

Meeting: IESBA Consultative Advisory Group
Meeting Location: Grand Hyatt New York, United States
Meeting Date: March 7, 2011

Inadvertent Violation

Objective of Agenda Item

1. To consider the IESBA's direction on its inadvertent violations project and provide input on preliminary wording for a new provision in the Code.

Background

At its November 2010 meeting, the IESBA approved a project proposal to address the inadvertent violation sections in the Code (Agenda Paper C-1). The IESBA undertook this project to address concerns expressed by the International Organization of Securities Commissions ("IOSCO"). The concerns expressed may be summarized as follows:

- An exception that implies that all inadvertent violations can be corrected through the application of "any necessary safeguards" may encourage unscrupulous behavior and potential abuse of compliance with the Code. It could also detract from motivating firms to establish robust preventive controls to properly identify threats to independence prior to providing prohibited services;
- If an exception is retained there should be a sufficiently narrow and prescriptive definition of the term "inadvertent" as well as a materiality threshold for evaluating when an inadvertent violation could and could not be deemed to compromise independence.

At its February 2011 meeting, the IESBA discussed Task Force¹ proposals (Agenda Paper C) and provided input on preliminary wording for a new provision in the Code (Agenda Paper C-2). The Task Force plans to present a revised document to the IESBA for approval as an exposure draft at its June 2011 meeting.

Issues

Need for Provisions

The Task Force recommended to the IESBA that the Code contain provisions addressing a violation of an independence provision of the Code. The Task Force was of the view

¹ Kate Spargo (chair), Wui San Kwok, Alice McCleary and Marisa Orbea

that such provisions are in the public interest because if the automatic consequence of any violation is that the firm is not independent and therefore unable to continue the audit engagement, regardless of the magnitude of the violation and its impact on the firm's ability to maintain its objectivity, the public interest is not well served. For example, if a violation stemming from an insignificant interest or relationship that is terminated upon identification has not affected the firm's ability to be objective, forcing the company to switch auditors anyway could have implications for the company's ability to meet its filing deadline, provide timely information to meet market expectations, and take advantage of market opportunities, all results that could be considered disproportionate to the violation.

The IESBA is approaching pragmatically the question of whether such a provision should be provided for independence purposes. The fact is that despite firms having policies and procedures in place to maintain independence, violations will occur from time to time. Not all jurisdictions have a regulator that is willing to deal with violations or have a regulatory process for dealing with them. Member bodies also differ in their ability to deal with violations. How violations are being dealt with in those situations is unknown, and comment letters might provide some insight into the processes in use today. In the meantime, the IESBA has not seen any evidence that audit firms are resigning as a result of independence violations. Therefore, the IESBA presumes that firms are dealing with violations on their own on an ad hoc basis. The IESBA considered whether this indicates that provisions in the Code dealing with violations are therefore unnecessary because the violations are being addressed successfully, either with or without consultation with a relevant regulator or member body.

The IESBA notes that whatever process is being used today to address violations is being conducted pursuant to the general guidance in the Code on inadvertent violations. Without that guidance, users of the Code could assume that the intention is that any violation should result in the firm's resignation, regardless of the magnitude of the violation. Resignation can certainly be an appropriate outcome in some situations, depending on the facts. However, the absence of auditor resignations due to an independence violation does not necessarily mean that whatever process firms are using today to deal with violations results in appropriate outcomes.

If a firm believes that it can continue as the client's auditor despite a violation of an independence provision in the Code, the IESBA believes the firm should be required to apply a rigorous and transparent process that will support that conclusion. Including such a process in the Code makes the process authoritative and therefore mandatory if the outcome could be anything other than resignation. This is appropriate, as overcoming the consequences of a violation should involve meeting a very high mandatory hurdle. Further, requiring firms to follow a mandatory process would mean that haphazard approaches that may be in use today because of the general nature of the existing guidance in the Code would not be considered effective.

The IESBA notes that other authorities (e.g., the U.S. SEC, the U.S. GAO, the UK APB, and the Australian APESB) have built into their standards and regulations provisions that

set out mandatory processes for dealing with violations. The IESBA does not interpret those provisions as ways to get around the rules and believe that the provisions in the Code must also be presented in a way that does not promote such behavior. The key is that the provisions should be presented in a manner that makes it clear that if the firm believes a result other than resignation may be appropriate, it follow a prescribed approach for demonstrating whether that is an appropriate outcome under the circumstances.

The IESBA also believes that provisions for dealing with violations will benefit those charged with governance (e.g., audit committees). Such provisions would provide them with a framework by which to judge the effects of a violation for themselves and determine, independent of the auditor's judgment, whether the actions taken by the auditor are sufficient to support a conclusion that the auditor's objectivity had not been compromised, or that it has and the auditor should resign. This is important if the relevant regulator or member body is consulted by the firm, as they would typically consider the views of those charged with governance in determining the outcome. It is especially important if the jurisdiction is one in which the regulator or member body is not equipped to deal with consultations involving a violation, making the judgment of those charged with governance the only judgment that is reached by those who are not connected with the firm.

In summary, the IESBA concluded that it is in the public interest to have an appropriate mechanism that can be consistently applied across all jurisdictions in order to provide companies facing an issue with the independence of their auditor and relevant regulators and similar authorities with a framework to evaluate the impact of the independence issue and determine whether resignation is the only appropriate outcome. It is the potential consequences to the company, its investors, and the capital markets of an auditor resigning whenever there is a violation of an independence provision without considering the impact of the violation that raise the public interest argument. There needs to be some guidance on dealing with such situations.

Action requested

CAG members are asked to provide their views on whether the Code should contain such provisions.

Inadvertent

The Task Force concluded that the cause of the violation, be it unintentional, intentional, unknowing, or reckless was less significant than the potential impact on the company and those consequently affected – the investors and potential investors. It is the violation that gives rise to the potential impairment of independence, regardless of its nature. Accordingly, the Task Force concluded that the term “inadvertent” should be dropped. If a violation has occurred but the firm believes it can continue as auditor, an analysis needs

to be undertaken to determine whether actions can be taken such that the firm can provide the audit opinion or whether resignation is necessary. Whether the action creating the violation was inadvertent does not alter the fact that the firm needs to evaluate the implications of the violation and take action. Resignation from the audit can be a disproportionate outcome irrespective of whether the violation was inadvertent or not. The disproportionate outcome also can be of the same magnitude whether the violation was inadvertent or not.

The IESBA agreed with the proposal but asked the Task Force to consider whether the provision could be written in a way to reduce the risk that it would promote a wilful disregard of the independence requirements. Such a disregard would be a breach of the fundamental principle of integrity and it may be useful for the text to reflect this.

Action requested

CAG members are asked to provide their views on whether the designation “inadvertent” is helpful.

Types of Possible Violation

The Task Force recommended that the provisions address any violation of an independence requirement because what was relevant was the consequence of the violation as opposed to the interest or relationship that caused the violation. For example, if the consequence of the violation is that the audit client is required to find a replacement auditor to complete the audit, it would not matter whether the violation was created by the holding of a prohibited financial interest or the provision of a non-assurance service. The impact of the violation and, therefore, the actions to be taken to address the violation may differ, but both types of violations need to be addressed.

The IESBA agreed with the recommendation of the Task Force.

Action requested

CAG members are asked to provide their views on whether the provisions should address any violation of an independence provision.

Actions to be Taken

The Task Force recommendation is that if a violation is identified and the firm believes its objectivity has not been compromised as a result:

- The firm shall determine whether corrective measures can be applied that will resolve the situation;

- The firm shall evaluate whether the corrective measures will resolve the situation such that the firm can continue the audit engagement;
- Except as noted below, all violations shall be discussed with those charged with governance, The matters to be discussed shall include:
 - The nature and significance of the violation;
 - Any corrective measures taken or proposed;
 - The rationale as to whether, in the firm’s professional judgment, the corrective measures resolve the situation such that the firm can continue the audit engagement;
 - A description of the firm’s relevant policies and procedures designed to provide it with reasonable assurance that independence is maintained; and
 - An explanation of why, despite the policies and procedures, the violation occurred, and the steps taken or proposed to address any identified weakness in those policies and procedures; and
- The firm shall obtain the agreement of those charged with governance that the corrective measures, including any additional measures required by those charged with governance, resolve the situation such that the firm can continue the audit engagement.

The Task Force recognized that those charged with governance may have determined that the firm need not communicate some violations, such as those that are trivial and inconsequential and do not affect the firm’s ability to continue the audit engagement. However, the firm would be required to determine whether a matter should be communicated despite the determination of those charged with governance that it need not be. In addition, if the violation involves a financial interest held by an immediate family member of a partner or employee of the firm, disclosure would not be necessary provided certain conditions are met.

The IESBA discussed the Task Force recommendation and, while broadly agreeing with the actions to be taken, provided the following direction to the Task Force:

- All violations should be disclosed to those charged with governance irrespective of magnitude or who committed the violation;
- It was not clear what was meant by “resolve the situation”;
- The drafting should not imply that all violations could be rectified such that the audit could continue. It may be useful to make it clear that in some cases resignation may be necessary;
- The drafting should not convey the impression that the aim is to continue the audit at all costs and it may be preferable for the drafting to expressly state that resignation would be necessary unless certain conditions could be met.

Action requested

CAG members are asked to provide their views on the actions to be taken when a violation is identified.

Need for Provisions to Address other Parts of the Code

The Task Force recommended that the provisions apply only to the independence requirements of the Code. A distinguishing feature of the independence provisions is the consequences of the violation – if an independence requirement is violated and the firm cannot issue an opinion, there is a potential for harm to, for example, third parties who are planning certain activities upon receiving the audited financial statements and may be working within tight time constraints. Switching auditors could, depending upon the timing, result in the company having difficulty meeting its filing requirements, missing a market opportunity, and delaying a planned transaction. It also could impact public perceptions about the company and the condition of its financial accounts, and raise doubt about management's stewardship of company assets and the company's compliance culture. If the impact of the violation was trivial or inconsequential, the consequences of a firm resignation would thus be disproportionate to the violation. In the case of the other provisions in the Code, there are not the same consequences to the public.

The IESBA generally agreed with the Task Force recommendation.

Action requested

CAG members are asked to provide their views on whether the provisions should apply only to the independence requirements.

Review of Drafting

The IESBA reviewed the preliminary draft wording and provided the following comments to the Task Force:

- There should be greater emphasis on the need to have policies and procedures to monitor independence and there should also be a recognition that violations could be an indication that there were deficiencies with the policies and procedures;
- The significance of the violation should also take into account whether the action leading to the violation was intentional, the role of the person who committed the violation and whether that individual was a member of the engagement team;
- There seems to be some inconsistency between paragraphs 290.40 and 290.41(b). Paragraph 290.40 requires the interest or relationship that caused the violation to be terminated promptly but 290.41(b) focuses on whether the interest or relationship can be terminated promptly.
- The provisions are focused on violations identified in the current audit. A violation could relate to a prior audit, in which case the impact on the prior audit would need to be considered;

Action requested

CAG members are asked to provide any comments they might have on the drafting of the provisions.

Material Presented

Agenda Paper C	This Agenda Paper
Agenda Paper C-1	IESBA Lead Agenda Paper as discussed in Delhi
Agenda Paper C-2	Approved Project Proposal as discussed in Delhi
Agenda Paper C-3	Proposed draft paragraphs as discussed in Delhi

Action Requested

1. CAG members are asked to consider the questions raised in the paper