedures, then breaches of auditor independence provisions should be the exception to the norm. However, we suggest the factors listed in paragraph 290.42 also include consideration of the audit firm's quality control processes, particularly the frequency with which similar breaches have or have not occurred within the firm. A breach may be evaluated differently if the occurrence of such a breach is common within the audit firm because of the risk that the known incident is not the only one affecting the engagement. Also, when the auditor considers and



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communicates information regarding the frequency of such breaches within the audit firm it provides transparency and context to those charged with governance in evaluating the auditor's conclusion.

One additional factor mentioned in paragraph 290.42 in evaluating a breach is "If the breach was caused by a non-assurance service, the impact of that non-assurance service on the accounting records or amounts recorded in the financial statements on which the firm will express an opinion." While we agree that a breach that has a direct effect on the accounting records or amounts recorded in the financial statements can factor into the effect of the breach on the audit firm's objectivity, those breaches that may have a less direct effect on the financial statements should not be regarded as unimportant with respect to their impact on the firm's objectivity. Certain non-assurance services that may not have a direct effect on the financial statements can still create significant threats of self-interest, advocacy, familiarity and intimidation. As such, we believe that in evaluating the significance of a breach the last bullet point in paragraph 290.42 should be amended to include the threat of non-assurance services that may have these other effects.

Reaching a Conclusion

We believe the Code should make clear that there are those situations in which the nature of the breach is such that it is likely not credible to conclude that the firm's objectivity was not impaired. Those situations that come to mind include instances of breaches of independence requirements in which the nature of those involved included a key audit partner and/or an individual within the firm who can directly influence the outcome of the audit engagement, and if the breach was intentional. However, the Board should also emphasize that the aforementioned should not be interpreted in a manner that suggests other breaches do not result in impairment of objectivity as well.

The Audit Firm's Actions to Address the Consequences of a Breach

Paragraph 290.43 makes the provision that, depending upon the significance of the breach, it may be possible for the audit firm to satisfactorily address the consequences of the breach by taking action that is short of terminating the audit engagement. We believe that situations in which a breach of an independence requirement causes the firm's objectivity to be compromised means that there are no safeguards or actions that can be instituted to resolve the matter or provide an opportunity for the auditor to continue the audit engagement. We believe the Code should be explicit in stating that in such circumstances the audit firm will not be able to issue an independent auditor's report that is consistent with section 120 of the Code. Other terminology in the Code should support this statement. For example, the phrase in paragraph 290.43 which states that "...objectivity would be compromised



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such that the firm is unable to issue an audit report” would be strengthened by replacing the term “such that” with “therefore.”

Alternatively, in situations in which the audit firm concluded that objectivity was not compromised the audit firm would take steps to satisfactorily address the violation of the underlying independence requirement. Examples of these steps may be as outlined in paragraph 290.44. However, if the audit firm finds that actions cannot be taken to satisfactorily address the violation of the independence provision, then we believe this should result in reconsideration of the conclusion relative to the effect on the firm’s objectivity. This reconsideration may lead to the conclusion that objectivity was indeed compromised and thus the need for resignation of the audit firm. The Board would need to revise paragraph 290.43 to reflect the approach as we have suggested above.

Notwithstanding the overall approach we have described above, we observe that in certain jurisdictions the laws or regulations would not permit the audit firm to terminate the audit engagement. As such, paragraphs 290.45 and 290.48 should state “...terminate the audit engagement, where legally possible, in compliance with...” Further, we encourage the Board to explore options to address steps to be taken by the audit firm when termination is not permitted by law or regulation in the situations in which objectivity has been impaired. As the Board explores such options, we believe an important consideration is transparency to investors in some manner of information that is accurate, complete and accessible.

The Audit Firm’s Reporting to Those Charged with Governance of the Issuer

Reporting of Breaches

We believe that requiring the firm to communicate a breach of an auditor independence provision to those charged with governance increases the transparency surrounding compliance with the independence rules. It provides an opportunity for those charged with governance to understand factors that may affect the audit firm’s ability to complete the audit and, if it can be completed, to understand factors that may cast a negative shadow on the quality of the audit. Conversely, we do not believe that simply reporting a breach to those charged with governance should be a substitute to withdrawal from the audit engagement nor does it provide any safeguard that absolves the auditor independence issue or the consequences thereof.

More specifically, we support the Board’s direction as contained in paragraphs 290.45 and 290.46 of requiring the firm to communicate its conclusions regarding a breach of an auditor independence provision with those charged with governance so that in the interest of investors those charged with



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governance can have the opportunity to consider, based on the applicable auditor independence requirements and the facts and circumstances associated with the breach, whether they agree with the audit firm's conclusion. We believe this check and balance and transparency can add rigor to the audit firm's assessment process. However, in terms of timing, we believe that the Board should make clear that breaches should be initially reported to those charged with governance as soon as possible upon the auditor concluding that a breach has occurred.

Matters to Discuss

Paragraph 290.46 includes matters to be discussed with those charged with governance. One of the matters listed is "A description of the firm's relevant policies and procedures designed to provide it with reasonable assurance that independence is maintained." We believe this sentence should be expanded to include "...reasonable assurance that independence is maintained and will be maintained during the engagement period and the period covered by the financial statements." Further, we believe additional matters that should be discussed with those charged with governance are the implications of the firm's independence being breached and relevant regulatory requirements.

Risks to the Process

Imposing obligations upon those charged with governance is, as a practical matter, beyond the purview of the Code. This raises the question of what actions the audit firm should take if those charged with governance (1) will not engage with the audit firm on the matter or (2) face potentially negative pragmatic consequences to disagreeing with the firm's reasoning/assessment that the audit firm's objectivity is uncompromised. The Board should consider what steps are required of the audit firm in these situations. To this end, we believe that prior to finalizing the proposed revisions to the Code the Board should perform specific outreach to organizations representing those charged with governance to obtain their views on the engagement with those charged with governance.

The Audit Firm's Reporting to Regulators and Investors

Paragraph 290.41 states that "When a breach is identified, the firm shall consider whether there are any legal or regulatory requirements that apply with respect to the breach and, if so, shall comply with those requirements." We agree that the audit firm should consider and comply with any applicable legal and regulatory requirements with respect to addressing a breach. These may involve requirements to report to regulators (or absent a regulator to the professional bodies overseeing the audit profession) and/or to investors. These requirements would be incremental to the Code's provisions for reporting to those charged with governance of the issuer.



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We believe that the Code should also go one step further in calling for the audit firm to promptly report the breach to regulators (or absent a regulator to the professional bodies overseeing the profession) and/or to investors if such reporting is encouraged in the jurisdiction, even though it is not required. Including this requirement in the Code would make provision for the audit firm to handle the breach in the paramount manner.

Thank you for the opportunity to comment on the Paper. If you have any questions or would like to further discuss the matters noted in this letter, please contact either Nigel James or me at 202-551-5300.

Sincerely,

Julie A. Erhardt
Chair
Standing Committee No. 1
International Organization of Securities Commissions