

APB ETHICAL STANDARD 4

FEES, REMUNERATION AND EVALUATION POLICIES, LITIGATION, GIFTS AND HOSPITALITY

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PREFACE

APB Ethical Standards apply in the audit of financial statements. They should be read in the context of the Auditing Practices Board's Statement "The Auditing Practices Board – Scope and Authority of Pronouncements (Revised)" which sets out the application and authority of APB Ethical Standards.

The terms used in APB Ethical Standards are explained in the Glossary.

APB Ethical Standards apply to audits of financial statements in both the private and the public sectors. However, auditors in the public sector are subject to more complex ethical requirements than their private sector counterparts. This includes, for example, compliance with legislation such as the Prevention of Corruption Act 1916, concerning gifts and hospitality, and with Cabinet Office guidance.

INTRODUCTION

- 1 APB Ethical Standard 1 requires the audit engagement partner to identify and assess the circumstances which could adversely affect the auditors' objectivity ('threats'), including any perceived loss of independence, and to apply procedures ('safeguards') which will either:

- (a) eliminate the threat; or
- (b) reduce the threat to an acceptable level (that is, a level at which it is not probable that a reasonable and informed third party would conclude that the auditors' objectivity and independence either is impaired or is likely to be impaired).

When considering safeguards, where the audit engagement partner chooses to reduce rather than to eliminate a threat to objectivity and independence, he or she recognises that this judgment may not be shared by users of the financial statements and that he or she may be required to justify the decision.

- 2 This Standard provides requirements and guidance on specific circumstances arising out of fees, economic dependence, litigation, remuneration and evaluation of partners and staff, and gifts and hospitality, which may create threats to the auditors' objectivity or perceived loss of independence. It gives examples of safeguards that can, in some situations, eliminate the threat or reduce it to an acceptable level. In circumstances where this is not possible, either the situation is avoided or the auditors either do not accept or withdraw from the audit engagement, as appropriate.
- 3 Whenever a possible or actual breach of an APB Ethical Standard is identified, the audit engagement partner, in the first instance, and the ethics partner, where appropriate, assesses the implications of the breach, determines whether there are safeguards that can be put in place or other actions that can be taken to address any potential adverse

consequences and considers whether there is a need to resign from the audit engagement.

- 4 An inadvertent violation of this Standard does not necessarily call into question the audit firm's ability to give an audit opinion provided that:
- (a) the audit firm has established policies and procedures that require all partners and staff to report any breach promptly to the audit engagement partner or to the ethics partner, as appropriate;
 - (b) the audit engagement partner or ethics partner ensures that any matter which has given rise to a breach is addressed as soon as possible;
 - (c) safeguards, if appropriate, are applied (for example, having another partner review the work done by the relevant partner or member of staff or by removing him or her from the engagement team); and
 - (d) the actions taken and the rationale for them are documented.

FEES

- 5 **The audit engagement partner should be satisfied and able to demonstrate that the audit engagement has assigned to it sufficient partners and staff with appropriate time and skill to perform the audit in accordance with all applicable Auditing and Ethical Standards, irrespective of the audit fee to be charged.**
- 6 Paragraph 5 is not intended to prescribe the approach to be taken by audit firms to the setting of audit fees, but rather to emphasise that there are no circumstances where the amount of the audit fee can justify any lack of appropriate resource or time taken to perform a proper audit in accordance with applicable Auditing and Ethical Standards.
- 7 **An audit should not be undertaken on a contingent fee basis.**

- 8 A contingent fee basis is any arrangement made at the outset of an engagement under which a pre-determined amount or a specified commission on or percentage of any consideration or saving is payable to the audit firm upon the happening of a specified event or the achievement of an outcome (or alternative outcomes). Differential hourly fee rates, or arrangements under which the fee payable will be negotiated after the completion of the engagement, do not constitute contingent fee arrangements.
- 9 Contingent fee arrangements in respect of audit engagements create self-interest threats to the auditors' objectivity and independence that are so significant that they cannot be eliminated or reduced to an acceptable level by the application of any safeguards.
- 10 The audit fee ordinarily reflects the time spent and the skills and experience of the personnel performing the audit in accordance with all the relevant requirements. It does not depend on whether the auditors' report on the financial statements is qualified or unqualified.
- 11 The basis for the calculation of the audit fee is agreed with the audit client each year before significant audit work is undertaken. The audit engagement partner explains to the audit client that the estimated audit fee is based on the expected level of audit work required and that, if unforeseen problems are encountered, the cost of any additional audit work found to be necessary will be reflected in the audit fee actually charged. This is not a contingent fee arrangement.
- 12 **The audit firm should establish policies and procedures to ensure that the audit engagement partner and the ethics partner are notified where others within the audit firm propose to adopt contingent fee arrangements in relation to the provision of non-audit services to the audit client or its affiliates.**

- 13 Contingent fee arrangements in respect of non-audit services provided by the auditors to an audit client may create a threat to the auditors' objectivity and independence. The circumstances in which such fee arrangements are not permitted for such non-audit services are dealt with in APB Ethical Standard 5.
- 14 **In the case of listed companies the audit engagement partner should disclose to the audit committee, in writing, any contingent fee arrangements for non-audit services provided by the auditors or their network firms.**
- 15 In the case of a group audit of a listed company, which involves other auditors, the letter of instruction sent by the group audit engagement partner to the other auditors requests disclosure of any contingent fees for non-audit services charged or proposed to be charged by the other auditors.
- 16 **The actual amount of the audit fee for the previous audit and the arrangements for its payment should be agreed with the audit client before the audit firm formally accepts appointment as auditors in respect of the following period.**
- 17 Ordinarily, any outstanding fees for the previous audit period are paid before the audit firm commences any new audit work. Where they are not, it is important for the audit engagement partner to understand the nature of any disagreement or other issue.
- 18 **Where fees for professional services from the audit client are overdue and the amount cannot be regarded as trivial, the audit engagement partner, in consultation with the ethics partner, should consider whether the audit firm can continue as auditors or whether it is necessary to resign.**

- 19 Where fees due from an audit client, whether for audit or for non-audit services, remain unpaid for a long time - and, in particular, where a significant part is not paid before the auditors' report on the financial statements for the following year is due to be issued - a self-interest threat to the auditors' objectivity and independence is created because the issue of an unqualified audit report may enhance the audit firm's prospects of securing payment of such overdue fees.
- 20 Where the outstanding fees are in dispute and the amount involved is significant, the threats to the auditors' objectivity and independence may be such that no safeguards can eliminate them or reduce them to an acceptable level. The audit engagement partner therefore considers whether the audit firm can continue with the audit engagement.
- 21 Where the outstanding fees are unpaid because of exceptional circumstances (including financial distress), the audit engagement partner considers whether the audit client will be able to resolve its difficulties. In deciding what action to take, the audit engagement partner weighs the threats to the auditors' objectivity and independence, if the audit firm were to remain in office, against the difficulties the audit client would be likely to face in finding a successor, and therefore the public interest considerations, if the audit firm were to resign.
- 22 In any case where the audit firm does not resign from the audit engagement, the audit engagement partner applies appropriate safeguards (such as a review by an audit partner who is not involved in the audit engagement) and notifies the ethics partner of the facts concerning the overdue fees.
- 23 **Where it is expected that the total fees for both audit and non-audit services receivable from a listed audit client and its subsidiaries**

audited by the audit firm¹ will regularly exceed 10% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm should not act as the auditors of that entity and should either resign as auditors or not stand for reappointment, as appropriate.²

- 24 **Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audit client and its subsidiaries audited by the audit firm will regularly exceed 15% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm should not act as the auditors of that entity and should either resign as auditors or not stand for reappointment, as appropriate.**
- 25 Where it is expected that the total fees for both audit and non-audit services receivable from an audit client and its subsidiaries that are audited by the audit firm will regularly exceed 10% in the case of listed companies and 15% in the case of non-listed entities of the annual fee income of the part of the firm by reference to which the audit engagement partner's profit share is calculated, it may be possible to assign the audit client to another part of the firm.
- 26 Paragraphs 23 and 24 are not intended to require the audit firm to resign as auditors or not stand for reappointment as a result of an individual event or engagement, the nature or size of which was unpredictable and where a reasonable and informed third party would regard ceasing to act

¹ Total fees will include those billed by others where the audit firm is entitled to the fees, but will not include fees billed by the audit firm where it is acting as agent for another party.

² Paragraphs 23 to 32 do not apply to the audits of those public sector bodies where the responsibility for the audit is assigned by legislation. In such cases, the auditors cannot resign from the audit engagement, irrespective of considerations of economic dependence.

as detrimental to the shareholders (or equivalent) of the audit client. However, in such circumstances, the audit firm discloses full details of the position to the ethics partner and to those charged with governance of the audit client and discusses with both what, if any, safeguards may be appropriate.

- 27 **Where it is expected that the total fees for both audit and non-audit services receivable from a listed audit client and its subsidiaries audited by the audit firm will regularly exceed 5% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 10%, the audit engagement partner should disclose that expectation to the ethics partner and to those charged with governance of the audit client and consider whether appropriate safeguards should be applied to eliminate or reduce to an acceptable level the threat to the auditors' objectivity and independence.**
- 28 It is fundamental to the auditors' objectivity that they be willing and able, if necessary, to disagree with the directors and management, regardless of the consequences to their own position. Where the auditors are, to any significant extent, economically dependent on the audit client, this may inhibit their willingness or constrain their ability to express a qualified opinion on the financial statements, since this could be viewed as likely to lead to them losing the audit client.
- 29 An audit firm is deemed to be economically dependent on a listed audit client if the total fees for audit and all other services from that client and its subsidiaries which are audited by the audit firm represent 10% of the total fees of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated. Where such fees are between 5% and 10%, the audit engagement partner and the ethics

partner consider the significance of the threat and the need for appropriate safeguards.

- 30 Such safeguards might include:
- taking steps to reduce the non-audit work to be undertaken and therefore the fees earned from the audit client;
 - applying independent internal quality control reviews.
- 31 **Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audit client and its subsidiaries audited by the audit firm will regularly exceed 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 15%, the audit engagement partner should disclose that expectation to the ethics partner and to those charged with governance of the audit client and the firm should arrange an external independent quality control review of the audit engagement to be undertaken before the auditors' report is finalised³.**
- 32 A quality control review involves discussion with the audit engagement partner, a review of the financial statements and the auditors' report, and consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments the engagement team has made and the conclusions they have reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review includes considering the following:
- Significant risks identified during the audit and the responses to those risks.

³ As provided in APB Ethical Standard – Provisions Available for Small Entities, auditors of Small Entities are not required to comply with this paragraph.

- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The appropriateness of the report to be issued.

Where the quality control reviewer makes recommendations that the audit engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the audit firm's procedures for dealing with differences of opinion.

- 33 A new audit firm seeking to establish itself may find the requirements relating to economic dependence difficult to comply with in the short term. In these circumstances, such firms would:
- (a) not undertake any audits of listed companies, where fees from such a client would represent 10% or more of the annual fee income of the firm; and
 - (b) for a period not exceeding two years, require external independent quality control reviews of those audits of unlisted entities that represent more than 15% of the annual fee income before the audit opinion is issued.

The firm might also develop its practice by accepting work from non-audit clients so as to bring the fees payable by each audit client below 15%.

- 34 A self-interest threat may also be created where an audit partner in the engagement team:
- is employed exclusively or principally on that audit engagement;
 - is remunerated on the basis of the performance of part of the firm which is substantially dependent on fees from that audit client.

- 35 Where the circumstances described in paragraph 34 arise, the audit firm assesses the significance of the threat and, if it is other than clearly insignificant, applies safeguards to reduce the threat to an acceptable level. Such safeguards might include:
- reducing the dependence of the office, partner or person in a position to influence the conduct and outcome of the audit by reallocating the work within the practice;
 - a review by an audit partner who is not involved with the audit engagement to ensure that the auditors' objectivity and independence is not affected by the self-interest threat.

REMUNERATION AND EVALUATION POLICIES

- 36 **The audit firm should establish policies and procedures to ensure that, in relation to each audit client:**
- (a) the objectives of the members of the audit team do not include selling non-audit services to the audit client;**
 - (b) the criteria for evaluating the performance of members of the audit team do not include success in selling non-audit services to the audit client; and**
 - (c) no specific element of the remuneration of a member of the audit team and no decision concerning promotion within the audit firm is based on his or her success in selling non-audit services to the audit client.**
- 37 Where auditors identify areas for possible improvement in a client they may provide general business advice, which might include suggested solutions to problems. Before discussing any non-audit service that might be provided by the audit firm or effecting any introductions to colleagues from outside the audit team, the audit engagement partner

considers the threats that such a service would have on the audit engagement, in line with the requirements of APB Ethical Standard 5.

- 38 The policies and procedures required for compliance with paragraph 36 are not intended to inhibit normal profit-sharing arrangements. However, such policies and procedures are central to an audit firm's ability to demonstrate its objectivity and independence and to rebut any suggestion that an audit that it has undertaken and the opinion that it has given are influenced by the nature and extent of any non-audit services that it has provided to that audit client. Because it is possible that, despite such policies and procedures, such factors may be taken into account in the evaluation and remuneration of members of an audit team, the ethics partner pays particular attention to the actual implementation of those policies and procedures and makes himself or herself available for consultation when needed.

THREATENED AND ACTUAL LITIGATION

- 39 **Where litigation in relation to audit or non-audit services between the audit client or its affiliates and the audit firm, which is other than insignificant, is already in progress, or where the audit engagement partner considers such litigation to be probable, the audit firm should either not continue with or not accept the audit engagement.**⁴
- 40 Where litigation (in relation to audit or non-audit services) actually takes place between the audit firm (or any person in a position to influence the conduct and outcome of the audit) and the audit client, or where litigation

⁴ Paragraphs 39 to 41 do not apply to the audits of those public sector bodies where the responsibility for the audit is assigned by legislation. In such cases, the auditors cannot resign from the audit engagement: the auditors report significant litigation to the relevant legislative authority.

is threatened and there is a realistic prospect of such litigation being commenced, self-interest, advocacy and intimidation threats to the auditors' objectivity and independence are created because the audit firm's interest will be the achievement of an outcome to the dispute or litigation that is favourable to itself. In addition, an effective audit process requires complete candour and full disclosure between the audit client management and the engagement team: such disputes or litigation may place the two parties in opposing adversarial positions and may affect management's willingness to make complete disclosure of relevant information. Where the auditors can foresee that such a threat may arise, they inform the audit committee of their intention to resign or, where there is no audit committee, the board of directors.

- 41 The auditors are not required to resign immediately in circumstances where a reasonable and informed third party would not regard it as being in the interests of the shareholders for them to do so. Such circumstances might arise, for example, where:
- the litigation was commenced as the audit was about to be completed and shareholder interests would be adversely affected by a delay in the audit of the financial statements;
 - on appropriate legal advice, the audit firm deems that the threatened or actual litigation is vexatious or designed solely to bring pressure to bear on the opinion to be expressed by the auditors.

GIFTS AND HOSPITALITY

- 42 **The audit firm, those in a position to influence the conduct and outcome of the audit and immediate family members of such persons should not accept gifts from the audit client, unless the value is clearly insignificant.**

- 43 **Those in a position to influence the conduct and outcome of the audit and immediate family members of such persons should not accept hospitality from the audit client, unless it is reasonable in terms of its frequency, nature and cost.**
- 44 Where gifts or hospitality are accepted from an audit client, self-interest and familiarity threats to the auditors' objectivity and independence are created. Familiarity threats also arise where gifts or hospitality are offered to an audit client.
- 45 Gifts from the audit client, unless their value is clearly insignificant, create threats to objectivity and independence which no safeguards can eliminate or reduce.
- 46 Hospitality is a component of many business relationships and can provide valuable opportunities for developing an understanding of the client's business and for gaining the insight on which an effective and successful working relationship depends. Therefore, the auditors' objectivity and independence is not necessarily impaired as a result of accepting hospitality from the audit client, provided it is reasonable in terms of its frequency, its nature and its cost.
- 47 **The audit firm should establish policies on the nature and value of gifts and hospitality that may be accepted from and offered to audit clients, their directors, officers and employees, and should issue guidance to assist partners and staff to comply with such policies.**
- 48 In assessing the acceptability of gifts and hospitality, the test to be applied is not whether the auditors consider that their objectivity is impaired but whether it is probable that a reasonable and informed third party would conclude that it is or is likely to be impaired.

- 49 Where there is any doubt as to the acceptability of gifts or hospitality offered by the audit client, members of the engagement team discuss the position with the audit engagement partner. If there is any doubt as to the acceptability of gifts or hospitality offered to the audit engagement partner, or if the audit engagement partner has any residual doubt about the acceptability of gifts or hospitality to other individuals, the audit engagement partner reports the facts to the ethics partner, for further consideration regarding any action to be taken.
- 50 Where the cumulative amount of gifts or hospitality accepted from the audit client appears abnormally high, the audit engagement partner reports the facts to both:
- the ethics partner; and
 - the audit committee (or, where there is no audit committee, the board of directors),
- together with other significant facts and matters that bear upon the auditors' objectivity and independence.

EFFECTIVE DATE

- 51 Effective for audits of financial statements for periods commencing on or after 15 December 2004.
- 52 Firms may complete audit engagements relating to periods commencing prior to 15 December 2004 in accordance with existing ethical guidance from the relevant professional body, putting in place any necessary changes in the subsequent engagement period.
- 53 Firms may implement revisions to their policies and procedures as required under paragraphs 12, 36 and 47 during the year commencing 15 December 2004.

- 54 Where the requirements of paragraph 23 or 24 would result in an audit firm being required to resign from providing one or more services to an entity, the firm may continue to provide services under existing arrangements, until the appointment as auditors for the first period commencing on or after 15 December 2005 is considered, provided that:
- the engagements held at 15 December 2004 were permitted by existing ethical guidance from the relevant professional body;
 - the level of dependence on the audit client is not increased from that in existence at 15 December 2004;
 - any safeguards required by existing ethical guidance continue to be applied; and
 - the need for additional safeguards is assessed and, if considered necessary, those additional safeguards are applied.

NOTICE TO READERS

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