

22 January 2010

Hazel O'Sullivan  
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The Auditing Practices Board Limited  
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Dear Ms. O'Sullivan

**CONSULTATION ON AUDIT FIRMS PROVIDING  
NON-AUDIT SERVICES TO LISTED COMPANIES THAT THEY AUDIT**

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £3.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that in 2008, IMA members managed holdings amounting to 43% of the domestic equity market.

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. We have an interest in the requirements governing the audit of companies' accounts and auditors' reports to our members as users and welcome this consultation on non-audit services. The consultation follows a Treasury Select Committee's recommendation<sup>1</sup> to determine whether there is support, especially from investors, for a prohibition on audit firms conducting non-audit work for the same company in order to enhance confidence and trust in audits.

Non-audit services can impair perception of auditor independence in that the significant revenues generated and the nature of the services can lead the auditor to identify himself with the interests of management rather than investors. In this

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<sup>1</sup> In May 2009 the Treasury Select Committee report called for the appropriateness of the provision of non-audit services by auditors to the entities that they audit to be revisited, saying: "We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity".

context, we welcome the trend noted in the consultation paper that the provision of non-audit services to listed audit clients has fallen significantly since 2002. It appears that the current regulatory framework around such services has generally been effective whereby the audit committee is responsible for policy, there are requirements on independence and disclosure, and certain services are prohibited. Thus we do not believe there needs to be an overhaul of current requirements but do consider that investor confidence would be enhanced by more detailed analysis of the nature of the non-audit services provided and the associated fees, and if audit committees reported on the reasons for commissioning such services. Moreover, there are certain specific situations where investors have had concerns that we consider could be addressed as set out below.

- When non-audit fees are significant and are a multiple of the audit fee. For example, Deloitte provided audit and a variety of non-audit services to MG Rover and its parent company, Phoenix Venture Holdings, and was auditor when the group collapsed in 2005. The then BERR's final report<sup>2</sup> into the collapse showed that from 2002 to 2005 Deloitte received £30.65 million in fees of which £28.75 million was for non-audit work. However, even at the peak in 2002, as these fees only made up 1.2 per cent of Deloitte's UK fee income, they were well within the limits in the ethical standards<sup>3</sup>.

Deloitte is currently being investigated by the Accountancy & Actuarial Discipline Board in relation to services provided to the group. This is yet to report but we consider that requirements in this area should be reviewed. At the least non-audit services beyond a certain threshold, say, where the associated fees are a multiple of the audit fee, should be formally approved by the audit committee in advance and, as noted above, there should be disclosure of the nature and rationale for the services provided, and of the associated fees.

- When conflicts of interest arise when the same firm provides both an audit and certain restructuring services to a company in distress. It would be difficult to provide sufficient safeguards to ensure that the auditor's decision on, say, going concern, could avoid being influenced when the firm has given substantive advice on restructuring the company, on the company's debt when its covenants are close to breach or when the company's survival is otherwise in doubt. A number of investors consider that the Ethical Standards should ban a company's auditor from carrying out restructuring services in such a situation.

Other investors, however, consider that in providing such services auditors' awareness of the need for objectivity in assessing the entity's going concern can be enhanced<sup>4</sup> and as the need for restructuring services can be urgent, often the existing auditor can be best placed to assist. As opposed to such services being prohibited, they would like to see more meaningful disclosures so that they can make informed decisions.

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<sup>2</sup> <http://www.berr.gov.uk/files/file52783.pdf>, page 681

<sup>3</sup> Ethical Standard 4 only requires the firm to resign when it is expected that the fees for both audit and non-audit services from a non-listed audited entity exceed 15 per cent of the firm's annual fee income (for a listed entity the limit is 10 per cent).

<sup>4</sup> Auditing Practices Board's Bulletin 2008/10, Going Concern Issues During the Current Economic Conditions sets out such safeguards in paragraphs 52 to 54.

- The provision of both internal and external audit services. For example, until this year Rentokil had one audit firm as external auditors and another for much of the internal audit work. When new external auditors were appointed they took on internal audit work alongside Rentokil's own internal team. We understand that this resulted in a reduction of the external and internal auditors' fees by £1 million, or almost a third, a year and that other companies have looked into such arrangements.

We are concerned that this could mean that Rentokil's auditors are in effect auditing their own internal work and taking on management functions. Although paragraph 44 of ES 5 prohibits the provision of internal and external audit services in certain circumstances, this situation indicates that this may need to be strengthened. In addition, we believe there should be better disclosure by audit committees on why they consider such an arrangement is of benefit to the company and its overall control environment.

Set out in the attached are our observations on the specific questions raised. Please do contact me if you would like clarification on any of the points in this letter or the attached, or if you would like to discuss any issues further.

Yours sincerely



Liz Murrall  
Director  
Corporate Governance and Reporting

**IMA RESPONSE TO APB CONSULTATION PAPER – AUDIT FIRMS PROVIDING NON - AUDIT SERVICES TO LISTED COMPANIES THAT THEY AUDIT**

IMA's answers to the specific questions raised are set out below.

**In respect of listed companies**

1. **(a) Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?**
1. **(b) Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have affected audit quality?**

Non-audit services can impair perception of the auditors' independence in that the significant revenues generated and the nature of the services may lead the auditor to identify himself with the interests of management rather than investors. This is particularly the case when the fees for non-audit services become significant as compared to the audit fee and when the relationship between the client and the auditor becomes too close such that the latter's impartiality is affected. Thus it is important that such services are regulated and, although the current regulatory framework has generally been effective and does not need to be radically changed, we believe certain specific situations where investors have had concerns could be addressed.

2. **If you do consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors please identify which non-audit services are of concern. Please give the reasons for your view.**

Ethical Standard 4 requires the firm to resign when it is expected that the fees for both audit and non-audit services from a non-listed audited entity exceed 15 per cent of the firm's annual fee income (for a listed entity the limit is 10 per cent). However, when the non-audit fees are significant and a multiple of the audit fee then we believe this could impact the auditors' objectivity.

For example, Deloitte provided audit and a variety of non-audit services to MG Rover and its parent company, Phoenix Venture Holdings, and was auditor when the group collapsed in 2005. The collapse was investigated and the final report from the then BERR shows that from 2002 to 2005 Deloitte received £30.65 million in fees of which £28.75 million were for non-audit work. Deloitte is currently being investigated by the Accountancy & Actuarial Discipline Board (AADB), the independent, investigative and disciplinary body for accountants and actuaries in the UK, in relation to services provided to the group. The AADB is yet to report but even at the peak in 2002, Deloitte's fees only made up 1.2 per cent of its UK income and were well within the limits set in the Ethical Standard.

Another situation that gives a number of investors concern is when the same firm provides both an audit and a restructuring service to a company in distress. It would be difficult to provide sufficient safeguards to ensure that the auditor's decision on say, going concern, could avoid being influenced when the firm has given substantive advice on restructuring a company, on the company's debt when its covenants are close to breach, or when the company's survival is otherwise in doubt.

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Lastly, there were concerns when Rentokil's new external auditors took on internal audit work alongside Rentokil's own internal team - previously, one major firm did the external work and another much of the internal audit. We understand the new arrangements resulted in a reduction of the external and internal auditors' fees by £1 million, or almost a third, a year. There are concerns that Rentokil's auditors are in effect auditing their own internal work and have taken on management functions.

**3. In the light of your answers to questions 1 and 2, do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit? Please give reasons for your view.**

We consider the current regulatory framework around such services whereby the audit committee is responsible for policy, there are requirements on independence and disclosure, and certain services are prohibited, has generally been effective. We welcome the trend noted in the consultation paper that the provision of non-audit services to listed audit clients has fallen significantly since 2002 and do not believe there needs to be a radical overall of the current requirements but do consider that investor confidence would be enhanced by more detailed analysis of the nature of the non-audit services provided and the associated fees, and if audit committees reported on the reasons for commissioning such services. Moreover, there are certain specific situations where investors have had concerns that we consider could be addressed - as set out in this response.

**4. If you think that there should be change in the current arrangements, would you advocate:**

- **Complete or more extensive prohibitions on the provision of non-audit services by accounting firms to their audit clients within the Ethical Standards for Auditors;**

IMA does not support a complete prohibition of non-audit services but supports them being restricted and the existing framework of control and disclosure, and prohibition of specific services. In particular, as well as the threat certain non-audit services can pose to the audit, providing such services to audit clients can lead to cross-subsidisation and underbidding for "foot in the door" opportunities. This can create a barrier for smaller firms that do not have the capacity to provide such a wide range of services and restrict the development of the audit market, and competition and choice.

Moreover, as noted, we consider there are certain non-audit services where investors have had concerns which could be addressed as set out below.

- Where the same firm provides both an audit and a restructuring service to a company in distress, a number of investors consider Ethical Standards should ban a company's auditor from carrying out restructuring services in such situations. Other investors, however, consider that in providing such services auditors' awareness of the need for objectivity in assessing the entity's going concern can

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be enhanced and as the need for restructuring services can be urgent, often the existing auditor can be best placed to assist. As opposed to such services being prohibited, they would like to see more meaningful disclosures so that they can make informed decisions.

- Where non-audit fees are significant and a multiple of the audit fee - the Ethical Standards only address the situation when the total fees (audit and non-audit) from a particular client became too large a proportion of the income of the firm as a whole<sup>5</sup>. We consider that these requirements should be reviewed. At the least, non-audit services beyond a certain threshold, say, when the fees are a certain multiple of the audit fee so that it changes with inflation and avoids the need for regulations to be regularly updated, should be approved in advance by the audit committee and there should be more detailed disclosures to investors.

- **The imposition of other requirements through the Ethical Standards for Auditors (and if so which);**

We consider the existing ethical standards could be clearer and easier to understand – particularly in explaining the different types of non-audit services that exist and why it can make sense to obtain the service from the audit firm.

- **More active corporate governance – e.g. so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee;**

As regards corporate governance, the Combined Code provides for the following:

- Code provision C.3.2 that the Audit Committee develops and implements a policy on the auditor supplying non-audit services, taking into account relevant ethical guidance, and reports to the board, identifying any matters in respect of which it considers that action or improvement is needed and makes recommendations as to the steps to be taken.
- Code provision C.3.7 that the annual report explains to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

We support these provisions and note that no changes are proposed in the FRC's latest consultation on Code amendments. In this context, Rentokil's approach to the provision of internal audit services by its external auditor appeared to be driven by cost considerations. This was a concern, particularly as we understand that there was interest in the service from other companies. In such situations, we believe there should be better disclosure by audit committees on why they consider such an arrangement is of benefit to the company and its overall control environment. See also comment above on pre-approval by the audit committee when fees are a certain multiple of the audit fee.

- **Better (and more extensive) disclosure in financial statements.**

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<sup>5</sup> Paragraphs 25 to 34 of Ethical Standard 4.

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Existing rules on disclosure broadly cover the fees payable for the company's audit, fees payable for other services, including fees for the audit of subsidiaries, and separate disclosure in respect of specified categories. This has led to complex disclosures, and requirements could be improved and the information disclosed made clearer.

- 5. In setting the standards relating to auditor independence, do you believe regard should be had to the perceived benefits that are derived by companies from the provision of non-audit services by their auditors? If your answer is yes, please provide specific examples of these benefits and indicate the magnitude of any cost savings that arise.**

We consider the standards relating to auditor independence are important and whilst there may be benefits in the provision of non-audit services for the effectiveness and efficiency of the audit, these benefits should not compromise the standards on independence.

- 6. Are there any other views that you would like the APB to take into account?**

IMA has no other observations to make.