

## Exposure Draft

December 2015

*Comments due: March 21, 2016*

*International Ethics Standards Board for  
Accountants®*

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# Proposed Revisions Pertaining to Safeguards in the Code—Phase 1

**IESBA**

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This Exposure Draft was developed and approved by the International Ethics Standards Board for Accountants® (IESBA®).

The IESBA is an independent standard-setting board that develops and issues high-quality ethical standards and other pronouncements for professional accountants worldwide. Through its activities, the IESBA develops the *Code of Ethics for Professional Accountants™*, which establishes ethical requirements for professional accountants.

The objective of the IESBA is to serve the public interest by setting high-quality ethical standards for professional accountants and by facilitating the convergence of international and national ethical standards, including auditor independence requirements, through the development of a robust, internationally appropriate code of ethics.

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## REQUEST FOR COMMENTS

This Exposure Draft, *Proposed Revisions Pertaining to Safeguards in the Code—Phase 1*, was developed and approved by the International Ethics Standards Board for Accountants® (IESBA®).

The proposals in this Exposure Draft may be modified in light of comments received before being issued in final form. **Comments are requested by March 21, 2016.**

Respondents are asked to submit their comments electronically through the IESBA website, using the “[Submit a Comment](#)” link. Please submit comments in both PDF and Word files. Also, please note that first-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website. Although IESBA prefers that comments are submitted via its website, comments can also be sent to Ken Siong, IESBA Technical Director at [KenSiong@ethicsboard.org](mailto:KenSiong@ethicsboard.org).

This publication may be downloaded from the IESBA website: [www.ethicsboard.org](http://www.ethicsboard.org). The approved text is published in the English language.

## CONTENTS

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	Page
EXPLANATORY MEMORANDUM .....	5
Introduction .....	5
Background.....	5
Significant Matters .....	6
Guide for Respondents.....	15
EXPOSURE DRAFT: PROPOSED REVISIONS PERTAINING TO SAFEGUARDS IN THE CODE (PHASE 1).....	17
Proposed Section 120 (Revised Section 100 of the Extant Code).....	17
Proposed Section 300 (Revised Section 200 of the Extant Code).....	20

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# EXPLANATORY MEMORANDUM

## Introduction

1. This memorandum provides background to, and an explanation of, the proposed changes to the International Ethics Standards Board for Accountants (IESBA or the Board) *Code of Ethics for Professional Accountants* (the Code) in Section 100<sup>1</sup> and Section 200<sup>2</sup> of the extant Code (numbered proposed Sections 120 and 300 in the [restructured Code](#)<sup>3</sup>) pertaining to safeguards (herein referred to as the exposure draft (ED)). The Board approved these proposed changes for exposure at its November/December 2015 meeting.

## Background

2. During its most recent consultation in developing its *Strategy and Work Plan 2014-2018*, the Board heard of regulatory concerns that certain safeguards identified in the Code may be inappropriate or ineffective. For example, it was suggested that some safeguards merely duplicate existing requirements imposed by quality control and auditing standards or the existing best practice for situations that do not involve a threat to independence. It was suggested that the Board should (a) bring clarity to safeguards that are not clear and eliminate those that are inappropriate, (b) better correlate a safeguard with the threat it is intended to address, and (c) make clear that not every threat can be addressed by a safeguard. In addition, some within the small and medium practices (SMP) community have expressed support for the Board to review the safeguards in the Code given the practical challenges SMPs tend to face from having limited resources, including numbers of partners.
3. The Board therefore determined to undertake this project with the aim of improving the clarity, appropriateness, and effectiveness of the safeguards in the Code. This ED has been developed under Phase I of the project.
4. This phase deals with a review of the conceptual framework and the sections relating to its general application for all professional accountants, as well as for professional accountants in public practice (i.e., proposed revisions to Sections 100 and 200 of the extant Code only). Through enhanced clarity and more robust application material relating to the conceptual framework, the proposals in the ED are aimed at further promoting the appropriate use of the conceptual framework among all professional accountants to comply with the fundamental principles of the Code. The Board believes that its proposals, which also include more robust application material to explain threats to compliance with the fundamental principles, will support professional accountants in fulfilling their responsibility to act in the public interest, and with respect to audits of financial statements, contribute to supporting audit quality.

### *Phase II*

5. Informed by feedback from respondents on this ED, the Board plans to consider potential revisions to other sections of the extant Code with respect to safeguards as part of Phase II of the project. During this second phase, the Board will:
  - (a) Review the clarity, appropriateness and effectiveness of safeguards that pertain to non-

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<sup>1</sup> Extant Section 100, *Introduction and Fundamental Principles*

<sup>2</sup> Extant Section 200, *Introduction* (Part B – Professional Accountants in Public Practice)

<sup>3</sup> See Exposure Draft, [Improving the Structure of the Code of Ethics for Professional Accountants—Phase 1](#).

- assurance services (NAS) in extant Section 290 of the Code;<sup>4</sup>
- (b) Review the conceptual framework approach to independence,<sup>5</sup> in light of the proposed revised description of the conceptual framework in proposed Section 120;
  - (c) Consider whether there is a need for alignment to the requirements and application material in ISA 220<sup>6</sup> with respect to documentation of safeguards in the context of audits of financial statements; and
  - (d) Update other areas in the Code based on new terminology or revised concepts developed under the first phase of the project.
6. As part of this phase, the Board will consider, as appropriate, the unique challenges faced by the SMP sector in employing safeguards.
  7. As part of its future work, the Board plans to continue to consider whether additional guidance is needed in the Code to explain the differences in the evaluation of whether a threat is at an acceptable level for a public interest entity (PIE) and an entity that is not a PIE.
  8. In developing this ED, the Board agreed to apply the proposed structure and drafting conventions developed under its Structure of the Code project. See the [Safeguards Mapping Table](#). This Mapping Table is intended to assist respondents understand the proposed revisions to the extant Code.

## Significant Matters

<b>Public Interest Issues Addressed by this Project</b>	
9.	<p>The Board believes that there are public interest benefits to be derived from its proposals because of the improved correlation between threats, safeguards and the fundamental principles. The proposed revisions:</p> <ul style="list-style-type: none"> <li>(a) Include a strengthened emphasis on the requirements in the Code for professional accountants (including those in public practice) to: <ul style="list-style-type: none"> <li>(i) Comply with the fundamental principles, rather than simply complying with specific requirements in the Code. The fundamental principles are not simply background information but establish the overarching objectives professional accountants are required to meet; and</li> <li>(ii) Apply the conceptual framework, which involves identifying, evaluating and addressing threats to compliance with the fundamental principles. The proposed revisions relating to the conceptual framework retain the principles-based approach in the extant Code, and continue to emphasize the need for professional accountants to exercise professional judgment in applying the conceptual framework.</li> </ul> </li> <li>(b) Establish a new requirement and corresponding application material for the professional accountant to re-evaluate threats to compliance with the fundamental principles when the professional accountant becomes aware of new information or if there are changes in facts and circumstances that might impact whether a threat has been eliminated or reduced to an</li> </ul>

<sup>4</sup> Extant paragraphs 290.154–290.216

<sup>5</sup> Extant paragraphs 290.14–290.12 and 291.4–291.11, *The Conceptual Framework Approach to Independence*; 290.100–290.101 and 291.100–291.101, *Application of the Conceptual Framework Approach to Independence*

<sup>6</sup> International Standard on Auditing (ISA) 220, *Quality Control for an Audit of Financial Statements*

- acceptable level.
- (c) Introduce a new requirement for the professional accountant to do an overall assessment by reviewing judgments made and overall conclusions reached to determine that threats to compliance with the fundamental principles are eliminated, or reduced to an acceptable level and that no further action is needed.
  - (d) Provide a revised definition of the term “acceptable level” that explains, in an affirmative manner, what it means. This relates to the professional accountant’s evaluation of whether a threat to the fundamental principles is at an acceptable level and the requirements to address a threat that is not at an acceptable level by eliminating it or reducing it to an acceptable level.
  - (e) Provide an enhanced description of, and more application material on, the “reasonable and informed third party” test. The professional accountant is required to perform a reasonable and informed third party test, as part of applying the conceptual framework, by taking into account whether such a third party would likely conclude that the professional accountant has complied with the fundamental principles. The proposals emphasize the importance of, and give more prominence to, the reasonable and informed third party test as part of evaluating and addressing threats.
  - (f) Clarify what constitutes a safeguard. In particular, actions are safeguards only when they are effective in eliminating threats to compliance with the fundamental principles or reducing them to an acceptable level; and
  - (g) Include enhanced application material that:
    - (i) Clarifies the types of threats to compliance with the fundamental principles; and
    - (ii) Better explains that certain conditions, policies and procedures are likely to assist professional accountants in evaluating the level of threats to compliance with the fundamental principles.
10. In addition, the proposals:
- (a) Build on the requirement in the extant Code for the professional accountant to decline or discontinue the specific professional activity when safeguards are not available, or cannot be applied by introducing a new, more robust requirement that better explains the actions the professional accountant should take to address threats.
  - (b) Improve the examples provided on safeguards by more clearly linking them to the relevant threats to the fundamental principles.
  - (c) Clarify that certain conditions, policies and procedures established by the profession, legislation, regulation, the firm or the employing organization are not regarded as safeguards (e.g., educational, training and experience requirements for the profession).

11. The remainder of this Explanatory Memorandum further explains each of the above proposed improvements to the Code with respect to safeguards.

**Proposed Enhancements to the Conceptual Framework**

*Applicability of the Conceptual Framework and Approach Used to Develop the Proposals*

12. Section 100 of the extant Code includes provisions that are applicable to all professional accountants and which address their responsibility to apply the conceptual framework in order to comply with the fundamental principles. Other sections of the extant Code (e.g., Section 200, in the case of professional accountants in public practice, and the provisions in Section 290 dealing with NAS) build

on Section 100 of the extant Code and provide more engagement-specific or service-specific guidance. The Board has agreed to retain this approach.

13. Accordingly, the proposed requirements and application material in proposed Section 120 pertaining to safeguards are applicable to all professional accountants, and are incorporated by reference in proposed Section 300 and therefore not repeated. Thus, proposed Section 300 includes revised application material for the appropriate application of the conceptual framework by professional accountants in public practice.
14. In developing proposed Section 120 pertaining to safeguards, the Board agreed to re-organize the conceptual framework in the extant Code as outlined below:
  - The Conceptual Framework
    - Introduction
  - Requirements and Application Material
    - Reasonable and Informed Third Party
    - Identifying Threats
    - Evaluating Threats
    - Addressing Threats
    - Re-evaluating Threats
    - Overall Assessment

*Requirement to Apply the Conceptual Framework*

15. The Board's proposals include a more explicit overarching requirement for all professional accountants to apply the conceptual framework to eliminate threats to compliance with the fundamental principles or reduce them to an acceptable level (see paragraph R120.3). The proposals also include a more extensive introduction that better explains that the conceptual framework is an approach, required by the Code, for professional accountants to identify, evaluate and address<sup>7</sup> threats to compliance with the fundamental principles (see paragraphs 120.1–120.2).
16. The Board considered having only the overarching requirement described above, supported by corresponding application material to explain how professional accountants should apply the conceptual framework. However, on advice from its Consultative Advisory Group (CAG), the Board agreed that it is important to also establish explicit requirements and application material with respect to identifying, evaluating, addressing and re-evaluating threats in the Code as a way of giving more prominence to each of these steps (see paragraphs R120.5–R120.8; 120.5 A1 – 120.5 A4; 120.6 A1 – 120.6 A3; 120.7 A1 – 120.7 A2; and 120.8 A1 – 120.8 A2).

*Overall Assessment*

17. The Board felt it important to include—as part of, and not distinct from, the application of the conceptual framework—a new requirement for the professional accountant to perform an *overall* assessment by reviewing the judgments made and overall conclusions reached. Under the proposal,

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<sup>7</sup> Threats to compliance with the fundamental principles are addressed when they are eliminated, or reduced to an acceptable level.

the professional accountant is required to determine, through an objective lens, that threats to compliance with the fundamental principles are eliminated or reduced to an acceptable level, and that no further action is needed. The proposed requirement notes that the reasonable and informed third party test is relevant when performing the overall assessment (see paragraphs R120.9 and R120.4 A1).

*Enhancing Consistency in the Terminology Used in the Code*

18. The Board is of the view that the Code is clearer when terms are used in a consistent manner. Accordingly, in developing its proposals, the Board has sought to enhance the consistency in use of terms throughout the Code. Terms that were revisited as part of the Board's deliberations include:
- (a) "Facts and circumstances," "circumstances and relationships," "facts, circumstances and relationships," and "interests and relationships." The Board agreed to use the term "facts and circumstances" in a broader context as an "umbrella" term, and the terms "...facts and circumstances, including professional activities (services), interests and relationships..." in situations where the Code requires a more specific reference or emphasis to "relationships" or "interests" (see paragraphs R120.5 and 300.1).
  - (b) Materiality and significance. Generally, the Board has not used the term "material" and "significant" or "significance" in proposed Sections 120 and 300. The Board believes that those terms, the meaning of which is consistent with the auditing concept of materiality as described in the ISAs, are not appropriate for establishing the overarching requirements and principles about threats and safeguards. However, the Board acknowledged that those terms may be relevant in the context of threats and safeguards relating to NAS, which the Board will consider under Phase II of this project.
19. The Board is of the view that the proposed changes relating to terminology will have implications for the rest of the Code and plans to consider potential conforming amendments in Phase II of the project.

*Reasonable and Informed Third Party*

20. The Board is of the view that applying the "reasonable and informed third party" concept is an important step established in the extant Code whereby the professional accountant considers whether there has been compliance with the fundamental principles.<sup>8</sup> The ED clarifies this concept by proposing a more fulsome description of the term in paragraph 120.4 A1 as follows:

The concept of a reasonable and informed third party is a test which involves an evaluation by a hypothetical person. Such a person possesses skills, knowledge and experience to objectively evaluate the appropriateness of the professional accountant's judgments and conclusions. This evaluation entails weighing all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time that the evaluation is made to determine whether the accountant complies with the fundamental principles.

21. The proposed description of a "reasonable and informed third party" clarifies that the concept is a test intended to prompt an objective evaluation of the professional accountant's judgements and

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<sup>8</sup> Paragraphs 100.7 of the extant Code state that "..., the professional accountant shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at the time, would be likely to conclude that the threats would be eliminated or reduced to an acceptable level by the application of the safeguards, such that compliance with the fundamental principles is not compromised."

conclusions. This evaluation takes into account all the relevant facts and circumstances that the professional accountant knows, or could be reasonably expected to know, at the time that the evaluation was made to determine whether the professional accountant complies with the fundamental principles.

22. The Board believes that its proposed description of a reasonable and informed third party supports professional accountants' appropriate application of the conceptual framework (i.e., in identifying, evaluating and addressing threats). The ED also provides practical guidance for how the reasonable and informed third party concept applies in re-evaluating threats and in performing the proposed required overall assessment explained above.
23. The Board has emphasized that the reasonable and informed third party is a hypothetical person (rather than an actual person). It is the Board's view that this hypothetical person should be competent and possess sufficient skills to objectively evaluate the appropriateness of the professional accountant's judgments and conclusions.

#### *Identifying Threats*

24. With respect to the identification of threats, the proposed revisions to the Code include a general discussion about threats, drawing from paragraphs 100.8 and 100.12 of the extant Code. The proposed revised application material describes the factors that may threaten compliance with the fundamental principles, and more clearly articulates that the identification of threats supports compliance with the fundamental principles (see paragraphs 120.5 A1 and 120.5 A2).
25. As part of its deliberations, the Board considered the threats listed in other national ethics codes, laws and regulations, including the way they were categorized. The Board ultimately concluded that the listing and categories of threats used in the extant Code remain appropriate.<sup>9</sup>

#### *Conditions Policies and Procedures*

26. The Board is proposing to withdraw the terms "safeguards created by the profession or legislation," "safeguards in the work environment" and "safeguards implemented by the entity" from the Code.
27. The Board accepts that there are conditions, policies and procedures that are established by the profession, legislation, regulation, the firm or employing organization that may impact the level of a threat to compliance with the fundamental principles. These conditions, policies and procedures can therefore affect the likelihood of identification of threats to compliance with the fundamental principles. Such conditions, policies and procedures, however, do not meet the revised description of "safeguards" (see discussion below). The Board has included examples of these conditions, policies and procedures in the ED (see paragraph 120.5 A4).

#### *Evaluating Threats*

28. The Board proposes to expand the application material in the extant Code<sup>10</sup> to better describe the process by which professional accountants should evaluate threats. The Board believes that the conditions, policies and procedures (discussed above) might impact the professional accountant's evaluation of threats to compliance with the fundamental principles. Accordingly, the proposals include new application to this effect (see paragraph 120.6 A3).

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<sup>9</sup> See extant paragraph 100.12.

<sup>10</sup> See extant paragraphs 100.8, 100.9, 100.14 and 100.16.

Revised Definition of Acceptable Level

29. The term “acceptable level” is critical to the proper understanding of the conceptual framework and the Code more broadly.<sup>11</sup> As a result, the Board accepted the advice of its CAG and proposes to:
- (a) Include the definition of “acceptable level” (currently in the Glossary of the extant Code) in the main body of the Code to give this important term appropriate prominence; and
  - (b) Better explain, in an affirmative manner, what the term means. The proposed definition states that “[a]n acceptable level is a level at which a reasonable and informed third party would likely conclude that the professional accountant complies with the fundamental principles” (see paragraph 120.6 A1).
30. The Board acknowledges that the rest of the extant Code will need to be reviewed to ascertain the need for potential conforming changes. As noted in the Background section to this Explanatory Memorandum, the Board plans to undertake this review as part of Phase II of this project.

*Addressing Threats*

31. The Board observed inconsistencies in how the term “safeguards” is used in the extant Code. Specifically, the Board noted that there are instances where the term “safeguards” is intended to have a broad and conceptual meaning. In other instances, the term is used to more narrowly describe actions that the professional accountant undertakes to address threats to compliance with the fundamental principles. The Board proposes to discontinue using the term “safeguards” in its broader context. As discussed above, the Board is also proposing to withdraw the concepts of “safeguards created by the profession or legislation,” “safeguards in the work environment” and “safeguards implemented by the entity” from the Code.

Revised Description of Safeguards

32. In response to some of the concerns and suggestions raised by some stakeholders, the Board proposes a more robust description of safeguards in paragraph 120.7 A2 as follows:
- Safeguards are actions, individually or in combination, that the professional accountant takes that effectively eliminate threats to compliance with the fundamental principles or reduce them to an acceptable level.
33. The Board is of the view that its proposed description of safeguards, together with the other proposed clarifications to the conceptual framework, establishes a stronger correlation between “threats and safeguards” and the fundamental principles in the Code.
34. Application of professional judgement continues to be a critical aspect of effectively applying safeguards. The professional accountant’s exercise of professional judgment is needed to determine

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<sup>11</sup> The extant Code defines acceptable level as “A level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant at that time, that compliance with the fundamental principles is not compromised.”

whether an action is a safeguard, and whether the safeguard remains appropriate to address the identified threat, if new information becomes available or if facts or circumstances change.

#### New Guidance for Addressing Threats to Compliance with the Fundamental Principles

35. The Board's proposal builds on the principles in paragraph 100.9 of the extant Code<sup>12</sup> and establishes a more robust requirement that specifies the actions the professional accountant should take to address threats (see paragraph R120.7). The new requirement states that if the professional accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the accountant shall address the threats by eliminating or reducing them to an acceptable level by:
- (a) Eliminating the circumstances, including interests or relationships, that are creating the threats;
  - (b) Applying safeguards, where available and capable of being applied; or
  - (c) Declining or discontinuing the specific professional activity or service involved.
36. New application material has also been included in the Code to note that there are some situations where the threat created would be so significant that no safeguards could reduce the threat to an acceptable level (see paragraph 120.7 A1).

#### *Re-evaluating Threats*

37. The Board acknowledges that facts and circumstances might change over time and new information about threats and the appropriateness of safeguards might come to the attention of the professional accountant that might either:
- (a) Impact the level of a threat; or
  - (b) Affect the professional accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats.

Accordingly, the Board's proposals include a new requirement for the professional accountant to re-evaluate and address threats when new information becomes available, or when there are changes in facts or circumstances (see paragraph R120.8).

38. This new requirement is supported by new application material which explains that if the professional accountant identifies a new threat, the application of the conceptual framework requires that the professional accountant evaluate and address the threat as set out in accordance with the requirements and application material pertaining to evaluating and addressing threats in paragraphs R120.5–R120.8 (see paragraph 120.8 A2).

#### **Application of the Conceptual Framework by Professional Accountants in Public Practice**

39. As part of its Structure of the Code project, the Board has clarified the scope of proposed Section

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<sup>12</sup> Paragraph 100.9 of the extant Code states: "... When applying the conceptual framework, a professional accountant may encounter situations in which threats cannot be eliminated or reduced to an acceptable level, either because the threat is too significant or because appropriate safeguards are not available or cannot be applied. In such situations, the professional accountant shall decline or discontinue the specific professional activity or service involved or, when necessary, resign from the engagement (in the case of a professional accountant in public practice) or the employing organization (in the case of a professional accountant in business)."

300 to better describe how the conceptual framework set out in proposed Section 120 applies to professional accountants in public practice (see paragraph 300.1). As this paragraph provides important context to the Safeguards proposals, it is also repeated in this ED.

#### More Prominent Overarching Requirement for Professional Accountants in Public Practice

40. The Board believes that the professional accountant should apply the requirements in the conceptual framework to address threats to compliance with the fundamental principles. Accordingly, the ED includes a proposed requirement upfront in proposed Section 300 that requires the professional accountant to comply with each of the fundamental principles and apply the conceptual framework set out in proposed Section 120 (see paragraph R300.2).
41. Through the revised introduction discussed above, and better alignment with proposed Section 120, the Board intends to strengthen the provisions in the extant Code that address the application of the conceptual framework for professional accountants in public practice.

#### *Enhanced Application Material for Professional Accountants in Public Practice*

42. As noted above, the application material in proposed Section 300 has been improved and builds on, but does not repeat, the proposals in Section 120. For example, proposed new application material has been developed for professional accountants in public practice to explain the conditions that might impact the evaluation of whether a threat is at an acceptable level. Similarly, enhanced application material has been added to assist professional accountants in evaluating and addressing threats to compliance with the fundamental principles (see paragraphs 300.2 A2–300.2 A8).

#### *Streamlined Examples of Threats and Safeguards*

43. With a new lead-in, the inclusion of sub-headings and improved drafting, the Board has streamlined and thereby clarified the examples of the types of threats that are included in the extant Code<sup>13</sup> (see paragraph 300.2 A1).
44. In response to concerns from certain stakeholders about the quality and usefulness of the examples of safeguards in the extant Code, the Board is proposing to:
  - (a) Clarify that certain matters formerly characterized as safeguards in the extant Code<sup>14</sup> are in fact conditions that might impact the professional accountant's evaluation of whether a threat is at an acceptable level. Those conditions include the nature of the client and its operating environment; the professional service being provided, and the firm and its operating environment (see paragraph 300.2 A2).
  - (b) Streamline the list of examples of conditions in the work environment within a firm that might impact the evaluation of the level of a threat (see paragraph 300.2 A6). To do so, the Board considered and leveraged the requirements in ISQC 1<sup>15</sup> as well as analogous requirements and best practices included in the ethics codes of national standard setters.

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<sup>13</sup> See paragraphs 200.4–200.8 of the extant Code.

<sup>14</sup> See paragraphs 200.12 and 200.15 of the extant Code.

<sup>15</sup> International Standard on Quality Control (ISQC 1), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraphs 21 – 25

### Examples of Safeguards

45. The Board is proposing to retain some of the examples of engagement-specific safeguards that are included in the extant Code.<sup>16</sup> To better assist professional accountants in public practice address threats, those examples of safeguards now indicate the type of threat that is being addressed – an approach that assists in clarifying the correlation between the safeguards and threats in the Code (see paragraph 300.2 A9). For example, the Board agreed to include as an example of a safeguard the use of different partners and engagement teams with separate reporting lines for the provision of NAS to an assurance client to address self-review and familiarity threats.
46. The Board is also proposing to delete the examples included in the extant Code that no longer meet the proposed revised description of safeguards (for example, discussing ethical issues with those charged with governance of the client; and disclosing to those charged with governance of the client the nature of services provided and extent of fees charged).<sup>17</sup>

### *Re-evaluating Threats*

47. The Board's proposals in Section 300 emphasize the requirement in proposed Section 120 pertaining to re-evaluating threats and state that new information or changes in facts or circumstances might:
  - (a) Impact the level of a threat; or
  - (b) Affect the professional accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats. (See paragraph 300.2 A10.)
48. A list of examples of new information or changes in facts and circumstances that might trigger the need for a professional accountant to re-evaluate threats is included in the ED (see paragraph 300.2 A11).
49. The proposals emphasize that in those situations, certain actions that have already been implemented as safeguards might no longer be effective in eliminating the threats or reducing them to an acceptable level (see paragraph 300.2 A11).

### *Overall Assessment*

50. The proposals in Section 300 also emphasize that the requirement for an overall assessment or "step-back" in Section 120 that is discussed in paragraph 17 of this Explanatory Memorandum is also applicable to professional accountants in public practice (see paragraph 300.3 A12).

### **Project Timetable and Effective Date**

51. As noted above, the Board's proposals pertaining to safeguards in this ED have been developed using the structure and drafting conventions established by the Structure of the Code project. The December 2015 [IESBA Update, Restructuring the Code of Ethics for Professional Accountants](#), outlines the IESBA's plan for coordination of its work on this project with the Structure of the Code project.
52. The Board intends to align the effective date of the revisions pertaining to safeguards with the effective date of the restructured Code.

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<sup>16</sup> See paragraph 200.13 of the extant Code.

<sup>17</sup> See fourth and fifth bullet in paragraph 200.13 of the extant Code.

## Guide for Respondents

53. The IESBA welcomes comments on all matters addressed in this ED, but especially those identified in the *Request for Specific Comments* below. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in this ED, it will be helpful for the IESBA to be made aware of this view.

### **Request for Specific Comments**

#### *Proposed Revisions to the Conceptual Framework*

1. Do respondents support the Board's proposed revisions to the extant Code pertaining to the conceptual framework, including the proposed requirements and application material related to:
- (a) Identifying threats;
  - (b) Evaluating threats;
  - (c) Addressing threats;
  - (d) Re-evaluating threats; and
  - (e) The overall assessment.

If not, why not?

#### *Proposed Revised Descriptions of "Reasonable and Informed Third Party" and "Acceptable Level"*

2. Do respondents support the proposed revisions aimed at clarifying the concepts of (a) "reasonable and informed third party;" and (b) "acceptable level" in the Code. If not, why not?

#### *Proposed Revised Description of Safeguards*

3. Do respondents support the proposed description of "safeguards?" If not, why not?
4. Do respondents agree with the IESBA's conclusions that "safeguards created by the profession or legislation," "safeguards in the work environment," and "safeguards implemented by the entity" in the extant Code:
- (a) Do not meet the proposed description of safeguards in this ED?
  - (b) Are better characterized as "conditions, policies and procedures that affect the professional accountant's identification and potentially the evaluation of threats as discussed in paragraphs 26–28 of this Explanatory Memorandum?"

If not, why not?

#### *Proposals for Professional Accountants in Public Practice*

5. Do respondents agree with the IESBA's approach to the revisions in proposed Section 300 for professional accountants in public practice? If not, why not and what suggestions for an alternative approach do respondents have that they believe would be more appropriate?

**Request for General Comments**

54. In addition to the request for specific comments above, the IESBA is also seeking comments on the matters set out below:
- (a) Small and Medium Practices (SMPs) – The IESBA invites comments regarding the impact of the proposed changes for SMPs.
  - (b) *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the Code, the IESBA invites respondents from these nations to comment on the proposals, and in particular, on any foreseeable difficulties in applying them in their environment.
  - (c) *Translations*—Recognizing that many respondents may intend to translate the final pronouncement for adoption in their environments, the IESBA welcomes comment on potential translation issues respondents may note in reviewing the proposals.

# PROPOSED REVISIONS PERTAINING TO SAFEGUARDS IN THE CODE (PHASE 1)

## Section 120

### The Conceptual Framework

#### Introduction

- 120.1 The circumstances in which professional accountants operate might create specific threats to compliance with the fundamental principles. The conceptual framework assists the accountant in complying with the fundamental principles and meeting the responsibility to act in the public interest. It accommodates the many variations in facts and circumstances that create threats to compliance with the fundamental principles and deters an accountant from concluding that a situation is permitted if it is not specifically prohibited by this Code.
- 120.2 The conceptual framework specifies an approach for the professional accountant to:
- (a) Identify threats to compliance with the fundamental principles;
  - (b) Evaluate the threats identified; and
  - (c) Address the threats by eliminating or reducing them to an acceptable level.

#### Requirements and Application Material

- R120.3** The professional accountant shall apply the conceptual framework which involves identifying, evaluating and addressing threats to compliance with the fundamental principles.
- R120.4** When applying the conceptual framework, the professional accountant shall exercise professional judgment, remain alert to changing circumstances, and take into account whether a reasonable and informed third party would likely conclude that the accountant has complied with the fundamental principles.

#### Reasonable and Informed Third Party

- 120.4 A1 The concept of a reasonable and informed third party is a test which involves an evaluation by a hypothetical person. Such a person possesses skills, knowledge and experience to objectively evaluate the appropriateness of the professional accountant's judgments and conclusions. This evaluation entails weighing all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time that the evaluation is made to determine whether the accountant complies with the fundamental principles.

#### Identifying Threats

- R120.5** The professional accountant shall identify threats to compliance with the fundamental principles. An understanding of the facts and circumstances, including professional activities, interests and relationships, that might compromise compliance with the fundamental principles is a prerequisite to the accountant's identification of threats to such compliance.
- 120.5 A1 Threats might be created by a broad range of facts and circumstances. It is impossible to define every situation that creates threats. In addition, the nature of engagements and work assignments might differ and, consequently, different types of threats might be created.

- 120.5 A2 Threats to compliance with the fundamental principles fall into one or more of the following categories:
- (a) Self-interest threat – the threat that a financial or other interest will inappropriately influence the professional accountant’s judgment or behavior;
  - (b) Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made, or activity or service performed by the accountant, or by another individual within the accountant’s firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity or providing a current service;
  - (c) Advocacy threat – the threat that a professional accountant will promote a client’s or employer’s position to the point that the accountant’s objectivity is compromised;
  - (d) Familiarity threat – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
  - (e) Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.
- 120.5 A3 A circumstance might create more than one threat, and a threat might affect compliance with more than one fundamental principle.
- 120.5 A4 Certain conditions, policies and procedures established by the profession, legislation, regulation, the firm or the employing organization can affect the likelihood of the accountant’s identification of threats to compliance with the fundamental principles. Examples of such conditions, policies and procedures include:
- Corporate governance requirements.
  - Educational, training and experience requirements for the profession.
  - Effective complaint systems.
  - An explicitly stated duty to report breaches of ethical requirements.
  - Professional or regulatory monitoring and disciplinary procedures.

### **Evaluating Threats**

- R120.6** When the professional accountant identifies a threat, the accountant shall evaluate whether such a threat is at an acceptable level.
- 120.6 A1 An acceptable level is a level at which a reasonable and informed third party would likely conclude that the professional accountant complies with the fundamental principles.
- 120.6 A2 The existence of qualitative as well as quantitative factors is relevant to the professional accountant’s evaluation of threats, as is the combined effect of multiple threats, if applicable.
- 120.6 A3 The existence of conditions, policies and procedures discussed in paragraph 120.5 A4 above might impact the professional accountant’s evaluation of threats to compliance with the fundamental principles.

### Addressing Threats

**R120.7** If the professional accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the accountant shall address the threats by eliminating or reducing them to an acceptable level. The accountant shall do so by:

- (a) Eliminating the circumstances, including interests or relationships, that are creating the threats;
- (b) Applying safeguards, where available and capable of being applied; or
- (c) Declining or discontinuing the specific professional activity or service involved.

120.7 A1 There are some situations where the threat created would be so significant that no safeguards could reduce the threat to an acceptable level. International Independence Standards C1 and C2 of the Code provide examples of such situations.

#### *Safeguards*

120.7 A2 Safeguards are actions, individually or in combination, that the professional accountant takes that effectively eliminate threats to compliance with the fundamental principles or reduce them to an acceptable level.

### Re-evaluating Threats

**R120.8** If the professional accountant becomes aware of new information or changes in facts and circumstances that might impact whether a threat has been eliminated or reduced to an acceptable level, the accountant shall re-evaluate and address that threat accordingly.

120.8 A1 Remaining alert throughout the professional activity or service assists the professional accountant in determining whether new information has emerged or changes in facts and circumstances have occurred that:

- (a) Impact the level of a threat; or
- (b) Affect the professional accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats.

120.8 A2 If the professional accountant identifies a new threat, the application of the conceptual framework requires that the accountant evaluate and address this new threat as set out in paragraphs R120.5–R120.8 above.

### Overall Assessment

**R120.9** The professional accountant shall review judgments made and overall conclusions reached to determine that threats to compliance with the fundamental principles are eliminated or reduced to an acceptable level, and that no further action is needed. The reasonable and informed third party test described in paragraph 120.4 A1 is relevant to this assessment.

**[Extant 100.17 – 100.25 that deal with Conflicts of Interest and Communicating with Those Charged With Governance are dealt with by the [Structure Project](#).]**

## **C. SECTION 300 PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE**

### **Section 300**

#### **Application of the Conceptual Framework Approach by Professional Accountants in Public Practice**

##### **Introduction**

300.1 This Part of the Code describes considerations for professional accountants in public practice in the application of the conceptual framework set out in Section 120. This Part does not describe all of the facts and circumstances, including professional services, interests and relationships, that could be encountered by accountants<sup>18</sup> that create or might create threats to compliance with the fundamental principles. Therefore, accountants are encouraged to be alert for such facts and circumstances.

##### **Requirements and Application Material**

**R300.2** A professional accountant shall comply with each of the fundamental principles and apply the conceptual framework set out in Section 120 to eliminate threats to compliance with those fundamental principles or to reduce them to an acceptable level.

##### **Identifying Threats**

300.2 A1 Compliance with the fundamental principles might be threatened by a broad range of facts and circumstances. The following are categories of threats, and examples of facts and circumstances that might create those threats for a professional accountant when undertaking a professional activity or providing a professional service:

(a) Self-interest Threats

- A professional accountant having a direct financial interest in a client.
- A firm having undue dependence on total fees from a client or the possibility of losing a significant client.
- A professional accountant having a significant close business relationship with a client.

(b) Self-review Threats

- A professional accountant issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
- A professional accountant having prepared the original data used to generate records that are the subject matter of the assurance engagement.
- A professional accountant being, or having recently been, a director or officer of the client, or having recently been employed by the client in a position to exert significant influence over the subject matter of the engagement.

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<sup>18</sup> In Part C and in C1 and C2, the term “professional accountant” refers to professional accountants in public practice and firms of professional accountants in practice.

- (c) Advocacy Threats
  - The professional accountant promoting shares in a client.
  - A professional accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties.
- (d) Familiarity Threats
  - A member of the engagement team having a close or immediate family member who is a director or officer of the client, or is an employee of the client who is in a position to exert significant influence over the subject matter of the engagement.
  - A director or officer of the client, or an employee in a position to exert significant influence over the subject matter of the engagement, having recently served as the engagement partner.
  - Senior personnel having a long association with the assurance client.
- (e) Intimidation Threats
  - A firm being threatened with dismissal from a client engagement.
  - A professional accountant feeling pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.
  - A professional accountant being informed by a partner of the firm that a planned promotion will not occur unless the accountant agrees with an audit client's inappropriate accounting treatment.

The categories of threats are also discussed in Section 120.

### **Evaluating Threats**

- 300.2 A2 Conditions that might impact the evaluation of whether a threat is at an acceptable level include the nature of:
- (a) The client and its operating environment;
  - (b) The professional service being provided; and
  - (c) The firm and its operating environment.

#### *The Client and its Operating Environment*

- 300.2 A3 The level of a threat might be impacted by the following types of client or professional service that is provided:
- (a) An audit client and whether the audit client is a public interest entity;
  - (b) An assurance client that is not an audit client; or
  - (c) A non-assurance client.

For example, providing a service to an audit client might be perceived to result in a higher level of threat to the fundamental principle of objectivity. Such a threat might be further increased when the audit client is a public interest entity with a large number and wide range of stakeholders.

300.2 A4 A professional accountant's evaluation of the level of the threat might also be impacted by a client's operating environment. For example:

- The client requires appropriate persons other than management to ratify or approve the appointment of a firm to perform an engagement.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that facilitate objective choices in tendering non-assurance engagements.
- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

*The Professional Service Being Provided*

300.2 A5 The level of a threat is impacted by the nature and scope of the professional service. Examples of professional services, the threats that might arise as a result, and how a professional accountant may address those threats are discussed in International Independence Standards C1 and C2.

*The Firm and its Operating Environment*

300.2 A6 A professional accountant's evaluation of the level of a threat might be impacted by the work environment within a firm and its operating environment. For example:

- Leadership of the firm that promotes compliance with the fundamental principles and establishes the expectation that professional accountants will act in the public interest.
- Methods and processes for establishing and monitoring compliance with the fundamental principles by all personnel.
- Compensation, performance appraisal and disciplinary policies and procedures that promote compliance with the fundamental principles.
- Management of the reliance on revenue received from a single client.
- The engagement partner having authority for compliance with the fundamental principles, including decisions about the permissibility of services to an audit client.
- Educational, training and experience requirements.
- Processes to facilitate and address internal and external complaints.

**Addressing Threats**

300.2 A7 If the professional accountant determines that the identified threats to compliance are not at an acceptable level, Section 120 requires that the accountant address those threats by:

- (a) Eliminating the circumstances, including interests or relationships, that are creating the threats;
- (b) Applying safeguards, where available and capable of being applied; or
- (c) Declining or discontinuing the specific professional activity or service involved.

300.2 A8 There are some situations where the threat created would be so significant that no safeguards could reduce the threat to an acceptable level, and the threats may not be addressed by applying

the requirements in Section 120. International Independence Standards C1 and C2 provide examples of such situations.

### *Examples of Safeguards*

300.2 A9 Safeguards vary depending on the facts and circumstances. The following are examples of actions that in certain circumstances might be safeguards in addressing threats:

- Having a professional accountant who was not involved with the non-assurance service provided to an audit client review the non-assurance work performed, or otherwise advise as necessary might address a self-review threat.
- Having a professional accountant who was not a member of the team review the work performed or otherwise advise as necessary might address self-review threats.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client might address self-review and familiarity threats.
- Consulting those charged with governance or an independent third party, including a committee of independent directors, a professional regulatory body or another professional accountant might address advocacy or intimidation threats.
- Involving another firm to perform or re-perform part of the engagement might address self-interest, self-review, advocacy or familiarity threats.
- Rotating assurance team personnel might address self-interest and familiarity threats.

### **Re-evaluating Threats**

300.2 A10 New information or changes in facts and circumstances might:

- (a) Impact the level of a threat; or
- (b) Affect the professional accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats.

300.2 A11 Examples of new information or changes in facts and circumstances include:

- When the scope of a professional service is expanded.
- When the client becomes a listed entity or acquires another business unit.
- When the firm merges with another firm.
- Where the engagement partner's immediate family member is recently employed by the client.

In those situations described above, actions already implemented as safeguards might no longer be effective in eliminating those threats or reducing them to an acceptable level.

### **Overall Assessment**

300.2 A12 When applying the conceptual framework, Section 120 requires that the professional accountant reviews judgments made and overall conclusions reached to determine that threats to compliance with the fundamental principles are eliminated, or reduced to an acceptable level and that no further

action is needed. The reasonable and informed third party test described in Section 120 is relevant to this assessment.

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**International  
Ethics Standards  
Board for Accountants®**

529 Fifth Avenue, New York, NY 10017  
T + 1 (212) 286-9344 F +1 (212) 286-9570  
[www.ethicsboard.org](http://www.ethicsboard.org)