

***APB Ethical Standards***

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**THE PROVISION OF NON-AUDIT SERVICES  
BY AUDITORS**

**Feedback on July 2010 Consultation**

**December 2010**

**The Auditing Practices  
Board**

# 1 Background

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- 1.1 The Auditing Practices Board (the 'APB') issued a Consultation Paper in October 2009 to respond to the Treasury Select Committee's call for a consultation on their proposal that there should be a prohibition on auditors providing non-audit services to the entities that they audit.
- 1.2 Responses to that Consultation Paper indicated that commentators (irrespective of the constituency involved) were overwhelmingly of the view that there should:
  - not be an outright prohibition; and
  - be no major change to the conceptual approach taken to the provision of non-audit services by auditors to the entities that they audit.
- 1.3 The vast majority of commentators saw no evidence that audit quality is, as a matter of fact, compromised by non-audit services engagements, given the threats and safeguards approach and specific prohibitions which are set out in the APB Ethical Standards for Auditors. However, there was broad acknowledgement that there is a perception amongst investors that confidence in the audit can be reduced where certain non-audit services are provided by the auditor. This perception is particularly heightened where there is a high ratio of non-audit fees to audit fees paid to an entity's auditor.
- 1.4 Following consideration of the responses to the October 2009 Consultation, the APB issued a further Consultation Paper in July 2010 which sought views on a number of matters:
  - Proposals to address the perception concerns described in paragraph 1.3 above. These proposals, based upon improved transparency and governance, developed a theme expressed in many responses - namely that decisions as to whether a company's auditors should be engaged to provide non-audit services is first and foremost a matter of corporate governance but that improved disclosure should provide shareholders with the tools they need to be more effective in their challenge of management and those charged with governance. Such an approach would, it was argued, stimulate a dialogue between companies and shareholders which could result in a mutual understanding of what are and are not considered to be acceptable types of non-audit services to be provided by the auditor and, where considered relevant, what level of non-audit services is generally appropriate.

- Amendments to the FRC's Guidance on Audit Committees that were necessary if the amendments proposed by the APB were implemented;
- Amendments to the APB's Ethical Standards for Auditors arising from the October 2009 Consultation; and
- Proposals in relation to certain areas that were identified by respondents to the October 2009 Consultation as giving rise to concern, namely:
  - Restructuring services provided to audited entities in distress;
  - The approach taken to contingent fees together with a revised definition of a contingent fee;
  - Additional guidance paragraphs on conflicts of interest in the provision of non-audit services in respect of audited entities and the approach to be taken to connected parties.

## 2 Summary of responses

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2.1 Responses to the July 2010 consultation were received from 39 commentators, representing the following stakeholder groups:

Investors:	
• Asset managers	1
• Representative institutional investor organisations	2
• Private equity investor organisation	1
Corporate sector:	
• Companies	8
• Audit committee chairs	1
• Representative organisations	2
Accountancy profession:	
• Audit service providers	11
• Representative organisations	7
Other individuals and organisations	6
Total	39

A full list of respondents is given in Appendix 1 to this Feedback Paper.

### *Overall summary of the views of respondents*

- 2.2 Respondents were overwhelmingly supportive of the APB's overall approach of not introducing a blanket ban on the provision of non-audit services by the auditor, but addressing the perception issue through improved transparency and governance.
- 2.3 As regards restructuring services, contingent fees and conflicts of interest, respondents generally recognised the merits of the concerns raised but, on practical grounds, were less supportive of some of the specific proposals, particularly where they involved an absolute prohibition, where implementation might involve significant complexity or where the proposals were considered to be disproportionate, especially in the context of smaller companies.
- 2.4 The APB has therefore amended the Ethical Standards to emphasise the importance of these issues and to highlight how they can be given proper consideration by audit firms, audit committees (in the case of listed companies) and others who might be affected, such as shareholders in private companies.

- 2.5 Nevertheless, no standards can address every situation that may arise. Where a situation is not expressly addressed in the Ethical Standards, it is critical that a proper assessment of threats and safeguards is made by the auditor paying full regard to the fundamental principles set out in ES 1 (Revised). The APB, together with the FRC's Audit Inspection Unit, will continue to monitor the application of this approach and specific requirements could be introduced in the future where it is not found to be operating effectively.
- 2.6 Each of the issues considered in the course this consultation is explored in more detail in the following paragraphs.

### 3 Addressing perception through improved transparency and governance

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- 3.1 The October 2009 consultation on non-audit services clearly indicated that there is a perceived threat to auditor independence where non-audit services are provided by the auditor. This perception is particularly heightened where there is a high ratio of non-audit fees to audit fees paid to a company's auditor. As the issue was mainly one of perception, APB's approach was founded on improved governance and transparency, rather than further requirements in the Ethical Standards for Auditors.
- 3.2 A key finding from a detailed analysis of the responses received is that the information which is currently disclosed on the provision of non-audit services is variable in terms of the nature and detail of the information provided. The APB proposed two ways in which disclosure could be improved:
- The provision by auditors to audit committees of detailed information about the fees they received for the provision of non audit services; and
  - Enhanced disclosure in annual reports of the company's policy on non-audit services, an explanation of why a company's auditors were engaged to provide certain non-audit services and how the auditor's independence has been safeguarded.

#### *Improved disclosures – categorisation of non-audit services*

- 3.3 Current disclosures in annual reports do not provide consistent details of the non-audit services provided by the auditor. The APB's proposals were intended to address this situation, whilst also providing colour by differentiating those services that are similar to an audit and, as a result, do not give rise to significant threats to auditor independence.
- 3.4 Disclosure in the financial statements of information relating to the provision of non-audit services by auditors is the responsibility of the company, although under the UK statutory requirements<sup>1</sup> the auditor must supply such information as is necessary to enable this disclosure to be made.

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<sup>1</sup> These requirements are contained in the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008, which can be accessed at [http://www.opsi.gov.uk/SI/si2008/uksi\\_20080489\\_en\\_1](http://www.opsi.gov.uk/SI/si2008/uksi_20080489_en_1).

- 3.5 The July 2010 exposure draft included a template for reporting information on auditor remuneration to the audit committee in the case of listed companies. This approach was broadly supported, although a number of respondents said that they would be concerned if this template were to be mandated. Paragraph 70 of ES 1 (Revised) (which introduces the template) indicates that the template's use is considered best practice and that flexibility is needed so that it can be adapted to fit the circumstances of the audit engagement.
- 3.6 A number of respondents expressed concern that the template does not provide the necessary information to support the statutory disclosure in the financial statements. Consideration of changes to the statutory disclosure is a matter for Government. To address the concerns that had been raised, the APB revised the template in ES 1 (Revised) so that the template illustrates how the information included reconciles to that required by statute<sup>2</sup>. Whilst this adds a further level of complexity, the APB believes that this will be useful to many audit practitioners and preparers of financial information.
- 3.7 The APB exposed a new section within ES 5 (Revised) establishing 'audit related services' as a category of non audit services and making it clear that the threats to the auditor's independence and objectivity which are associated with such services are clearly insignificant. The type of service falling within the category of 'audit related services' was limited to a list of specific services.
- 3.8 There was general support for the proposed approach to 'audit related services' with a broadly equal balance of respondents who supported the proposed list and those who considered either that it should not be closed or that it should be extended to include specific additional services (in particular investment circular reporting work and pension scheme audits<sup>3</sup>).
- 3.9 The APB believes that confidence in this categorisation is best served by ensuring the integrity of the list by including only those services that clearly meet the test of being audit related. Accordingly, the original list remains unchanged - see paragraph 55 of ES 5 (Revised).
- 3.10 It is unclear where public sector statutory audit engagements that are not connected with the financial statements (such as value for money

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<sup>2</sup> In Ireland, statutory disclosures are based directly on the EU Statutory Audit Directive which requires the categories of audit, other assurance, taxation and all other non-audit services to be disclosed.

<sup>3</sup> Fees for a pension scheme audit are required under UK legislation to be disclosed in the accounts of companies. Although a pension scheme is a stand-alone entity independent of the employer organisation, it is likely to be connected with the employer organisation in a number of ways.

reporting) should be included. This matter will need to be addressed in due course by those bodies responsible for ethical standards in this sector.

***Improved disclosure and governance – compliance with the UK Corporate Governance Code***

3.11 A consultation on amendments to the FRC's Guidance on Audit Committees was issued concurrently with the Exposure Draft of changes to the Ethical Standards for Auditors.

3.12 The amendments to the Guidance on Audit Committees were aimed at:

- giving more prominence to non-audit services within the section on the independence of the external auditor;
- helping the audit committee distinguish audit related services from other non-audit services;
- improving the formulation of the audit committee policy on the provision of non-audit services and the way in which this is disclosed in the annual report.

These amendments were believed to be consistent with provision C3.7 of the UK Corporate Governance Code which states:

*"The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded."*

3.13 There was general support for the proposed amendments to the Guidance on Audit Committees put forward by the FRC. As a result, this revised guidance is being published concurrently with the APB Ethical Standards for Auditors (Revised).

3.14 The APB believes that the improved disclosures resulting from the revisions to its Ethical Standards, combined with the revisions to the FRC Guidance to Audit Committees, will reduce perceived threats to auditor objectivity and independence arising from the provision of non-audit services by the auditor in listed companies.

***Improved audit firm governance – discussion with the Ethics Partner***

3.15 In order to ensure that appropriate attention is paid to the issue of the quantum of non-audit services provided to audited entities within an audit firm, the APB proposed an amendment to paragraph 18 of ES 5 (Revised) (now paragraph 28), making it a requirement that situations where fees for non-audit services are, or are expected to, exceed the audit fees are discussed with and approved by the Ethics Partner within the firm and reported to those charged with governance.<sup>4</sup>

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<sup>4</sup> An exemption for the audit of smaller entities was proposed in ES – PASE (Revised) in respect of this requirement.

- 3.16 A number of respondents from the profession considered this new requirement to be unnecessarily bureaucratic, as it could result in routine services (which happened to tip the balance) being the subject of discussion between the audit engagement partner and the Ethics Partner. It was also thought that it would require complex internal processes to be implemented in order to track fees on a real-time basis.
- 3.17 The APB's intention was not that this would become an onerous requirement. Audit engagement partners are required under paragraph 14 of ES 5 (Revised) to be informed where others within the firm are considering whether to accept a proposed engagement to provide a non-audit service to an audited entity or any of its affiliates. As a result it should be clear to the audit partner if and when there is an expectation that the ratio of non-audit to audit fees is approaching 1:1 and that would, in turn, trigger the proposed discussion between the audit engagement partner and the Ethics Partner.
- 3.18 As the threat to auditor independence is one of perception, and as that perception is greater in the case of listed companies where there is a diverse shareholder base, the APB has concluded that this requirement should apply to listed companies only.

## 4 Specific proposed amendments to APB Ethical Standards for Auditors

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4.1 In addition to the proposals on improved transparency, there were further amendments to the Ethical Standards for Auditors proposed by the APB arising from:

- The October 2009 consultation on the provision of non-audit services;
- Unresolved issues from the APB's March 2009 consultation;
- Other issues which APB became aware of subsequent to its consultation and where it considered that action was required.

### *Extended and internal audit services*

4.2 There is a spectrum of views on whether it is appropriate for the external auditor to perform internal audit work. The debate in the UK was re-energised by concerns amongst investor respondents that Rentokil's arrangement for its new external auditor to undertake some internal audit work would result in them auditing their own work and taking on management functions. The APB undertook a survey of the auditors of FTSE 350 companies which revealed that such 'extended audits' were undertaken in about 5% of these companies.

4.3 The APB decided to seek greater consistency in this area by amending ES 5 (Revised) to:

- Clarify what work should be treated as audit work rather than non-audit services;
- Distinguish 'extended audit services' from internal audit within non-audit services;
- Include 'extended audit services' within the definition of audit related services; and
- Give greater guidance on what internal audit services comprises, including making a distinction between 'assurance activities' designed to assess the design and operating effectiveness of existing or proposed systems or controls and 'advisory activities' where the auditor is involved in advising an entity on the design and implementation of its risk management, control and governance processes.

4.4 Changes were also proposed to the FRC's Guidance on Audit Committees as part of the consultation referred to in paragraphs 3.10 to 3.12 to emphasise the impact that the provision of internal audit services by the external auditor can have on investor perceptions.

- 4.5 Overall approximately 60% of respondents expressing a view supported this approach towards extended audit services. However, a number of respondents (predominantly mid-size audit firms) felt that there would still remain a blurred boundary between internal audit and extended audit work and were concerned that the proposed changes might lead to more rather than less work being carried out by the auditor as a result of introducing the extended audit services category.
- 4.6 The APB concluded that the proposed position on extended audit services in its Consultation Paper was appropriate and has not amended the proposed guidance on this subject.
- 4.7 A number of respondents from the profession felt that, by making it clear that outsourcing substantially all of the internal audit activity to the audit firm was unacceptable in paragraph 45 (now paragraph 64) of ES 5 (Revised), the APB had effectively introduced a prohibition that would adversely affect smaller businesses. These respondents argued that the guidance would prevent the auditor from undertaking any internal audit services where the entity's total internal audit activity is insignificant, even if those services were otherwise considered appropriate for the auditor to perform. One respondent also questioned whether this guidance was less restrictive than the equivalent international approach to internal audit services. Neither of these conclusions was intended and in response to these two points the APB has amended paragraph 64, clarifying that outsourcing substantially all of the internal audit activity to the audit firm is unacceptable where the work undertaken is significant to the audited entity. Further examples have also been given of circumstances where internal audit services provided by the auditor present an unacceptable self-review threat to objectivity in listed companies, which are consistent with those in the international approach.

*Clarifying the threats and safeguards approach and the Ethics Partner role*

- 4.8 A number of respondents to the October 2009 consultation highlighted the importance they place on having a robust threats and safeguards framework around the supply of non-audit services by the auditor. This is supported by the Ethics Partner, whose role is to try to ensure that decision-making in an audit firm on difficult ethical judgments is undertaken in a consistent manner.
- 4.9 In the exposure draft the APB included some enhancements to its guidance on the application of the threats and safeguards approach and the way that the Ethics Partner role should operate. These were broadly supported by respondents to the consultation and remain substantially unchanged in the final version.

4.10 The APB's intent in including this additional guidance is to emphasise the importance of high quality thinking and judgment by the audit engagement partner when making decisions as to the safeguards required in response to the assessment of threats to independence and objectivity. This is fundamental to the operation of the principles underlying the APB Ethical Standards and the role of the Ethics Partner is intended to support this thinking.

*Unresolved issues from March 2009 consultation*

4.11 In October 2009 the APB decided that changes to the Ethical Standards for Auditors consulted on in the March 2009 Consultation Paper (other than in relation to partner rotation) would be deferred pending responses to the new consultation paper on non-audit services.

4.12 Proposed amendments relating to

- o securitisation services,
- o financial interests of new partners joining the firm,
- o serving as a director or officer of an audited entity,
- o the definition of an affiliate of an audited entity and
- o valuations of non-cash consideration for shares ,

were broadly supported by respondents to the consultation and remain largely unchanged in the final version of the standards.

4.13 The APB proposed amendments to the requirements in relation to the remuneration and evaluation policies adopted by audit firms so as to extend the prohibition on staff members being rewarded for selling non-audit services to audited entities to all members of the engagement team.

4.14 Although eight respondents (from all constituencies) supported this proposal, a majority of respondents from the profession felt that the policies only needed to extend to those staff who are in a position to influence the significant decisions on the audit. This was consistent with the response received to the March 2009 consultation.

4.15 Having given this matter further consideration, the APB has concluded that the revision is required as all staff involved in an audit have the ability to influence the decisions that are made in the course of an audit by influencing what is reported to senior staff. In order to avoid unintended bureaucracy an exception has been added to the proposed wording to exclude from this provision those staff whose involvement is 'clearly insignificant'.

*Other issues raised by respondents*

- 4.16 30% of respondents raised a concern that an amendment to ES 5 (Revised), paragraph 78 (now paragraph 99), a requirement relating to tax calculations used in preparing financial statements, would bring in a new prohibition that would be burdensome for AIM and other small listed companies.
- 4.17 The APB's proposed amendment had been intended only to clarify the current text. Notwithstanding that the responses received suggest that there is a wider misunderstanding of what the APB intended by the existing requirement than was thought to be the case, the wording remains unchanged from that included in the exposure draft.

*Other amendments made to the Ethical Standards*

- 4.18 In the March 2009 consultation on amendments to the Ethical Standards, it was proposed that a cross reference would be made in ES 2 (Revised) to material in ISA (UK and Ireland) 610 on internal audit staff working directly for the audit team. The intention was to make it clear that such arrangements would not constitute dual employment.
- 4.19 APB reconsidered this issue in the context of its review of an IAASB exposure draft of ISA 610. It believes that internal audit staff providing direct assistance to the external auditor would appear to fall within the definition of the audit team<sup>5</sup>. As a result, notwithstanding the amendment to ES 2 (Revised) proposed in March 2009, internal auditors providing direct assistance would be subject to other provisions of the Ethical Standards for Auditors (including, for example, prohibiting other relationships that they may have with the audited entity, such as holding shares and having family and other personal relationships with individuals who are in a position to influence the financial statements of the audited entity).
- 4.20 To avoid this unintended consequence, and given that the responses to the March 2009 consultation did not raise any issues on the substance of the proposal to exclude internal audit staff from the specific requirements of the Ethical Standard for Auditors, the APB has decided to take internal audit staff out of the definition of the audit team.

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<sup>5</sup> All audit professionals who, regardless of their legal relationship with the auditor or audit firm, are assigned to a particular audit engagement in order to perform the audit task (e.g. audit partner(s), audit manager(s) and audit staff).

## 5 Issues on which further consultation was sought

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### *Restructuring services*

- 5.1 In the March 2009 consultation, the APB proposed the inclusion of a new section in ES 5 (Revised) dealing with restructuring services. This clarified how the general approach to non-audit services is applied to restructuring services, addressed the advocacy and management threats that are created with a prohibition and recognised the self-review threat that also arises.
- 5.2 In developing the July 2010 exposure draft, the prohibitions included in the March 2009 consultation relating to taking management decisions or acting as an advocate were repeated in the new section on restructuring services without amendment, together with an exemption in ES – PASE (Revised). However, the guidance in relation to the self-review threat that was included in the March 2009 consultation was subject to more extensive discussion.
- 5.3 The APB understood that there were investor concerns that the self-review threat is too great and cannot be safeguarded where the auditor participates in the development or implementation of a restructuring plan and then reviews it as part of the consideration of the going concern assumption. These concerns are believed to be most pronounced in relation to developing or implementing a restructuring plan designed to address actual or anticipated financial or operational difficulties that threaten the survival of an audited entity as a going concern ('an audited entity in distress'). In such circumstances where the subject matter and substance of the restructuring services, taken together, are central to the overall success of a restructuring plan and, therefore, in assuring the survival of the entity as a going concern, the auditor is likely to be significantly associated with the design and efficacy of the overall restructuring plan, and the numbers underpinning it.
- 5.4 The APB identified three possible approaches that could be taken to the self-review threats arising from the provision of restructuring services in respect of a listed company that is an 'audited entity in distress':
- Option 1.** The Ethical Standards could contain an outright prohibition on the provision of restructuring services to listed entities in distress.
- Option 2.** A threats and safeguards approach might be appropriate in certain situations resulting in the prohibition under Option 1 with the following exceptions:
- Preliminary general advice to a listed entity in distress;

- Assistance with the implementation of elements of an overall restructuring plan, such as the sale of a non-significant component business, provided those elements are not material to the overall restructuring plan;
- Involvement in challenging the projections and assumptions within a financial model that has been produced by the entity; and
- Reporting on a restructuring plan, or aspects of it, in connection with the proposed issue of an investment circular.

**Option 3.** A threats and safeguards approach along the lines suggested in the proposals that were exposed for comment in the March 2009 consultation, supplemented with further explanation and guidance.

- 5.5 Respondents from all stakeholder groups recognised the risk that a self-review threat could arise. The issue was how to address that threat.
- 5.6 A majority of respondents from the profession preferred option 3 and were supported by those respondents from the corporate sector who expressed a preference. Some of these respondents felt that the detailed work undertaken and the conclusions reached in restructuring services may improve the overall quality of an audit. Investor respondents are split equally over each of the three options. There was least support overall for Option 1 together with a broad recognition that such a complete prohibition of restructuring services is not warranted, even in the case of listed companies. This view was supported even by investors who originally raised these concerns in 2008.
- 5.7 Further meetings have been held by APB staff with various stakeholders including investors, a lending bank, an audit firm and a non-audit firm restructuring services provider. These meetings have provided the APB with a clearer understanding of the operation of the market for these services, especially for listed companies, and of the different perspectives of these market participants in relation to the potential benefits and concerns about the use of the auditor in the provision of these services.
- 5.8 Consistent with feedback from the consultation, these discussions have confirmed there is broad agreement that the auditor's involvement in discussions with management at the early stages of a restructuring can be critical in getting the company to recognise that they are in difficulty.
- 5.9 Some stakeholders believed that there is a cost benefit in using the auditor, as information from the audit team is more likely to be transferred to the restructuring team where both teams are from the same firm. This benefit is thought to be especially important to smaller entities, particularly in the current uncertain economic climate. Other stakeholders believe that this benefit is of limited importance – they

contend that the essence of providing such services is that the service provider is capable of rapidly assimilating a knowledge of the business and of the issues. They recognise that the auditor's knowledge is more likely to be critical where the entity has complex accounting issues, such as in a complex financial institution.

5.10 The market for restructuring services has a limited number of suppliers capable of delivering these services to the more complex, global entities, particularly where a service provider is assisting with the development of the detailed financial analysis and plan. Some stakeholders expressed a concern that prohibiting the auditor from supplying these services could further restrict choice in some cases.

5.11 In summary, the self-review threat is recognised by all stakeholders. In private companies a substantial proportion of shareholders whose interests will be affected by any restructuring that takes place are likely to be taking part in the decision as to who to appoint to undertake these services. However, in listed companies, this is not the case. Having reflected on the merits of the various views, the APB concluded that a partial prohibition on the lines proposed in option 2 of the consultation paper would be appropriate in the case of listed companies. For all other entities a threats and safeguards approach should apply.

5.12 Two amendments have been made to the prohibition under option 2 of the consultation paper to address concerns expressed in meetings with stakeholders:

- Situations where a service provider is engaged simply to challenge the projections and assumptions in a financial model, rather than to provide expert input and assist in the development of such plans to ensure that the model will survive scrutiny by the company's stakeholders, are thought to be limited. Accordingly, where the audit firm is engaged to carry out this work, it needs to take great care that partners and staff are not drawn into the development of the financial model, and this is highlighted in paragraph 153(c) of ES 5 (Revised).
- In certain limited circumstances an audit firm may be the most appropriate provider of restructuring services to a key player in a regulated market. If both the audit committee and the regulator of such a market believe that some flexibility is appropriate in such circumstances, the addition of (e) to paragraph 153 enables this to happen.

### *Contingent fees*

- 5.13 The July 2010 consultation paper recognised that the current definition of a “contingent fee basis”<sup>6</sup> excludes many arrangements that are dependent on a future event or condition through the exception permitted for differential hourly fee rates. The APB therefore proposed to amend this definition to remove this exception and to conform it more closely to the IESBA Code definition. Provisions to allow for arrangements that contemplated a lower fee in relation to a transaction or engagement that was either aborted or prematurely terminated were also included in the exposure draft.
- 5.14 The APB also considered whether to retain or modify the current approach to contingent fees in the Ethical Standards. Alternative approaches that could be taken to contingent fees were:
- (i) to prohibit all contingent fees; or
  - (ii) to extend the current prohibitions (where contingent fees are material or where the amount of the contingent fee is dependent on an audit judgment) to all non-audit services, rather than restricting them to tax, corporate finance and transaction related services.
- 5.15 Of those responding to the question about the definition, half could see no problems, but others either preferred the IFAC definition, or felt that the words ‘or other event’ could be interpreted inconsistently. Many felt that the important factor is the dependency of the amount of the contingent fee on material matters in the financial statements that are subject to audit.
- 5.16 As regards the approach to contingent fees, only one respondent supported a total prohibition and a quarter of those expressing a view supported the extension of the current prohibition to all non-audit services. Others expressed opposition to the total prohibition, but did not state whether they were supportive of the extension of the current approach to all non-audit services. Some respondents expressing this view stated that a complete ban on contingent fees would mean that private companies may not be able to access some professional services easily.
- 5.17 It is clear that investor respondents believe that contingent fees should only be used in the provision of non-audit services by the auditor after careful consideration. However, a complete prohibition appears to have little support and arguably runs counter to the general theme in many

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<sup>6</sup> Any arrangement made under which a fee is calculated on a pre-determined basis relating to the outcome or result of a transaction or the result of the work performed. 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.

responses, namely that decisions as to whether a company's auditors should be engaged to provide non-audit services is first and foremost a matter for the audit committee or those charged with governance.

- 5.18 The APB has therefore decided that an outright ban on contingent fees is not appropriate and the second of the two options presented should be followed. The proposed amendments to the FRC's Guidance on Audit Committees suggested that it would be best practice for contingent fee arrangements to be specifically approved by the audit committee before they were entered into and then disclosed in the annual report.
- 5.19 As it would be rare for the auditor to enter into contingent fee arrangements outside the areas of corporate finance, tax and transaction related services, the impact of the proposed extension of the prohibition to all non-audit services is small. The main impact of the proposals would therefore result from the change in definition. The adverse effect of these changes that might affect private companies as suggested by some respondents is mitigated by allowing abort fees as proposed in the consultation paper.

#### *Conflicts of interest*

- 5.20 In the July 2010 consultation paper the APB sought respondents' views on whether to recognise the impact of relationships with connected parties more overtly in the Ethical Standards through:
- Defining the audited entity's connected parties.
  - Including a paragraph on conflicts in the discussion of integrity in ES 1 (Revised);
  - Including additional guidance on the threats arising from conflicts of interest;
  - Including services to connected parties and services to third parties in respect of the audited entity in the definition of non-audit services.
- 5.21 There is broad recognition by all stakeholders that connected parties can present a threat to auditor independence and therefore the auditor should consider this issue when making their assessment of threats to independence and objectivity. However, the proposed definition of connected parties included a category of persons with an ability to influence the audited entity, its affiliates or its management. This led many respondents to raise concerns that this would be likely to require costly and complex systems and procedures to be maintained in order to identify such connected parties and to gather non-audit services information for such parties. A quarter of respondents expressing a view supported the suggestion that this definition should refer to related parties rather than the formula used in part (c) of the definition of connected parties.

- 5.22 The APB recognises that this is a difficult practical issue. It has proved challenging to extend all the requirements of the Ethical Standards that apply to services provided directly to the audited entity to services provided to connected parties in respect of the entity without giving rise to unintended bureaucracy. The APB has concluded that the costs associated with proactively identifying all connected parties are disproportionate to the benefits achieved and has therefore removed any provisions that create a requirement for comprehensive identification and data gathering in relation to them.
- 5.23 The APB believes that concerns about taking connected parties into consideration when assessing the threats to auditor independence should nonetheless be addressed. Guidance has therefore been added in the final version of ES 1 (Revised) at paragraph 37 to recognise that where there are known conflicts arising as a result of relationships with a connected party, these are reported to the audit engagement partner who then makes an assessment of the threats to independence and objectivity and the safeguards that are necessary to put in place. In this context the definition of connected parties has been retained.
- 5.24 This approach should result in a more proportional response to the issue than was originally proposed, whilst avoiding the excessive costs of a more comprehensive identification and data gathering regime.

## 6 Timing of implementation

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- 6.1 A December 2010 implementation date was proposed in order to progress amendments in respect of non-audit services as quickly as it would be practical to do so.
- 6.2 A majority of respondents from the profession believe that a longer implementation period will be required, although many of the concerns expressed relate to changes that would be required in order for the firms to develop systems to deal with issues arising from the proposals for discussions with the Ethics Partner where the ratio of non-audit to audit fees exceed 1:1 and to identify and gather data in relation to non-audit services provided to all connected parties (see above). The proposals in these two areas have been significantly modified in a way that should address these concerns.
- 6.3 Many of the changes now being made to the Ethical Standards have been subject to an extensive review that has been undertaken over a number of years. The APB is keen to complete this process quickly and believes that many of the objections to a December 2010 implementation date resulted from either a misunderstanding as to the nature of the proposed requirements or from concerns about implementing proposals in relation to the above mentioned matters that are now being addressed in a different way. Nevertheless, in the final standards the effective date has been amended to 30 April 2011, so as to enable firms time to implement the changes through guidance and training of partners and staff members.

## Appendix 1 - List of respondents

<b><i>Investors</i></b>	
Association of British Insurers British Private Equity and Venture Capital Association	Hermes Investment Management Association
<b><i>Corporate respondents</i></b>	
The 100 Group of Finance Directors British American Tobacco Confederation of British Industry Confidential 1 Compass Group London Stock Exchange	Pennon Group plc John Rennocks RSA Insurance Group plc SEGRO plc Travelport
<b><i>Accountancy profession</i></b>	
ACCA Baker Tilly Chartered Accountants Ireland Consultative Committee of Accountancy Bodies Charity Practitioners Forum Confidential 2 Deloitte LLP Ernst & Young LLP Grant Thornton UK LLP	Institute of Chartered Accountants in England and Wales Institute of Chartered Accountants of Scotland Kingston Smith LLP KPMG LLP London Society of Chartered Accountants Mazars LLP PKF PricewaterhouseCoopers (Ireland) PricewaterhouseCoopers LLP
<b><i>Other</i></b>	
Audit Commission Chartered Accountants Regulatory Board Chartered Institute of Internal Auditors	International Corporate Governance Network National Audit Office Wales Audit Office