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31 March 2016

Dear Mr Siong,

Exposure Draft – Proposed Revisions Pertaining to Safeguards in the Code – Phase 1

The Financial Reporting Council (FRC) welcomes the opportunity to comment on the proposed changes to the Code of Ethics for Professional Accountants (the Code) pertaining to safeguards set out in the above exposure draft.

The FRC endorses the Board's proposals to make revisions to the Code, intended to clarify the requirements pertaining to safeguards, and to provide a better definition of safeguards and clarify that certain conditions, policies and procedures established by the profession, legislation, regulation, the firm or the employing organization are not regarded as safeguards. We also strongly endorse the Board's efforts to bring greater consistency between the terms used in the Code.

Our observations are drawn from our own experience of making revisions to the FRC Ethical Standard, including those required by the EU Audit Regulation and Directive. In doing so, we have sought to focus practitioners on the paramount importance of meeting the ethical outcomes required by our overarching ethical principles and supporting ethical provisions. We believe this will enable practitioners to better understand that this is the context in which the detailed requirements should be interpreted and that meeting those requirements is not in itself enough. In so doing, we are providing users of the standard with greater clarity as to the ethical outcomes they are expected to meet, and are supplementing the overarching principles and provisions with information on certain actions and behaviours that are necessary to meet those ethical outcomes.

We also emphasise the importance of the objective, reasonable and informed third party test and explain how this provides a link between meeting the outcomes required by the overarching ethical principles and supporting ethical provisions set out in our standard, and the maintenance of public confidence in the accounting profession.

Responses to questions asked in the Exposure Draft

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?**

The FRC supports the Board in making revisions to the Code, in this area, which improve the overall clarity of the requirements that professional accountants should satisfy. The inclusion of an explicit statement to require the application of the conceptual framework is welcome, as is the provision of additional application material to better describe the conceptual framework. However, based on the responses to our own consultations on our Ethical Standard, we have set out in our other responses a number of ways in which we believe the revisions should be improved, and we also suggest:

- (a) that the Board consider using terminology that requires the professional accountant to meet the ethical outcomes required by the fundamental principles rather than focusing on 'compliance'. This will mitigate the risk that applying the Ethical Code is seen as a compliance exercise, with the focus on meeting the technical requirements rather than identifying and taking any other actions that may be appropriate to ensure that they meet the ethical outcomes required; and
 - (b) that the Board consider making explicit cross references between the conceptual framework and the requirements in the revised sections of the Code. This will mitigate the risk that the material in the revised Code is considered in isolation, and the Board's intended focus on principles is lost as a result. We also believe that more explicit linkage into Section 300 will mitigate the risk that the material in 300.2 is seen as an exhaustive list of examples to be addressed, rather than material to support a principles-based assessment by the professional accountant.
- 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?**

Although the FRC supports the Board's aim of clarifying the concepts referred to, we do not consider that the proposed revisions in the Exposure Draft adequately achieve that aim. We believe that it is unhelpful that the concept of the 'reasonable and informed third party' at 120.4.A1 now refers to a "hypothetical" person. Whilst we understand the thinking behind this proposal, we believe it may undermine, and does not appropriately clarify, the concept. It may lead to the concept of such a person being seen as an artificial construct rather than as a reasonable and informed party who has a legitimate interest in the professional accountant meeting the ethical outcomes required by the fundamental principles. It is just such a misapprehension of the third party concept that has led some to consider that, in the context of an audit, 'those charged with governance' (rather than the body of intended users of the audit report) provide the most appropriate perspective for the 'third party'.

This weakness in the definition is further compounded by the requirement for the third party to “possess skills, knowledge and experience to objectively evaluate the appropriateness of the professional accountant’s judgements”. We consider that this risks an overly narrow focus, whereby a professional accountant might assess their judgements purely from the perspective of what another professional accountant might consider reasonable, rather than considering the views of those whose interests may be harmed by a failure of the professional accountant to behave in accordance with the fundamental principles.

We believe it would be more helpful to explain that the third party in this concept is one who has a legitimate interest in the professional accountant meeting the ethical outcomes required by the fundamental principles – i.e. that the third party test is intended to be applied through the objective lens of the public in whose interests the professional accountant accepts a responsibility to act. Thus, the test should reflect the anticipated views of such parties, whilst assuming that they are informed about the circumstances (e.g. about the nature of the threats and the nature of any safeguards) on the assumption that they would be reasonable (i.e. rational, fair and moderate rather than extreme) in forming those views.

We also suggest that the reference to the third party be extended to read ‘objective, reasonable and informed third party’, which would reflect the importance of the objectivity of the third party (i.e. one not influenced by interests that would conflict with the public interest) and would also align it with the term used in the 2014 EU Audit Regulation (EU 537/2014) and Directive (2014/43/EC).

For the reasons set out above, we believe that the third party needs to be objective, reasonable and informed, but we suggest that it would be better to require them to be ‘informed’ in a general sense rather than implying that they require specific professional skills. Our experience is that a professional accountant will often not question a behaviour or course of action that might subsequently be challenged by a non-accountant who may well be the user of the professional accountant’s services.

We support the aim of expressing the requirement to eliminate or reduce threats “to an acceptable level’ in an affirmative manner. However, the continued use of the term “acceptable level” causes us concern. We believe the term itself implies a bar at too low a level. We believe that the most direct and affirmative manner in which to express this bar is to require threats to be eliminated or reduced “to a level at which the fundamental principles would not be compromised”. This would avoid the implication that the professional accountant’s focus should be on finding a level of threats that is “acceptable” and rather would focus them on ensuring that threats were eliminated or reduced to a level where the third party test would be passed. We believe this (implicit) link to the third party test would better accord with the expectations of stakeholders, and better support their confidence in the professional accountant.

We also suggest that it should be made clear that the third party test would only be passed when it is probable (i.e. more likely than not) that the [objective,] reasonable and informed third party would conclude that none of the fundamental principles had been compromised.

3) Do respondents support the proposed description of “safeguards?” If not, why not?

We support the Board’s proposed description of safeguards, but suggest that for it to be effective, it should be expanded to make it explicit that:

- A safeguard to eliminate a threat to meeting the outcomes required by the fundamental principles might include removing a professional accountant from any involvement in, or any position of influence over, an engagement, or withdrawing from the engagement;
- Reducing a threat to a level where the fundamental principles would not be compromised would be a level where the third party test would be passed.

In common with our response to Question 2, we believe that the test to be passed, when assessing whether a safeguard reduces the risk to a level where the fundamental principles would not be compromised, should be whether an [*objective,*] reasonable and informed third party would conclude that none of the fundamental principles had been compromised.

4) Do respondents agree with 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 descriptions of safeguards in the ED?

b) Are better characterised 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?”

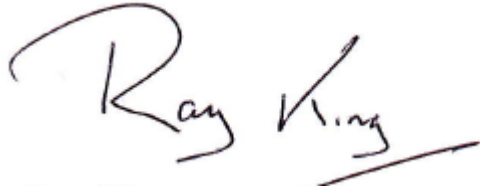
We agree with IESBA’s conclusions that the three safeguards referred to in the extant Code do not meet the proposed description in the ED. The FRC supports this proposed change, as the three classes of actions taken by other parties referred to in the extant Code may, for some professional accountants, be treated as automatically sufficient ‘safeguards’, thereby ending consideration of whether or not a threat has been appropriately identified and that therefore needs to be addressed by their own action.

In making revisions to the FRC’s Ethical Standard, we have focused on how best to ensure that auditors/ professional accountants make an assessment of threats and safeguards from a principles-based position, rather than considering whether or not a process will identify potential threats, and then address adequately any threat. We agree it may be useful to retain the reference to “conditions, policies and procedures”, but on the basis that, proposed by IESBA, it is made clear that these are contextual factors that may underpin an assessment rather than providing safeguards in their own right.

5) Do respondents agree with IESBA’s approach to 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?

The FRC considers the revisions made by IESBA in proposed Section 300 to be helpful to professional accountants in public practice. The requirements and application material will, we expect, be of value in supporting those in public practice to carry out appropriate threats and safeguards assessments. However, we reiterate our responses to Questions 1 to 4.

Yours sincerely,

A handwritten signature in black ink that reads "Ray King". The signature is written in a cursive style with a long horizontal stroke at the end.

Ray King

Director of the FRC and Chairman of the FRC's Audit & Assurance Council

Enquiries in relation to this letter should be directed to Marek Grabowski, Director of Audit Policy.

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