

25 January 2010

**For the attention of Hazel O'Sullivan**  
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Our ref: mjs/tp25.01

Dear Sirs

### **Consultation on audit firms providing non-audit services to listed companies that they audit**

We submit for your attention our response to your consultation paper on the provision of non-audit services by audit firms to their listed audit clients. Before addressing the specific questions posed in the consultation paper, we believe that there are a number of other issues which also need to be raised.

#### **The background to the consultation**

The issue of the consultation paper follows on from the recommendation in the Treasury Select Committee Report on the banking crisis (the McFall Report) that the Financial Reporting Council should consult on whether audit firms should be able to provide non-audit services to their audit clients. Indeed, the report expressed the view that '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'. Indeed, this comment was couched more widely than the current consultation, by implying that non-audit services should not be provided to *any* audit clients regardless of industry or public accountability.

This statement appears, for the most part, to have been based on views from certain parts of the institutional investor community and certain other commentators who believe that audit independence *may* be compromised by the provision of non-audit services. As will be clear from our response to the consultation, we do not agree with this viewpoint; indeed, we believe that the current regime – which includes, but is not limited to, the Ethical Standards for Auditors – already comprehensively addresses any potential risks arising from the provision of non-audit services. The perception referred to above is, in fact, a misperception.

Specifically, the concerns expressed by institutional investors and referred to in the consultation paper are that some believe that the nature of certain non-audit services increases the risk of the views of the auditor being too closely aligned with management; that the more significant the non-audit services the greater the risk the auditor will not challenge management's views sufficiently robustly; and that auditors cannot themselves assess objectively whether a particular non-audit service gives rise to threats and apply suitable safeguards. Of these points, the first two are, in our view, already dealt with by the existing prohibitions in, and principles of, the Ethical Standards,

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including the requirement to apply safeguards. This includes dealing with the threat that the auditor may take on a management role, and with potential threats from economic dependence or from contingent fee arrangements; these also address the 'self interest threat' which appears to be the main concern in respect of the second point. The whole thrust of the Ethical Standards involves recognising that potential or perceived threats to independence and objectivity may arise, but can either be addressed by applying appropriate safeguards, or cannot be in which case the auditor must either not provide the non-audit service, or must resign. Indeed, the strength of the Ethical Standards is that they are, for the most part, based on principles rather than set rules, and proper application of 'substance over form' compliance with the Standards ensures that they work effectively and as they are designed to do.

The misperception that auditors cannot themselves assess objectively whether a particular non-audit service gives rise to threats and apply suitable safeguards, appears to attempt to undermine the Ethical Standards by implying that they cannot be effective and indeed that auditors are not capable of behaving in accordance with the fundamental principle of objectivity – this is clearly not the case. We would also stress that whilst the Ethical Standards, as currently drafted, are robust, they do not exist in isolation but as part of an integrated framework which includes the Combined Code and the Smith Guidance, as well as monitoring of the profession by the Professional Oversight Board and the Audit Inspection Unit. Whilst the initial assessment is down to the auditor, these other elements of the framework can and do play an important part in ensuring that auditors' assessment of threats and safeguards are acceptable.

Finally, we would note that your consultation paper itself notes that the views expressed by institutional investors and other commentators are based on 'perceptions and opinions' and not on any track record linking audit failure with a lack of independence arising from the provision of non-audit services. Indeed, what research has been conducted does not demonstrate any such link and we have referred to this further below. The entire consultation appears to be driven by the perceptions of certain sections of the institutional investor community, rather than based on any evidence of actual issues with the current regime (i.e. the application of the Ethical Standards, taken together with corporate governance requirements and the oversight of the POB and AIU). A perception – indeed a *misperception*- of a lack of independence is not the same as an actual lack of independence and we would again argue that the current regime already comprehensively addresses the issue.

### **Definition of a listed company**

At this stage, the consultation discusses only the question of the provision of non-audit services to listed audit clients. However, the term 'listed company' is not defined in the consultation paper. The lack of any specific definition would appear to indicate that the consultation paper is intended to apply to all entities that would be defined as 'listed' in the current versions of the Ethical Standards – i.e. not just those companies listed on the main London Stock Exchange, but also those traded on the Alternative Investment Market or Plus Markets. Many such companies are very small and simply do not have the same public profile or level of public accountability as larger listed companies or banks; such companies pose no systemic risk whatsoever to the conduct of audit. Any additional prohibitions introduced as a result of this consultation therefore risk causing additional difficulties for such companies (at a time when many can ill afford it) with no benefit to the conduct of audit as a result.

### **Issues on which you have specifically sought comment**

We have set out below our responses to the specific questions on which you are seeking feedback.

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?***  
***(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 adversely affected audit quality?***

In answer to question 1(a) there are two issues here – firstly whether anyone's confidence in the independence of auditors has been impacted, and secondly whether or not this is justified.

It is clear from the McFall report and indeed from the consultation paper itself that there is a *perception* in the institutional investor community that provision of non-audit services by audit firms to their audit clients impairs their independence – and that this has consequently impacted the institutional investor community's confidence in that independence. However, this community, whilst undoubtedly a significant stakeholder in the UK's major businesses, is not their only stakeholder. The directors, both executive and non-executive, of those companies, as well as their non-institutional shareholders, are also stakeholders. There does not appear to be any reason to believe that there is a loss of confidence by boards of directors, or indeed by audit committees, in auditor independence. Indeed, the audit committee acts as a check on any actual or perceived issues, and the auditor is required to inform those charged with governance of any potential issues as part of compliance with the Ethical Standards.

Furthermore, we understand that research conducted by the AIU shows no evidence of provision of non-audit services detracting from audit quality; additionally, recent research set out in 'Briefing: the Impact of Changes to the Non-Audit Services Regime on Finance Directors, Audit Committee Chairs and Audit Partners of UK Listed Companies' also states that the current regime has '*contributed significantly to reducing the perceived risk to auditor independence arising from high levels of NAS provision. It is not obvious from our research that a total ban is needed. Furthermore, the already emerging unintended consequences to the efficiency and effectiveness of the financial reporting process arising from the existing restrictions on NAS delivery are likely to be exacerbated by a total ban or by further restriction on NAS provision*'.

In other words, the Ethical Standards are doing their job, whilst being already more restrictive than is perhaps ideal – and bearing in mind both this and the research referred to, there appears to be no evidence that any change to the status quo is required. Indeed, any change which introduces further restrictions would be counterproductive.

Finally, as acknowledged in the consultation paper, clients perceive that the provision of non-audit services by audit firms is beneficial because the audit firm is already in a position of knowledge about the client and how it operates. This not only makes the process of providing the services more efficient but has clear cost benefits to the client. We discuss this point further in our response to question 5.

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.***

As noted above, any impact on confidence in the independence of auditors as a result of the provision of non-audit services appears to be driven by certain parts of the institutional investor community and potentially, limited to them and certain other parties such as regulators. Given that the call from the institutional investor community and the Treasury Select Committee Report appears to be to prohibit all non-audit services for (as a minimum) banking entities, it is not possible to identify which services are of most concern and it will be the responses of the investor community itself which will be of most relevance in this respect. However, as noted above this is a perception which does not appear to be shared by listed companies themselves or indeed by their auditors.

Clearly, in applying the Ethical Standards, certain projects or services may require more judgement in determining whether there is an actual or potential threat to audit independence – for instance tax advisory work or transaction services work in certain circumstances. However, in each

circumstance the potential threats will vary and will depend on the details of the project in question. It is not therefore possible to state definitively that a particular type of transaction services work is of more concern than another type, and in any case those types of non-audit service of most concern (for instance accounts preparation work for listed companies, save in case of dire emergency) have already been prohibited by the current Ethical Standards. Maintenance of a principles-based approach, rather than increasing general prohibitions or introducing a total prohibition on non-audit services, is essential so that the circumstances of each situation and each specific non-audit service can be taken into account.

**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 the APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit?**

We do not believe that there needs to be a change in the approach taken by the APB to the setting of standards relating to the provision of non-audit services. As noted above, we believe that a principles-based set of Ethical Standards must be retained, rather than introducing additional or even total prohibitions on non-audit services. The Ethical Standards are *not*, to our mind, fundamentally flawed which is what this question appears to be implying.

Rather, the Ethical Standards, as currently drafted, already constitute a robust set of principles; they have already restricted the types of non-audit work that an audit firm can perform for its audit clients and ensured that suitable safeguards are put in place for other types of work to address any potential or perceived threat. They allow audit firms to apply safeguards which are appropriate to them and tailored to the particular circumstances of the situation.

The Ethical Standards also take into account the fundamental principles of the ICAEW code of ethics and in particular the objectivity of the auditor. They presume that auditors are generally objective and address situations where, for whatever reason, that objectivity may be perceived to be threatened – and provide guidance on suitable safeguards. The view of a few individuals representing the institutional investor community that auditors cannot possibly be sufficiently objective to decide what constitutes a sufficient safeguard to mitigate threats to independence, is a misperception rather than a reality. The Ethical Standards manage to bridge the gap of acknowledging that there may be threats to independence and objectivity whilst crediting that auditor with sufficient integrity to deal with them in an ethical fashion.

**4. If you think that there should be a 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;**
- **The imposition of other requirements through the Ethical Standards for Auditors;**
- **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;**
- **Better (and more extensive) disclosure in financial statements.**

As noted above, we do not believe that there is any need for a change in the current arrangements. The Ethical Standards are, when properly applied in accordance with the substance of the principles on which they are based, already adequate for the purpose for which they were drafted. We would not therefore favour any additional prohibitions or other requirements within the Ethical Standards as we do not believe that any such prohibitions are necessary.

As regards disclosure in financial statements, we believe that the requirements of company law to disclose details of auditors' remuneration and provide specific details in respect of the quantum of

different types of non-audit services is already adequate. Additional disclosures would not enhance the quality of the financial statements and might lead to the information that is of importance to the users of the accounts in this respect – including the institutional investor community – being lost in the detail.

The suggestion of introducing more active corporate governance is interesting. Although we do not believe that it is necessary, we can see that this might be a potential way in which even those few individuals representing the institutional investor community could be satisfied that sufficient consideration had been made by those charged with governance of potential independence issues, without the need for any increased prohibitions on the types of non-audit services that auditors could perform. One possibility would be if approval of the audit committee was required in advance of agreeing an engagement for the provision of non-audit services where the fee for the non-audit services was in excess of a certain percentage of the audit fee, or in the event of a contingent fee arrangement for those non-audit services.

If this was incorporated in a separate regulatory document, rather than in the Ethical Standards for Auditors, then its application could be restricted – for instance only to those companies to which the Combined Code applies i.e. those listed on the London Stock Exchange and where the focus of the institutional investor community is strongest. It would therefore not need to be applied to companies listed on Plus or on the Alternative Investment Market which are less of a concern to that community, and which would be required to comply if such a provision was included in the Ethical Standards, given that the definition of 'listed company' in the Ethical Standards includes such companies.

Aside from this, we also believe it would be helpful if the Smith Guidance could once more be drawn to the attention of audit committees.

**5. *In setting the standards relating to auditor independence, do you believe regard should be had to the potential 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 believe very strongly that regard should be had to the benefits that companies derive from the provision of non-audit services by their auditors and that there is no doubt that such benefits exist. We would argue that the provision of non-audit services leads to a better rather than a worse audit, due to the enhanced knowledge of the client obtained from provision of such services; a rounded rather than an audit-centric perspective enables the firm to provide clients with the best possible advice, and enables the client to benefit from that advice.

A good example is the provision by the auditor of tax services, which in our view clearly impacts favourably on audit quality. As part of the audit, the auditor has to form judgements about their client's tax affairs, and by far the most efficient way of doing this is where the audit team and the firm's tax specialists are able to pool their knowledge and resources (obviously also applying suitable safeguards as required by the Ethical Standards) in a way that is not possible where two different firms are used. We believe that an enforced separation of audit and taxation services would be highly detrimental to audit quality, and indeed could well lead to an increased likelihood that more financial statements would need to be restated due to error.

Furthermore, enforced separation of non-audit services – particularly in some areas of which preparation of the corporation tax computations is one – would undoubtedly lead to increased costs for firms providing the non-audit services in order to obtain the necessary knowledge of the client, and therefore inevitably lead to increased costs for the clients.

Finally, the provision of non-audit services is viewed by clients of all sizes as an efficient, integral and valuable part of the overall management of their business. To prohibit all companies, or even certain types of companies such as listed companies, from benefiting from the provision of an integrated professional service because of a *misperception* that independence is affected as a result, is to our mind both unnecessary and damaging; a recession is not the time to introduce

additional, and unjustified, prohibitions which will adversely impact companies both financially and in terms of the audit and non-audit service quality that they receive.

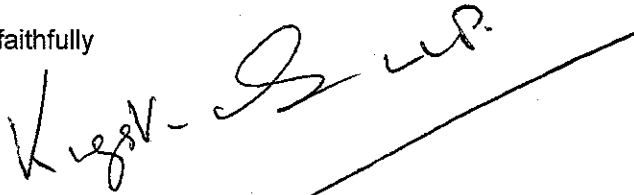
**6. Are there any other views that you would like the APB to take into account?**

In considering the responses to the consultation paper, we believe that it is vital that a broad range of views is taken into account. This should include the views of all of the investor community, not just a few vociferous individuals representative of institutional investors, and should also include the views of companies, both those that are listed and those that are not, and of their auditors – both those that deal with the larger listed companies on a regular basis, and those that do not. It is essential that a balanced view is taken and that misperceptions arising out of the banking crisis – being recent events which have affected a small number of companies in a highly specialised industry – are not given undue weight when considering how the results of the consultation are applied to companies in other industries or which do not have the same level of public accountability. It may be necessary to recognise that companies in the banking industry are affected by different issues and considerations from other commercial companies, although we do not believe that any additional prohibitions in respect of non-audit services are required for such companies.

We also do not believe that introducing a prohibition on the provision of non-audit services to listed companies would necessarily enhance audit choice or enable mid tier firms to increase their exposure to the larger listed companies. A prohibition from a FTSE 100 company's Big Four auditor performing tax compliance work for them does not mean that the company will look to the mid tier for such work; it is probably more likely that the company will look to another of the large firms. This is perhaps particularly likely in respect of companies in the banking and financial services industries where it will be very difficult for mid tier firms to obtain such work – particularly in the case of audit – because of lack of prior experience of such work.

We believe that it is essential that the Auditing Practices Board support the Ethical Standards for Auditors, and the principles underpinning them, robustly. Whilst acknowledging that there may be a *misperception* among certain elements of the investor community that provision of non-audit services affects auditor independence, the *reality* is that in the vast majority of cases it does not, regardless of the size or public profile of the client. The Ethical Standards already provide a coherent and effective mechanism for ensuring that the provision of non-audit services does not compromise auditor independence, which is based on a set of principles rather than rigid rules, and we believe that this constitutes the most effective mechanism, currently and in the future, for ensuring that auditors and their clients are aware of any potential issues arising from the provision of non-audit services and can deal with them in an appropriate fashion which does not compromise their independence. Any additional regulation on the provision of non-audit services must be driven only by any reality of actual events or problems experienced as a result of the provision of non-audit services, and not as a knee-jerk reaction to misperceptions and misinformation as a result of events which have affected a highly specialised industry.

Yours faithfully



KINGSTON SMITH LLP