

# APB ETHICAL STANDARD 5

## NON-AUDIT SERVICES PROVIDED TO AUDIT CLIENTS

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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 from the provision of non-audit services by audit firms to their audit clients, which may create threats to the auditors' objectivity or perceived loss of independence. It gives examples of safeguards that can, in some circumstances, eliminate the threat or reduce it to an acceptable level. In circumstances where this is not possible, either the non-audit service engagement in question is not undertaken 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, assess the implications of the breach, determine whether there are safeguards that can be put in place or other actions that can be taken to address any potential adverse consequences and consider 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 promptly notifies the partner or member of staff that any matter which has given rise to a breach is to be addressed as soon as possible and ensures that such action is taken;
  - (c) safeguards, if appropriate, are applied (for example, by 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.

## **GENERAL APPROACH TO NON-AUDIT SERVICES**

- 5 Paragraphs 6 to 38 of this Standard set out the general approach to be adopted by audit firms and auditors in relation to the provision of non-audit services to their audit clients. This approach is applicable irrespective of the nature of the non-audit services, which may be in question in a given case. (Paragraphs 39 to 125 of this Standard illustrate the application of the general approach to a number of common non-audit services.)
- 6 In this Standard, 'non-audit services' comprise any engagement in which an audit firm provides professional services to an audit client other than pursuant to:
- (a) the audit of financial statements; and
  - (b) those other roles which legislation or regulation specify can be performed by the auditors of the entity (for example, considering the

preliminary announcements of listed companies, complying with the procedural and reporting requirements of regulators, such as requirements relating to the audit of the client's internal controls and reports in accordance with Section 151 or 173 of the Companies Act 1985).

- 7 There may be circumstances where the audit firm is engaged to provide a non-audit service and where that engagement and its scope are determined by a client which is not an audit client. However, it might be contemplated that an audit client may gain some benefit from that engagement<sup>1</sup>. In these circumstances, whilst there may be no threat to the audit firm's objectivity and independence at the time of appointment, the audit firm considers how the engagement may be expected to develop, whether there are any threats that the audit firm may be subject to if additional relevant parties which are audit clients are identified and whether any safeguards should be put in place.
- 8 In the case of a group, non-audit services, for the purposes of this Standard, include:
- services provided by the audit firm, to the parent company or to any affiliate;
  - services provided by a network firm to the audit client or any of its significant affiliates; and
  - services provided by the audit firm of a significant affiliate to the parent company.
- 9 **The audit firm should establish policies and procedures that require others within the firm, and its network, when considering whether to accept a proposed engagement to provide a non-audit service to**

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<sup>1</sup> For example, in a vendor due diligence engagement, the engagement is initiated and scoped by the vendor before the purchaser is identified. If an audit client of the firm undertaking the due diligence engagement is the purchaser, that audit client may gain the benefit of the report issued by its auditor, it may be a party to the engagement letter and it may pay an element of the fee.

**an audit client or any of its affiliates, to communicate details of the proposed engagement to the audit engagement partner.**

- 10 The audit firm establishes appropriate channels of internal communication to ensure that, in relation to an existing audit client, the audit engagement partner (or their delegate) is informed about any proposed engagement to provide a non-audit service to the audit client or any of its affiliates and that he or she considers the implications for the auditors' objectivity and independence before the engagement is accepted.
- 11 In the case of a listed company, the group audit engagement partner establishes that the company has communicated its policy on the engagement of external auditors to supply non-audit services to its affiliates and obtains confirmation that the auditors of the affiliates will comply with this policy.<sup>2</sup>

## ***IDENTIFICATION AND ASSESSMENT OF THREATS AND SAFEGUARDS***

- 12 **Before the audit firm accepts a proposed engagement to provide a non-audit service to an audit client, the audit engagement partner should:**
- (a) consider whether it is probable that a reasonable and informed third party would regard the objectives of the proposed engagement as being inconsistent with the objectives of the audit of the financial statements; and**
  - (b) identify and assess the significance of any related threats to the auditors' objectivity, including any perceived loss of independence; and**

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<sup>2</sup> The Combined Code on Corporate Governance requires audit committees to develop the company's policy on the engagement of the external auditors to supply non-audit services.

**(c) identify and assess the effectiveness of the available safeguards to eliminate the threats or reduce them to an acceptable level.**

- 13 The objective of the audit of financial statements is to express an opinion on the preparation and presentation of those financial statements. For example, in the case of a limited company, legislation requires the auditors to make a report to the members on all annual accounts laid before the company in general meeting during their tenure of office. The report must state whether, in the auditors' opinion, the accounts have been properly prepared in accordance with the requirements of the legislation, and, in particular, whether they give a true and fair view in accordance with the relevant financial reporting framework.
- 14 **Where the audit engagement partner considers that it is probable that a reasonable and informed third party would regard the objectives of the proposed non-audit service engagement as being inconsistent with the objectives of the audit of the financial statements, the audit firm should either:**
- (a) not undertake the non-audit service engagement; or**
  - (b) not accept or withdraw from the audit engagement.**
- 15 The objectives of engagements to provide non-audit services vary and depend on the specific terms of the engagement. In some cases these objectives may be inconsistent with those of the audit, and, in such cases, this may give rise to a threat to the auditors' objectivity and to the appearance of their independence. Audit firms do not undertake non-audit service engagements where the objectives of such engagements are inconsistent with the objectives of the audit, or do not accept or withdraw from the audit engagement.
- 16 Similarly, in relation to a possible new audit client, consideration needs to be given to recent, current and potential engagements to provide non-

audit services by the audit firm for the prospective audit client and whether the scope and objectives of those engagements are consistent with the proposed audit engagement. In the case of listed companies, when tendering for a new audit engagement, the audit firm ensures that relevant information on recent non-audit services is drawn to the attention of the audit committee, including:

- when recent non-audit services were provided to the potential client;
- the materiality of those non-audit services to the proposed audit engagement;
- whether those non-audit services would have been prohibited if the client had been an audit client at the time when they were undertaken; and
- the extent to which the outcomes of non-audit services have been audited or reviewed by another audit firm.

### **Threats to objectivity and independence**

17 The principal types of threats to the auditors' objectivity and independence are:

- self-interest threat;
- self-review threat;
- management threat;
- advocacy threat;
- familiarity (or trust) threat; and
- intimidation threat.

The auditors remain alert to the possibility that any of these threats may occur in connection with non-audit services. However, the threats most commonly associated with non-audit services are self-interest threat, self-review threat, management threat and advocacy threat.

18 A **self-interest threat** exists when auditors have financial or other interests which might cause them to be reluctant to take actions that would be adverse to the interests of the audit firm or any individual in a position to influence the conduct or outcome of the audit. In relation to

non-audit services, the main self-interest threat concerns fees and economic dependence and these are addressed in APB Ethical Standard 4.

- 19 Where substantial fees are regularly generated from the provision of non-audit services, and the fees for non-audit services are significantly greater than the annual audit and audit-related fees, the audit firm has regard to the possibility that there may be perceived to be a loss of independence. The audit firm addresses such perceived loss of independence by determining whether there is any risk that there will be an actual loss of independence and objectivity by the audit engagement team. The audit firm ensures that those charged with governance are informed of the position on a timely basis.
- 20 Where fees for non-audit services are calculated on a contingent fee basis, the perception may be that the audit firm's interests are so closely aligned with the audit client that it threatens the auditor's objectivity and independence. Any contingent fee that is material to the audit firm, or that part of the firm by reference to which the audit engagement partner's profit share is calculated, will create an unacceptable self-interest threat and the audit firm does not undertake such an engagement.
- 21 A **self-review threat** exists when the results of a non-audit service performed by the engagement team or by others within the audit firm are reflected in the amounts included or disclosed in the financial statements.
- 22 A threat to objectivity and independence arises because, in the course of the audit, the auditors may need to re-evaluate the work performed in the non-audit service. As, by virtue of providing the non-audit service, the audit firm is associated with aspects of the preparation of the financial statements, it may be (or may appear to be) unable to take an impartial view of relevant aspects of those financial statements.

- 23 In assessing the significance of the self-review threat, the auditors consider the extent to which the non-audit service will:
- involve a significant degree of subjective judgment; and
  - have a material effect on the preparation and presentation of the financial statements.
- 24 Where a significant degree of judgment relating to the financial statements is involved in a non-audit service engagement, the auditors may be inhibited from questioning that judgment in the course of the audit. Whether a significant degree of subjective judgment is involved will depend upon whether the non-audit service involves the application of well-established principles and procedures, and whether reliable information is available. If such circumstances do not exist because the non-audit service is based on concepts, methodologies or assumptions that require judgment and are not established by the client or by authoritative guidance, the auditors' objectivity and the appearance of their independence may be adversely affected. Where the provision of a proposed non-audit service would also have a material effect on the financial statements, it is unlikely that any safeguard can eliminate or reduce to an acceptable level the self-review threat.
- 25 A **management threat** exists when the audit firm undertakes work that involves making judgments and taking decisions that are properly the responsibility of management.
- 26 A threat to objectivity and independence arises because, by making judgments and taking decisions that are properly the responsibility of management, the audit firm erodes the distinction between the audit client and the audit firm. The auditors may become closely aligned with the views and interests of management and this may, in turn, impair or call into question the auditors' ability to apply a proper degree of professional scepticism in auditing the financial statements. The auditors'

objectivity and the appearance of their independence therefore may be, or may be perceived to be, impaired.

- 27 Factors to be considered in determining whether a non-audit service does or does not give rise to a management threat include whether:
- the non-audit service results in recommendations by the audit firm justified by objective and transparent analyses or the client being given the opportunity to decide between reasonable alternatives;
  - the auditors are satisfied that a member of management (or senior employee of the audit client) has been designated by the audit client to receive the results of the non-audit service and make any judgments and decisions that are needed; and
  - that member of management has the capability to make independent management judgments and decisions on the basis of the information provided ('informed management').
- 28 Where there is 'informed management', the auditors assess whether there are safeguards that can be introduced that would be effective to avoid a management threat or to reduce it to a level at which it can be disregarded. In the absence of such circumstances, it is unlikely that any safeguards can eliminate the management threat or reduce it to an acceptable level.
- 29 An **advocacy threat** exists when the audit firm undertakes work that involves acting as an advocate for an audit client and supporting a position taken by management in an adversarial context.
- 30 A threat to objectivity and independence arises because, in order to act in an advocacy role, the audit firm has to adopt a position closely aligned to that of management. This creates both actual and perceived threats to the auditors' objectivity and independence. For example, where the audit firm, acting as advocate, has supported a particular contention of

management, it may be difficult for the auditors to take an impartial view of this in the context of the audit of the financial statements.

- 31 Where the provision of a non-audit service would require the auditors to act as advocates for the audit client in relation to matters that are material to the financial statements, it is unlikely that any safeguards can eliminate or reduce to an acceptable level the advocacy threat that would exist.

### **Safeguards**

- 32 Where any threat to the auditors' objectivity and the appearance of their independence is identified, the audit engagement partner assesses the significance of that threat and considers whether there are safeguards that could be applied and which would be effective to eliminate the threat or reduce it to an acceptable level. If such safeguards can be identified and are applied, the non-audit service may be provided. However, where no such safeguards are applied, the only course is for the audit firm either not to undertake the engagement to provide the non-audit service in question or not to accept (or to withdraw from) the audit engagement.

- 33 **Where the audit engagement partner concludes that no appropriate safeguards are available to eliminate or reduce to an acceptable level the threats to the auditors' objectivity, including any perceived loss of independence, related to a proposed engagement to provide a non-audit service to an audit client, he or she should inform the others concerned within the audit firm of that conclusion and the firm should either:**

- (a) not undertake the non-audit service engagement; or**
- (b) not accept or withdraw from the audit engagement.**

**If the audit engagement partner is in doubt as to the appropriate action to be taken, he or she should resolve the matter through consultation with the ethics partner.**

- 34 An initial assessment of the threats to objectivity and independence and the safeguards to be applied is required when the audit engagement partner is considering the acceptance of an engagement to provide a non-audit service. That assessment is reviewed whenever the scope and objectives of the non-audit service change significantly. If such a review suggests that safeguards cannot reduce the threat to an acceptable level, the audit firm withdraws from the non-audit service engagement, or does not accept re-appointment or withdraws from the audit engagement.

### ***COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE***

- 35 **The audit engagement partner should ensure that those charged with governance of the audit client are appropriately informed on a timely basis of:**
- (a) all significant facts and matters that bear upon the auditors' objectivity and independence, related to the provision of non-audit services, including the safeguards put in place; and**
  - (b) for listed companies, any inconsistencies between APB Ethical Standards and the company's policy for the supply of non-audit services by the audit firm and any apparent breach of that policy.<sup>2</sup>**

- 36 Transparency is a key element in addressing the issues raised by the provision of non-audit services by audit firms to their audit clients. This can be facilitated by timely communication with those charged with governance of the audit client (see APB Ethical Standard 1, paragraphs 49 to 53). Such communications are addressed to the audit committee, where there is one; in other circumstances, they are addressed to the board of directors (or those in an equivalent position). In the case of listed companies, ensuring that the audit committee is properly informed

about the issues associated with the provision of non-audit services will assist them to comply with the provisions of the Combined Code on Corporate Governance relating to reviewing and monitoring the external auditors' independence and objectivity and to developing a policy on the engagement of external auditors to supply non-audit services. This will include discussion of any inconsistencies between the company's policy and APB Ethical Standards and ensuring that the policy is communicated to affiliates.

### ***DOCUMENTATION***

**37 The audit engagement partner should ensure that the reasoning for a decision to undertake an engagement to provide non-audit services to an audit client, and any safeguards adopted, is appropriately documented.**

38 Matters to be documented include any significant judgments concerning:

- threats identified;
- safeguards adopted and the reasons why they are considered to be effective; and
- communication with those charged with governance.

## **APPLICATION OF GENERAL PRINCIPLES TO SPECIFIC NON-AUDIT SERVICES**

### ***INTERNAL AUDIT SERVICES***

39 The range of 'internal audit services' is wide and they may not be termed as such by the audit client. For example, the audit firm may be engaged:

- to outsource the audit client's entire internal audit function; or

- to supplement the audit client's internal audit function in specific areas (for example, by providing specialised technical services or resources in particular locations); or
- to provide occasional internal audit services to the audit client on an *ad hoc* basis.

All such engagements would fall within the term 'internal audit services'.

- 40 The main threats to the auditors' objectivity and independence arising from the provision of internal audit services are the self-review threat and the management threat.
- 41 Engagements to provide internal audit services - other than those prohibited in paragraph 43 - may be undertaken, provided that the auditors are satisfied that 'informed management'<sup>3</sup> has been designated by the audit client and provided that appropriate safeguards are applied.
- 42 Examples of safeguards that may be appropriate when internal audit services are provided to an audit client include ensuring that:
- internal audit projects undertaken by the audit firm are performed by partners and staff who have no involvement in the external audit of the financial statements;
  - the audit of the financial statements is reviewed by an audit partner who is not involved in the audit engagement, to ensure that the internal audit work performed by the audit firm has been properly and effectively assessed in the context of the audit of the financial statements.

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<sup>3</sup> The nature of 'informed management' is discussed in paragraph 27.

- 43 **The audit firm should not undertake an engagement to provide internal audit services to an audit client where it is reasonably foreseeable that:**
- (a) for the purposes of the audit of the financial statements, the auditors would place significant reliance on the internal audit work performed by the audit firm; or**
  - (b) for the purposes of the internal audit services, the audit firm would undertake part of the role of management.**
- 44 The self-review threat is unacceptably high where the auditors cannot perform the audit of the financial statements without placing significant reliance on the work performed for the purposes of the internal audit services engagement. For example, the provision of internal audit services on the internal financial controls for an audit client which is a large bank, is likely to be unacceptable as the external audit team is likely to place significant reliance on the work performed by the internal audit team in relation to the bank's internal financial controls.
- 45 The management threat is unacceptably high where the audit firm provides internal audit services that involve audit firm personnel taking decisions or making judgments, which are properly the responsibility of management. For example, such situations can arise where the nature of the internal audit work involves the audit firm in taking decisions as to:
- the scope and nature of the internal audit services to be provided to the audit client, or
  - the design of internal controls or implementing changes thereto.
- 46 During the course of the audit the auditors generally evaluate the design and test the operating effectiveness of some of the entity's internal financial controls, including the operation of any internal audit function and provide management with observations on matters that have come to their attention, including comments on weaknesses in the internal control systems (including the internal audit function) and suggestions for

addressing them. This work is a by-product of the audit service rather than the result of a specific engagement to provide non-audit services and therefore does not constitute internal audit services for the purposes of this Standard.

- 47 In some circumstances, additional internal financial controls work is performed during the course of the audit in response to a specific request for an extended scope to the external audit. Whether it is appropriate for this work to be undertaken by the audit firm will depend on the extent to which it gives rise to a management threat to the auditor's objectivity and independence. The audit engagement partner reviews the scope and objectives of the proposed work and assesses the threats to which it gives rise and the safeguards available.

### ***INFORMATION TECHNOLOGY SERVICES***

- 48 Design, provision and implementation of information technology (including financial information technology) systems by audit firms for their audit clients creates threats to the auditors' objectivity and independence. The principal threats are the self-review threat and the management threat.
- 49 Engagements to design, provide or implement information technology systems that are not important to any significant part of the accounting system or to the production of the financial statements and do not have significant reliance placed on them by the auditors, may be undertaken, provided that 'informed management'<sup>3</sup> has been designated by the audit client and provided that appropriate safeguards are applied.
- 50 Examples of safeguards that may be appropriate when information technology services are provided to an audit client include ensuring that:

- information technology projects undertaken by the audit firm are performed by partners and staff who have no involvement in the external audit of the financial statements;
- the audit of the financial statements is reviewed by an audit partner who is not involved in the audit engagement to ensure that the information technology work performed has been properly and effectively assessed in the context of the audit of the financial statements.

**51 The audit firm should not undertake an engagement to design, provide or implement information technology systems for an audit client where:**

**(a) the systems concerned would be important to any significant part of the accounting system or to the production of the financial statements and the auditors would place significant reliance upon them as part of the audit of the financial statements; or**

**(b) for the purposes of the information technology services, the audit firm would undertake part of the role of management.**

52 Where it is reasonably apparent that, having regard to the activities and size of the audit client and the range and complexity of the proposed system, the management lacks the expertise required to take responsibility for the systems concerned, it is unlikely that any safeguards would be sufficient to eliminate these threats or to reduce them to an acceptable level. In particular, formal acceptance by management of the systems designed and installed by the audit firm is unlikely to be an effective safeguard when, in substance, the audit firm have been retained by management as experts and they make important decisions in relation to the design or implementation of systems of internal control and financial reporting.

- 53 The provision and installation of information technology services associated with a standard 'off the shelf accounting package' (including basic set-up procedures to make the package operate on the client's existing platform and peripherals, setting up the chart of accounts and the entry of standard data such as the client's product names and prices) is unlikely to create a level of threat to the auditor's objectivity and independence that cannot be addressed through applying appropriate safeguards.

### **VALUATION SERVICES**

- 54 **The audit firm should not undertake an engagement to provide a valuation to an audit client where the valuation would both:**
- (a) involve a significant degree of subjective judgment; and**
  - (b) have a material effect on the financial statements.**
- 55 The main threats to the auditors' objectivity and independence arising from the provision of valuation services are the self-review threat and the management threat. The self-review threat is considered too high to allow the provision of valuation services which involve the valuation of amounts with a significant degree of subjectivity that may have a material effect on the financial statements.
- 56 This restriction does not apply in circumstances where the auditors are designated by legislation or regulation as being eligible to carry out a valuation<sup>4</sup>. In such circumstances, the audit engagement partner applies relevant safeguards.

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<sup>4</sup> For example, Section 103 of the Companies Act 1985 requires a public company to obtain a report on the value of assets to be received in payment for shares to be allotted from independent accountants who either are the auditors or are qualified to act as auditors, of the allotting company.

57 It is usual for the auditors to provide the management with accounting advice in relation to valuation matters that have come to their attention during the course of the audit. Such matters might typically include:

- comments on valuation assumptions and their appropriateness;
- errors identified in a valuation calculation and suggestions for correcting them;
- advice on accounting policies and any valuation methodologies used in their application.

Advice on such matters does not constitute valuation services for the purpose of this Standard.

58 Where auditors are engaged to collect and verify the accuracy of data to be used in a valuation to be performed by others, such engagements do not constitute valuation services under this Standard.

### ***ACTUARIAL VALUATION SERVICES***

59 **The audit firm should not undertake an engagement to provide actuarial valuation services to an audit client, unless the firm is satisfied that either:**

- (a) all significant judgments, including the assumptions, are made by 'informed management'; or**
- (b) the valuation has no material effect on the financial statements.**

60 Actuarial valuation services are subject to the same general principles as other valuation services. Where they involve the audit firm in making a subjective judgment and have a material effect on the financial statements, actuarial valuations give rise to an unacceptable level of self-review threat and so may not be performed by audit firms for their audit clients.

- 61 However, in cases where all significant judgments concerning the assumptions, methodology and data for the actuarial valuation are made by 'informed management' and the audit firm's role is limited to applying proven methodologies using the given data, for which the management takes responsibility, it may be possible to establish effective safeguards to protect the auditors' objectivity and the appearance of their independence.

## **TAX SERVICES**

- 62 The range of activities encompassed by the term 'tax services' is wide. Three broad categories of tax service can be distinguished. They are where the audit firm:

- (a) provides advice to the audit client on one or more specific matters at the request of the audit client; or
- (b) undertakes a substantial proportion of the tax planning or compliance work for the audit client; or
- (c) promotes tax structures or products to the audit client, the effectiveness of which is likely to be influenced by the manner in which they are accounted for in the financial statements.

Whilst it is possible to consider tax services under broad headings, such as tax planning or compliance, in practice these services are often interrelated and it is impracticable to analyse services in this way for the purposes of attempting to identify generically the threats to which specific engagements give rise. As a result, audit firms need to identify and assess, on a case-by-case basis, the potential threats to the auditors' objectivity and independence before deciding whether to undertake a proposed engagement to provide tax services to an audit client.

- 63 The provision of tax services by audit firms to their audit clients may give rise to a number of threats to the auditors' objectivity and independence, including the self-interest threat, the management threat, the advocacy threat and, where the work involves a significant degree of subjective

judgment and has a material effect on the financial statements, the self-review threat.

- 64 Where the audit firm provides advice to the audit client on one or more specific matters at the request of the audit client, a self-review threat may be created. This self-review threat is more significant where the audit firm undertakes a substantial proportion of the tax planning and compliance work for the audit client. However, the auditors may be able to adopt appropriate safeguards.
- 65 Examples of such safeguards that may be appropriate when tax services are provided to an audit client include ensuring that:
- the tax services are provided by partners and staff who have no involvement in the audit of the financial statements;
  - the tax services are reviewed by an independent tax partner, or other senior tax employee;
  - external independent advice is obtained on the tax work;
  - tax computations prepared by the audit team are reviewed by a partner or senior staff member with appropriate expertise who is not a member of the audit team; or
  - an audit partner not involved in the audit engagement reviews whether the tax work has been properly and effectively addressed in the context of the audit of the financial statements.
- 66 **The audit firm should not promote tax structures or products or undertake an engagement to provide tax advice to an audit client where the audit engagement partner has, or ought to have, reasonable doubt as to the appropriateness of the related accounting treatment involved, having regard to the requirement for the financial statements to give a true and fair view in accordance with the relevant financial reporting framework.**

- 67 Where the audit firm promotes tax structures or products or undertakes an engagement to provide tax advice to the audit client, it may be necessary to adopt an accounting treatment about which there is reasonable doubt as to its appropriateness, in order to achieve the desired result. A self-review threat arises in the course of an audit because the auditors may be unable to form an impartial view of the accounting treatment to be adopted for the purposes of the proposed arrangements. Accordingly, this Standard does not permit the promotion of tax structures or products by audit firms to their audit clients where, in the view of the audit engagement partner, after such consultation as is appropriate, the effectiveness of the tax structure or product depends on an accounting treatment about which there is reasonable doubt as to its appropriateness.
- 68 The audit firm should not undertake an engagement to provide tax services to an audit client wholly or partly on a contingent fee basis where:**
- (a) the engagement fees are material to the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated; or**
  - (b) the outcome of those tax services (and, therefore, the entitlement to the fee) is dependent on:**
    - (i) the application of tax law which is uncertain or has not been established; and**
    - (ii) a future or contemporary audit judgment relating to a material balance in the financial statements of the audit client.**
- 69 Where tax services, such as advising on corporate structures and structuring transactions to achieve a particular effect, are undertaken on a contingent fee basis, self-interest threats to the auditors' objectivity and independence may arise. The auditors may have, or may appear to have, an interest in the success of the tax services, causing them to make an audit judgment about which there is reasonable doubt as to its

appropriateness. Where the contingent fee is determined by the outcome of the application of tax law, which is uncertain or has not been established, and where the tax implications are material to the financial statements, the self-interest threat cannot be eliminated or reduced to an acceptable level by the application of any safeguards.

**70 The audit firm should not undertake an engagement to provide tax services to an audit client where the engagement would involve the audit firm undertaking a management role.**

71 When providing tax services to an audit client, there is a risk that the audit firm undertakes a management role, unless the firm is working with 'informed management'<sup>3</sup> and appropriate safeguards are applied.

72 For entities other than listed companies or significant affiliates of listed companies, auditors may undertake an engagement to prepare accounting entries relating to tax and deferred tax calculations, provided that:

(a) such services:

(i) do not involve initiating transactions or taking management decisions; and

(ii) are of a technical, mechanical or an informative nature; and

(b) appropriate safeguards are applied.

**73 The audit firm should not undertake an engagement to provide tax services to an audit client where this would involve acting as an advocate for the audit client, before an appeals tribunal or court<sup>5</sup> in the resolution of an issue:**

**(a) that is material to the financial statements; or**

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<sup>5</sup> The restriction applies to the first level of Tax Court that is independent of the tax authorities and to more authoritative bodies. In the UK this would be the General or Special Commissioners of the Inland Revenue or the VAT and Duties Tribunal.

**(b) where the outcome of the tax issue is dependent on a future or contemporary audit judgment.**

- 74 Where the tax services to be provided by the audit firm include representing the client in any negotiations or proceedings involving the tax authorities, advocacy threats to the auditors' objectivity and independence may arise.
- 75 The audit firm is not acting as an advocate where the tax services involve the provision of information to the tax authorities (including an explanation of the approach being taken and the arguments being advanced by the audit client). In such circumstances effective safeguards may exist and the tax authorities will undertake their own review of the issues.
- 76 Where the tax authorities indicate that they are minded to reject the audit client's arguments on a particular issue and the matter is likely to be determined by an appeals tribunal or court, the audit firm may become so closely identified with management's arguments that the auditors are inhibited from forming an impartial view of the treatment of the issue in the financial statements. In such circumstances, if the issue is material to the financial statements or is dependent on a future or contemporary audit judgment, the audit firm discusses the matter with the audit client and makes it clear to the client that it will have to withdraw from that element of the engagement to provide tax services that requires it to act as advocate for the audit client, or resign from the audit engagement from the time when the matter is formally listed for hearing before the appeals tribunal.
- 77 The audit firm is not, however, precluded from having a continuing role (for example, responding to specific requests for information) for the audit client in relation to the appeal. The audit firm assesses the threat associated with any continuing role in accordance with the provisions of paragraphs 78 to 80 of this Standard.

## ***LITIGATION SUPPORT SERVICES***

- 78 **The audit firm should not undertake an engagement to provide litigation support services to an audit client where this would involve the estimation by the audit firm of the likely outcome of a pending legal matter that could be material to the amounts to be included or the disclosures to be made in the financial statements and there is a significant degree of subjectivity involved.**
- 79 Although management and advocacy threats may arise in litigation support services, such as acting as an expert witness, the primary issue is that a self-review threat will arise where such services involve a subjective estimation of the likely outcome of a matter that is material to the amounts to be included or the disclosures to be made in the financial statements.
- 80 Litigation support services that do not involve such subjective estimations are not prohibited, provided that the audit firm has carefully considered the implications of any threats and established appropriate safeguards.

## ***LEGAL SERVICES***

- 81 **The audit firm should not undertake an engagement to provide legal services to an audit client where this would involve acting as the solicitor formally nominated to represent the client in the resolution of a dispute or litigation which is material to the amounts to be included or the disclosures to be made in the financial statements.**
- 82 Although the provision by auditors of certain types of legal services to their audit clients may create advocacy, self-review and management threats, this Standard does not impose a general prohibition on the

provision of legal services. However, in view of the degree of advocacy involved in litigation or other types of dispute resolution procedures and the potential importance of any assessment by the auditors of the merits of the audit client's position when auditing its financial statements, this Standard prohibits an audit firm from acting as the formally nominated representative for an audit client in the resolution of a dispute or litigation which is material to the financial statements (either in terms of the amounts recognised or disclosed in the financial statements).

### ***RECRUITMENT AND REMUNERATION SERVICES***

- 83 **The audit firm should not undertake an engagement to provide recruitment services to an audit client that would involve the firm taking responsibility for the appointment of any director or employee of the audit client.**
- 84 A management threat arises where audit firm personnel take responsibility for any decision as to who should be appointed by the audit client.
- 85 **For an audit client that is a listed company, the audit firm should not undertake an engagement to provide recruitment services in relation to a key management position of the audit client, or a significant affiliate of such an entity.**
- 86 A familiarity threat arises if the audit firm plays a significant role in relation to the identification and recruitment of senior members of management within the company, as the audit engagement team may be less likely to be critical of the information or explanations provided by such individuals than might otherwise be the case. Accordingly, for listed companies, and for significant affiliates of such entities, the audit firm does not undertake engagements that involve the recruitment of individuals for key management positions.

- 87 The audit firm's policies and procedures will set out circumstances in which recruitment services are not undertaken for non-listed audit clients. These policies will take into consideration the nature of the entity's business, its size, the number of its employees and the range of its stakeholders.
- 88 Recruitment services involve a specifically identifiable, and separately remunerated, engagement. Audit firms and engagement teams may contribute to an entity's recruitment process in less formal ways. The prohibition set out in paragraph 85 does not extend to senior members of an audit team interviewing prospective employees of the audit client or to the audit entity using information gathered by the audit firm, including that relating to salary surveys.
- 89 **The audit firm should not undertake an engagement to provide advice on the quantum of the remuneration package or the measurement criteria on which the quantum is calculated, for a director or key management position of an audit client.**
- 90 The provision of advice on remuneration packages (including bonus arrangements, incentive plans and other benefits) to existing or prospective employees of the audit client gives rise to familiarity threats. The significance of the familiarity threat is considered too high to allow advice on the overall amounts to be paid or on the quantitative measurement criteria included in remuneration packages for directors and key management positions.
- 91 For other employees, these threats can be adequately addressed by the application of safeguards, such as the advice being provided by partners and staff who have no involvement in the audit of the financial statements.

- 92 In cases where all significant judgments concerning the assumptions, methodology and data for the calculation of remuneration packages for directors and key management are made by 'informed management' or a third party and the audit firm's role is limited to applying proven methodologies using the given data, for which the management takes responsibility, it may be possible to establish effective safeguards to protect the auditors' objectivity and independence.
- 93 Advice on tax, pensions and interpretation of accounting standards relating to remuneration packages for directors and key management can be provided by the audit firm, provided they are not prohibited by the requirements of this Standard relating to tax, actuarial valuations and accounting services. Disclosure of the provision of any such advice would be made to those charged with governance of the audit client (see APB Ethical Standard 1, paragraphs 49 to 53).

### ***CORPORATE FINANCE SERVICES***

- 94 The range of services encompassed by the term 'corporate finance services' is wide. For example, the audit firm may be engaged:
- to identify possible purchasers for parts of the audit client's business and provide advisory services in the course of such sales; or
  - to identify possible 'targets' for the audit client to acquire; or
  - to advise the audit client on how to fund its financing requirements, including advising on debt restructuring and securitisation programmes; or
  - to act as sponsor on admission to listing on the London Stock Exchange, or as Nominated Advisor on the admission of the audit client on the Alternative Investments Market (AIM); or
  - to act as financial adviser to audit client offerors or offerees in connection with public takeovers.

- 95 The potential for the auditors' objectivity and independence to be impaired through the provision of corporate finance services varies considerably depending on the precise nature of the service provided. The main threats to auditors' objectivity and independence arising from the provision of corporate finance services are the self-review, management and advocacy threats. Self-interest threats may also arise, especially in situations where the audit firm is paid on a contingent fee basis.
- 96 When providing corporate finance services to an audit client, there is a risk that the audit firm undertakes a management role, unless the firm is working with 'informed management'<sup>3</sup> and appropriate safeguards are applied.
- 97 Examples of safeguards that may be appropriate when corporate finance services are provided to an audit client include ensuring that:
- the corporate finance advice is provided by partners and staff who have no involvement in the audit of the financial statements,
  - any advice provided is reviewed by an independent corporate finance partner within the audit firm,
  - external independent advice on the corporate finance work is obtained,
  - an audit partner who is not involved in the audit engagement reviews the audit work performed in relation to the subject matter of the corporate finance services provided to ensure that such audit work has been properly and effectively reviewed and assessed in the context of the audit of the financial statements.
- 98 Where the audit firm undertakes an engagement to provide corporate finance services to an audit client in connection with conducting the sale or purchase of a material part of the audit client's business, the audit engagement partner should inform the audit committee (or equivalent)

about the engagement, as set out in paragraphs 49 to 53 of APB Ethical Standard 1.

**99 The audit firm should not undertake an engagement to provide corporate finance services to an audit client where:**

**(a) the engagement would involve the audit firm taking responsibility for dealing in, underwriting or promoting shares; or**

**(b) the audit engagement partner has, or ought to have, reasonable doubt as to the appropriateness of an accounting treatment that is related to the advice provided, having regard to the requirement for the financial statements to give a true and fair view in accordance with the relevant financial reporting framework; or**

**(c) such corporate finance services are to be provided on a contingent fee basis and:**

**(i) the engagement fees are material to the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated; or**

**(ii) the outcome of those corporate finance services (and, therefore, the entitlement to the fee) is dependent on a future or contemporary audit judgment relating to a material balance in the financial statements of the audit client; or**

**(d) the engagement would involve the audit firm undertaking a management role.**

100 An unacceptable advocacy threat arises where, in the course of providing a corporate finance service, the audit firm promotes the interests of the audit client by taking responsibility for dealing in, underwriting, or promoting shares.

- 101 Where the audit firm acts as a sponsor under the Listing Rules<sup>6</sup>, or as Nominated Adviser on the admission of the audit client to the AIM, the audit firm is required to confirm that the audit client has satisfied all applicable conditions for listing and other relevant requirements of the listing (or AIM) rules. Where there is, or there ought to be, reasonable doubt that the audit firm will be able to give that confirmation, it does not enter into such an engagement.
- 102 A self-review threat arises where the outcome or consequences of the corporate finance service provided by the audit firm may be material to the financial statements of the audit client, which are, or will be, subject to audit by the same firm. Where the audit firm provides corporate finance services, for example advice to the audit client on financing arrangements, it may be necessary to adopt an accounting treatment about which there is reasonable doubt as to its appropriateness in order to achieve the desired result. A self-review threat is created because the auditors may be unable to form an impartial view of the accounting treatment to be adopted for the purposes of the proposed arrangements. Accordingly, this Standard does not permit the provision of advice by audit firms to their audit clients where there is reasonable doubt about the appropriateness of the related accounting treatments.
- 103 Advice to audit clients on funding issues and banking arrangements, where there is no reasonable doubt as to the appropriateness of the accounting treatment, is not prohibited provided this does not involve the audit firm in taking decisions or making judgments which are properly the responsibility of management.
- 104 Where a corporate finance engagement is undertaken on a contingent fee basis, self-interest threats to the auditors' objectivity and

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<sup>6</sup> In the United Kingdom, the UK Listing Authority's publication the 'Listing Rules'. In the Republic of Ireland, the United Kingdom 'Listing Rules' as modified by the 'Notes on the Listing Rules' published by the Irish Stock Exchange.

independence also arise as the auditors may have, or may appear to have, an interest in the success of the corporate finance services. The significance of the self-interest threat is primarily determined by the materiality of the contingent fee to the audit firm, or to the part of the firm by reference to which the audit engagement partner's profit share is calculated. Where the contingent fee and the outcome of the corporate finance services is dependent on a future or contemporary audit judgment relating to a material balance included in the financial statements of the audit client, the self-interest threat cannot be eliminated or reduced to an acceptable level by the application of any safeguards.

- 105 These restrictions do not apply in circumstances where the auditors are designated by legislation or regulation as being eligible to carry out a particular service. In such circumstances, the audit engagement partner establishes appropriate safeguards.

### ***TRANSACTION RELATED SERVICES***

- 106 In addition to corporate finance services, there are other non-audit services associated with transactions that an audit firm may undertake for an audit client. For example:
- investigations into possible acquisitions or disposals ('due diligence' investigations); or
  - investigations into the tax affairs of possible acquisitions or disposals; or
  - the provision of information to sponsors in relation to prospectuses and other investment circulars (for example, long form reports, comfort letters on the adequacy of working capital).
- 107 When providing transaction related services to an audit client, unless the firm is working with 'informed management'<sup>3</sup> and appropriate safeguards

are applied, there is a risk that the audit firm undertakes a management role.

108 Examples of safeguards that may be appropriate when transaction related services are provided to an audit client include ensuring that:

- the transaction related advice is provided by partners and staff who have no involvement in the audit of the financial statements,
- any advice provided is reviewed by an independent transactions partner within the audit firm,
- external independent advice on the transaction related work is obtained,
- an audit partner who is not involved in the audit engagement reviews the audit work performed in relation to the subject matter of the transaction related service provided to ensure that such audit work has been properly and effectively reviewed and assessed in the context of the audit of the financial statements.

109 **The audit firm should not undertake an engagement to provide transaction related services to an audit client where:**

- (a) the audit engagement partner has, or ought to have, reasonable doubt as to the appropriateness of an accounting treatment that is related to the advice provided, having regard to the requirement for the financial statements to give a true and fair view in accordance with the relevant financial reporting framework; or**
- (b) such transaction related services are to be provided on a contingent fee basis and:**
  - (i) the engagement fees are material to the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated; or**
  - (ii) the outcome of those transaction related services (and, therefore, the entitlement to the fee) is dependent on a**

**future or contemporary audit judgment relating to a material balance in the financial statements of the audit client; or**  
**(c) the engagement would involve the audit firm undertaking a management role.**

110 A self-review threat arises where the outcome of the transaction related service undertaken by the audit firm may be material to the financial statements of the audit client which are, or will be, subject to audit by the same firm. Where the audit client proposes to undertake a transaction, it may be necessary to adopt an inappropriate accounting treatment in order to achieve the desired result. A self-review threat is created if the auditors undertake transaction related services in connection with such a transaction. Accordingly, this Standard does not permit the provision of advice by audit firms to their audit clients where there is reasonable doubt about the appropriateness of the accounting treatments related to the transaction advice given.

111 Where a transaction related services engagement is undertaken on a contingent fee basis, self-interest threats to the auditors' objectivity and independence also arise as the auditors may have, or may appear to have, an interest in the success of the transaction. The significance of the self-interest threat is primarily determined by the materiality of the contingent fee to the audit firm, or to the part of the firm by reference to which the audit engagement partner's profit share is calculated. Where the contingent fee and the outcome of the transaction related services is dependent on a future or contemporary audit judgment on a material balance included in the financial statements of the audit client, the self-interest threat cannot be eliminated or reduced to an acceptable level by the application of any safeguards, other than where the transaction is subject to a pre-established dispute resolution procedure.

112 These restrictions do not apply in circumstances where the auditors are designated by legislation or regulation as being eligible to carry out a

particular service. In such circumstances, the audit engagement partner establishes appropriate safeguards.

## **ACCOUNTING SERVICES**

- 113 In this Standard, the term 'accounting services' is defined as the provision of services that involve the maintenance of accounting records or the preparation of financial statements that are then subject to audit. Advice on the implementation of current and proposed accounting standards is not included in the term 'accounting services'.
- 114 The range of activities encompassed by the term 'accounting services' is wide. In some cases, the audit client may ask the audit firm to provide a complete service including maintaining all of the accounting records and the preparation of the financial statements. Other common situations are:
- the audit firm may take over the provision of a specific accounting function on an outsourced basis (for example, payroll);
  - the audit client maintains the accounting records, undertakes basic bookkeeping and prepares a year-end trial balance and asks the audit firm to assist with the preparation of the necessary adjustments and the financial statements.
- 115 The provision of accounting services by the audit firm to the audit client creates threats to the auditors' objectivity and independence, principally self-review and management threats, the significance of which depends on the nature and extent of the accounting services in question and upon the level of public interest in the audit client.
- 116 When providing accounting services to an audit client, unless the firm is working with 'informed management'<sup>3</sup>, there is a risk that the audit firm undertakes a management role.

**117 The audit firm should not undertake an engagement to provide accounting services to:**

- (a) an audit client that is a listed company or a significant affiliate of such an entity, save where the circumstances contemplated in paragraph 121 apply; or**
- (b) any other audit client, where those accounting services would involve the audit firm undertaking part of the role of management.**

118 Even where there is no engagement to provide any accounting services, it is usual for the auditors to provide the management with accounting advice on matters that have come to their attention during the course of the audit. Such matters might typically include:

- comments on weaknesses in the accounting records and suggestions for addressing them;
- errors identified in the accounting records and in the financial statements and suggestions for correcting them;
- advice on the accounting policies in use and on the application of current and proposed accounting standards.

This advice is a by-product of the audit service rather than the result of any engagement to provide non-audit services. Consequently, as it is part of the audit service, such advice cannot be regarded as giving rise to any threat to the auditors' objectivity and independence.

119 For listed companies or significant affiliates of such entities, the threats to the auditors' objectivity and independence that would be created are too high to allow the audit firm to undertake an engagement to provide any accounting services, save where the circumstances contemplated in paragraph 121 apply.

120 The audit firm's policies and procedures will set out circumstances in which accounting services are not undertaken for non-listed audit clients. These policies will take into consideration the nature of the entity's

business, its size, the number of its employees and the range of its stakeholders.

- 121 In emergency situations, the audit firm may provide a listed audit client, or a significant affiliate of such a company, with accounting services to assist the company in the timely preparation of its financial statements. This might arise when, due to external and unforeseeable events, the audit firm personnel are the only people with the necessary knowledge of the audit client's systems and procedures. A situation could be considered an emergency where the audit firm's refusal to provide these services would result in a severe burden for the audit client (for example, withdrawal of credit lines), or would even threaten its going concern status. In such circumstances, the audit firm ensures that:
- (a) any staff involved in the accounting services have no involvement in the audit of the financial statements; and
  - (b) the engagement would not lead to any audit firm staff or partners taking decisions or making judgments which are properly the responsibility of management.
- 122 For entities other than listed companies or significant affiliates of listed companies, auditors may undertake an engagement to provide accounting services, provided that:
- (a) such services:
    - (i) do not involve initiating transactions or taking management decisions; and
    - (ii) are of a technical, mechanical or an informative nature; and
  - (b) appropriate safeguards are applied.
- 123 The maintenance of the accounting records and the preparation of the financial statements are the responsibility of the management of the audit client. Accordingly, in any engagement to provide the audit client with accounting services, the audit firm does not initiate any transactions

or take any decisions or make any judgments, which are properly the responsibility of the management. These include:

- authorising or approving transactions;
- preparing originating data (including valuation assumptions);
- determining or changing journal entries, or the classifications for accounts or transactions, or other accounting records without management approval.

124 Examples of accounting services of a technical or mechanical nature or of an informative nature include:

- recording transactions for which management has determined the appropriate account classification, posting coded transactions to the general ledger, posting entries approved by management to the trial balance or providing certain data-processing services (for example, payroll);
- assistance with the preparation of the financial statements where management takes all decisions on issues requiring the exercise of judgment and has prepared the underlying accounting records.

125 Examples of safeguards that may be appropriate when accounting services are provided to an audit client include:

- accounting services provided by the audit firm are performed by partners and staff who have no involvement in the external audit of the financial statements;
- the accounting services are reviewed by a partner or other senior staff member with appropriate expertise who is not a member of the audit team;
- the audit of the financial statements is reviewed by an audit partner who is not involved in the audit engagement to ensure that the accounting services performed have been properly and effectively assessed in the context of the audit of the financial statements.

## EFFECTIVE DATE

- 126 Effective for audits of financial statements for periods commencing on or after 15 December 2004.
- 127 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.
- 128 Where compliance with the requirements of ES 5 would result in a service not being supplied, services contracted before 5 October 2004 may continue to be provided until either:
- (a) the completion of the specific task or the end of the contract term, where this is set out in the contract; or
  - (b) 15 December 2005, where a task or term is not defined,
- as long as the following apply:
- the engagement was permitted by existing ethical guidance (including transitional provisions) from the relevant professional body;
  - any safeguards required by existing ethical guidance continue to be applied; and
  - the need for additional safeguards is assessed, including where possible any additional safeguards specified by ES5, and if considered necessary, those additional safeguards are applied.
- 129 In the first year of appointment as auditors to an audit client, an audit firm may continue to provide non-audit services which are already contracted at the date of appointment, until either:
- (i) the completion of the specific task or the end of the contract term, where this is set out in the contract; or
  - (ii) one year after the date of appointment, where a task or term is not defined,

provided that the need for additional safeguards is assessed and if considered necessary, those additional safeguards are applied.

## **NOTICE TO READERS**

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