

## **Summary of the changes to the rule on independence referred to in the *Code of Ethics of Chartered Professional Accountants*\***

Section 36.4 of the *Code of Ethics of Chartered Professional Accountants*, which came into effect on May 16, 2012, provides a dynamic reference to independence rules – “Rule 204 on independence” – included in the Canadian Harmonized Rules of Professional Conduct and adopted by the Public Trust Committee of the Canadian Institute of Chartered Accountants (now CPA Canada).

Rule 204 of the Canadian Harmonized Rules of Professional Conduct applies to all Order members.

The dynamic reference to Rule 204 on independence allows for the consistent application of independence rules by all accounting professionals in Canada. Of course, these rules are accessible at all times on the Web sites of the Order and CPA Canada. This dynamic reference also means that amendments to Rule 204 are automatically incorporated as they are approved by the Public Trust Committee.

Some amendments to the standards prescribed by Rule 204 on independence were adopted on November 14, 2013 by this Committee.

### **Background**

The Canadian CA, CGA, CMA and CPA professions are members of the International Federation of Accountants (IFAC) and, as such, monitor IFAC developments to facilitate convergence of Canadian and international standards. For this reason, the Code of Ethics, and specifically the rules on independence adopted by the provincial orders, must not be less stringent than the requirements included in the code of ethics issued by the International Ethics Standards Board for Accountants (IESBA), i.e. the *Code of Ethics for Professional Accountants* (hereinafter the “IESBA Code”).

The Public Trust Committee formed an Independence Task Force (ITF) to review the independence provisions. The ITF considered changes in the Canadian environment and the independence revisions to the IESBA Code to determine what changes may be appropriate to ensure the protection of the public. The ITF reviewed Rule 204 on independence to determine what changes were needed to conform to the IESBA Code where the IESBA Code was considered to be more rigorous, amended to address Canadian circumstances. At the end of this process, the ITF made various recommendations to the Public Trust Committee, which resulted in the adoption of the following changes:

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\* This summary is provided for information purposes only and does not replace the complete version of the adopted changes. Members are invited to read the changes to Rule 204 and the transitional measures, which have the force of law.

## **Overview of the changes to Rule 204 on independence**

### General changes

Some wording changes have been made to Rule 204 on independence (Rule 204) to improve its clarity and enforceability. For example:

- A new Rule 204.2 has been added to make it clear that, in addition to identifying threats to independence and applying safeguards to reduce the threats to an acceptable level, it is necessary to comply with the specific provisions in Rule 204.4.
- The rule addressing documentation has been moved to a new Rule 204.5 to make it clear that a failure to adequately document a matter would not, in itself, compromise independence, though the member would not be in compliance with the Canadian Harmonized Rules of Professional Conduct.
- The existing standard contains several “relieving provisions,” such as the exclusion of financial interests held by immediate family members of certain individuals if the financial interest was received as a result of employment. Provisions such as these have been moved to the relevant Rule for clarity and improved enforceability.
- Some editorial changes have also been made to improve clarity.

### Reporting issuer threshold

When the independence requirements of Rule 204 were revised in 2003, the more restrictive independence requirements applied only to the audits of reporting issuers with either market capitalization or total assets in excess of \$10 million. This threshold approach was adopted to allow smaller entities to obtain more accounting assistance from their auditors rather than engage a third party. This exemption, which is not included in the IESBA Code, will be maintained in Canada. It was considered in the public interest to exclude auditors of smaller reporting issuers from the need to comply with the more restrictive independence requirements. It enables these reporting issuers to receive more accounting and tax assistance from their auditors, who have a detailed knowledge of the business, without the additional expense of retaining other professionals to provide the services. The Public Trust Committee has limited the application of the more restrictive requirements to audits of reporting issuers and listed entities.

### Listed entities that are not Canadian reporting issuers

The changes extend the more restrictive independence provisions to audits of listed entities that are not reporting issuers in Canada but are listed elsewhere. Therefore, a new definition of "listed entity" has been adopted.

### Co-operatives, credit unions or caisses populaires, and social clubs

Until these changes were adopted, a member of the engagement team (or an immediate or close family member) was permitted to hold qualifying shares in a social club, such as a golf club, curling club, co-operative or similar organization, provided the shareholding was a prerequisite of club membership and certain specified conditions were met. The ITF determined that no unacceptable threat to independence would be created if such interests were held. Therefore, paragraph 2.1 of Rule 204.4 retains this provision.

Similarly, since the ITF is of the view that no unacceptable threat to independence would be created if interests in other co-operatives and credit unions or caisses populaires were held by such individuals, the above-mentioned provision extends to such entities [Rule 204.4(2.1)].

#### Network firms

Rule 204 extends certain independence requirements to network firms of the audit firm. Up to now, Rule 204 provided that a network firm is defined as an entity under common control ownership or management with the firm or an entity that a reasonable and informed third party would conclude would be part of the firm. The IESBA Code contains a more prescriptive definition of a network firm and also has guidance on the application of this definition. Therefore, a revised definition of a network firm was included to reflect the position taken in the IESBA Code.

#### Related entity

The criteria under which entities would be considered to be related entities of reporting issuers and non-reporting issuers have been changed.

#### Partner rotation requirements

Previously, in addition to the lead engagement partner and the engagement quality control reviewer, subsidiary entity engagement partners and partners providing more than ten hours of assurance services were required to rotate in the audit of reporting issuers. However, the IESBA Code requires all "key audit partners" to rotate, which comprise the lead engagement partner, the engagement quality control reviewer and other partners who make key decisions or judgments with respect to the audit. The ITF determined that the IESBA Code approach was more appropriate because it focuses on the familiarity threat as opposed to establishing an arbitrary bright-line test. As a result, this approach was adopted.

#### Key audit partner compensation

Previously, an audit partner on the engagement team was precluded from earning or receiving compensation based on that partner selling non-assurance services to his or her audit or review client. The proposed changes state that key audit partners shall not be evaluated or compensated on selling such services to their audit or review clients [Rule 204.4 (38)].

#### Taxation services

Previously, Rule 204 did not contain any specific prohibitions related to the provision of taxation services to audit or review clients. The IESBA Code contains several prohibitions in this area, which is why the following prohibitions have been included:

- Providing tax planning or other tax advice to an audit or review client where the effectiveness of the advice depends upon a particular accounting treatment or presentation in the financial statements, the outcome is material and the engagement team has reasonable doubt as to the appropriateness of the treatment or disclosure [Rule 204.4 (34)(a)]; and
- Except in emergency situations, preparing tax calculations of current and future tax liabilities or assets for a reporting issuer or listed entity for the purpose of preparing accounting entries that are material [Rule 204.4(34)(b)].

Under the changes, if tax calculations are provided in emergency situations, the service is not to be provided by members of the audit engagement team, no management decisions are to be made and the service is to be prior approved by the audit committee. Also, the services shall only be provided if the provision of the service in such circumstances is not expected to recur. Documentation requirements were also added.

The ITF was of the view that the provisions related to the tax calculations for preparing accounting entries and the provisions related to preparing accounting records should be consistent. Similar emergency provisions for accounting and bookkeeping services were therefore adopted.

### Relative size of fees

The IESBA Code contains certain provisions when total fees from an audit client that is a listed entity represent more than 15% of the total fees of the firm. The changes to Rule 204 take account of the approach in the IESBA Code. When total revenue from a reporting issuer or listed entity audit client represents more than 15% of the total revenue of the firm, this fact shall be disclosed to the audit committee of the client. In addition, another professional accountant who is not a member of the firm shall perform a review that is substantially equivalent to an engagement quality control review either prior to the audit opinion in respect of the financial statements being issued or after the audit opinion in respect of the financial statements but before the audit opinion in respect of the next financial statements [Rule 204.4 (37)(a)].

### Mergers and acquisitions

The IESBA Code contains provisions to address independence issues arising from merger and acquisition activities of audit and review clients. New provisions were added to Rule 204 to reflect the position taken in the IESBA Code [Rule 204.4(40)].

### Other changes to conform to the IESBA Code

- External experts are not subject to the independence provisions applicable to the engagement team.
- A one year cooling off period is required before the former chief executive officer of the firm accepts certain positions at a reporting issuer or listed entity audit client of the firm [Rule 204.4(16)(b)].
- Staff may only be loaned to an audit client if the loan is for a short period of time, is not made on a recurring basis, the individual does not perform any activities that would be prohibited under Rule 204 and management of the entity directs or supervises the work performed by the individual [Rule 204.4(17)(b)].
- Prohibited management decisions or functions for assurance clients that are not audit or review clients are limited to those decisions or functions that are related to the subject matter of the assurance engagement [Rule 204.4(22)(a)].
- Valuation services that involve a significant degree of subjectivity and relate to amounts that are material to the financial statements are prohibited for all audit and review clients, unless the valuation is performed for taxation purposes and the valuation relates to amounts that will affect the financial statements only through accounting entries related to tax [Rule 204.4(25)(a)].
- Certain conditions must be in place if a firm provides internal audit services or certain information systems services to an audit or review client [Rules 204.4(27)(a) and 204.4(28)(a)].
- Litigation support services for the purpose of advancing an audit or review client's interest in certain proceedings or investigations are prohibited if the amounts are material [Rule 204.4(29)(a)].
- Corporate finance services are prohibited if the effectiveness of the advice depends upon a particular accounting treatment or presentation in the financial statements, the outcome is material and the engagement team has reasonable doubt about the appropriateness of the treatment or presentation [Rule 204.4(33)].

### **Transitional provisions**

Under section 36.4 of the *Code of Ethics of Chartered Professional Accountants*, the changes come into effect and apply to all Quebec CPAs as soon as they are adopted by the Public Trust Committee. To help members comply, transitional rules have been adopted and the changes will take effect as follows:

- (1) for the first reporting period commencing **after December 15, 2014** for an assurance engagement in respect of a particular reporting period;
- (2) for any other assurance engagement and an engagement to issue a report of the results of applying specified auditing procedures where the engagement is commenced **after December 15, 2014**;
- (3) a special transitional provision applies for expert services provided to an assurance client [Rule 204.4(29)(a)];
- (4) the proposed standard does not apply to litigation support services **that have not been completed by July 1, 2014 if, on June 30, 2014, there is a binding contract for the services and the provision of the services would be permitted under the existing standard**; and
- (5) the revised definition of “key audit partner” [Rule 204.4(38)] might require some partners to rotate who are not required to rotate under the existing standard. The proposed standard, therefore, states that such partners may continue to participate in the audit up to and including the client’s second fiscal year commencing after **December 15, 2014**.