

***APB Ethical Standards***

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

**Feedback on Previous Consultations**

**and**

**Consultation Paper on Revised Draft  
Ethical Standards for Auditors**

**July 2010**

**The Auditing Practices  
Board**



## **THE AUDITING PRACTICES BOARD**

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and the Republic of Ireland:

- standards and guidance for auditing;
- standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- standards and guidance for the work of reporting accountants in connection with investment circulars; and
- standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence,

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The APB comprises individuals who are eligible for appointment as company auditors, and those who are not so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

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# Feedback on Previous Consultations

## Consultation Paper on Revised Draft Ethical Standards for Auditors

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<i>Contents</i>	<i>Page</i>
Invitation to comment	5
1 Background	6
2 Feedback on Consultation on Audit Firms Providing Non-Audit Services to Listed Companies that they Audit	9
3 Further research	16
4 Addressing perception through improved transparency and governance	20
5 Specific proposed amendments to APB Ethical Standards for Auditors	25
6 Restructuring services	33
7 Contingent fees	39
8 Conflicts of interest in providing non-audit services	43
9 Questions on which the APB seeks views	47
Exposure Draft of Revisions to APB Ethical Standards for Auditors	49
• ES 1 (Revised) - Integrity, objectivity and independence	50
• Extracts from ES 2 (Revised) - Financial, business, employment and personal relationships	81
• Extracts from ES 4 (Revised) - Fees, remuneration and evaluation policies, litigation, gifts and hospitality	84
• ES 5 (Revised) - Non-audit services provided to audited entities	90

• Extracts from ES - Provisions Available for Small Entities (Revised)	150
• Extracts from Glossary of terms	154
Appendix 1 – List of respondents to Consultation on Audit Firms Providing Non-audit Services to Listed Companies that they Audit	157
Appendix 2 – Summary of responses to questions in the October 2009 Consultation Paper and analysis of positions taken by respondents	160
Appendix 3 – Proposed amendment to FRC Guidance on Audit Committees	169

## Invitation to Comment

The APB is issuing for public comment an exposure draft of a number of revisions to their Ethical Standards for Auditors together with some options on other revisions. These draft revisions and options are shown as mark-up amendments to the current standards which were issued in April 2008.

To assist commentators in appreciating the context for its work and the revisions proposed to the Ethical Standards for Auditors, the APB has prepared this Feedback and Consultation Paper to set out the main issues considered in reviewing the Ethical Standards for Auditors and the approach taken to each of them.

The APB would welcome responses to the specific questions set out in the Consultation Paper and on any other aspects of the Exposure Draft. It would be most helpful if respondents could refer to the relevant paragraphs and give full reasons for their views.

The APB would prefer to receive letters of comment in electronic form. These may be sent by e-mail to [h.osullivan@frc-apb.org.uk](mailto:h.osullivan@frc-apb.org.uk). If this is not possible, please send letters of comment to:

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In either case, letters of comment should be sent so as to be received no later than **23<sup>rd</sup> October 2010**.

All comments will be regarded as being on the public record, unless otherwise requested.

# 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. That Consultation Paper provided an analysis of the approach that has been taken to auditor independence since 2004 when the APB was given responsibility for setting ethical standards for auditors.
- 1.2 This Feedback and Consultation Paper gives a summary of the responses that were received to the October 2009 consultation. It also sets out explanations in relation to:
- amendments that the APB proposes to make to the APB Ethical Standards for Auditors;
  - amendments that the FRC is proposing to their Guidance on Audit Committees; and
  - the following issues on which further consultation is being sought:
    - Restructuring services provided to audited entities in distress;
    - The approach to take to contingent fees, given a proposed amendment in the definition of a contingent fee;
    - Additional guidance paragraphs on conflicts of interest in providing non-audit services to audited entities and the approach to take to connected parties.
- 1.3 Some of the proposed amendments arise directly from feedback from the respondents to the consultation on non-audit services while other amendments relate to other aspects of the work of the APB and the FRC, including:
- Issues arising since the consultation was launched which the APB considers require further action to be taken.
  - Issues raised by the FRC's Audit Inspection Unit (AIU) reports on audit quality inspections.
  - Outstanding issues relating to changes to the APB Ethical Standards consulted on in the APB's March 2009 Consultation Paper. The APB decided to defer these changes pending responses to the October 2009 Consultation Paper on non-audit services so as to avoid the implementation problems that arise from frequent changes to the APB Ethical Standards for relatively detailed matters.

- 1.4 As the Treasury Select Committee made its recommendation in the context of investor confidence, the October 2009 Consultation Paper focused primarily on the provision of non-audit services to listed companies. The APB has considered the position of all entities subject to audit when drafting the proposed amendments and has asked a question where it might be appropriate to restrict an amendment to listed companies only.
- 1.5 The APB has also specifically considered how the proposed amendments might be implemented in the case of smaller entity audits. Where an exemption in ES Provisions Available for Small Entities (Revised) (ES – PASE (Revised)) might be appropriate, this is indicated in this consultation paper and in the extracts from ES – PASE (Revised) which are included in the Exposure Draft. The APB will also be interested to receive views on the appropriateness of the proposed additional exemptions and to understand the experience of the SME sector in connection with the other issues on which further consultation is being sought, in particular restructuring services provided to an ‘audited entity in distress’ and ‘connected parties’.
- 1.6 This Consultation Paper follows two previous consultations in the course of which commentators were asked to comment on whether the costs that might arise from the proposals under discussion would outweigh the benefits of those proposals. Whilst many corporate commentators drew attention to a general concern that costs of non-audit services to companies might increase if auditors were to be prohibited from providing some or all of the non-audit services that are currently permitted, no commentators thought that the costs of the approaches that the APB discussed in the October 2009 consultation and those approaches the APB is adopting in this consultation paper would be such as to outweigh the benefits. This is primarily because the APB's approach has been to address the concerns expressed in relation to non-audit services by improving transparency and the reporting of information about such services. Most other proposed amendments are aimed at clarifying the existing position (e.g. by improving definitions, removing potential for misinterpretation etc.) or implementing changes relating to the policies and procedures to be applied by audit firms. The APB does not therefore believe that the amendments that flow out of the two previous consultations will have a significant impact on the costs of an audit (or the costs borne by preparers).
- 1.7 In relation to the three issues referred to in the third bullet of paragraph 1.2 and on which further consultation is being sought, the APB is keen to understand the impact which each of the different options may have on the costs of an audit and other costs to business and the benefits which commentators believe will arise from their implementation. In particular, the APB is interested to know the precise nature and extent of

any incremental costs which might arise from switching the provision of specific types of non-audit service from the auditor to a provider who is not. Feedback on such information will be provided following the consultation when any relevant amendments to the APB Ethical Standards are finalised.

- 1.8 The APB plans that any changes to the APB Ethical Standards as a result of this review will apply to audits of financial statements for periods commencing on or after 15 December 2010. As the consultation period will run until towards the end of October 2010, it may prove challenging to achieve this timetable. However, many of the amendments will not involve a significant change in practice and, in view of the transition arrangements that are proposed, the APB does not anticipate that there should be any problems with implementation of the proposed revisions. If the final standards are published after the effective date, those provisions associated with issues under consultation (see paragraph 1.2 above) will not come into effect until the date of publication.
- 1.9 The APB invites responses to the questions set out in section 9. It would be most helpful if respondents give full reasons for their views. The APB would prefer to receive letters of comment in electronic form. These may be sent by e-mail to [h.osullivan@frc-apb.org.uk](mailto:h.osullivan@frc-apb.org.uk). If this is not possible, please send letters of comment to:

**Hazel O'Sullivan**  
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**71-91 Aldwych**  
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In either case, letters of comment should be sent so as to be received no later than *23rd October 2010*.

- 1.10 All comments will be regarded as being on the public record and will be published on the APB's website within seven days of receipt, unless you specifically request that your response be treated as confidential.

## 2 Feedback on Consultation on Audit Firms Providing Non-Audit Services to Listed Companies that they Audit

### *Summary of responses*

2.1 Responses to the October 2009 consultation were received from 150 commentators representing a wide variety of stakeholder groups as shown below.

Institutional investors <sup>1</sup> :	
• Asset managers and investment trusts <sup>2</sup>	4
• Pension fund	1
• Representative organisations	4
Corporate sector:	
• Companies	79
• Audit committee chairs and other directors of corporate entities	26
• Representative organisations	4
Accountancy profession:	
• Audit service providers	16
• Representative organisations	8
Other individuals and organisations (largely consultants and academics)	<u>8</u>
Total	150

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

2.2 The APB sought the views of stakeholders by asking a number of questions in the Consultation Paper. A summary of the responses to these questions and an analysis of overall positions taken by respondents are provided in Appendix 2 to this Feedback Paper. An overall summary of the responses is given below.

2.3 When the Treasury Select Committee made its recommendation to review the appropriateness of the provision of non-audit services by auditors to the entities that they audit, it expressed its view particularly

<sup>1</sup> Responses in this category were those that were submitted from an investor perspective. Responses were also received from a number of banks and insurance companies but were drafted from an audit committee or company perspective and were accordingly classified as 'companies' for the purposes of this paper.

<sup>2</sup> One response in this group confirmed that its response had the express support of eight funds to which it provides stewardship services.

in the context of investor confidence<sup>3</sup>. The APB has established relationships with investors and those bodies that represent investors – the ABI, NAPF and IMA in particular. In the course of this consultation, substantive responses have been received from investors and investor representative bodies and those responses have been carefully reviewed. In the course of its review of the responses, the APB also noted the unprecedented response received by or on behalf of corporate entities (including chairs of audit committees).

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

2.4 The message from the review undertaken by the APB is 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.

*'... we believe that the recent evolution of UK company law, the Ethical Standards for Auditors issued by the APB and the FRC's Combined Code on Corporate Governance with its supporting Guidance on Audit Committees provide a generally robust framework for the assessment of the independence of a company's external audit. In particular, by specifically prohibiting non-audit services in certain situations, ES 5 ... captures those conflicts of interest that are most likely to degrade the quality of the audit and confidence in the independence of the external auditor.'*

*Investor respondent*

*'The current ethical requirements for auditors coupled with the guidance for audit committees results in a system where both auditors and audited entity are cognisant of the issues that could give rise to a reduction in independence and act appropriately to avoid any such issues arising in practice.'*

*Corporate respondent*

*'The Consultation Paper usefully summarises the various measures that have been established in the 'post-Enron' era aimed at improving audit quality, safeguarding auditor independence, and establishing new governance measures for companies and, in particular, audit committees. Such measures have included the establishment of independent auditor oversight structures in Ireland and the UK and independent monitoring of auditors of public interest entities. We believe that these initiatives have contributed significantly to the maintenance of high quality and robust*

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<sup>3</sup> The text of the recommendation from the report 'Banking Crisis: reforming corporate governance and pay in the City' read:

*"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".*

*audits of listed entities and we are not aware of any systemic threats to auditor independence, including situations where non-audit services are provided, that have been identified or highlighted in recent reports from these oversight bodies.'*

*Accountancy profession respondent*

- 2.5 There are two key elements to the current framework surrounding the provision of non-audit services:
- (i) The Ethical Standards issued by the APB, under which:
    - All services provided by the auditor (other than the audit itself) are regarded as non-audit services (no matter how directly related to or consequential upon the audit they may be);
    - Where a potential non-audit service engagement poses actual or potential threats (that are not clearly insignificant) to the objectivity and independence of the auditor, safeguards must be identified to reduce the threats to an acceptable level or the engagement should be declined (an overarching principle); and
    - Certain non-audit services are prohibited on the basis that the threats that arise are too significant to be overcome by any safeguards.
  - (ii) A corporate governance regime under which:
    - those charged with corporate governance are expected to assess the objectivity and independence of the company's auditor annually;
    - the annual report is expected to explain how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded<sup>4</sup>.
    - data about the fees paid by a company to its auditor in relation to non-audit service engagements are disclosed in a company's annual report; and
    - investors are expected to monitor and challenge the work of those charged with governance in respect of maintaining an appropriate relationship with the company's auditor.

- 2.6 There were three commentators (an investor respondent, an academic and an MP) who argued that audit quality is compromised in both fact and perception when the auditor carries out any non-audit service. This was argued primarily on the basis that any reward for additional work compromises the likelihood that auditors will confront the directors of an audited company on difficult issues.

*'The sale of other services creates fee dependency and forces auditors to align their interests with those of the audit clients'*

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<sup>4</sup> Provision C3.7 of the UK Corporate Governance Code, published in May 2010.

*Other respondent*

- 2.7 In contrast, as set out in paragraph 2.4, the vast majority of commentators see no evidence that audit quality is, as a matter of fact, compromised by non-audit services engagements, given the safeguards approach and specific prohibitions which are set out in the APB Ethical Standards for Auditors.
- 2.8 Among respondents not asking for a change in the current approach there is, however, broad acknowledgement that there is a perception amongst investors that confidence in the audit can be reduced 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 an entity's auditor. It is thought that one reason for the focus on such a ratio is that companies give insufficient disclosure in their annual reports of non-audit services provided by the auditor to enable investors to decide for themselves whether the auditor's objectivity and independence may have been adversely affected by being retained to undertake non-audit services.
- 2.9 A number of investor respondents argued that there should be greater disclosure about the nature and level of non-audit services provided by auditors. Corporate respondents also recognised that there was scope for better disclosure of the type of work being undertaken by the auditor and, where this requires the application of safeguards, how companies ensure that auditor independence is maintained.

*'It is fair to say that reporting by the audit committee is too often boilerplate and uninformative in its approach.'*

*Investor respondent*

*'...greater clarity and explanation of why audit firms are used and disclosure of non-audit fees would benefit understanding.'*

*Corporate respondent*

***Summary of proposed response to the views expressed***

- 2.10 There are obviously different perceptions about the impact that the provision of non-audit services by the auditor has on objectivity and independence and the APB has considered a number of possible responses to the comments received.
- 2.11 In light of the responses received and in view of the prohibitions already imposed on the provision of non-audit services to audited entities, the APB believes that a blanket prohibition of non-audit services would not be proportionate. Furthermore, there are a number of specific services (audit related services) in relation to which the APB believes that most shareholders would not consider it controversial for the auditor to undertake the work.
- 2.12 Commentators, and in particular investor respondents, emphasise the need to address the perception issue through improved transparency

and governance. The APB has developed a proposal on these improvements which is explored in more detail in section 4 of this feedback paper. This focus on governance and the disclosure of the policies and decisions taken on the provision of non-audit services by the auditor (in particular those non-audit services that are not audit related services) reflects a theme of many responses 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.

*'We believe that these matters are best addressed by those that commission these services, namely listed company boards. Greater disclosure of the oversight and context of these services would enhance confidence in audited accounts and corporate stewardship.'*

*Investor respondent*

*'The role of the [Audit] Committee in monitoring the application of these principles is key and I believe that the Committee is eminently capable of exercising this role. The ongoing dialogue between the Committee, management and the auditors allows for an effective mechanism to assess independence risks.'*

*Corporate respondent*

*'It is our experience that audit committees are concerned currently about being seen to be overly close to the company's external auditors and that this pervades their consideration of both the commissioning of non-audit services and indeed the tendering process for the audit itself.'*

*Accountancy profession respondent*

2.13 The APB believes that these disclosures, if implemented effectively, will result in greater transparency, especially of companies' policies on non-audit services, the nature of the non-audit services provided by auditors, the extent and nature of safeguards applied and the reasons why it was appropriate for the auditor, rather than another party, to provide these services. This should provide investors with the tools they need to be more effective in their challenge of management and those charged with governance and thereby stimulate a dialogue between companies and the investment community which could result in a mutual understanding of what are 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.

2.14 In addition to considering an outright ban of non-audit services and improvements in disclosures, the APB also considered the possibility of including a quantitative limit on the amount of non-audit services fees that the auditor is permitted to receive from the audited entity (for example, as a percentage of audit fees). From research undertaken (as set out in detail in section 3 of this paper), the APB has concluded that it is not reasonable to conclude that there is a widespread issue in respect of the quantum of non-audit services provided by the auditor. The APB

has also recognised that any quantitative limit could be difficult to implement, particularly in relation to the natural peaks and troughs that arise in the provision of such services and the uncertainties that may exist at the outset of the work as to possible changes in scope and related fees, especially in respect of certain types of services (such as transaction related services). The APB is not therefore proposing any quantitative restrictions to the provision of non-audit services by the auditor.

- 2.15 However, in order to ensure that appropriate attention is paid to this important issue and its impact on the perception of independence of auditors, the APB does propose an amendment to paragraph 18 of ES 5 (Revised), making it a requirement that where fees for non-audit services are, or are expected to, exceed the audit fees, this must be discussed with and approved by the Ethics Partner within the firm and reported to those charged with governance. The APB recognises that this may be impractical in the case of smaller audits where there is often additional work undertaken in respect of tax and accounting at the same time as the audit. An exemption for the audit of smaller entities is therefore proposed in ES – PASE (Revised) in respect of this requirement.
- 2.16 The FRC has also proposed that the Guidance for Audit Committees should be enhanced to encourage audit committees to consider fees incurred, or to be incurred, for non-audit services, both for individual services and in aggregate, relative to the audit fee and to provide an explanation of the policy on the provision of non-audit services by the auditor and why it was thought appropriate that specific services should be provided.
- 2.17 In conclusion, the APB believes that enhanced investor stewardship in this area should enable the market to develop in a way that is responsive to concerns about investor perceptions whilst not preventing companies from accessing benefits that may ensue from using their auditor for certain types of non-audit services. The APB believes that this is a more proportionate response to the comments received than either an outright prohibition or a quantitative restriction on non-audit services fees.
- 2.18 In coming to this conclusion, the APB recognises that it will be necessary to monitor the implementation of its recommendations to improve transparency. Accordingly, the APB intends to undertake further research once these changes have had a chance to take effect, to monitor and assess whether this approach is successful in reducing the levels of concern about non-audit services on the part of investors.

**Question 1: Do you support the approach outlined in paragraphs 2.10 to 2.18? If not, please indicate what, if any, other action should be taken. In particular, does the proposal in paragraph 2.15 present practical difficulties to auditors of small or medium sized entities?**

- 2.19 In addition to improvements in transparency and governance, investor respondents identified a number of other specific topics which should be revisited and there are a number of other issues that have arisen subsequent to the October 2009 consultation on which the APB believes that a response is required. The issues that are associated with each of these areas are complex. In their discussions the APB has heard a variety of arguments about the appropriate action that should be taken in regard to each. Where the APB has reached a view on the approach that is appropriate, their proposals are presented in section 5 of this paper.
- 2.20 However, there are some issues where there is a diversity of opinion that exists and in these cases the APB is now seeking commentators' views on the action that should be taken with a number of options being presented for consideration in the following sections:
- restructuring services (paragraphs 6.10 to 6.14 );
  - contingent fees (paragraphs 7.9 to 7.13); and
  - conflicts of interest (section 8).

### 3 Further research

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- 3.1 Given the weight of concerns about perception that clearly exists as a result of the limited information available on non-audit services provided by auditors to the entities that they audit, the APB concluded that further research was appropriate:
- To determine the latest trends in the non-audit fees paid by the largest listed groups, other listed groups and public interest entities to their auditors;
  - To identify the nature of the non-audit services provided by auditors in the different market segments.

#### *Trends in ratios of audit to non-audit fees*

- 3.2 In response to question 1(a) in the October 2009 Consultation Paper, three investor respondents felt that there was a negative impact on confidence in the independence of auditors arising from the provision of non-audit services, particularly where the size of non-audit fees was high.

*'...this is in part a matter of perception in that the significant revenues generated and the nature of the services could lead the auditor to identify with the interests of management rather than investors. This is a particular risk when the fees for non-audit services become significant in relation 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.'*

*Investor respondent*

- 3.3 Four of the nine investor respondents took comfort from the fall in non-audit services fees during the last decade which was set out in paragraph 5.4 of the October 2009 Consultation Paper. While one of these investor respondents noted that this should not be a cause for complacency, another commented that the evidence of declining fees provided support for no additional regulation.
- 3.4 In light of these comments, the APB has undertaken further research on the magnitude of non-audit services fees, both for listed companies and non-listed public interest entities (based on non-audit services fees reported by entities in their most recent available annual reports at the time of the research – mainly 2008 and 2009 reports).
- 3.5 In relation to listed companies, APB reviewed the reported audit and non-audit services fees reported by 1,740 UK companies with a listing or AiM quotation, as extracted and summarised by a third party data provider. In relation to non-listed public interest entities, the APB reviewed the audit and non-audit services fees reported in their annual

reports by a sample of 49 entities selected from those that fall within the scope of the Audit Inspection Unit. In relation to FTSE 100 companies, the APB gained more detailed information on the non-audit services provided both in 2008 and 2009.

- 3.6 The key findings from the research on 1,740 listed companies are as follows:
- (a) The 2008 average ratio of non-audit to audit fees for these listed companies was 76%.
  - (b) In 2008, 300 of the 1,740 listed UK companies had ratios of non-audit to audit fees that are equal to or exceed 1:1. Two thirds of these companies had a ratio of 2:1 or less, and only a few had ratios above 5:1.
  - (c) Those 300 listed companies with ratios in excess of 1:1 in 2008 accounted for about 49% of the total value of non-audit services fees reported by the 1,740 listed companies.
  - (d) In 2008, FTSE 100 companies accounted for about 70% of the total of all non-audit services fees (and 66% of the audit fees) reported by the 1,740 listed companies. This prompted the APB to continue with its focus on analysis of information in relation to the FTSE 100 companies set out below.
- 3.7 The key findings from the research on non-listed public interest entities are as follows:
- (a) The 2008 average ratio of non-audit to audit fees for non-listed public interest entities included in the sample of 49 is 61%. This had reduced from 80% in the previous year for the entities included in the sample.
  - (b) 24% of the non-listed public interest entities reviewed had ratios in excess of 1:1. The maximum ratio of non-audit to audit fees in the sample was just over 2:1.
- 3.8 The data on audit and non-audit services fees for FTSE 100 companies presented in Section 5 of the October 2009 Consultation Paper has been updated to include data for 2009:

<i>All figures in £m</i>	<b>Financial years ended in*:</b>						
	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2008</b>	<b>2009</b>
<b>Audit fees</b>	238	275	326	371	402	530	527
<b>Non-audit services (incl. services pursuant to legislation)</b>	454	357	328	329	312	379	320
<b>Non-audit fees as % of audit fees</b>	191%	130%	100%	89%	78%	71%	61%

\* Figures for 2002 – 2006 were taken from a survey by Financial Director magazine. This survey was not published in 2007. Figures for 2008 and 2009 have been taken direct from financial statements.

3.9 This data confirms the previous trends and in particular shows that the fees for non-audit services provided by the auditors to FTSE 100 companies between 2002 and 2009:

- reduced in absolute terms by 30%; and
- reduced as a percentage of audit fees from 191% to 61%, a further fall from 71% in 2008.

3.10 These trends in the level of non-audit services fees to individual audited entities are broadly consistent with the overall pattern shown by total audit and non-audit services fees earned by audit firms from entities that they audit over the same period<sup>5</sup>.

3.11 Within the FTSE 100 there are some companies in which higher ratios are a persistent feature. In 2008 34% of FTSE 100 companies had ratios at or in excess of 1:1, the highest ratio being approximately 4:1. Looking at these same 34 companies, 12 also had ratios at or in excess of 1:1 in each of the three years from 2007 to 2009 and another 15 had such ratios in two of the three years.

#### *Nature of the non-audit services provided by auditors*

3.12 In order to understand in more detail the types of non-audit services that were provided by auditors to FTSE 100 companies for 2008 and 2009, more detailed information was sought from firms auditing FTSE 100 companies. The latest data for auditor remuneration was requested from the auditors of all companies appearing in the FTSE 100 at the end of 2009. Some of these companies were not in the FTSE 100 in the 2008 figures and some of the data provided relates to 2010 year ends. The totals do not therefore reconcile to the figures included in the table in paragraph 3.8.

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<sup>5</sup> See “Key Facts and Trends in the Accountancy Profession” published by the Professional Oversight Board in June 2010.

3.13 The types of services that were provided to the FTSE 100 companies by their auditor were found to be as follows:

Type of service		2008 - £m		2009- £m
<b>Audit of company and subsidiaries</b>		<b>514.1</b>		<b>539.2</b>
Interim reviews	34.4		35.7	
Reporting on regulatory returns	22.1		23.7	
Reporting on internal financial controls required by law or regulation	29.2		28.0	
Other 'audit related services'	<u>17.6</u>		<u>18.6</u>	
<b>Total audit related services</b>		<b><u>103.3</u></b>		<b><u>106.0</u></b>
Public reporting on investment circulars		6.8		13.6
Private reporting on investment circulars		45.4		42.0
Other transaction related services		40.9		30.4
Tax compliance		35.5		38.6
Tax advisory services		55.2		55.6
Other services		<u>67.7</u>		<u>71.2</u>
<b>Total non audit services</b>		<b><u>354.8</u></b>		<b><u>357.4</u></b>
<b>Total*</b>		<b><u>868.9</u></b>		<b><u>896.6</u></b>

\* Totals are not equivalent to the table in paragraph 3.8 above as explained in paragraph 3.12.

3.14 'Other services' includes a variety of services, such as assurance reports (e.g. on sustainable development), agreed upon procedures (e.g. on earn out calculations), advice on process improvements, accounting advice, training and IT services.

## 4 Addressing perception through improved transparency and governance

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- 4.1 APB undertook a detailed analysis of the comments on the perceptions associated with the provision of non-audit services by the auditor that were received in response to the October 2009 consultation. APB also sought to understand better the reasoning behind certain respondents' specific concerns through further discussion.
- 4.2 A key finding from this work is that, while many commentators take the view that audit committees are best placed to decide which non-audit services the company should purchase from its auditors, the information which is currently disclosed on this matter is variable. There are three aspects of disclosure where respondents felt an improvement could be made:
- The statutory disclosure of auditor remuneration<sup>6</sup> is not always provided on a consistent basis, suggesting that the regulations are not helpful and the associated guidance<sup>7</sup> has not been followed consistently. This results in the detailed nature of the services provided by the auditors not being readily apparent, especially as there is a degree of summarisation of the data on non-audit service fees that is carried out;
  - Within disclosures in annual reports about compliance with the UK Corporate Governance Code there is often disclosure of the fact that a company has a policy on non-audit services without specifying what this policy is; and
  - There is no explanation of why individual non-audit service engagements have been provided by a company's auditor rather than by another party and how the auditor's independence has been safeguarded.

### *Categorisation of non-audit services: amendments proposed in paragraphs AB of ES 5 (Revised), (following the current paragraph 36) and new section in ES 5 (Revised) (following the current paragraph 39)*

- 4.3 Respondents to the October 2009 Consultation Paper expressed concerns about the disclosures of fees for non-audit services in financial statements.

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<sup>6</sup> 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)

<sup>7</sup> ICAEW published TECH 06/06 'Disclosure of Auditor Remuneration' when the regulations were first implemented and this guidance was updated in July 2007.

*'Existing rules on disclosure ... have led to complex disclosures, and requirements could be improved and the information disclosed made clearer.'*

*Investor respondent*

- 4.4 A number of companies expressed the view that disclosing services that are audit related or required by statute as non-audit services was misleading to shareholders. Other corporate respondents thought that disclosing the nature of the services provided (particularly where they are similar to an audit) would allay fears that auditors are conflicted by the allocation of such non-audit services to them and therefore help maintain confidence in the quality of the audit.
- 4.5 An ICAS working party which included company and investor representatives recommended a 'banding approach' that distinguishes:
- audit services,
  - other assurance services provided to stakeholders, and
  - other services.
- 4.6 Disclosure of fees for non-audit services in financial statements is currently determined by legislation<sup>6</sup> and changes to this are therefore a matter for the Government to consider. However, APB proposes that it should introduce into the Ethical Standards a category of non-audit services called 'audit related services' where, by virtue of the nature of the work done, the threats to the auditor's objectivity and independence are clearly insignificant.
- 4.7 The APB believes that this approach will have the benefit of:
- clarifying the extent to which ES 5 (Revised) applies to audit related services;
  - better distinguishing those non-audit services that most users would not generally consider contentious for the external auditor to provide; and
  - assisting audit committees to focus their attention on other non-audit services where the threat to auditor independence may be greater and will therefore require more careful consideration.
- 4.8 The practical challenge has been to define which services should be classified as audit related services. The APB looked at a variety of ways to approach this classification, including the ICAS working party proposal that this band of non-audit services should be identified as 'other assurance services'. APB preferred an approach that focused on the impact of the service on auditor independence rather than on the nature of the service and concluded that audit related services should be those non-audit services where the work involved is closely related to the work performed in the audit or is often carried out by members of the audit team and the threats to auditor objectivity are clearly

insignificant. However, as any definition of this nature would involve much subjectivity and could be abused, the APB proposes to specify the services that would fall into the category of audit related services. This approach is also likely to be easier to reflect in legislation should the Government determine that changes are to be made to it.

- 4.9 An implication of APB taking a narrow view of the services to be described as audit related services is that the other category of non-audit services will include some non-audit services where the threats to auditor objectivity and independence are in fact low and others where such threats are high. In particular the APB considered work on investment circulars where the auditor will provide public reports to the shareholders (current and future) as well as private reports which are closely connected with the public work. In the UK, regulation and related standards facilitate the provision of such services by other accounting firms – although in practice the services are usually carried out by the auditor. Although the provision of such services by the auditor is generally uncontroversial, these services have been retained within other non-audit services. To ensure that the circumstances in relation to such work are clearly understood, it is suggested that additional disclosure is provided to the audit committee (or to those charged with governance) separately identifying any such services which are not regarded as giving rise to threats to an auditor's objectivity and independence (other than threats that are clearly insignificant).

**Question 2: Are the correct services included in the list of audit related services (see ES 5 (Revised), paragraph [AD])? If not, please identify the changes that should be made and indicate whether the provision of such services gives rise to threats to auditor objectivity and independence (other than threats which are clearly insignificant).**

- 4.10 Disclosure in the financial statements of information relating to the provision of non-audit services by auditors is the responsibility of the company. While this is typically done in notes to the financial statements according to a format driven by legislation, the auditor may be able to influence the detail provided on auditor remuneration through the use of a common template for this information when reporting to the audit committee or to those charged with governance. The use of such a template is explained in the proposed amendments to ES 1 (Revised) (paragraph 61) and a draft template is included as an Appendix to ES 1 (Revised).
- 4.11 There is no presumption that services in this third category are services that the entity's auditor should not provide. A judgment needs to be made by audit committees as to the cost and efficiency benefits and the real or perceived threats to auditor independence which are associated with them. Where there is increased transparency, as a result of the proposals set out in paragraphs 4.12 to 4.14 below, investors will also be

able to monitor these judgments and make it known to audit committees where they disagree.

**Question 3: Will disclosure of additional information about non-audit services in the form of a template (such as that included as an appendix to ES 1 (Revised)) reduce the perceived threats to objectivity and independence arising out of the provision of non-audit services? Do you have any suggestions to improve the template?**

*Audit committee reporting: amendments proposed in paragraphs 4.29 to 4.38 of the FRC's Guidance on Audit Committees (included at Appendix 3)*

4.12 A theme of many of the responses to the October 2009 consultation was that better disclosure was required of:

- the audit committee's policy on the purchase of non-audit services; and
- the reasons why the audit committee had concluded that it was appropriate to purchase these services from the auditors rather than from another party.

4.13 Recognising that these issues closely interact with the FRC's Corporate Governance Code and the guidance supporting it, the APB recommended changes to the FRC's Guidance on Audit Committees (formerly known as the Smith Guidance). A consultation on amendments to this guidance is being issued concurrently with this exposure draft and is included at Appendix 3. The APB supports the proposed changes to the FRC's Guidance on Audit Committees and encourages respondents to comment on those proposed changes too. These are aimed at:

- giving more prominence to non-audit services (by moving the guidance currently in paragraphs 4.28 and 4.29 to later in the document);
- helping the audit committee distinguish those non-audit services which are closely related to an audit and which give rise to a very low threat to auditor objectivity from those where the threat needs more careful consideration. This is consistent with the proposed changes to ES 5 (Revised);
- improving the disclosures of the audit committee policy, providing more detail on the nature of services provided by the auditor and outlining the reasons why the audit committee decided to purchase non-audit services, other than audit related services, from the auditor rather than from another party.

4.14 The APB is of the view that these changes are consistent with provision C3.7 of the UK Corporate Governance Code that states 'The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded'.

**Question 4: Will the proposed changes to the FRC's Guidance on Audit Committees reinforce audit committees' responsibility for:**

- **determining whether a company's auditor should be permitted to provide particular non-audit services? If not, what further guidance should be given, and**
- **providing information about the non-audit services provided by a company's auditor**

**and therefore reduce the perceived threats to auditor objectivity and independence arising from the provision of non-audit services?**

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

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5.1 In addition to the proposals on improved transparency that affect the Ethical Standards for Auditors, there are further amendments to these standards proposed by the APB which arise from the October 2009 consultation on the provision of non-audit services. APB is also proposing a number of further amendments to the APB Ethical Standards arising from the following:

- Unresolved issues from the APB's March 2009 consultation;
- Other issues which APB has become aware of subsequent to its consultation and where it considers that action is required.

*Extended and internal audit services: amendments proposed in paragraphs [P] to [U] of ES 5 (Revised) (following the current paragraph 5) and paragraphs 40 to [AI] of ES 5 (Revised) and in paragraph 4.8 of the FRC's Guidance on Audit Committees (included at Appendix 3)*

5.2 When APB issued the original Ethical Standards in 2004 there was considerable discussion about the requirements in ES 5 (Revised) relating to internal audit services and there continues to be debate about this.

5.3 There is a spectrum of views on whether it is appropriate for the external auditor also to perform internal audit work, with strongly held positions at both ends of it. Some believe that there is a natural synergy between aspects of internal and external audit (and that a close integration leads to efficiency and effectiveness). Others believe that the internal and external audit have fundamentally different objectives, provide separate channels of assurance about a company's controls and should therefore be undertaken by different parties. The Institute of Internal Auditors takes this latter view. The argument is, in effect, that transferring internal audit work from an internal audit function to the external auditor may weaken the overall governance structure.

5.4 The debate in the UK on internal audit being performed by external auditors has been reenergised by Rentokil's announcement in July 2009 that its new external auditor would be undertaking some work previously undertaken by internal audit<sup>8</sup>.

5.5 Responses to APB's consultation paper on non-audit services revealed concern in this area from investor respondents. Three investor respondents were concerned that Rentokil's external auditors would be auditing their own work and would take on management functions and

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<sup>8</sup> See Rentokil's interim results statement published on 31 July 2009

- two others called for the provision of internal audit services by the external auditor to be more strongly discouraged or indeed prohibited.
- 5.6 Information provided by KPMG, Rentokil's new auditors and by the chair of the company's audit committee, helped APB understand the details of the arrangements and why, under the proposed amendments to the standards, KPMG view the work involved as audit or 'extended audit' rather than a separate internal audit service. To assist APB understand how common such 'extended audit' arrangements were, the AIU undertook a survey of the auditors of FTSE 350 companies. This revealed that 'extended audits' were undertaken in about 5% of companies and that other services, which might be considered as internal audit services, were provided to another 12% of companies. Arrangements for the extended audit work varied. In some cases the work was subject to a separate engagement letter and billing arrangements but in other cases it was treated as part of the audit engagement.
- 5.7 The APB has decided to seek greater consistency in this area by amending ES 5 (Revised) to:
- Improve the guidance as to what work should be treated as audit work rather than non-audit services;
  - Include extended audit services within '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.
- 5.8 Guidance on internal audit is provided to audit committees in the FRC's Guidance on Audit Committees. Changes have been proposed to this guidance as part of the consultation referred to in paragraph 4.13 to emphasise the impact that the provision of internal audit services by the external auditor can have on investor perceptions.

*Clarifying the threats and safeguards approach: amendments proposed in paragraphs 46 to 50 of ES 1 (Revised) with consequential minor amendments throughout ES 1 (Revised) and paragraphs [V] to [X] (following paragraph 11) and paragraphs 32 to [Z] of ES 5 (Revised)*

- 5.9 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 and on the audit inspections that are carried out by the AIU. Commentators also highlight the publication of reports on these inspections which they believe generally provide positive feedback that the threats and

safeguards approach outlined in paragraph 2.5 of this paper is operating effectively to safeguard auditor independence.

- 5.10 In its 2008/09 public audit inspections report, the AIU reported that the overall quality of auditing of major public companies in the UK remains fundamentally sound. However, the AIU noted that:

*'firms need to exercise greater care in assessing whether it is appropriate for them to provide certain non-audit services to audit clients, in identifying threats to their independence and objectivity and in assessing whether proposed safeguards are sufficient to reduce threats to an acceptable level.'*<sup>9</sup>

- 5.11 The APB believes that such concerns are likely to weaken stakeholders' confidence in auditor objectivity and independence where non-audit services are provided by the auditor. Improving the application of the threats and safeguards approach is primarily the responsibility of the audit firms, but the APB has reviewed its guidance on threats and safeguards and considers that some enhancements may be helpful to audit firms in addressing the AIU's concerns. The APB proposes to enhance guidance in this area as follows:

- (i) Providing guidance on factors to consider when an audit engagement partner makes an assessment of the significance of all identified threats associated with the acceptance of a non-audit services engagement. The APB believes that outlining such factors will help to improve the quality of thinking and judgment that supports any decisions made as to the safeguards required. Additional guidance is therefore proposed following paragraph 11 of ES 5 (Revised). These new paragraphs also discuss how the audit engagement partner might approach the delegation of decisions on accepting routine non-audit engagements.
- (ii) Confirming explicitly that the cumulative impact of a series of threats should be assessed, both when individual non-audit services are being considered and at the end of the audit when forming an opinion on the financial statements (before issuing the auditor's report). The cumulative impact will include an assessment of all current and recent relationships that have a continuing relevance to the threats to auditor independence. Current guidance in ES 1 (Revised) suggests this, but it is not explicitly stated. Suggested amendments to paragraph 48 of ES 1 (Revised) and related supporting guidance are provided in the Exposure Draft.
- (iii) Clarifying that where a review of the audit work by the engagement quality control reviewer (EQCR) or another audit partner not involved in the audit engagement is identified as a

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<sup>9</sup> Audit Inspection Unit 2008/9 Audit Quality Inspections: An Overview, December 2009, page 14

safeguard, the person in this role needs to know what the specific threats are which arise from the provision of the non-audit service and pay particular regard to the audit work performed in relation to the subject matter of the non-audit services provided. Guidance is proposed to be added after paragraph 47 of ES 1 (Revised) to indicate that where the EQCR role is extended to provide a safeguard in respect of non-audit services provided, the audit documentation should make it clear how the review undertaken addressed the specific threats identified;

- (iv) Setting out in more detail the procedures which are appropriate in order to make the safeguards, which are typically listed as examples in ES 5, effective. This is included at paragraph [Z], following paragraph 32 of ES 5 (Revised).

***Ethics Partners: amendments proposed in paragraphs 21 to 24 of ES 1 (Revised) and [AA] of ES 5 (Revised) (following the current paragraph 34)***

5.12 The Ethics Partner role was included in the Ethical Standards for Auditors in 2004 as a way of achieving consistent decision-making in an audit firm on difficult ethical judgments. This role is also important in ensuring that compliance with the Ethical Standards for Auditors is placed above commercial considerations, through having responsibility for the effectiveness of the firm's communication to partners and staff within the firm.

5.13 In its report on the 2008/09 public audit inspections, the AIU also reported that it had:

*'found some evidence of firms increasing the emphasis on maintaining or improving financial performance in their ... communications to audit personnel due to the current economic climate.'*<sup>10</sup>

5.14 In addition, the experience of the AIU suggests that the Ethics Partner role and its supporting staff team, are usually combined with other related roles such as Risk Management and Compliance. The APB has some concern that the objectives of these other roles may not always be consistent with the public interest perspective that the Ethics Partner role was intended to address. Furthermore, since the Ethics Partner role was introduced, the Audit Firm Governance Code<sup>11</sup> has been published.

5.15 Taken together with the AIU finding that audit firms need to exercise greater care in assessing the threats to their independence and objectivity and whether proposed safeguards are sufficient to reduce threats to an acceptable level (see paragraph 5.10), these matters led the APB to

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<sup>10</sup> Audit Inspection Unit 2008/9 Audit Quality Inspections: An Overview, December 2009, page 13

<sup>11</sup> In January 2010, the FRC and the Institute of Chartered Accountants in England and Wales published the Audit Firm Governance Code

consider whether the role of the Ethics Partner is operating as it was intended to be and whether it should be strengthened.

5.16 The APB proposes the following amendments to ES 1 (Revised) and ES 5 (Revised) to provide some strengthening of the Ethics Partner role:

- (i) Guidance following paragraph 21 of ES 1 (Revised) which sets out that:
  - where the Ethics Partner role is combined with another role (typically the Compliance Partner role), the Ethics Partner responsibilities take precedence;
  - in the case of larger firms that audit listed entities, the Ethics Partner has direct access to the independent non-executives<sup>12</sup> where such roles are introduced in an audit firm or, alternatively, to the firm's most senior governance body;
  - the Ethics Partner role is undertaken on a proactive basis in addition to reacting to requests for guidance.
- (ii) Text added to the requirement in paragraph 21 of ES 1 (Revised) and guidance following paragraph 34 of ES 5 (Revised) to clarify that part of the Ethics Partner's responsibility is to achieve a consistent approach to the application of the Ethical Standards for Auditors, particularly in difficult situations.

#### *Unresolved issues from March 2009 consultation*

5.17 In October 2009 the APB finalised changes to ES 3 (Revised) in connection with partner rotation. However, it was decided that other changes to the Ethical Standards consulted upon in the March 2009 Consultation Paper would be deferred pending responses to the new consultation paper on non-audit services, as this would help to avoid any implementation problems that might arise from frequent changes to the APB Ethical Standards for relatively detailed matters.

5.18 The background to each of the issues is set out briefly below. If further detail is required, the text of the March 2009 consultation may help. This is available on the APB website at <http://www.frc.org.uk/apb/publications/pub1885.html>. Specific follow up questions for this consultation are only included under question 5 where the approach taken is different to that set out in the March 2009 consultation.

Securitisation services: amendments proposed in paragraphs 104 to 120 of ES 5 (Revised)

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<sup>12</sup> The Audit Firm Governance Code, published in January 2010, provides that firms which audit listed companies should appoint independent non-executives to be involved in public interest aspects of the firm's decision making, stakeholder dialogue and management of reputational risks.

5.19 Concerns relating to securitisation services were expressed by the Treasury Select Committee in its inquiry into Northern Rock. A subsequent review of the work undertaken indicated that there do not appear to be any significant threats to auditor independence arising as a result of this particular work, which was in the nature of audit related services. However, the APB recognised that other non-audit services connected with securitisations, which are not audit related services, may pose threats to auditor independence. Two respondents to the March 2009 consultation suggested that no securitisation services should be undertaken for a contingent fee (see section 7).

5.20 Proposed amendments in paragraphs 104 and 116 of ES 5 (Revised) make it clear where securitisation services are covered. Any remaining perceived threats to independence arising from the provision of securitisation services are addressed by proposed amendments in paragraphs 119 and 120 which make it clear that the original intent in drafting these paragraphs was to prohibit auditors from providing transaction services where the success of the transaction is dependent upon the application of a particular accounting treatment that is novel or is not based on a well established interpretation of the relevant financial reporting framework and which is or will be the subject of a future or contemporary audit judgment relating to a material matter in the financial statements. Conforming changes are also proposed in the section on corporate finance services.

Financial interests of new partners joining the firm: amendments proposed in paragraphs 7 to [G] of ES 2 (Revised)

5.21 Respondents to the March 2009 consultation supported the APB's proposal to permit financial interests of new partners joining the firm where there is no market for disposal in such financial interests, provided that the new partner is not involved in the provision of any services to the entity concerned and that they work in a different part of the firm to the audit engagement partner. The proposed amendments in paragraph [G] of ES 2 (Revised) also extend the relief to immediate family members and suggest that this information would be communicated to the audit engagement partner and the ethics partner of the firm.

Governance roles: amendments proposed in paragraph 53 of ES 2 (Revised)

5.22 One amendment to the APB Ethical Standards thought to be necessary to be able to continue to state that the APB is not aware of any significant instances where the relevant parts of the Code of Ethics for Professional Accountants (the IESBA Code) are more restrictive than the APB Ethical Standards, was to prohibit all partners and employees of the audit firm from serving as a director or officer of an audited entity. This is different to the requirement in respect of dual employment which will continue to apply to all partners and employees who undertake audit work. Overall support was expressed for this proposal, which is included within the

exposure draft at paragraph 53 of ES 2 (*Revised*). This has also now been extended to circumstances where an audit firm takes on such a role.

Definition of an affiliate of an audited entity: amendments and new term proposed in glossary of terms

- 5.23 In the March 2009 consultation paper the APB proposed a different materiality test for determining those entities that should be treated as affiliates to that used within the IESBA Code. Views on this proposal were split. The APB recognises the value of harmonisation with the IESBA Code definition and so now proposes to use a definition of affiliates that follows this closely, but which clarifies that both qualitative and quantitative aspects are applied to the use of the word 'material', including the nature and magnitude of the possible threats to auditor independence.
- 5.24 The term 'significant affiliate' is also used in a number of places within the APB Ethical Standards to identify those affiliates of listed companies to which additional prohibitions of specific non-audit services apply. This term has also been defined in the glossary, using words based on the definition of a significant component in ISA 600 (UK and Ireland).

Remuneration and evaluation policies: amendments proposed in paragraph 38 of ES 4 (*Revised*)

- 5.25 The APB asked a question in the March 2009 Consultation Paper as to whether the requirement for remuneration and evaluation policies should be applied to other partners and staff from non-audit disciplines in addition to key partners involved in the audit. While a majority of respondents did not believe that the requirements should be extended further, there were some who felt that this was necessary in order to promote consistency. The APB now proposes that these policies should apply to all members of the engagement team.

Valuation of non-cash consideration for shares: amendments proposed in paragraphs 6, 60, 115 and 122 of ES 5 (*Revised*)

- 5.26 Respondents agreed with APB's proposal to only permit an auditor to undertake valuations (and other non-audit services) that are otherwise prohibited under ES 5 (*Revised*) where this is required by legislation or regulation, rather than where the auditor is eligible to act.

**Question 5: Do you support:**

- the approach taken to the provision of 'extended audit services' in ES 5 (Revised), paragraphs [AH] and [AI] ?
- the additional guidance on the threats and safeguards approach in ES 5 (Revised), paragraphs [AH] and [AI] ?
- the strengthening of the role of the Ethics Partner in ES 1 (Revised), paragraphs 21 to 24 and ES 5 (Revised), paragraph [AA] ?
- the amended definition of 'affiliate' and 'significant affiliate' ?
- the application of the remuneration and evaluation policies to all members of the engagement team in ES4 (Revised), paragraph 38 ?
- the other amendments referred to in Section 5 ?

If not, please explain your reasons and the approach that you think the APB should take.

**Question 6: Are there any reasons why the revisions to the Ethical Standards proposed by the APB in Sections 2, 4 and 5 will be difficult to implement for audits of financial statements for periods commencing on or after 15 December 2010? If so, what further transitional arrangements might be necessary?**

## 6 Restructuring services

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*Amendments proposed and options for consultation included in new section of ES 5 (Revised) (following the current paragraph 122)*

### **Introduction**

- 6.1 The term 'restructuring services' includes a variety of non-audit services which relate to the development or implementation of a transaction or package of transactions (a 'restructuring plan') undertaken to change the equity or debt financing structure, the corporate structure or the operating structure of an entity. They may be undertaken for a variety of purposes, for example to address financial or operating difficulties, to support tax planning, to improve operating efficiency or to improve the cost of capital.
- 6.2 The range of non-audit services provided under the banner of restructuring services may be quite varied, even in relation to a single restructuring plan. The nature of those services could encompass many of the other types of services described in ES 5 (Revised) (for example, corporate finance advisory services, taxation services, transaction support services such as due diligence, accounting advice, etc).

### **March 2009 consultation**

- 6.3 In the March 2009 consultation, the APB proposed the inclusion of a new section in ES 5 (Revised) dealing with restructuring services. This did not change the approach taken to such services, but it did draw together the existing requirements and guidance so as to clarify how the general approach to non-audit services is applied to restructuring services, addressing the advocacy and management threats that are created with a prohibition and recognising the self-review threat that also arises.
- 6.4 Three of the four investor respondents who commented on the proposals for restructuring services believed that there should be an outright prohibition on all such services, particularly where the survival of the company is in question. The other investor respondent commenting on restructuring services recognised that there were benefits in such services being provided by the auditor in some circumstances. In contrast, the proposals were supported widely by the profession as they were based on the threats and safeguards approach.
- 6.5 The prohibitions included in the March 2009 consultation relating to taking management decisions or acting as an advocate are repeated in the new section on restructuring services without amendment, together with an exemption in ES - PASE (Revised). APB is not seeking comment

on this requirement as it has already been exposed and commented on in this format.

- 6.6 The guidance in relation to the self-review threat that was included in the March 2009 consultation has been subject to more extensive discussion since this consultation and this is analysed in more detail below.

**Additional comments and views in relation to the self-review threat**

- 6.7 Further comments on restructuring services were received from eight respondents to the October 2009 consultation on non-audit services, although no specific question was asked on this subject. The investor respondents who commented echoed their previous concerns about the implications of such services, when companies are in financial distress, in relation to the auditor's consideration of the going concern assumption. Corporate respondents who commented suggested that a number of benefits can arise from using the auditor to provide such services.
- 6.8 Since the end of the October 2009 consultation the APB has discussed with investors, corporate respondents and audit firms concerns that have been expressed about the self review threat that arises when restructuring services are provided by the auditor. These discussions have shown that for every argument there is a counter-argument on the extent of the self-review threat and the benefits that arise:
- (a) *Cost of services provided.* It is argued that there are lower costs associated with restructuring services where the auditor is used, as the audit firm is already knowledgeable about the business. Others argue that these benefits cannot be substantiated as such cost savings would not arise because a separate team from the audit firm is usually used to provide the restructuring advice;
  - (b) *Ready access to urgent advice.* There is a concern that prohibiting the auditor from being involved may make it harder for companies to obtain appropriate advice quickly at a critical time. As well as the knowledge already held by the audit firm about the business, it is also argued that excluding the auditor from the firms that a company can approach will limit the number of advisors who may be available or willing to act, especially in certain industries. However, others point out that insolvency and restructuring advisors are used to responding to requests for assistance at short notice and there is unlikely to be a shortage of appropriate advisors as there are a number of alternative providers outside the audit firms;
  - (c) *Importance of confidence when purchasing restructuring services.* In a stressful and complicated situation such as a restructuring

situation, the directors of a company are likely to be happier working with those with whom they have existing relationships rather than having to develop confidence in a third party. Additionally, the company may feel less exposed to an inadvertent breach of confidentiality (both internally and externally) when using the auditor rather than bringing in an additional advisor. Others argue, on the contrary, that it may be easier for companies to discuss their restructuring needs with a third party. They also point out that confidentiality is a fundamental obligation of practitioners operating in this area and similar issues in highly sensitive mergers and acquisitions situations are regularly dealt with satisfactorily;

- (d) ***Interest in providing a successful solution.*** It is argued that as the auditor will have to assess the efficacy of the plan in due course, their involvement in developing the plan makes it more likely that an effective plan will be developed as well as reducing the number of different advisors that have to be involved. However, there is no less interest on the part of other providers in achieving a successful outcome for the company and it is argued that the self-review threat outweighs any potential benefits.
  - (e) ***Strength of the safeguards implemented when restructuring services are provided.*** Auditors have argued that it is possible to address the concerns about the self-review threat through the application of appropriate safeguards, such as using a team separate from the audit team to provide the restructuring services. They have also commented that it may be easier for the auditor to challenge a restructuring plan developed by a partner from another part of the audit firm than one developed by a third party. In contrast, investors believe that the auditor can be more challenging of the restructuring plan if the audit firm is not associated with it and a completely fresh pair of eyes to evaluate the restructuring plan is a good thing. They believe that the audit firm is put in a more difficult position where they have also provided restructuring services.
- 6.9 In summary, a number of investors are concerned that, where an auditor participates in the development or implementation of a restructuring plan and then, either concurrently or retrospectively, reviews the efficacy of that plan in assuring the survival of the entity as part of their consideration of the going concern assumption. They believe the auditor may be unable, or will be perceived to be unable, to take an impartial view of the restructuring plan in those circumstances. They therefore think that the self-review threat is too great and cannot be safeguarded.

**Further consultation on the approach to the self-review threat associated with restructuring services**

6.10 The extent and nature of restructuring services can vary enormously and may take the form of:

- (a) Relatively isolated inputs to the overall restructuring plan (for example, providing preliminary general advice on the options and approaches available to an entity or providing assistance with the implementation of one or a few isolated elements of an overall restructuring plan, such as the sale of a non-significant component business).
- (b) Engagements to report on a restructuring plan developed and implemented without the auditor's involvement, for example an engagement to report on a working capital statement in an Investment Circular.
- (c) Services provided to a stakeholder in the audited entity, such as a bank providing debt finance. The auditor may need to consider the conflicts of interest that arise when providing services to a connected party of the audited entity (see paragraphs 8.3 and 8.4). Furthermore, where the auditor is also the auditor of the stakeholder there may be a self-review threat in relation to the carrying amount of the stakeholder's investment in, or loan to, the audited entity in the audit of the stakeholder<sup>13</sup>.
- (d) Challenging the projections and assumptions within a financial model that has been produced by the audited entity.
- (e) Aspects of preparing cash flow and other forecasts and financial models underpinning the overall restructuring plan. Involvement in preparation might include, for example, developing a model which is then used by the audited entity to generate a forecast using management assumptions and inputs or producing a forecast from assumptions and inputs provided by management of the audited entity.

6.11 In considering the threats associated with providing more integral restructuring services in respect of an entity in distress, there is a risk that, whatever scope is determined formally at the outset, the inherent uncertainties and the time pressures under which such an engagement is undertaken may lead to significant formal or informal increases in the scope of the work as the restructuring plan develops and is negotiated.

6.12 The APB's approach has been to provide guidance on the self review threat associated with the provision of restructuring services in general

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<sup>13</sup> Guidance in respect of such situations is given in paragraph 33 of ES 1 (Revised)

and then to identify the types of circumstances where this threat is most acute – namely where the restructuring services are designed to address the actual or anticipated financial or operational difficulties that threaten the survival of the audited entity as a going concern.

- 6.13 The APB believes that the concerns of investors are 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 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 in relation to an overall restructuring plan, are central to the overall success of that plan 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.
- 6.14 The APB recognises that there are polar views about this amongst stakeholders and wishes to hear views from as many different perspectives as possible. To facilitate that consultation, it has identified three possible approaches that could be taken to the self-review threats arising from the provision of restructuring services in respect of an 'audited entity in distress' that is a listed company (or a significant affiliate):

**Option 1.** The Ethical Standards could contain an outright prohibition on the provision of restructuring services to listed entities in distress – because there are no safeguards that could be put in place that would reduce the perceived self-review threats to the auditor's objectivity and independence to an acceptable level.

**Option 2.** A threats and safeguards approach might be appropriate in certain situations and therefore the Ethical Standards could contain the prohibition under Option 1 but with the following exceptions:

- Auditors could provide preliminary general advice to a listed entity in distress;
- Auditors could provide 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;
- Auditors could be involved in challenging the projections and assumptions within a financial model that has been produced by the entity; and
- Auditors could report 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 might be appropriate along the lines suggested in the proposals that were exposed for comment in the March 2009 consultation, supplemented with further explanation and guidance.

**Question 7: Which of the options (to address the self review threat arising from the provision of restructuring services) set out in paragraph 6.14 should the APB adopt? Should the option that you have chosen apply to all entities, or only to listed entities?**

6.15 APB is conscious that where a company moves into distress, lenders become more important stakeholders and the views of such parties will be sought during the exposure period.

## 7 Contingent fees

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*Amendments proposed in glossary of terms and paragraph 11 of ES 4 (Revised) and options for consultation set out in paragraphs 10 to 15 of ES 4 (Revised) and paragraphs 74, 109, 114, 119 and 121 of ES 5 (Revised)*

- 7.1 In ES 5 (Revised) the current approach to services provided to audited entities on a contingent fee basis is that tax services, corporate finance services and transaction related services are prohibited where:
- (a) the 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 the services is dependent on a future or contemporary audit judgment relating to a material matter in the financial statements of an audited entity.
- 7.2 ES 5 (Revised) also contains guidance that in general contingent fees that are material will create an unacceptable self-interest threat and the audit firm does not undertake such an engagement. There are also requirements in ES 4 (Revised) that:
- no audit is undertaken on a contingent fee basis,
  - firms have policies and procedures to notify the audit engagement partner of prospective contingent fees, and
  - the audit engagement partner notifies the audit committee of a listed company of any contingent fee arrangements.
- 7.3 The current definition of a "contingent fee basis"<sup>14</sup> excludes many arrangements that are dependent on a future event or condition through the addition of the second sentence on differential hourly fee rates. There is a risk that this could provide a mechanism for structuring variable fee arrangements so that they do not fall within the definition, and circumvent the provisions of the Ethical Standards, although it is recognised that no particular instances of this have been identified.

### **Comments on contingent fees received in responses to APB consultations**

- 7.4 In response to the March 2009 consultation, two investor respondents suggested that contingent fees should be prohibited in the case of

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<sup>14</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.

For completeness, it should be noted that the definition included in paragraph 11 of ES 4 (Revised) is different to the one set out above.

securitisation services. It appears that they were referring to those securitisation services that resulted in assets and liabilities being taken off the balance sheet (rather than services that did not).

- 7.5 In addition, in responding to the October 2009 consultation on non-audit services, one investor representative group suggested that the approach to contingent fees might be reconsidered. It said that, although it was against contingent fees in principle there were two circumstances in which they might serve the best interests of the company and its shareholders (as a success incentive in certain smaller projects and in relation to abortive transactions). In addition, the ICAS working party on non-audit services recommended in its report (attached to the ICAS consultation response) that contingent fees should require pre-approval by the Audit Committee.

### **Alternative approaches to contingent fees internationally**

- 7.6 In April 2006 the PCAOB prohibited all contingent fees for services provided to audit clients<sup>15</sup>. The IESBA Code<sup>16</sup> prohibits material contingent fees and those that are dependent on a future or contemporary judgment related to the audit of a material amount in the financial statements. The EC Recommendation<sup>17</sup> followed a threats and safeguards approach.

### **Proposed amended definition of “a contingent fee basis”**

- 7.7 The APB proposes to amend the definition of a contingent fee basis in the Glossary as follows, and to conform the definition in paragraph 11 of ES 4 (Revised):

*Any arrangement made under which a fee is calculated on a pre-determined basis relating to the outcome or result of a transaction, or other event, or the result of the work performed. A fee that is established by a court or other public authority is not a contingent fee.*

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<sup>15</sup> PCAOB Rule 3521 effective pursuant to SEC Release No. 34-53677, File No. PCAOB-2006-01 (April 19, 2006): The term "contingent fee" means -

(1) Except as stated in paragraph (2) below, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service.

(2) Solely for the purposes of this definition, a fee is not a "contingent fee" if the amount is fixed by courts or other public authorities and not dependent on a finding or result.

<sup>16</sup> Under the IESBA Code a contingent fee is:

*A fee calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm. A fee that is established by a court or other public authority is not a contingent fee.*

<sup>17</sup> Commission Recommendation 2002/590/EC - Statutory Auditors' Independence in the EU: A Set of Fundamental Principles: "A fee arrangement where the statutory auditor's remuneration depends on either any performance figures of the audit client or the outcome of the audit itself. Audit fees that are fixed by any courts or governmental body do not constitute contingent fees."

- 7.8 This amended definition is based on the first sentence of the existing Glossary definition, with the addition<sup>18</sup> of the words “, or other event,” after the word “transaction”, together with the second sentence of the IESBA Code definition. One consequence of this is that the revised definition conforms more closely to the IESBA Code definition. Another consequence is that a fee basis involving differential hourly fee rates or under which the fee payable is negotiated after the completion of the engagement (such as arrangements commonly adopted to allow for a smaller abort fee in a transaction services engagement) would be a contingent fee basis under the new definition but were not under the previous definition.

**Question 8: Does the revised definition of a ‘contingent fee basis’ give rise to any practical issues?**

**Consultation on approach to non-audit service fees on a contingent fee basis**

- 7.9 Certain types of non-audit services are commonly provided on a contingent fee basis. Examples include: corporate finance services, recruitment services, certain tax advisory services (such as supporting VAT and other tax recovery claims), some legal services and transaction support services.
- 7.10 In relation to corporate finance services, the fee is typically contingent on the outcome of the transaction. Often there is only a nominal fee or no fee if the transaction is not undertaken, and the fee level is related to the value of the transaction (rather than to the value of the service inputs) if the transaction is successful. The contingent element of the fee is typically used to incentivise a service provider and therefore creates a self-interest for the service provider in the outcome of the transaction or, potentially, more generally. Where auditors provide such services, their objectivity may be, or be seen to be, impaired in relation to any audit judgments that they are required to make then or subsequently, where:
- (a) The subject matter of the services is also relevant to the audit ; or
  - (b) The contingent element of the fee (the difference between the success fee and the failure fee) is significant to the part of the firm by reference to which the audit engagement partner’s profit share is calculated or the audit firm as a whole and whether the

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<sup>18</sup> The additional words are necessary, in the view of the APB, to avoid narrowing the definition of a contingent audit fee compared to the existing definition in paragraph 11 of ES 4 (Revised). For example, if the level of the audit fee was dependent upon the amount of the profit reported by an entity in the audited accounts, it would be a contingent fee basis under the first sentence of the current definition in paragraph 11 of ES 4 (Revised) (the level of profit reported by the entity would be an ‘outcome’) but not under the first sentence of the current Glossary definition (because the level of profit reported by the entity is neither the ‘outcome or result of a transaction’ nor the ‘result of the [audit] work performed’).

fee, in the event of failure, would not cover the costs of providing the service.

- 7.11 In relation to transaction services, the essence of the service is usually to report on some aspect of the subject matter of the transaction. In such circumstances, it is common for the engagement to be on a contingent fee basis where the customer pays for the service at a lower rate, if the transaction is aborted, and at a higher rate, if the transaction is successful, to reflect differences in the level of risks taken on by the service provider. Such an arrangement might not align the interests of the service provider with the objectives of management to the same degree as a contingent fee where the success fee is based on the value of the transaction. Such an arrangement may therefore pose a lesser self-interest threat for the service provider because the contingent element of the fee is likely to be lower. However, the proposed change to the definition of a contingent fee basis would bring typical abort fee arrangements within the definition and would cause them to be prohibited in the circumstances described in paragraph 7.1 above.
- 7.12 The APB is seeking views on whether to retain or modify the current approach to contingent fees in the Ethical Standards. Alternative approaches that could be taken to contingent fees are:
- (i) to prohibit all contingent fees; or
  - (ii) to extend the prohibitions described in paragraph 7.1 (a) and (b) to all non-audit services in order to address the threats identified in paragraph 7.10 (a) and (b) more generally.
- 7.13 Finally, given the wider definition of a contingent fee basis, the APB is seeking views on whether abort fees in relation to transaction services and fees in relation to any other non-audit services (for example in relation to VAT or other tax recovery claims assistance) should be exempt from any extended prohibition.

**Question 9: Which approach do you consider that the APB should adopt in relation to contingent fees and why?**

## 8 Conflicts of interest in providing non-audit services

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*Amendments proposed in paragraphs 7 to 14 and 30 to 37 of ES 1 (Revised) and paragraphs 6 and 31 of ES 5 (Revised).*

- 8.1 In light of growing public interest in the provision of advisory services by the auditors to parties associated with an audited entity<sup>19</sup>, the APB has considered whether and to what extent non-audit services relationships between the auditor and certain parties connected with the audited entity may, or may be seen to, impact on the auditor's objectivity and independence.
- 8.2 There are a limited number of references to conflicts of interest in the Ethical Standards:
- Paragraph 9 of ES 1 (Revised)<sup>20</sup> is drawn widely and underpins the requirement for the auditor to conduct the audit with integrity, objectivity and independence. However, in the detail, the Ethical Standards principally address the threats to the objectivity of the auditor that arise from direct relationships (including those arising from the performance of non-audit services engagements) with the audited entity and its affiliates and do not discuss the threats arising from relationships with other parties.
  - Paragraph 33 of ES 1 (Revised) states: *“Threats to the auditor’s objectivity, including a perceived loss of independence, may arise where the audit firm is appointed to a non-audit service engagement for an entity not audited by the firm, but where an audited entity makes this decision.”*
  - Paragraph 31 of ES 5 (Revised) states: *“Threats to the auditor’s objectivity, including a perceived loss of independence, may arise where a non-audit service is provided by the audit firm to an entity not audited by the firm, but which is connected in some way to an audited*

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<sup>19</sup> For example, according to the Report on the affairs of Phoenix Venture Holdings Limited, MG Rover Group Limited and 33 other companies by Gervase MacGregor FCA and Guy Newey QC (Inspectors appointed by the Secretary of State for Trade and Industry under section 432(2) of the Companies Act 1985): “[The auditors] ... undertook extensive advisory work for individuals and companies associated with the Group, as well as acting as auditors to the Group” ... “With such high fees being earned from non-audit work, it would be natural for someone outside ... to think that this might lead to some internal conflict ... Nonetheless, we find that the [processes] to sign off an audit, were sufficient to ensure that the independence and objectivity of [the] audit of the Group was not compromised.”

<sup>20</sup> Objectivity requires that the auditor's judgment is not affected by conflicts of interest. Like integrity, objectivity is a fundamental ethical principle.

*entity, and the outcome of that service has a material impact on the financial statements of the audited entity.”*

- In dealing with Corporate Finance Services, paragraph 109 of ES 5 (Revised) states: *“The audit firm shall not undertake an engagement to provide **corporate finance services in respect of an audited entity...**”* Paragraph 119 on Transaction Related Services is similarly constructed.

8.3 The APB concluded that many parties connected with the audited entity could be relevant in this regard:

- Parties who have a connection with the audited entity, may have an interest that is inconsistent with the general interests of the shareholders and other stakeholders of the audited entity. Where the auditor develops a relationship with that connected party, for example through the provision of accounting or consulting/advisory services, a threat to the auditor’s objectivity and independence would be created if the connected party were to seek to influence the conduct of the audit of the audited entity.
- Relationships with key members of management (including directors and shadow directors) and other parties with an ability to influence management of the audited entity (such as significant shareholders) have the potential to influence or be seen to influence the objectivity of the auditor.
- Where an auditor provides services to other parties whose interests run counter to those of the audited entity and its stakeholders, such as potential purchasers of the audited entity.

8.4 The references to conflicts of interest in the APB Ethical Standards which are outlined in paragraph 8.2 are relatively narrow recognitions of the general point that relationships with parties connected with the audited entity may have, or be seen to have, an influence over the auditor’s objectivity. Accordingly, the APB seeks respondents’ views on whether to recognise the impact of relationships with connected parties more overtly in the Ethical Standards through:

- a. Defining the audited entity’s connected parties to include:
  - i. affiliates,
  - ii. management (including directors and those charged with governance); and
  - iii. other persons (other than as professional advisors) who have an ability to influence such persons in relation to their responsibility for or approach to any matter or judgment that is material to the entity’s financial statements.

- b. Including, in the discussion of integrity in ES 1 (Revised), a paragraph on conflicts of interest arising from relationships with third parties;
  - c. Including in ES 1 (Revised) additional guidance on the threats arising from conflicts of interest caused by relationships with connected parties and to replicate this in the general provisions of ES 5 in relation to the provision of non-audit services;
  - d. Including in paragraph 12 of ES 1 (Revised) additional guidance on the threats arising from conflicts of interest caused by relationships with other third parties;
  - e. Including services to connected parties and services to third parties in respect of the audited entity in the definition of non-audit services
- 8.5 Part (c) of the definition of connected parties has caused some to question whether it would be difficult and/or unduly burdensome to identify all the parties who could be covered by that part of the definition.
- 8.6 One alternative may be to replace part (c) with “related parties of the audited entity and its significant affiliates”. It has been suggested that this would enable audit firms to use well established management processes for identifying related parties as defined for financial reporting purposes. It is argued that this would avoid any difficulties that may arise in identifying those ‘with an ability to influence’ those parties with responsibilities relating to the financial statements, a definition at once both considerably narrower than related parties and yet potentially wider in some respects.
- 8.7 However, others have argued that this approach would not necessarily identify relationships between the auditor and all those parties that were intended (ie where influence could be exerted). For example, the recently revised IFRS definition of a related party broadly includes persons or entities covered by parts (a) and (b) of the proposed definition of a connected party (affiliates and key members of management) and some persons covered by part (c) of the proposed definition (persons who control or have significant influence over the entity and close members of the family of such persons and of key members of management). However, for example, a private equity house may not have a direct or indirect investment in a portfolio company but may have the ability to influence those with responsibility for that entity’s financial statements even though the level of that influence may not amount to ‘significant influence’. In those circumstances, the relationship between the private equity house and the auditor of the portfolio company may be relevant to a consideration of the objectivity and independence of the auditor but the private equity house would not be a related party.

**Question 10:** Does the definition of a 'connected party' give rise to any practical issues? If so, how could those practical issues be addressed? What are the relative advantages and disadvantages of the alternative approach suggested in paragraph 8.6?

**Question 11:** Would the adoption of any of the approaches discussed in Sections 6, 7 and 8 give rise to any significant costs that would not be outweighed by the benefits of the relevant proposal? If so, please describe and, to the extent possible, quantify the costs that you think would be incurred and why the benefits would not outweigh the costs.

## 9 Questions on which the APB seeks views

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**Question 1:** Do you support the approach outlined in paragraphs 2.10 to 2.18? If not, please indicate what, if any, other action should be taken. In particular, does the proposal in paragraph 2.15 present practical difficulties to auditors of small or medium sized entities?

**Question 2:** Are the correct services included in the list of audit related services (see ES 5 (Revised), paragraph [AD])? If not, please identify the changes that should be made and indicate whether the provision of such services gives rise to threats to auditor objectivity and independence (other than threats which are clearly insignificant).

**Question 3:** Will disclosure of additional information about non-audit services in the form of a template (such as that included as an appendix to ES 1 (Revised)) reduce the perceived threats to objectivity and independence arising out of the provision of non-audit services? Do you have any suggestions to improve the template?

**Question 4:** Will the proposed changes to the FRC's Guidance on Audit Committees reinforce audit committees' responsibility for:

- determining whether a company's auditor should be permitted to provide particular non-audit services? If not, what further guidance should be given, and
- providing information about the non-audit services provided by a company's auditor

and therefore reduce the perceived threats to auditor objectivity and independence arising from the provision of non-audit services?

**Question 5:** Do you support:

- the approach taken to the provision of 'extended audit services' in ES 5 (Revised), paragraphs [AH] and [AI] ?
- the additional guidance on the threats and safeguards approach in ES 5 (Revised), paragraphs [AH] and [AI] ?
- the strengthening of the role of the Ethics Partner in ES 1 (Revised), paragraphs 21 to 24 and ES 5 (Revised), paragraph [AA] ?
- the amended definition of 'affiliate' and 'significant affiliate' ?
- the application of the remuneration and evaluation policies to all members of the engagement team in ES 4 (Revised), paragraph 38 ?
- the other amendments referred to in Section 5 ?

If not, please explain your reasons and the approach that you think the APB should take.

**Question 6:** Are there any reasons why the revisions to the Ethical Standards proposed by the APB in Sections 2, 4 and 5 will be difficult to implement for audits of financial statements for periods commencing on or after 15 December 2010? If so, what further transitional arrangements might be necessary?

**Question 7:** Which of the options (to address the self review threat arising from the provision of restructuring services) set out in paragraph 6.14 should the APB adopt? Should the option that you have chosen apply to all entities, or only to listed entities?

**Question 8:** Does the revised definition of a 'contingent fee basis' give rise to any practical issues?

**Question 9:** Which approach do you consider that the APB should adopt in relation to contingent fees and why?

**Question 10:** Does the definition of a 'connected party' give rise to any practical issues? If so, how could those practical issues be addressed? What are the relative advantages and disadvantages of the alternative approach suggested in paragraph 8.6?

**Question 11:** Would the adoption of any of the approaches discussed in Sections 6, 7 and 8 give rise to any significant costs that would not be outweighed by the benefits of the relevant proposal? If so, please describe and, to the extent possible, quantify the costs that you think would be incurred and why the benefits would not outweigh the costs.

# Exposure Draft of Revisions to APB Ethical Standards for Auditors

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## Contents

- ES 1 - integrity, objectivity and independence.
- ES 2 - Financial, business, employment and personal relationships.
- ES 4 - Fees, remuneration and evaluation policies, litigation, gifts and hospitality.
- ES 5 - Non-audit services provided to audited entities.
- ES – Provisions Available for Small Entities.
- Glossary of Terms.

# APB ETHICAL STANDARD 1 (REVISED)

## INTEGRITY, OBJECTIVITY AND INDEPENDENCE

*(Revised April 2008[December 2010])*

<b>Contents</b>	<b>paragraph</b>
Introduction	1 - 14
Compliance with ethical standards	15 - 26
Identification and assessment of threats	27 - 37
Identification and assessment of safeguards	38 - 45
Engagement quality control review	46 <del>47</del> [E]
Overall conclusion	48 - 50
Other auditors involved in the audit of group financial statements	51 <del>52</del> 53
Network firms not involved in the audit	54 <del>55</del>
Communication with those charged with governance	56 <del>57</del> 63
Documentation	64 <del>65</del> 66
Effective date	67 <del>68</del> 69

## **PREFACE**

APB Ethical Standards apply in the audit of financial statements. They are 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 The financial statements of an entity may have a number of different users. For example, they may be used by suppliers and customers, joint venture partners, bankers and other suppliers of finance, taxation and regulatory authorities, employees, trades unions and environmental groups. In the case of a listed company, the financial statements are an important source of information to the capital markets. But the primary purpose of the financial statements of an entity is to provide its owners – the shareholders (or those in an equivalent position) – with information on the state of affairs of the entity and its performance and to assist them in assessing the stewardship exercised by the directors (or those in an equivalent position) over the business that has been entrusted to them.
- 2 The financial statements of an entity are the responsibility of its board of directors and are prepared by them, or by others on their behalf, for the shareholders or, in some circumstances, for other third parties.
- 3 The primary objective of an audit of the financial statements is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly. The auditor issues a report that includes an opinion as to whether or not the financial statements give a true and fair view<sup>1</sup>. Thus the auditor assists the shareholders to exercise their proprietary powers as shareholders in the Annual General Meeting.
- 4 Public confidence in the operation of the capital markets and in the conduct of public interest entities depends, in part, upon the credibility of the opinions and reports issued by the auditor in connection with the audit of the financial statements. Such credibility depends on beliefs concerning the integrity, objectivity and independence of the auditor and

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<sup>1</sup> In the case of certain bodies in the public sector, the auditor expresses an opinion as to whether the financial statements 'present fairly' the financial position.

the quality of audit work performed. APB establishes quality control, auditing and ethical standards to provide a framework for audit practice. The Auditors' Code underlies APB's standards and sets out the fundamental principles, which APB expects to guide the conduct of auditors.

- 5 APB Ethical Standards are concerned with the integrity, objectivity and independence of auditors. Ethical guidance on other matters, together with statements of fundamental ethical principles governing the work of all professional accountants, are issued by professional accountancy bodies.
- 6 **Auditors shall conduct the audit of the financial statements of an entity with integrity, objectivity and independence.**

### **Integrity**

- 7 Integrity is a prerequisite for all those who act in the public interest. It is essential that auditors act, and are seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candour, courage, intellectual honesty and confidentiality.

[A] Integrity requires that the auditor is not affected, and is not seen to be affected, by conflicts of interest. Conflicts of interest may arise from personal, financial, business, employment, and other relationships which the audit engagement team, the audit firm or its partners or staff have with its connected parties.<sup>2</sup>

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<sup>2</sup> For this purpose an audited entity's connected parties are:

- a. its affiliates;
- b. key members of management (including but not limited to directors and those charged with governance) of the audited entity and its significant affiliates, individually or collectively; and
- c. any person or entity with an ability to influence (other than in their capacity as professional advisor), whether directly or indirectly, key members of management and those charged with governance of the audited entity and its significant affiliates,

- 8 It is important that the directors and management of an audited entity can rely on the auditor to treat the information obtained during an audit as confidential<sup>3</sup>, unless they have authorised its disclosure, unless it is already known to third parties or unless the auditor has a legal right or duty to disclose it. Without this, there is a danger that the directors and management will fail to disclose such information to the auditor and that the effectiveness of the audit will thereby be impaired.

### **Objectivity**

- 9 Objectivity is a state of mind that excludes bias, prejudice and compromise and that gives fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not. ~~Objectivity~~ Like integrity, objectivity is a fundamental ethical principle and requires that the auditor's judgment is not affected by conflicts of interest. ~~Like integrity, objectivity is a fundamental ethical principle.~~

- 10 The need for auditors to be objective arises from the fact that many of the important issues involved in the preparation of financial statements do not relate to questions of fact but rather to questions of judgment. For example, there are choices to be made by the board of directors in deciding on the accounting policies to be adopted by the entity: the directors have to select the ones that they consider most appropriate and this decision can have a material impact on the financial statements. Furthermore, many items included in the financial statements cannot be measured with absolute precision and certainty. In many cases, estimates have to be made and the directors may have to choose one value from a range of possible outcomes. When exercising discretion in these areas, the directors have regard to the applicable financial reporting framework. If the directors, whether deliberately or

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individually or collectively, in relation to their responsibility for or approach to any matter or judgment that is material to the entity's financial statements.

<sup>3</sup> The fundamental principle of confidentiality is addressed in the ethical guidance issued by the auditor's professional accountancy body. This principle does not constrain the proper communication between the auditor and shareholders of the audited entity (or equivalent).

inadvertently, make a biased judgment or an otherwise inappropriate decision, the financial statements may be misstated or misleading.

- 11 It is against this background that the auditor is required to express an opinion on the financial statements. The audit involves considering the process followed and the choices made by the directors in preparing the financial statements and concluding whether the result gives a true and fair view. The auditor's objectivity requires that an impartial opinion is expressed in the light of all the available audit evidence and the auditor's professional judgment. Objectivity also requires that the auditor adopts a rigorous and robust approach and is prepared to disagree, where necessary, with the directors' judgments.

## **Independence**

- 12 Independence is freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity. However, whereas objectivity is a personal behavioural characteristic concerning the auditor's state of mind, independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditor and the audited entity and its connected parties. Relationships with parties whose interests may be contrary to the interests of the audited entity may also be relevant to the appearance of the auditor's independence.
- 13 The need for independence arises because, in most cases, users of the financial statements and other third parties do not have all the information necessary for judging whether the auditor is, in fact, objective. Although the auditor may be satisfied that its objectivity is not impaired by a particular situation, a third party may reach a different conclusion. For example, if a third party were aware that the auditor had certain financial, employment, business or personal relationships with the

audited entity, that individual might reasonably conclude that the auditor could be subject to undue influence from the directors or would not be impartial or unbiased. Public confidence in the auditor's objectivity could therefore suffer as a result of this perception, irrespective of whether there is any actual impairment.

- 14 Accordingly, in evaluating the likely consequences of such situations and relationships, the test to be applied is not whether the auditor considers that the auditor's objectivity is impaired but whether it is probable that a reasonable and informed third party would conclude that the auditor's objectivity either is impaired or is likely to be impaired. There are inherent ~~threats~~limits to the level of independence (both actual and perceived) that the auditor can achieve as a result of the influence that the board of directors and management have over the appointment and remuneration of the auditor. The audit engagement partner considers the application of safeguards where there are threats to auditor independence (both actual and perceived).

## COMPLIANCE WITH ETHICAL STANDARDS

- 15 **The audit firm shall establish policies and procedures, appropriately documented and communicated, designed to ensure that, in relation to each audit engagement, the audit firm, and all those who are in a position to influence the conduct and outcome of the audit, act with integrity, objectivity and independence.**
- 16 For the purposes of APB Ethical Standards, a person in a position to influence the conduct and outcome of the audit is:
- (a) any person who is directly involved in the audit ('the engagement team'), including:
    - (i) the audit partners, audit managers and audit staff ('the audit team');

(ii) professional personnel from other disciplines involved in the audit (for example, lawyers, actuaries, taxation specialists, IT specialists, treasury management specialists);<sup>4</sup>

(iii) those who provide quality control or direct oversight of the audit;

(b) any person who forms part of the chain of command for the audit within the audit firm;

(c) any person within the audit firm who, due to any other circumstances, may be in a position to exert such influence.

17 Compliance with the requirements regarding the auditor's integrity, objectivity and independence is a responsibility of both the audit firm and of individual partners and professional staff. The audit firm establishes policies and procedures, appropriate to the size and nature of the audit firm, to promote and monitor compliance with those requirements by any person who is in a position to influence the conduct and outcome of the audit.<sup>5, 6</sup>

**18 The leadership of the audit firm shall take responsibility for establishing a control environment within the firm that places**

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<sup>4</sup> Where external consultants are involved in the audit, ISA (UK and Ireland) 620 *'Using the work of an Auditor's Expert'* states that the auditor ~~should~~shall evaluate the objectivity of the expert.

<sup>5</sup> Monitoring of compliance with ethical requirements will often be performed as part of a broader quality control process. ISQC (UK & Ireland) 1 *'Quality Control for ~~firms~~Firms that perform auditsPerform Audits and reviewsReviews of historical financial informationFinancial Statements and other assuranceAssurance and related services engagements'Related Services Engagements'* establishes ~~the basic principles and essential~~ requirements in relation to a firm's responsibilities for its system of quality control for audits.

<sup>6</sup> In addition, UK legislation provides that each of the Recognised Supervisory Bodies must have adequate rules and practices to ensure that the audit firm has arrangements to prevent any person from being able to exert any influence over the way in which a statutory audit is conducted in circumstances in which that influence would be likely to affect the independence or integrity of the audit.

**adherence to ethical principles and compliance with APB Ethical Standards above commercial considerations.**

- 19 The leadership of the audit firm influences the internal culture of the firm by its actions and by its example ('the tone at the top'). Achieving a robust control environment requires that the leadership gives clear, consistent and frequent messages, backed up by appropriate actions, which emphasise the importance of compliance with APB Ethical Standards.
- 20 In order to promote a strong control environment, the audit firm establishes policies and procedures that include:
- (a) requirements for partners and staff to report where applicable:
    - family and other personal relationships involving an entity audited by the firm;
    - financial interests in an entity audited by the firm;
    - decisions to join an audited entity.
  - (b) monitoring of compliance with the firm's policies and procedures relating to integrity, objectivity and independence. Such monitoring procedures include, on a test basis, periodic review of the audit engagement partners' documentation of the consideration of the auditor's objectivity and independence, addressing, for example:
    - financial interests in audited entities;
    - economic dependence on audited entities;
    - the performance of non-audit services;
    - audit partner rotation;
  - (c) identification of the audited entities which partners in the chain of command and their immediate family need to be independent from<sup>7</sup>;

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<sup>7</sup> Such identification is necessary for those in the chain of command to understand how their firm responsibilities result in connections with different entities audited by the firm. It can be achieved by listing the individual audited entities or by a broader statement regarding categories of audited entity, for example, those of a certain business unit.

- (d) prompt communication of possible or actual breaches of the firm's policies and procedures to the relevant audit engagement partners;
  - (e) evaluation by audit engagement partners of the implications of any identified possible or actual breaches of the firm's policies and procedures that are reported to them;
  - (f) reporting by audit engagement partners of particular circumstances or relationships as required by APB Ethical Standards;
  - (g) operation of an enforcement mechanism to promote compliance with policies and procedures;
  - (h) empowerment of staff to communicate to senior levels within the firm any issue of objectivity or independence that concerns them; this includes establishing clear communication channels open to staff, encouraging staff to use these channels and ensuring that staff who use these channels are not subject to disciplinary proceedings as a result.
- 21 **Save where the circumstances contemplated in paragraph 23 apply, the audit firm shall designate a partner in the firm ('the ~~ethics partner~~ Ethics Partner') as having responsibility for:**
- (a) **the adequacy of the firm's policies and procedures relating to integrity, objectivity and independence, its compliance with APB Ethical Standards, and the effectiveness of its communication to partners and staff on these matters within the firm; and**
  - (b) **providing related guidance to individual partners with a view to achieving a consistent approach to the application of the APB Ethical Standards for Auditors.**

[B] In this role, the Ethics Partner has particular responsibility for engendering a culture in which the audit firm approaches ethical issues following the spirit of the principles in the Ethical Standards. The Ethics Partner is an individual possessing seniority, relevant experience, and

authority at leadership levels within the audit firm. Where the Ethics Partner undertakes this role together with a role such as Compliance or Risk Management he or she ensures that the responsibilities of the Ethics Partner set out in paragraph 21 above take precedence over the responsibilities of other functions.

[C] In the case of audit firms that audit listed companies, the Ethics Partner has direct access to the independent non-executives<sup>8</sup> where such roles are introduced in an audit firm or, alternatively, to the firm's most senior governance body.

22 In assessing the effectiveness of the firm's communication of its policies and procedures relating to integrity, objectivity and independence, ~~ethics partners~~Ethics Partners consider whether they are properly covered in induction programmes, professional training and continuing professional development for all partners and staff. ~~Ethics partners~~Partners also provide guidance on matters referred to them and on matters which they otherwise become aware of, where a difficult and objective judgment needs to be made or a consistent position reached. Ethics Partners are proactive in considering the ethical implications of developments in the business of the audit firm and the environment in which it operates and in providing advice and guidance to partners and staff where appropriate.

23 In audit firms with three or fewer partners who are 'responsible individuals'<sup>9</sup>, it may not be practicable for an ethics partner to be designated. In these circumstances all partners will regularly discuss ethical issues amongst themselves, so ensuring that they act in a consistent manner and observe the principles set out in APB Ethical

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<sup>8</sup> As is made clear in the definition of Chain of command in the Glossary, independent non-executives appointed in accordance with the Audit Firm Governance Code are not regarded as part of the Chain of Command for the purposes of these Ethical Standards.

<sup>9</sup> A 'responsible individual' is a partner or employee of the audit firm who is responsible for audit work and designated as such under the audit regulations of a Recognised Supervisory Body.

Standards. In the case of a sole practitioner, advice on matters where a difficult and objective judgment needs to be made is obtained through the ethics helpline of the auditor's professional body, or through discussion with a practitioner from another firm. In all cases, it is important that such discussions are documented.

24 To be able to discharge his or her responsibilities, the ~~ethics partner is an individual possessing seniority, relevant experience and authority within the firm and~~ Ethics Partner is provided with sufficient staff support and other resources, commensurate with the size of the firm. Alternative arrangements are established to allow for:

- the provision of guidance on those audits where the ~~ethics partner~~ Ethics Partner is the audit engagement partner; and
- situations where the ~~ethics partner~~ Ethics Partner is unavailable, for example due to illness or holidays.

Where such support is shared with other functions such as Compliance or Risk Management, the Ethics Partner establishes policies and procedures to ensure that:

- matters delegated to support staff by the Ethics Partner, whether directly or indirectly through the operation of delegation policies established by the Ethics Partner, are clearly identified in internal documentation as relating to the Ethics Partner role and are addressed and supervised in a manner consistent with the Ethics Partner role, avoiding conflicts with other objectives; and
- all matters required to be communicated to, consulted upon with or approved by the Ethics Partner are communicated to him or her or an authorised delegate personally, on a timely basis.

25 Whenever a possible or actual breach of an APB Ethical Standard, or of policies and procedures established pursuant to the requirements of an APB Ethical Standard, is identified, the audit engagement partner, in the first instance, and the ethics partner, where appropriate, assesses the implications of the breach, determines whether there are safeguards that

can be put in place or other actions that can be taken to address any potential adverse consequences and considers whether there is a need to resign from the audit engagement.

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

## **IDENTIFICATION AND ASSESSMENT OF THREATS**

- 27 The auditor identifies and assesses the circumstances, which could adversely affect the auditor's objectivity ('threats'), including any perceived loss of independence, and applies procedures ('safeguards'), which will either:
- (a) eliminate the threat (for example, by eliminating the circumstances, such as removing an individual from the engagement team or disposing of a financial interest in the audited entity); 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 auditor's objectivity is impaired or is likely to be

impaired (for example, by having the audit work reviewed by another partner or by another audit firm).

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.

## Threats to objectivity and independence

- 28 **The audit firm shall establish policies and procedures to require persons in a position to influence the conduct and outcome of the audit to be constantly alert to circumstances that might reasonably be considered threats to their objectivity or the perceived loss of independence and, where such circumstances are identified, to report them to the audit engagement partner or to the ethics partner, as appropriate.**
- 29 Such policies and procedures require that threats to the auditor's objectivity and independence are communicated to the appropriate person, having regard to the nature of the threats and to the part of the firm and the identity of any person involved. The consideration of all threats on an individual and cumulative<sup>10</sup> basis and the action taken is documented. If the audit engagement partner is personally involved, or is unsure about the action to be taken, the matter is resolved through consultation with the ethics partner.
- 30 **The audit firm shall establish policies and procedures which require that partners and employees of the firm, including those providing non-audit services to an audited entity or its connected parties, do**

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<sup>10</sup> For this purpose, 'cumulative' means all current relationships and any past completed relationships that may be expected to have a continuing relevance to the auditor's independence and consideration of the threats that might exist.

**not take decisions that are the responsibility of management of the audited entity.**

31 It is not possible to specify all types of decision that are the responsibility of management, but they typically involve leading and directing the audited entity, including making significant judgments and taking decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources. Examples of judgments and decisions that are not made by the auditor include:

- Setting policies and strategic direction;
- Directing and taking responsibility for the actions of the entity's employees;
- Authorising transactions;
- Deciding which recommendations of the audit firm or other third parties should be implemented;
- Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and
- Taking responsibility for designing, implementing and maintaining internal control.

32 The principal types of threats to the auditor's objectivity and independence are:

- ***self-interest threat***

A self-interest threat arises when the auditor has financial or other interests which might cause it 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 (for example, where the auditor has an investment in the audited entity, is seeking to provide additional services to the audited entity or needs to recover long-outstanding fees from the audited entity).

- ***self-review threat***

A self-review threat arises when the results of a non-audit service performed by the auditor or by others within the audit firm are reflected in the amounts included or disclosed in the financial statements (for example, where the audit firm has been involved in maintaining the accounting records, or undertaking valuations that are incorporated in the financial statements). In the course of the audit, the auditor 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 be perceived to be) unable to take an impartial view of relevant aspects of those financial statements.

- ***management threat***

Paragraph 30 prohibits partners and employees of the audit firm from taking decisions on behalf of the management of the audited entity or its connected parties. A management threat can also arise when the audit firm undertakes an engagement to provide non-audit services in relation to which management are required to make judgments and take decisions based on that work (for example, the design, selection and implementation of a financial information technology system). In such work, the audit firm may become closely aligned with the views and interests of management and the auditor's objectivity and independence may be impaired, or may be perceived to be, impaired.

- ***advocacy threat***

An advocacy threat arises when the audit firm undertakes work that involves acting as an advocate for an audited entity and supporting a position taken by management in an adversarial context (for example, by acting as a legal advocate for the audited entity in litigation or a regulatory investigation). 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 auditor's objectivity and independence.

- ***familiarity (or trust) threat***

A familiarity (or trust) threat arises when the auditor is predisposed to accept or is insufficiently questioning of the audited entity's point of view (for example, where close personal relationships are developed with the audited entity's personnel through long association with the audited entity).

- ***intimidation threat***

An intimidation threat arises when the auditor's conduct is influenced by fear or threats (for example, where the auditor encounters an aggressive and dominating individual).

These categories may not be entirely distinct: certain circumstances may give rise to more than one type of threat. For example, where an audit firm wishes to retain the fee income from a large audited entity, but encounters an aggressive and dominating individual, there may be a self-interest threat as well as an intimidation threat. Furthermore, relationships with the audited entity's connected parties may give rise to similar threats.

33 Threats to the auditor's objectivity, including a perceived loss of independence, may arise where the audit firm is appointed to a non-audit service engagement for an entity not audited by the firm, but where an audited entity makes this decision. In such cases, even if the entity not audited by the firm pays the fee for the non-audit service engagement, the auditor considers the implication of the threats (especially the self-interest threat) that arise from the appointment.

34 **The audit firm shall establish policies and procedures to require the audit engagement partner to identify and assess the significance of threats to the auditor's objectivity on an individual and cumulative<sup>10</sup> basis, including any perceived loss of independence:**

- (a) when considering whether to accept or retain an audit engagement;<sup>11</sup>**
- (b) when planning the audit;**
- (c) when forming an opinion on the financial statements;<sup>12</sup>**
- (d) when considering whether to accept or retain an engagement to provide non-audit services to an audited entity; and**
- (e) when potential threats are reported to him or her.**

35 An initial assessment of the threats to objectivity and independence is required when the audit engagement partner is considering whether to accept or retain an audit engagement. That assessment is reviewed and updated at the planning stage of each audit. At the end of the audit process, when forming an opinion on the financial statements but before issuing the report, the audit engagement partner draws an overall conclusion as to whether any threats to objectivity and independence have been properly addressed on an individual and cumulative basis in accordance with APB Ethical Standards. If, at any time, the auditor is invited to accept an engagement to provide non-audit services to an audited entity or its connected parties, the audit engagement partner considers the impact this may have on the auditor's objectivity and independence.

36 When identifying and assessing threats to the auditor's objectivity and independence, the auditor takes into account current relationships with the audited entity and its connected parties (including non-audit service engagements) and with other parties in certain circumstances (see paragraph [D]), those that existed prior to the current audit engagement and any known to be in prospect following the current audit engagement.

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<sup>11</sup> Consideration of whether to accept or retain an audit engagement does not arise with those bodies in the public sector where responsibility for the audit is assigned by legislation.

<sup>12</sup> In the case of listed companies, the auditor also assesses whether there is any threat to the auditor's objectivity and independence when discharging responsibilities in relation to preliminary announcements and when reporting on interim results.

This is because those prior and subsequent relationships may be perceived as likely to influence the auditor in the performance of the audit or as otherwise impairing the auditor's objectivity and independence.

[D] Threats to the auditor's objectivity, including a perceived loss of independence, may arise where a non-audit service is provided by the audit firm to a third party which is connected (through a relationship) to an audited entity, and the outcome of that service has a material impact on the financial statements of the audited entity.

- For example, if the audit firm provides actuarial services to the pension scheme of an audited entity, which is in deficit and the audit firm subsequently gives an opinion on financial statements that include judgments given in connection with that service.
- Another example might be where an audit firm is asked to undertake work on behalf of an entity that provides financial assistance to an audited entity whose financial position is uncertain, and the engagement team includes personnel who are familiar with or become aware of the business policies of the entity providing financial assistance. In those circumstances, the auditor's objectivity may be compromised if he or she allows knowledge of the business policies of the entity providing financial assistance to influence his or her assessment of management's assumption that the audited entity's financial statements should be prepared on a going concern basis.

37 Where the audited entity or a third party calls into question the objectivity and independence of the audit firm in relation to a particular audited entity, the ethics partner carries out such investigations as may be appropriate.

## IDENTIFICATION AND ASSESSMENT OF SAFEGUARDS

- 38 **If the audit engagement partner identifies threats to the auditor's objectivity, including any perceived loss of independence, he or she shall identify and assess the effectiveness of the available safeguards and apply such safeguards as are sufficient to eliminate the threats or reduce them to an acceptable level.**
- 39 The nature and extent of safeguards to be applied depend on the significance of the threats. Where a threat is clearly insignificant, no safeguards are needed.
- 40 Other APB Ethical Standards address specific circumstances which can create threats to the auditor's objectivity or loss of independence. They give 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 auditor does not accept or withdraws from the audit engagement.
- 41 APB Ethical Standards contain certain additional requirements or prohibitions that apply only in the case of listed company audited entities:
- ES 1, paragraphs 46 and 59;
  - ES 3, paragraphs 12, 18 and 19;
  - ES 4, paragraphs 16, 25 and 29;
  - ES 5, paragraphs 56, 63, 78, 88, 95, [AT]/[AU] and 127.
- These additional requirements also apply where regulation or legislation requires that the audit of an entity is conducted in accordance with the auditing standards or ethical requirements that are applicable to the audit of listed companies.
- 42 **The audit firm shall establish policies and procedures which set out the circumstances in which those additional requirements listed in**

**paragraph 41 that apply to listed companies are applied to other audit engagements.**

- 43 Such policies and procedures take into consideration any additional criteria set by the audit firm, such as the nature of the entity's business, its size, the number of its employees and the range of its stakeholders. For example, a firm may decide to extend the additional requirements to audit engagements of certain regulated financial institutions such as large non-listed banks and insurance companies.
- 44 **The audit engagement partner shall not accept or shall not continue an audit engagement if he or she concludes that any threats to the auditor's objectivity and independence cannot be reduced to an acceptable level.**
- 45 Where a reasonable and informed third party would regard ceasing to act as the auditor as detrimental to the shareholders (or equivalent) of the audited entity, then resignation may not be immediate. However, the audit firm discloses full details of the position to those charged with governance of the audited entity, and establishes appropriate safeguards.

## ENGAGEMENT QUALITY CONTROL REVIEW

46 In the case of listed companies the engagement quality control reviewer<sup>13</sup> shall:

(a) consider the audit firm's compliance with APB Ethical Standards in relation to the audit engagement;

(b) form an independent opinion as to the appropriateness and adequacy of the safeguards applied; and

(c) consider the adequacy of the documentation of the audit engagement partner's consideration of the auditor's objectivity and independence.

47 The audit firm's policies and procedures set out whether there are circumstances in which an engagement quality control review is performed for other audit engagements as described in paragraph 42.

[E] Where an engagement quality control reviewer provides a safeguard to reduce to an acceptable level those threats to independence that have been identified as potentially arising from the provision of non-audit services, his or her review specifically addresses the related threat by ensuring that the work that was performed in the course of the non-audit service engagement has been properly and effectively assessed in the context of the audit of the financial statements.

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<sup>13</sup> ISA (UK and Ireland) 220 'Quality control for ~~audits~~ Audit of historical financial information' Financial Statements, requires the audit engagement partner to appoint an engagement quality control reviewer for all audits of listed entities...The engagement quality control review involves consideration of...the engagement team's evaluation of the firm's independence ~~of~~ in relation to the firm's audit engagement ...'

## OVERALL CONCLUSION

48 **At the end of the audit process, when forming an opinion but before issuing the report on the financial statements, the audit engagement partner shall reach an overall conclusion that any threats to objectivity and independence on an individual and cumulative basis have been properly addressed in accordance with APB Ethical Standards. If the audit engagement partner cannot make such a conclusion, he or she shall not report and the audit firm shall resign as auditor.**

[F] In addition to assessing individual threats to auditor objectivity and independence, the audit engagement partner assesses the cumulative impact of all the threats identified on the audit engagement so as to reach a conclusion that the threats identified, when viewed individually and cumulatively, have been reduced to an acceptable level through the application of safeguards.

49 If the audit engagement partner remains unable to conclude that any ~~threat~~individual threats to objectivity and independence ~~has~~, or that all threats to objectivity and independence viewed on a cumulative basis have been properly addressed in accordance with APB Ethical Standards, or if there is a disagreement between the audit engagement partner and the engagement quality control reviewer, he or she consults the ~~ethics partner~~Ethics Partner.

50 In concluding on compliance with the requirements for objectivity and independence, the audit engagement partner is entitled to rely on the completeness and accuracy of the data developed by the audit firm's systems relating to independence (for example, in relation to the reporting of financial interests by staff), unless informed otherwise by the firm.

## OTHER AUDITORS INVOLVED IN THE AUDIT OF GROUP FINANCIAL STATEMENTS

- 51 **The group audit engagement partner shall be satisfied that other auditors (whether a network firm or another audit firm) involved in the audit of the group financial statements, who are not subject to APB Ethical Standards, are objective and document the rationale for that conclusion.**
- 52 The group audit engagement partner obtains appropriate evidence<sup>14</sup> that the other auditors have a sufficient understanding of and have complied with the current ~~IFAC~~ Code of Ethics for Professional Accountants, including the independence requirements<sup>15</sup>.

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<sup>14</sup> ISA (UK and Ireland) 600 *Using Special Considerations – Audits of Group Financial Statements (Including the Work of Another Auditor/Component Auditors)* states that “The principal auditor should perform procedures to obtain group engagement team shall evaluate whether sufficient appropriate audit evidence, that has been obtained from the audit procedures performed on the consolidation process and the work of the other auditor is adequate for the principal auditor’s purposes, in performed by the context group engagement team and the component auditors on the financial information of the specific assignment components, on which to base the group audit opinion..”

<sup>15</sup> The International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants (the IFAC IESBA Code) issued by the International Ethics Standards Board for Accountants establishes a conceptual framework for applying the fundamental principles of professional ethics for professional accountants. Section 290 of the IFAC IESBA Code illustrates the application of the conceptual framework to independence requirements for audit engagements and represents the international standard on which national standards should be based. No Member Body of the International Federation of Accountants (IFAC) is allowed to apply less stringent standards than those stated in that section. In addition, members of the IFAC Forum of Firms have agreed to apply ethical standards, which are at least as rigorous as those of the IFAC IESBA Code.

- 53 In the case of a listed company, the group audit engagement partner establishes that the company has communicated its policy<sup>16</sup> on the engagement of the external auditor to supply non-audit services to its affiliates and obtains confirmation that the other auditors will comply with this policy.

## NETWORK FIRMS NOT INVOLVED IN THE AUDIT

- 54 **The audit firm shall establish that network firms which are not involved in the audit are required to comply with global policies and procedures that are designed to meet the requirements of the current ~~IFAC Code~~<sup>42</sup> IESBA Code<sup>15</sup>.**
- 55 The ~~IFAC~~IESBA Code requires all network firms to be independent of the entities audited by other network firms<sup>17</sup>. International audit networks commonly meet this requirement through global independence policies and procedures designed to comply with the current ~~IFAC~~IESBA Code which are supported by appropriate monitoring and compliance processes within the network.

## COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

- 56 **The audit engagement partner shall ensure that those charged with governance of the audited entity are appropriately informed on a timely basis of all significant facts and matters that bear upon the auditor's objectivity and independence.**

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<sup>16</sup> The ~~Combined Code on~~UK Corporate Governance Code requires audit committees to develop the company's policy on the engagement of the external auditor to supply non-audit services.

<sup>17</sup> Paragraph 290.~~45~~13 of the ~~IFAC~~IESBA Code, as updated in July ~~2006~~2009.

57 The audit committee, where one exists, is usually responsible for oversight of the relationship between the auditor and the entity and of the conduct of the audit process. It therefore has a particular interest in being informed about the auditor's ability to express an objective opinion on the financial statements. Where there is no audit committee, this role is undertaken by the board of directors.<sup>18, 19</sup>

58 The aim of these communications is to ensure full and fair disclosure by the auditor to those charged with governance of the audited entity on matters in which they have an interest. These will generally include the key elements of the audit engagement partner's consideration of objectivity and independence, such as:

- the principal threats, if any, to objectivity and independence identified by the auditor, including consideration of all relationships between the audited entity, its affiliates and directors and the audit firm;
- any safeguards adopted and the reasons why they are considered to be effective, including any independent partner review;
- the overall assessment of threats and safeguards;
- information about the general policies and processes within the audit firm for maintaining objectivity and independence.

63 The most appropriate time for final confirmation of such matters is usually at the conclusion of the audit. However, communications between the auditor and those charged with the governance of the audited entity will also be needed at the planning stage and whenever significant judgments are made about threats to objectivity and

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<sup>18</sup> Where there is no audit committee, references to communication with the audit committee are to be construed as including communication with the board of directors.

<sup>19</sup> Some bodies in the public sector have audit committees but others have different governance models.

independence and the appropriateness of safeguards put in place, for example, when accepting an engagement to provide non-audit services.

### **Additional provisions related to audits of listed companies**

59 **In the case of listed companies, the audit engagement partner shall ensure that the audit committee is provided with:**

**(a) a written disclosure of relationships that bear on the auditor's objectivity and independence, the threats to auditor independence that these create, any safeguards that are have been put in place and why they address such threats, together with any other information necessary to enable the auditor's objectivity and independence to be assessed;**

**(b) details of non-audit services provided ~~to the audited entity~~ and the fees charged in relation thereto;**

**(c) written confirmation that the auditor is independent;**

**(d) details of 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.**

**(e) an opportunity to discuss auditor independence issues.**

60 The auditor of a listed company discloses in writing details of all relationships between the auditor and the audited entity, and its ~~directors and senior management and its affiliates~~connected parties, including all services provided by the audit firm and its network to the audited entity ~~its directors and senior management and its affiliates~~, and its connected parties that the auditor considers may reasonably be thought to bear on the auditor's objectivity and independence and the related safeguards that are in place.

61 The auditor ensures that the total amount of fees that the auditor and its network firms have charged to the audited entity and its affiliates for the provision of services during the reporting period, analysed into

appropriate categories<sup>20</sup> are disclosed. ~~For each category~~ Appendix 1 contains a template for the provision of such information to an audit committee. Separately, the auditor discloses any contingent fee arrangements<sup>21</sup> and the amounts of any future services which have been contracted, ~~or where a~~ any written proposal to provide non-audit services has been submitted, ~~are also separately disclosed.~~

62 The written confirmation that the auditor is independent indicates that the auditor considers that it complies with APB Ethical Standards and that, in its professional judgment, it is independent and its objectivity is not compromised. If it is not possible to make such a confirmation, the communication will include any concerns that the auditor has that its objectivity and independence may be compromised (including instances where the group audit engagement partner does not consider an other auditor to be objective) and an explanation of the actions which necessarily follow from this.

~~63 The most appropriate time for final confirmation of such matters is usually at the conclusion of the audit. However, communications between the auditor and those charged with the governance of the audited entity will also be needed at the planning stage and whenever significant judgments are made about threats to objectivity and independence and the appropriateness of safeguards put in place, for example, when accepting an engagement to provide non-audit services.~~

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<sup>20</sup> ~~When considering how to present this analysis of fees, the auditor takes account of any applicable legislation and whether the types of non-audit services provided differ substantially.~~

<sup>21</sup> Paragraph 16 of ES 4 requires the audit engagement partner to disclose to the audit committee, in writing, any contingent fee arrangements for non-audit services provided by the auditor or its network firms.

## DOCUMENTATION

- 64 **The audit engagement partner shall ensure that his or her consideration of the auditor's objectivity and independence is appropriately documented on a timely basis.**
- 65 The requirement to document these issues contributes to the clarity and rigour of the audit engagement partner's thinking and the quality of his or her judgments. In addition, such documentation provides evidence that the audit engagement partner's consideration of the auditor's objectivity and independence was properly performed and, for listed companies, provides the basis for review by the engagement quality control reviewer.
- 66 Matters to be documented<sup>22</sup> include all key elements of the process and any significant judgments concerning:
- threats identified, other than those which are clearly insignificant, and the process used in identifying them;
  - safeguards adopted and the reasons why they are considered to be effective;
  - review by an engagement quality control reviewer or an independent partner;
  - overall assessment of threats, on an individual and cumulative basis, and safeguards; and
  - communication with those charged with governance.

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<sup>22</sup> The necessary working papers can be combined with those prepared pursuant to paragraph 4224 of ISA (UK and Ireland) 220 '~~Quality control~~Control for audits~~an Audit of historical financial information~~Financial Statements', which states that: 'The ~~engagement partner should~~auditor shall ... document ... conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.'

## EFFECTIVE DATE

- 67 ~~Save for the requirements of paragraphs 42 and 54, revisions~~Revisions to this Ethical Standard become effective for audits of financial statements for periods commencing on or after ~~6 April 2008~~.[15 December 2010].
- 68 In the case of paragraphs ~~42~~21, ~~30~~ and ~~54~~59, audit firms will be in compliance with this Ethical Standard provided they have implemented ~~revisions to their policies and procedures~~ the amended requirements by ~~30 September 2008~~[April] 2011.
- 69 Firms may complete audit engagements relating to periods commencing prior to ~~6 April 2008~~[15 December 2010] in accordance with existing ethical standards, putting in place any necessary changes in the subsequent engagement period.

**APPENDIX 1: Illustrative template for disclosure of auditor remuneration**

	Current year £m	Prior year £m
<u>Audit of company</u>		
<u>Audit of subsidiaries</u>		
<b><u>Total audit</u></b>		
<u>Reporting required by law or regulation to be provided by the auditor</u>		
<u>Reviews of interim information</u>		
<u>Reporting on regulatory returns</u>		
<u>Reporting to a regulator on client assets</u>		
<u>Reporting on government grants</u>		
<u>Reporting on internal financial controls where required by law or regulation</u>		
<u>Extended work undertaken at the request of those charged with governance on financial information and/or financial controls performed where this work is integrated with the audit work and is performed on the same principal terms and conditions</u>		
<b><u>Total audit related services</u></b>		
<u>Public reporting on investment circulars</u>		
<u>Private reporting to sponsors or similar parties in connection with investment circulars (including comfort letters and reporting on working capital statements)</u>		
<u>Other services pursuant to legislation not covered above (give details)</u>		
<u>Internal audit services</u>		
<u>Information technology services</u>		
<u>Valuation services</u>		
<u>Actuarial services</u>		
<u>Tax compliance services (i.e. related to assistance with corporate tax returns)</u>		
<u>Tax advisory services</u>		
<u>Litigation support services</u>		
<u>Recruitment and remuneration services</u>		
<u>Corporate finance services (give details)</u>		
<u>Transaction related services not covered above (give details)</u>		
<u>Accounting services (give details)</u>		
<u>Pension fund audit</u>		
<u>Other non-audit services not covered above (give details)</u>		
<b><u>Total non-audit services</u></b>		
<b><u>Total fees</u></b>		

## Extracts from APB ETHICAL STANDARD 2 (REVISED)

### FINANCIAL, BUSINESS, EMPLOYMENT AND PERSONAL RELATIONSHIPS

*(Revised April 2008[December 2010])*

#### FINANCIAL RELATIONSHIPS

- 7 Save where the circumstances contemplated in paragraphs [G], 9, 11, 18 or 20 apply, the audit firm, any partner in the audit firm, a person in a position to influence the conduct and outcome of the audit or an immediate family member of such a person shall not hold:
- (a) any direct financial interest in an audited entity or an affiliate of an audited entity; or
  - (b) any indirect financial interest in an audited entity or an affiliate of an audited entity, where the investment is material to the audit firm or the individual, or to the intermediary; or
  - (c) any indirect financial interest in an audited entity or an affiliate of an audited entity, where the person holding it has both:
    - (i) the ability to influence the investment decisions of the intermediary; and
    - (ii) actual knowledge of the existence of the underlying investment in the audited entity.
- 8 The threats to the auditor's objectivity and independence, where a direct financial interest or a material indirect financial interest in the audited entity is held by the audit firm or by one of the individuals specified in

paragraph 7 are such that no safeguards can eliminate them or reduce them to an acceptable level.

[G] Where a person joins the audit firm as a partner, he or she or an immediate family member is not required to dispose of financial interests held where:

- a. the financial interests were acquired before the new partner joined the audit firm, and
- b. the individual is not able to influence the affairs of the audited entity; and
- c. either there is no market for such interests, or the individual does not have the power to sell or direct the sale of the interest; and
- d. the new partner:
  - is not in a position to influence the conduct and outcome of the audit;
  - does not work in the same part of the firm as the audit engagement partner; and
  - is not involved in the provision of a non-audit service to the audit client.

Such a financial interest is disposed of as soon as possible after the individual becomes able to make a disposal. The audit firm ensures that:

- such financial interests are approved by the Ethics Partner,
- a record is maintained of such individuals, including a description of the circumstances, and
- this information is communicated to the relevant audit engagement partner.

## **GOVERNANCE ROLE WITH AN AUDITED ENTITY**

- 53 ~~A~~**The audit firm or a partner, or employee of the audit firm ~~who undertakes audit work~~, shall not accept appointment or perform a role:**
- (a) ~~to~~ as an officer<sup>1</sup> or a member of the board of directors of the audited entity;**
  - (b) ~~to~~ as a member of any subcommittee of that board; or**
  - (c) ~~to~~ in such a position in an entity which holds directly or indirectly more than 20% of the voting rights in the audited entity, or in which the audited entity holds directly or indirectly more than 20% of the voting rights.**

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<sup>1</sup> As defined in Section 1173 of the Companies Act 2006 as including a director, manager or secretary.

## Extracts from APB ETHICAL STANDARD 4 (REVISED)

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

*(Revised April 2008[December 2010])*

#### FEES

~~10 An audit shall not be undertaken on a contingent fee basis.~~

~~11 A contingent fee basis is any arrangement made at the outset of an engagement under which a pre-determined amount or a specified commission or percentage of any consideration or saving is payable to the audit firm upon the happening of a specified event or the achievement of an outcome (or alternative outcomes). Differential hourly fee rates, or arrangements under which the fee payable will be negotiated after the completion of the engagement, do not constitute contingent fee arrangements.~~

*Drafting for option 1 in relation to contingent fees (outright prohibition), would result in the following amendments and the deletion of paragraphs 14 to 17 and relevant paragraphs in ES 5:*

**10 Neither an audit nor a non-audit service engagement in respect of an audited entity shall be undertaken on a contingent fee basis.**

**11 A contingent fee basis is any arrangement made under which a fee is calculated on a pre-determined basis related to the outcome or result of a transaction, or other event, or the result of the work performed. A fee that is established by a court or other public authority is not a contingent fee.**

- 12 Contingent fee arrangements in respect of audit engagements create self-interest threats to the auditor's objectivity and independence that are so significant that they cannot be eliminated or reduced to an acceptable level by the application of any safeguards.
- 13 The audit fee does not depend on whether the auditor's report on the financial statements is qualified or unqualified. The basis for the calculation of the audit fee is agreed with the audited entity each year before significant audit work is undertaken. The audit engagement partner explains to the audited entity that the estimated audit fee is based on the expected level of audit work required and that, if unforeseen problems are encountered, the cost of any additional audit work found to be necessary will be reflected in the audit fee actually charged. This is not a contingent fee arrangement.

[H] Contingent fee arrangements in respect of non-audit services provided by the auditor in respect of an audited entity create significant self-interest threats to the auditor's objectivity and independence as the auditor may have, or may appear to have, an interest in the outcome of the non-audit service.

*Additional optional paragraph under option 1:*

[I] Paragraph 10 is not intended to prohibit an audit firm from agreeing to a lower fee where a non-audit service engagement relates to a transaction or engagement that was either aborted or prematurely terminated for whatever reason and where the rationale for the lower fee is to take account of either the reduced risk and responsibility involved or the fact that less work was undertaken than had been anticipated.

**Drafting for option 2 in relation to contingent fees (to extend current prohibitions to all non-audit services), would result in the above amendments noted for both options (without the amendment of current paragraph 10), the following amendments and the deletion of relevant paragraphs in the sections on tax, corporate finance and transaction related services in ES5:**

**[J] The audit firm shall not undertake an engagement to provide non-audit services in respect of an audited entity on a contingent fee basis where:**

**(a) the contingent fee 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; or**

**(b) the outcome of those non-audit services (and, therefore, the amount of the fee) is dependent on a future or contemporary audit judgment relating to a material matter in the financial statements of an audited entity.**

**[K] Where non-audit services are provided on a contingent fee basis, there may be a perception that the audit firm's interests are so closely aligned with the audited entity that the auditor's objectivity and independence is threatened. 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 non-audit service is dependent on a future or contemporary audit judgment on a material matter included in the financial statements of an audited entity, the self interest threat cannot be eliminated or reduced to an acceptable level by the application of safeguards.**

**Additional optional paragraphs under option 2:**

**[L] Paragraph [J] is not intended to prohibit an audit firm from charging a lower fee where the engagement relates to a transaction or engagement that was either aborted or prematurely terminated for whatever reason and where the rationale for the lower fee is to take account of either the**

reduced risk and responsibility involved or the fact that less work was undertaken than had been anticipated.

[M] For other non-audit services provided on a contingent fee basis, the audit engagement partner assesses the significance of the self-interest threat and considers whether there are safeguards that could be applied which would be effective to eliminate the threat or reduce it to an acceptable level. The significance of the self-interest threat will depend on factors such as:

- the range of possible fee amounts;
- the nature of the non-audit service;
- the effect of the outcome of the non-audit service on the financial statements of the audited entity.

[N] Examples of safeguards that might be applied to reduce to an acceptable level any self-interest threats arising from the provision of non-audit services on a contingent fee basis (other than those set out in paragraph [L] above) include:

- [the exclusion of any member of the engagement team from the provision of such non-audit services/the provision of such non-audit services by partners and staff who have no involvement in the external audit of the financial statements];
- review of the audit of the financial statements by an audit partner who is not involved in the audit engagement to ensure that the subject matter of the non-audit service engagement has been properly and effectively addressed in the context of the audit of the financial statements.

Under option 1 in relation to contingent fees (outright prohibition), paragraphs 14 to 17 would be deleted

**14 The audit firm shall establish policies and procedures to ensure that the audit engagement partner and the ethics partner are notified where others within the audit firm propose to adopt**

**contingent fee arrangements in relation to the provision of non-audit services to the audited entity or its affiliates.**

- 15 Contingent fee arrangements in respect of non-audit services provided by the auditor to an audited entity may create a threat to the auditor's objectivity and independence. The circumstances in which such fee arrangements are not permitted for such non-audit services are dealt with in APB Ethical Standard 5.
- 16 **In the case of listed companies the audit engagement partner shall disclose to the audit committee, in writing, any contingent fee arrangements for non-audit services provided by the auditor or its network firms.**
- 17 In the case of a group audit of a listed company, which involves other auditors, the letter of instruction sent by the group audit engagement partner to the other auditors requests disclosure of any contingent fees for non-audit services charged or proposed to be charged by the other auditors.

## REMUNERATION AND EVALUATION POLICIES

- 38 **The audit firm shall establish policies and procedures to ensure that, ~~in relation to each audited entity:~~**
- (a) the objectives of the members of the ~~audit engagement team,~~ do not include selling non-audit services to the ~~audited entity they audit;~~**
  - (b) the criteria for evaluating the performance or promotion of members of the ~~audit engagement team,~~ do not include success in selling non-audit services to the ~~audited entity they audit;~~ and**

**(c) no specific element of the remuneration of a member of the ~~audit engagement~~ team, is based on his or her success in selling non-audit services to the ~~audited~~ entity. they audit.**

- 39 Where the auditor identifies areas for possible improvement in an audited entity it may provide general business advice, which might include suggested solutions to problems. Before discussing any non-audit service that might be provided by the audit firm or effecting any introductions to colleagues from outside the ~~audit engagement~~ team, the audit engagement partner considers the threats that such a service would have on the audit engagement, in line with the requirements of APB Ethical Standard 5.
- 40 The policies and procedures required for compliance with paragraph 38 are not intended to inhibit normal profit-sharing arrangements. However, such policies and procedures are central to an audit firm's ability to demonstrate its objectivity and independence and to rebut any suggestion that an audit that it has undertaken and the opinion that it has given are influenced by the nature and extent of any non-audit services that it has provided to that audited entity. Because it is possible that, despite such policies and procedures, such factors may be taken into account in the evaluation and remuneration of members of an ~~audit team, the ethics partner~~ engagement team, the Ethics Partner pays particular attention to the actual implementation of those policies and procedures and ~~makes himself or herself~~ is available for consultation when needed.

# APB ETHICAL STANDARD 5 (REVISED)

## NON-AUDIT SERVICES PROVIDED TO AUDITED ENTITIES

*(Revised April 2008[December 2010])*

<b>Contents</b>	<b>paragraph</b>
Introduction	1 – 4
General approach to non-audit services	5 – 39
Identification and assessment of threats and safeguards	11 – 34
Communication with those charged with governance	35 – 36
Documentation	37 – 39
Application of general principles to specific non-audit services	40[AC] – 135
<del>Internal audit</del> <u>Audit related</u> services	40 – 48[AC] – [AF]
<u>Internal audit services</u>	40 – [AI]
Information technology services	49 – 54
Valuation services	55 – 62
Actuarial valuation services	63 – 67
Tax services	68 – 86
Litigation support services	87 – 90
Legal services	91 – 92
Recruitment and remuneration services	93 – 103
Corporate finance services	104 – 115
Transaction related services	116 - 122

<u>Restructuring services</u>	[AJ] – [AV]	
Accounting services	123 – 135	
Effective date	136 - 139	

## **PREFACE**

APB Ethical Standards apply in the audit of financial statements. They are 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 auditor's 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 auditor's 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 entities audited by them which may create threats to the auditor's 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 auditor either does not accept or withdraws 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 39 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 entities audited by them. This approach is applicable irrespective of the nature of the non-audit services, which may be in question in a given case. (Paragraphs 40 to 135 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 audited entity other than:~~

~~(a) the audit of financial statements; and~~

~~(b) pursuant to those other roles which legislation or regulation specify can be performed by the auditor 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 audited entity's internal controls and a report in accordance with Section 714 of the Companies Act 2006).~~

~~In the case of a group, non-audit services include services provided by the audit firm, to the parent company or to any affiliate.~~

[P] An audit is the term used to describe the work that is undertaken by the auditor to enable him or her to express an independent audit opinion on an entity's financial statements and, where the entity is a parent company, on the group financial statements and/or the separate financial statements of its components<sup>1</sup>.

[Q] International Standards on Auditing (UK and Ireland) require that the auditor exercise professional judgment and maintain professional scepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained<sup>2</sup>.

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<sup>1</sup> In the public sector the statutory scope of an audit can extend beyond expressing an independent opinion on an entity's financial statements to include reporting on an entity's arrangements to ensure the proper conduct of its financial affairs, manage its performance or use of its resources.

<sup>2</sup> ISA (UK and Ireland) 200 paragraph 7.

[R] Judgments regarding the nature and extent of evidence necessary to support the audit opinion are a matter for the auditor but will include:

- identifying and testing those internal control systems the effectiveness of which is necessary for the audit of the financial statements and where, if any control weaknesses are identified, extended testing will be required, and
- additional work undertaken to respond to risks identified by management or the audit committee that the auditor considers could impact the auditor's opinion on the financial statements.

[S] Other work undertaken by the engagement team at the request of management or those charged with governance will not be categorised as part of the audit irrespective of whether it forms part of the audit proposal or engagement, unless it is clear that the predominant rationale for the performance of the work in question is to enable a soundly based audit opinion on the financial statements to be expressed. Therefore, an audit of financial statements does not include work where:

- The objective of that work is not to gather evidence to support the auditor's opinion on the financial statements, or
- The nature and extent of testing is not determined by the external auditor, or in the case of a group, the component auditors, in the context of expressing an opinion on the financial statements, or
- The principal terms and conditions differ from that of the audit.

[T] If, at the request of those charged with governance, additional work on financial information<sup>3</sup> and/or financial controls is performed by the audit team, but the objective of that work is not to enable the auditor to provide an audit opinion on the entity's financial statements, it will be considered as an 'audit related service' for the purpose of this Standard provided that it:

- is integrated with the work performed in the audit, and

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<sup>3</sup> This does not include accounting services.

- is performed on the same principal terms and conditions as the audit.

As a consequence of these factors, any threats to auditor independence arising from the performance of such additional work are considered to be clearly insignificant.

[U] Other additional work that:

- does not relate to financial information and/or financial controls, or
- is not integrated with the work performed in the audit, or is not performed largely by the existing audit team, or
- is not on the same principal terms and conditions as the audit, will be regarded as an 'other non-audit service' for the purpose of this Standard.

6 'Non-audit services' comprise any engagement in which an audit firm provides professional services to  
- an audited entity (including, in the case of a group, the parent company) and its connected parties or  
- another entity in respect of the audited entity  
other than the audit of financial statements of the audited entity<sup>4</sup>.

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 an entity which is not audited by the firm. However, it might be contemplated that an audited entity may gain some benefit from that engagement<sup>5</sup>. In these circumstances, whilst there may be no threat to the audit firm's objectivity and independence at the time of

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<sup>4</sup> For example, where an engagement is undertaken to assist in the preparation of listing particulars for a company acquiring the audited entity

<sup>5</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 entity audited by the firm undertaking the due diligence engagement is the purchaser, that audited entity 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.

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 audited entities are identified and whether any safeguards need to be put in place.

- 8 **The audit firm shall establish policies and procedures that require others within the firm, when considering whether to accept a proposed engagement to provide a non-audit service to an audited entity or any of its affiliates, to communicate details of the proposed engagement to the audit engagement partner.**
- 9 The audit firm establishes appropriate channels of internal communication to ensure that, in relation to an entity audited by the firm, the audit engagement partner (or their delegate) is informed about any proposed engagement to provide a non-audit service ~~to the audited entity or any of its affiliates~~ and that he or she considers the implications for the auditor's objectivity and independence before the engagement is accepted. Additionally, when addressing services provided to another entity in respect of the audited entity, the procedures address any requirement to preserve client confidentiality.
- 10 In the case of a listed company, the group audit engagement partner establishes that the company has communicated its policy on the engagement of the external auditor to supply non-audit services to its affiliates and obtains confirmation that the auditors of the affiliates will comply with this policy.<sup>6</sup> The group audit engagement partner also requires that relevant information on non-audit services provided by network firms is communicated on a timely basis.

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<sup>6</sup> The Combined Code on Corporate Governance requires audit committees to develop the company's policy on the engagement of the external auditor to supply non-audit services.

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

**11 Before the audit firm accepts a proposed engagement to provide a non-audit service to an audited entity, the audit engagement partner shall:**

- (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 auditor's objectivity, including any perceived loss of independence; and**
- (c) identify and assess the effectiveness of the available safeguards to eliminate the threats or reduce them to an acceptable level.**

[V] When assessing the significance of threats to the auditor's objectivity and independence, the audit engagement partner considers the following factors:

- The likely relevance and impact of the subject matter on the financial statements;
- The extent to which performance of the proposed engagement will involve the exercise of professional judgment;
- The size of the engagement and the associated fee;
- The staff who would be carrying out the non-audit service<sup>7</sup>;
- The staff from the audited entity who would be involved in the non-audit service<sup>8</sup>.

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<sup>7</sup> For example, where those handling the non-audit service engagement are particularly expert so that the audit team (or persons advising it) may be unable effectively to review the advice given or the work undertaken by the non-audit service team in the course of conducting a subsequent audit with the result that the effectiveness of the audit might be compromised.

<sup>8</sup> For example, where those involved are particularly senior and/or can be expected to be actively involved in any audit discussion, the safeguards necessary to address any self-review threat may not be effective.

To ensure that this assessment is made with a proper understanding of the nature of the engagement, it may be necessary to refer to a draft engagement letter in respect of the proposed non-audit services or to discuss the engagement with the partner involved.

[W] The assessment of the threats to the auditor's objectivity and independence arising from any particular non-audit engagement is a matter for the audit engagement partner. The audit engagement partner may decide to delegate some information gathering activities to senior personnel on the audit team and may allow such personnel to make decisions in relation to routine non-audit services. If this is the case, the audit engagement partner will:

- provide specific criteria for such decisions that reflect both the requirements of APB Ethical Standards and the audited entity's policy for the purchase of non-audit services, and
- monitor the decisions being made on a regular basis.

[X] Where the audit engagement partner is not able to undertake the assessment of the significance of threats in relation to a proposed engagement to provide a non-audit service to an audited entity, for example due to illness or holidays, alternative arrangements are established (for example, by authorising the engagement quality control reviewer to consider the proposed engagement).

12 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 auditor to make a report to the members on all annual accounts laid before the company in general meeting during its tenure of office. The report must include a statement as to whether, in the auditor's 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 of the state of the affairs and profit or loss for the year

13 **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 shall either:**

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

14 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 auditor's objectivity and to the appearance of its 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.

15 Similarly, in relation to a possible ~~new audit engagement for a prospective~~ appointment as auditor to an entity that the audit firm has not audited ~~entity~~ before, consideration needs to be given to recent, current and potential engagements to provide non-audit services by the audit firm ~~for the prospective audited entity~~ 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 entity~~;
- the materiality of those non-audit services to the proposed audit engagement;
- whether those non-audit services would have been prohibited if the entity had been an audited entity 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**

16 The principal types of threats to the auditor's objectivity and independence are:

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

The auditor remains 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.

17 A **self-interest threat** exists when the auditor has financial or other interests which might cause the auditor 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.

18 **Where substantial fees are regularly generated from the provision of non-audit services, and the fees for non-audit services for a financial year are, or are significantly expected to be, greater than the annual audit and audit-related fees, the audit engagement partner shall provide details of the circumstances to the Ethics Partner and discuss them with him or her with a view to determining whether there would be an actual loss of independence and objectivity by the audit engagement team and, if so, whether appropriate**

safeguards can be put in place. Where the audit firm has provides audit services to a group, the obligation to consider the fees and to provide information to the Ethics Partner shall be on a group basis for all services provided by the audit firm and its network firms to all entities in the group. If appropriate safeguards cannot be put in place, the auditor shall not undertake the proposed non-audit service.

[Y] The audit engagement partner and the Ethics Partner have regard to the possibility that there may be perceived to be a loss of independence resulting from the expected or actual level of fees for non-audit services. The audit firm addresses engagement partner and the Ethics Partner consider the implications of such perceived loss of independence by determining and determine whether there is any risk that there will be an actual loss of independence and objectivity by the engagement team. In making that assessment, the audit engagement team. The partner and the Ethics Partner consider matters such as whether the engagement or engagements giving rise to the fees for non-audit firm services were

- audit related services;
- consistent with the engagements undertaken and fees received on a consistent basis in previous years;
- in the case of a group, disproportionate in relation to any individual group entity;
- unusual in size but unlikely to recur, and/or
- of such a size and nature that a reasonable and informed third party would be concerned at the effect that such engagements would have on the objectivity and independence of the engagement team

Having made that assessment, the audit engagement partner and the Ethics Partner determine whether the threats to independence from the level of fees for non-audit services are at an acceptable level (or can be reduced to an acceptable level by putting in place appropriate safeguards) and the audit engagement partner ensures that those

charged with governance are appropriately informed of the position on a timely basis.

**Paragraph 19 will be amended, dependent on the option followed in respect of contingent fees:**

19 Where fees for non-audit services are calculated on a contingent fee basis, ~~the perception~~there is a risk that a reasonable and informed third party may be that regard the audit firm's interests ~~are to be~~ so closely aligned with the audited entity that it threatens the auditor's objectivity and independence. ~~Any~~

Option 1:

In those circumstances, as no safeguards can reduce that threat to an acceptable level, contingent fees<sup>9</sup> for non-audit services in respect of an audited entity are prohibited.

Or option 2:

Consequently, the audit firm does not accept a non-audit services engagement on a contingent fee basis where:

(a) that contingent fee 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.or

(b) the outcome of the service (and, therefore, the amount of the fee) is dependent on a future or contemporary audit judgment relating to a material matter in the financial statements of an audited entity.

20 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.

21 A threat to objectivity and independence arises because, in the course of the audit, the auditor may need to re-evaluate the work performed in the

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<sup>9</sup> For these purposes, paragraphs [I to N] of ES 4 apply

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.

- 22 In assessing the significance of the self-review threat, the auditor considers 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.
- 23 Where a significant degree of judgment relating to the financial statements is involved in a non-audit service engagement, the auditor 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 audited entity or by authoritative guidance, the auditor's objectivity and the appearance of its 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.
- 24 A **management threat** exists when the audit firm undertakes work that involves making judgments and taking decisions that are properly the responsibility of management.
- 25 Paragraph 30 of APB Ethical Standard 1 prohibits partners and employees of the audit firm from taking decisions on behalf of the management of the audited entity. A threat to objectivity and

independence also arises where the audit firm undertakes an engagement to provide non-audit services in relation to which management are required to make judgments and take decisions based on that work. The auditor may become closely aligned with the views and interests of management and this may erode the distinction between the audited entity and the audit firm, in turn, impairing or calling into question the auditor's ability to apply a proper degree of professional scepticism in auditing the financial statements. The auditor's objectivity and the appearance of its independence therefore may be, or may be perceived to be, impaired.

- 26 In determining whether a non-audit service does or does not give rise to a management threat, the auditor considers whether there is informed management. Informed management exists when:
- the auditor is satisfied that a member of management (or senior employee of the audited entity) has been designated by the audited entity to receive the results of the non-audit service and has been given the authority to make any judgments and decisions of the type set out in paragraph 31 of APB Ethical Standard 1 that are needed;
  - the auditor concludes that that member of management has the capability to make independent management judgments and decisions on the basis of the information provided; and
  - the results of the non-audit service are communicated to the audited entity and, where judgments or decisions are to be made they are supported by an objective analysis of the issues to consider and the audited entity is given the opportunity to decide between reasonable alternatives.
- 27 In the absence of such informed management it is unlikely that any other safeguards can eliminate a management threat or reduce it to an acceptable level.

- 28 An **advocacy threat** exists when the audit firm undertakes work that involves acting as an advocate for an audited entity and supporting a position taken by management in an adversarial context.
- 29 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 auditor's 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 auditor to take an impartial view of this in the context of the audit of the financial statements.
- 30 Where the provision of a non-audit service would require the auditor to act as an advocate for the audited entity 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.
- 31 Threats to the auditor's objectivity, including a perceived loss of independence, may arise where a non-audit service is provided by the audit firm to ~~an entity not audited by the firm, but~~ a third party which is ~~connected in some way~~ (through a relationship) to an audited entity, and the outcome of that service has a material impact on the financial statements of the audited entity.
- For example, if the audit firm provides actuarial services to the pension scheme of an audited entity, which is in deficit and the audit firm subsequently gives an opinion on financial statements that include ~~judgements~~ judgments given in connection with that service.  
The
  - Another example might be where an audit firm is asked to undertake work on behalf of an entity that provides financial assistance to an audited entity whose financial position is uncertain, and the engagement *partner assesses the significance of any related*

~~threats to~~ team includes personnel who are familiar with or become aware of the business policies of the entity providing financial assistance. In those circumstances, the auditor's objectivity and independence and the effectiveness may be compromised if he or she allows knowledge of the available safeguards to eliminate these threats or reduce them business policies of the entity providing financial assistance to an acceptable level. influence his or her assessment of management's assumption that the audited entity's financial statements should be prepared on a going concern basis.

### Safeguards

- 32 Where any threat to the auditor's objectivity and the appearance of its 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.

[Z] When considering what safeguards, if any, would be effective in reducing the threats to independence and objectivity to an acceptable level, the audit engagement partner has regard to the following characteristics of typical safeguards which, individually or in combination, may be effective, depending on the circumstances:

- a. The non-audit services are provided by a separate team from the engagement team, and:
- to address the threat identified, there is effective physical and electronic segregation of the individuals in each team, and of their documentation, at all times during the provision of the audit and non-audit services; and/or

- the team providing the non-audit services avoids taking any action or making any statement that compromises the independence or objectivity of the engagement team, for example, expressing any opinion about the approach that the engagement team might take or the conclusion it might reach when considering the appropriateness of accounting or other audit judgments.

Where safeguards of this nature are considered appropriate, the Ethics Partner establishes policies and procedures to ensure that the arrangements put in place are effective at all times. This will involve being satisfied that there are effective arrangements in place for each member of the non-audit services engagement team to acknowledge their responsibilities and for each member of the engagement team to notify him or her of any breach of this requirement that the team member becomes aware. Where notified of a breach, the Ethics Partner considers together with the audit engagement partner the significance of the breach and the implications for the independence and objectivity of the engagement team, including whether any further safeguards are necessary and whether the matter should be reported to those charged with governance of the audited entity;

- b The Engagement Quality Control Reviewer, or another audit partner of sufficient relevant experience and seniority who is, and is seen to be, an effective challenge to both the audit engagement partner and the partner leading the non-audit services engagement, reviews the work and conclusions of the audit team in relation to their consideration of the audit judgments relating to the subject matter of the non-audit service, having regard to the self-review threat identified, and determines and documents his or her conclusions as to whether the work is sufficient and the conclusions of the engagement team are appropriate. Where the review partner has concerns, the audit engagement partner does not sign the audit opinion until those concerns have been subject to full consultation, including escalation through any processes required by the audit

firm's policies. Where this safeguard is considered appropriate, the Ethics Partner is satisfied that the review partner undertaking this role is appropriate, that the review partner is aware of the circumstances leading to the conclusion that there is a significant self-review threat and that any concerns raised by the review partner have been satisfactorily resolved before signature of the audit opinion.

**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 auditor's objectivity, including any perceived loss of independence, related to a proposed engagement to provide a non-audit service to an audited entity, he or she shall inform the others concerned within the audit firm of that conclusion and the firm shall 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 shall resolve the matter through consultation with the ~~ethics partner~~ 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. The assessment of the threats and the safeguards applied 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.

[AA] Where there is doubt as to the appropriate action to be taken, consultation with the Ethics Partner ensures that an objective judgment is made and the firm's position is consistent.

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

35 The audit engagement partner shall ensure that those charged with governance of the audited entity are appropriately informed on a timely basis of:

(a) all significant facts and matters that bear upon the auditor's 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 the entities audited by them. This can be facilitated by timely communication with those charged with governance of the audited entity (see APB Ethical Standard 1, paragraphs 56 to 63). 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~~ UK Corporate Governance Code relating to reviewing and monitoring the external auditor's independence and objectivity and to developing a policy on the engagement of the external auditor 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.

[AB] Communications with those charged with governance regarding the impact on auditor objectivity of non-audit services are likely to be

facilitated if disclosure of such non-audit services distinguishes between audit related services and other non-audit services (as defined in this Standard).

### **DOCUMENTATION**

- 37 **The audit engagement partner shall ensure that the reasoning for a decision to undertake an engagement to provide non-audit services ~~to an audited entity~~, 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.
- 39 In situations where a management threat is identified in connection with the provision of non-audit services, this documentation will include the auditor's assessment of whether there is informed management. The documentation of communications with the audited entity where ~~judgements~~judgments and decisions are made by management may take a variety of forms, for example an informal meeting note covering the matters discussed.

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

### AUDIT RELATED SERVICES

[AC] Audit related services are those non-audit services specified in this Standard that are largely carried out by members of the engagement team and where the work involved is closely related to the work performed in the audit and the threats to auditor independence are clearly insignificant and, as a consequence, safeguards need not be applied.

[AD] Audit related services are:

- Reporting required by law or regulation to be provided by the auditor;
- Reviews of interim financial information;
- Reporting on regulatory returns;
- Reporting to a regulator on client assets;
- Reporting on government grants;
- Reporting on internal financial controls when required by law or regulation;
- Extended work undertaken at the request of those charged with governance on financial information<sup>10</sup> and/or financial controls performed where this work is integrated with the audit work and is performed on the same principal terms and conditions.

[AE] The audit engagement partner shall ensure that only those non-audit services listed in paragraph [AD] are described as audit related services in communications with those charged with governance of the audited entity.

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<sup>10</sup> This does not include accounting services.

[AF] There may be other services that the auditor considers are closely related to an audit. However the threats to auditor independence arising from such services are not necessarily clearly insignificant and the auditor considers whether such services give rise to threats to independence and, where appropriate, the need to apply safeguards.

### **INTERNAL AUDIT SERVICES**

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

- to outsource the audited entity's entire internal audit function; or
- to supplement the audited entity'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 audited entity on an *ad hoc* basis.

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

[AG] The nature of possible internal audit services is also wide. While the internal audit remit will vary from company to company, it often involves assurance activities designed to assess the design and operating effectiveness of existing or proposed systems or controls and advisory activities where advice is given to an entity on the design and implementation of risk management, control and governance processes.

41 The nature and extent of the threats to the external auditor's independence when undertaking internal audit services vary depending on the nature of the services provided. The main threats to the auditor's objectivity and independence arising from the provision of internal audit services are the self-review threat and the management threat. Generally these will be lower for activities that are primarily designed to provide assurance to those charged with governance, for example that internal

controls are operating effectively, than for advisory activities designed to assist the entity in improving the effectiveness of its risk management, control and governance processes.

- 42 Engagements to provide internal audit services - other than those prohibited in paragraph 44 - may be undertaken, provided that the auditor is satisfied that there is informed management and appropriate safeguards are applied to reduce the self-review threat to an acceptable level.
- 43 Examples of safeguards that may be appropriate when internal audit services are provided to an audited entity 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.
- 44 **The audit firm shall not undertake an engagement to provide internal audit services to an audited entity where it is reasonably foreseeable that:**
- (a) for the purposes of the audit of the financial statements, the auditor 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.**
- 45 The self-review threat is unacceptably high where substantially all of the internal audit activity is outsourced to the audit firm or the auditor 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 audited entity 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.

46 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 internal audit function is outsourced to the audit firm or where the nature of the internal audit work involves the audit firm in taking:

- Taking decisions ~~as to~~ on the scope and nature of the internal audit services to be provided to the audited entity, or
- ~~the design of~~ Designing internal controls or implementing changes thereto.
- Taking responsibility for risk management decisions,
- Undertaking work to evaluate the cost effectiveness of activities, systems and controls,
- Undertaking pre-implementation work on non-financial systems.

47 During the course of the audit the auditor generally evaluates the design and tests the operating effectiveness of some of the entity's internal financial controls, including and the operation of any internal audit function and ~~provide~~ provides management with observations on matters that have come to the attention of the auditor, including comments on weaknesses in the internal control systems (including and/or the internal audit function) ~~and~~ together with 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.

48 ~~In some circumstances, additional internal financial controls work is performed during the course of the audit in response undertaken to a specific request for an extended scope respond 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 risks identified by management threat to the auditor's objectivity and independence. or those charged with governance. Where the auditor considers that such risks could impact their opinion on the financial statements, such work is considered to be audit work for the purposes of this Standard (see paragraphs [T] and [U]).~~

[AH] If, to assist management or those charged with governance, extended audit work on financial information and/or financial controls is performed by the existing audit team, it will be considered as an 'audit related service' provided that it is integrated with the work performed in the audit, and the work is performed on the same principal terms and conditions as the audit.

[AI] Additional work will not be considered an audit related service if it:

- does not relate to financial information and/or financial controls, or
- is not integrated with the work performed in the audit, or is not performed largely by the existing audit team, or
- is not on the same principal terms and conditions as the audit.

(e) In such circumstances the threats and the safeguards will be communicated to those charged with governance. 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. 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 threats to the auditor's objectivity and independence.

## **INFORMATION TECHNOLOGY SERVICES**

- 49 Design, provision and implementation of information technology (including financial information technology) systems by audit firms for entities audited by them creates threats to the auditor's objectivity and independence. The principal threats are the self-review threat and the management threat.
- 50 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 auditor, may be undertaken, provided that there is informed management and appropriate safeguards are applied to reduce the self-review threat to an acceptable level.
- 51 Examples of safeguards that may be appropriate when information technology services are provided to an audited entity 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.
- 52 **The audit firm shall not undertake an engagement to design, provide or implement information technology systems for an audited entity 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 auditor 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.**

- 53 Where it is reasonably apparent that, having regard to the activities and size of the audited entity 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 it makes important decisions in relation to the design or implementation of systems of internal control and financial reporting.
- 54 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 audited entity's existing platform and peripherals, setting up the chart of accounts and the entry of standard data such as the audited entity'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**

- 55 A valuation comprises the making of assumptions with regard to future developments, the application of appropriate methodologies and techniques, and the combination of both to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

- 56 **The audit firm shall not undertake an engagement to provide a valuation to:**
- (a) an audited entity that is a listed company or a significant affiliate of such an entity, where the valuation would have a material effect on the listed company's financial statements, either separately or in aggregate with other valuations provided; or**
  - (b) any other audited entity, where the valuation would both involve a significant degree of subjective judgment and have a material effect on the financial statements either separately or in aggregate with other valuations provided.**
- 57 The main threats to the auditor's objectivity and independence arising from the provision of valuation services are the self-review threat and the management threat. In all cases, 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 and have a material effect on the financial statements.
- 58 For listed companies, or significant affiliates of such entities, the threats to the auditor's objectivity and independence that would be perceived to be created are too high to allow the audit firm to undertake any valuation that has a material effect on the listed company's financial statements.
- 59 The audit firm's policies and procedures will set out whether there are circumstances in which valuation services are not undertaken for non-listed audited entities as described in paragraph 42 of APB Ethical Standard 1.

60 In circumstances where the auditor is designated by legislation or regulation as being ~~eligible~~required to carry out a valuation<sup>4</sup>~~-valuation~~ the restrictions in paragraph 56 do not apply ~~as such a valuation would not be a non-audit service, as provided by paragraph 6~~. In such circumstances, the audit engagement partner applies relevant safeguards.

61 It is usual for the auditor to provide the management with accounting advice in relation to valuation matters that have come to the auditor's 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.

62 Where the auditor is 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***

**63 The audit firm shall not undertake an engagement to provide actuarial valuation services to:**

- (a) an audited entity that is a listed company or a significant affiliate of such an entity, unless the firm is satisfied that the valuation has no material effect on the listed company's**

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<sup>4</sup>For example, Section 593 of the Companies Act 2006 requires a public company to obtain an independent valuation on assets to be received in full or part payment for shares to be allotted from a person who is eligible for appointment as a statutory auditor.

**financial statements, either separately or in aggregate with other valuations provided; or**

**(b) any other audited entity, unless the firm is satisfied that either all significant judgments, including the assumptions, are made by informed management or the valuation has no material effect on the financial statements, either separately or in aggregate with other valuations provided.**

64 Actuarial valuation services are subject to the same general principles as other valuation services. In all cases, 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 entities audited by them.

65 In the case of non-listed companies 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 its independence.

66 For listed companies, or significant affiliates of such entities, the threats to the auditor's objectivity and independence that would be perceived to be created are too high to allow the audit firm to undertake any actuarial valuation unless the firm is satisfied that the valuation has no material effect on the listed company's financial statements.

67 The audit firm's policies and procedures will set out whether there are circumstances in which actuarial valuation services are not undertaken for non-listed audited entities as described in paragraph 42 of APB Ethical Standard 1.

## **TAX SERVICES**

- 68 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 audited entity on one or more specific matters at the request of the audited entity; or
  - (b) undertakes a substantial proportion of the tax planning or compliance work for the audited entity; or
  - (c) promotes tax structures or products to the audited entity, 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 auditor's objectivity and independence before deciding whether to undertake a proposed engagement to provide tax services to an audited entity.

- 69 The provision of tax services by audit firms to entities audited by them may give rise to a number of threats to the auditor's 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.
- 70 Where the audit firm provides advice to the audited entity on one or more specific matters at the request of the audited entity, 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 audited entity. However, the auditor may be able

to undertake such engagements, provided that there is informed management and appropriate safeguards are applied to reduce the self-review threat to an acceptable level.

71 Examples of such safeguards that may be appropriate when tax services are provided to an audited entity 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.

72 **The audit firm shall not promote tax structures or products or undertake an engagement to provide tax advice to an audited entity where the audit engagement partner has, or ought to have, reasonable doubt as to ~~the appropriateness of whether~~ the related accounting treatment involved is based on well established interpretations and/or is appropriate, having regard to the requirement for the financial statements to give a true and fair view in accordance with the relevant financial reporting framework.**

73 Where the audit firm promotes tax structures or products or undertakes an engagement to provide tax advice to the audited entity, 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 auditor 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 entities audited by them 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.

*If option 1 under contingent fees is adopted paragraphs 74 and 75 will be deleted. If option 2 is adopted, the following wording is proposed. If the current approach is retained, the changes marked in paragraph 74 will not be processed.*

**74 The audit firm shall not undertake an engagement to provide tax services wholly or partly on a contingent fee basis where:**

~~(a) the services are provided to an audited entity and 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 amount of the fee) is dependent on:~~

~~the application of tax law which is uncertain or has not been established; and~~

~~a future or contemporary audit judgment relating to a material matter in the financial statements of an audited entity.~~

75 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 auditor's objectivity and independence may arise. The auditor may have, or may appear to have, an interest in the success of the tax services, causing the audit firm 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.

76 **The audit firm shall not undertake an engagement to provide tax services to an audited entity where the engagement would involve the audit firm undertaking a management role.**

77 When providing tax services to an audited entity, there is a risk that the audit firm undertakes a management role, unless the firm is working with informed management.

78 **~~For~~Where an audited entity ~~that is~~ a listed company or a significant affiliate of such an entity, the audit firm shall not undertake an engagement to prepare current or deferred tax calculations ~~for the purpose of~~ that are or may reasonably be expected to be used when preparing accounting entries that are material to the relevant financial statements of the audited entity, save where the circumstances contemplated in paragraph 131 apply.**

79 For listed companies or significant affiliates of such entities, the threats to the auditor's objectivity and independence that would be created are too high to allow the audit firm to undertake an engagement to prepare calculations of current or deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the relevant financial statements, together with associated disclosure notes, save where the circumstances contemplated in paragraph 131 apply.

80 For entities other than listed companies or significant affiliates of listed companies, the auditor may undertake an engagement to prepare current or deferred tax calculations for the purpose of preparing accounting entries, 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.
- 81 The audit firm's policies and procedures will set out whether there are circumstances in which current or deferred tax calculations for the purpose of preparing accounting entries are not prepared for non-listed audited entities as described in paragraph 42 of APB Ethical Standard 1.
- 82 **The audit firm shall not undertake an engagement to provide tax services to an audited entity where this would involve acting as an advocate for the audited entity, before an appeals tribunal or court<sup>5</sup> in the resolution of an issue:**
- (a) that is material to the financial statements; or**
  - (b) where the outcome of the tax issue is dependent on a future or contemporary audit judgment.**
- 83 Where the tax services to be provided by the audit firm include representing the audited entity in any negotiations or proceedings involving the tax authorities, advocacy threats to the auditor's objectivity and independence may arise.
- 84 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 audited entity). In such circumstances effective safeguards may exist and the tax authorities will undertake their own review of the issues.

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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 HM Revenue & Customs or the VAT and Duties Tribunal.

- 85 Where the tax authorities indicate that they are minded to reject the audited entity'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 auditor is 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 audited entity and makes it clear 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 audited entity, or resign from the audit engagement from the time when the matter is formally listed for hearing before the appeals tribunal.
- 86 The audit firm is not, however, precluded from having a continuing role (for example, responding to specific requests for information) for the audited entity in relation to the appeal. The audit firm assesses the threat associated with any continuing role in accordance with the provisions of paragraphs 87 to 90 of this Standard.

### ***LITIGATION SUPPORT SERVICES***

- 87 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 in all cases 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.
- 88 **The audit firm shall not undertake an engagement to provide litigation support services to:**
- (a) an audited entity that is a listed company or a significant affiliate of such an entity, 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 listed company's financial statements, either separately or in aggregate with other estimates and valuations provided; or**

**(b) any other audited entity, 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, either separately or in aggregate with other estimates and valuations provided and there is a significant degree of subjectivity involved.**

89 In the case of non-listed entities, 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.

90 The audit firm's policies and procedures will set out whether there are circumstances in which litigation support services are not undertaken for non-listed audited entities as described in paragraph 42 of APB Ethical Standard 1.

### ***LEGAL SERVICES***

91 **The audit firm shall not undertake an engagement to provide legal services to an audited entity where this would involve acting as the solicitor formally nominated to represent the audited entity 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.**

92 Although the provision by the auditor of certain types of legal services to its audited entities 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 auditor of the merits of the audited entity's position when auditing its financial statements, this Standard prohibits an audit firm from acting as the formally nominated representative for an audited entity 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***

- 93 **The audit firm shall not undertake an engagement to provide recruitment services to an audited entity that would involve the firm taking responsibility for the appointment of any director or employee of the audited entity.**
- 94 A management threat arises where audit firm personnel take responsibility for any decision as to who is appointed by the audited entity.
- 95 **For an audited entity that is a listed company, the audit firm shall not undertake an engagement to provide recruitment services in relation to a key management position of the audited entity, or a significant affiliate of such an entity.**
- 96 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.

- 97 The audit firm's policies and procedures will set out whether there are circumstances in which recruitment services are not undertaken for non-listed audited entities as described in paragraph 42 of APB Ethical Standard 1.
- 98 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 95 does not extend to:
- senior members of an audit team interviewing prospective directors or employees of the audited entity and advising on the candidate's technical financial competence; or
  - the audit entity using information gathered by the audit firm, including that relating to salary surveys.
- 99 **The audit firm shall 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 audited entity.**
- 100 The provision of advice on remuneration packages (including bonus arrangements, incentive plans and other benefits) to existing or prospective employees of the audited entity 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.
- 101 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.

- 102 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 auditor's objectivity and independence.
- 103 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 audited entity (see APB Ethical Standard 1, paragraphs 56 to 63).

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

- 104 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 audited entity's business and provide advisory services in the course of such sales; or
  - to identify possible 'targets' for the audited entity to acquire; or
  - to advise the audited entity 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 audited entity on the Alternative Investments Market (AIM); or

- to act as financial adviser to audited entity offerors or offerees in connection with public takeovers.

105 The potential for the auditor's 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 auditor's 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.

106 When providing corporate finance services to an audited entity, there is a risk that the audit firm undertakes a management role, unless the firm is working with informed management. Appropriate safeguards are applied to reduce the self-review threat to an acceptable level.

107 Examples of safeguards that may be appropriate when corporate finance services are provided to an audited entity 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.

108 Where the audit firm undertakes an engagement to provide corporate finance services to an audited entity in connection with conducting the

sale or purchase of a material part of the audited entity's business, the audit engagement partner informs the audit committee (or equivalent) about the engagement, as set out in paragraphs 56 to 63 of APB Ethical Standard 1.

**109 The audit firm shall not undertake an engagement to provide corporate finance services in respect of an audited entity 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 whether~~ an accounting treatment that is ~~related~~ subject to the advice provided, a contemporary or future audit judgment relating to a material matter in the financial statements of the audited entity and upon which the success of the related transaction depends:**

**(i) is based on well established interpretations; and/or**

**(ii) is appropriate,**

**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**

~~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 amount of the fee) is dependent on a future or contemporary audit judgment relating to a material matter in the financial statements of an audited entity; or**~~

**~~(c)~~ the engagement would involve the audit firm undertaking a management role in the audited entity.**

**NB** If option 1 or 2 under contingent fees is followed, the deletion above in (c) is made. If the current approach is retained, the deletion of paragraphs 109(c) and 114 will not be processed:

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

111 Where the audit firm acts as a sponsor under the Listing Rules<sup>6</sup>, or as Nominated Adviser on the admission of the audited entity to the AIM, the audit firm is required to confirm that the audited entity 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.

112 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 audited entity, 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 audited entity on financing arrangements, it may be necessary to adopt an accounting ~~treatment about that is not based on well established interpretations or which there is reasonable doubt as to its appropriateness~~may not be appropriate, in order to achieve the desired result. A self-review threat is created because the auditor may be unable to form an impartial view of the accounting treatment to be adopted for the purposes of the proposed

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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.

arrangements. Accordingly, this Standard does not permit the provision of advice such services by audit firms ~~to~~ in respect of entities audited by them where there is ~~reasonable doubt about the appropriateness of the related accounting treatments~~ if that or ought to be reasonable doubt as to whether an accounting treatment that is subject to a contemporary or future audit judgment relating to a material matter in the financial statements of the audited entity and on which the success of a transaction depends is well established and appropriate.

113 Advice to audited entities 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.

~~114 Where a corporate finance engagement is undertaken on a contingent fee basis, self-interest threats to the auditor's objectivity and independence also arise as the auditor 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 matter included in the financial statements of an audited entity, the self-interest threat cannot be eliminated or reduced to an acceptable level by the application of any safeguards.~~

115 These restrictions do not apply in circumstances where the auditor is designated by legislation or regulation as being ~~eligible~~ required to carry out a particular service, ~~since such a service would not be a non-audit service, as provided by paragraph 6.~~ In such circumstances, the audit engagement partner establishes appropriate safeguards.

## **TRANSACTION RELATED SERVICES**

116 In addition to corporate finance services, there are other non-audit services associated with transactions that an audit firm may undertake for an audited entity. 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 management or sponsors in relation to prospectuses and other investment circulars (for example, long form reports, comfort letters on the adequacy of working capital); or
- agreed upon procedures or reports provided to management in relation to particular transactions (for example, securitisations).

117 When providing transaction related services to an audited entity, there is a risk that the audit firm may face a management threat, unless the firm is working with informed management. Appropriate safeguards are applied to reduce the self-review threat to an acceptable level.

118 Examples of safeguards that may be appropriate when transaction related services are provided to an audited entity 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.

**119 The audit firm shall not undertake an engagement to provide transaction related services in respect of an audited entity where:**

**(a) the audit engagement partner has, or ought to have, reasonable doubt as to ~~the appropriateness of whether an accounting treatment that is related to the advice provided, subject to a contemporary or future audit judgment relating to a material matter in the financial statements of the audited entity and upon which the success of the related transaction depends;~~**

**(i) is based on well established interpretations; and/or**

**(ii) is appropriate,**

**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 amount of the fee) is dependent on a future or contemporary audit judgment relating to a material matter in the financial statements of an audited entity; or~~**

**~~(c) the engagement would involve the audit firm undertaking a management role in the audited entity.~~**

**NB If option 1 or 2 under contingent fees is followed, all the amendments above are made. If the current approach is retained, the deletions in paragraphs 119(b) and 121 will not be processed**

120 A self-review threat arises where the outcome of the transaction related ~~to the service~~ services undertaken by the audit firm may be material to the financial statements of the audited entity which are, or will be, subject to audit by the same firm. Where the audited entity proposes to undertake a transaction, it may be necessary to adopt an ~~inappropriate~~ accounting treatment that is not based on well established interpretations or may not be appropriate, in order to achieve the desired result of the transaction (for example, to take assets off the balance sheet). A self-review threat is created if the auditor undertakes transaction related services in connection with such a transaction. Accordingly, this Standard does not permit the provision of ~~advice~~ services by audit firms ~~to in respect of entities~~ audited by them where there is or ought to be reasonable doubt about the appropriateness of the accounting treatments ~~if that as to whether an accounting treatment, that~~ is subject to a contemporary or future audit judgment relating to a material matter in the financial statements of the audited ~~entity~~ related to the entity and on which the success of a related transaction ~~advice given.~~ depends, is well established and appropriate.

~~121 Where a transaction related services engagement is undertaken on a contingent fee basis, self-interest threats to the auditor's objectivity and independence also arise as the auditor 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 matter included in the financial statements of an audited entity, 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.~~

122 These restrictions do not apply in circumstances where the auditor is designated by legislation or regulation as being ~~eligible~~required to carry out a particular service, ~~since such a service would not be a non-audit service, as provided by paragraph 6.~~ In such circumstances, the audit engagement partner establishes appropriate safeguards.

### **RESTRUCTURING SERVICES**

[AJ] Restructuring services are any non-audit services provided to an audited entity in connection with the entity's development or implementation of a transaction or package of transactions (a 'restructuring plan') designed to change its equity or debt financing structure, its corporate structure or its operating structure. There are a variety of possible purposes for developing a restructuring plan, for example to address financial or operating difficulties, to support tax planning, to improve operating efficiency or to improve the cost of capital. The range of non-audit services that may be regarded as 'Restructuring Services' is extensive, and the nature of those services may encompass many of the other types of non-audit services discussed in this Ethical Standard. Where applicable, the related requirements and guidance in this standard apply to Restructuring Services.

[AK] The services that an entity may engage an audit firm to provide may vary considerably and may range from the incidental and routine to advice that is fundamental to the efficacy of the restructuring plan. Consequently, where such services are provided by the entity's auditor, the [audit firm/audit engagement partner] evaluates

- the [actual] threats that the services may present to the audit firm's ability to conduct any contemporary or future audit with objectivity and independence, and
- the likelihood that a reasonable and informed third party would conclude that the auditor's objectivity and independence would be compromised.

**[AL] The audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity where:**

- a. the engagement would involve the audit firm undertaking a management role in or on behalf of the audited entity; or**
- b. the engagement would require the auditor to act as an advocate for the audited entity in relation to matters that are material to the financial statements.**

[AM] The potential for the auditor's objectivity and independence to be impaired through the provision of restructuring services varies depending on the nature of the service provided. Two of the three main threats to auditor objectivity and independence arising from the provision of restructuring services arise where the auditor undertakes a management or advocacy role.

- An audit firm may not undertake a management role if the entity does not have informed management capable of taking responsibility for the decisions to be made.
- To avoid undertaking an advocacy role on behalf of the audited entity, the audit firm takes particular care not to assume (or seen to be assuming) responsibility for the entity's proposals or being regarded as negotiating on behalf of the entity or advocating the appropriateness of the proposals such that its independence is compromised. This is particularly important when the auditor attends meetings with the entity's bank or other interested parties.

If the audit firm undertakes a management role or acts as advocate for the audited entity, the threats to that auditor's objectivity and independence are such that no safeguards can reduce the threat to an acceptable level<sup>11</sup>.

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<sup>11</sup> 'ES – Provisions Available for Small Entities' provides exemptions relating to informed management and the advocacy threat for auditors of small entities.

[AN] The audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity where that engagement may give rise to a self review threat in the course of a contemporary or future audit unless it is satisfied that such threats can be reduced to an acceptable level by appropriate safeguards and that such safeguards have been put in place.

[AO] The provision of restructuring services gives rise to a self review threat where the restructuring services to be provided involve advice or judgments which are likely to be material to a contemporary or future audit judgment.

[AP] Examples of restructuring services that the audit firm may be requested to undertake and which may give rise to a self review threat include:

- Providing preliminary general advice on the options and choices available to management or stakeholders of an entity facing urgent financial or other difficulties.
- Undertaking a review of the business of the entity with a view to advising the audited entity on liquidity management or operational restructuring options.
- Advising on the development of forecasts or projections, for presentation to lenders and other stakeholders, including assumptions.
- Advising the audited entity on how to fund its financing requirements, including equity and debt restructuring programmes.
- Participating in the design or implementation of an overall restructuring plan including, for example, participating in the preparation of cash flow and other forecasts and financial models underpinning the overall restructuring plan.

[AQ] The self review threat arising from the provision of such services is [heightened/particularly significant] where it has potential to impact the auditor's assessment of whether it is appropriate to prepare the entity's

financial statements on a going concern basis. Where the audit firm has been involved in aspects of the preparation of a cash flow, a forecast or a financial model, it is probable that a reasonable and informed third party would conclude that the auditor would have a significant self-review threat in considering the going concern assumption

[AR] In the case of entities that are not listed or which are not significant affiliates of listed entities, the audit firm puts in place those safeguards that it regards as appropriate to reduce the threats to its objectivity and independence to an acceptable level. The types of safeguards to be considered are described in paragraph [Z] above. If the audit firm concludes that the threats arising from some or all of the restructuring services involved cannot be addressed by putting appropriate safeguards in place, it declines the engagement, or those parts of the engagement, affected by those threats that cannot be addressed.

[AS] The following additional requirements and guidance apply where

- the restructuring services are provided in respect of an audited entity and involve developing or implementing a restructuring plan to address the actual or anticipated financial or operational difficulties that threaten the survival of that entity as a going concern (an 'audited entity in distress') and
- that entity is listed or is a significant affiliate of that listed entity.

*Drafting for option 1 (an outright prohibition):*

**[AT] The audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity in distress that is a listed company or a significant affiliate of that listed entity.**

*Drafting for option 2 (a partial prohibition):*

**[AU] Where an audited entity in distress is a listed company or a significant affiliate of that listed entity, the restructuring services provided by audit firm shall be limited to providing:**

- a. **preliminary general advice to an entity in distress;**

- b. 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
- c. challenging the projections and assumptions within a financial model that has been produced by the audited entity; and
- d. reporting on a restructuring plan, or aspects of it, in connection with the proposed issue of an investment circular.

[AV] [Except to the extent of the limited circumstances identified in paragraph [AU]], the significance of the self-review threat is too high to permit the provision of [other] restructuring services to an audited entity in distress that is a listed company or a significant affiliate of that listed entity because there are no safeguards that would be sufficient to reduce the resultant threats to an acceptable level.

[DEPENDING ON WHETHER OPTION 1 OR 2 IS ADOPTED, PARAGRAPH AV, SUITABLY AMENDED WOULD APPLY. IF OPTION 3 IS ADOPTED THE POSITION SET OUT IN PARAGRAPHS AN TO AR ABOVE (AMENDED TO REMOVE REFERENCES TO LISTED ENTITIES) WILL APPLY.]

### **ACCOUNTING SERVICES**

123 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'.

124 The range of activities encompassed by the term 'accounting services' is wide. In some cases, the audited entity 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 audited entity 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.

125 The provision of accounting services by the audit firm to the audited entity creates threats to the auditor's 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 audited entity.

126 When providing accounting services to an audited entity, unless the firm is working with informed management, there is a risk that the audit firm undertakes a management role.

**127 The audit firm shall not undertake an engagement to provide accounting services to:**

- (a) an audited entity that is a listed company or a significant affiliate of such an entity, save where the circumstances contemplated in paragraph 131 apply; or**
- (b) any other audited entity, where those accounting services would involve the audit firm undertaking part of the role of management.**

128 Even where there is no engagement to provide any accounting services, it is usual for the auditor to provide the management with accounting advice on matters that have come to the auditor's 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 is not regarded as giving rise to any threat to the auditor's objectivity and independence.

129 For listed companies or significant affiliates of such entities, the threats to the auditor's 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 131 apply.

130 The audit firm's policies and procedures will set out whether there are circumstances in which accounting services are not undertaken for non-listed audited entities as described in paragraph 42 of APB Ethical Standard 1.

131 In emergency situations, the audit firm may provide a listed audited entity, 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 audited entity'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 audited entity (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.

132 For entities other than listed companies or significant affiliates of listed companies, the auditor 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 to reduce the self-review threat to an acceptable level.

133 The maintenance of the accounting records and the preparation of the financial statements are the responsibility of the management of the audited entity. Accordingly, in any engagement to provide the audited entity 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.

134 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.

135 Examples of safeguards that may be appropriate when accounting services are provided to an audited entity 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

136 Revisions to this Ethical Standard become effective for audits of financial statements for periods commencing on or after ~~6 April 2008~~[15 December 2010].

137 Firms may complete audit engagements relating to periods commencing prior to ~~6 April 2008~~[15 December 2010] in accordance with existing ethical standards, putting in place any necessary changes in the subsequent engagement period.

138 Where compliance with the requirements of ES 5 would result in a service not being supplied, services contracted before ~~6 April 2008~~[date of finalisation of standard] may continue to be provided until the earlier of 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) ~~6 April 2009~~ [date of finalisation of standard plus 12 months], where a task or term is not defined, as long as the following apply:
- the engagement was permitted by existing ethical standards (including transitional provisions);
  - any safeguards required by existing ethical standards continue to be applied; and
  - the need for additional safeguards is assessed, including where possible any additional safeguards specified by ES 5, and if considered necessary, those additional safeguards are applied.

139 In the first year of appointment as auditor to an audited entity, an audit firm may continue to provide non-audit services which are already contracted at the date of appointment, until the earlier of 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.

**Extracts from APB ETHICAL STANDARD  
PROVISIONS AVAILABLE FOR SMALL ENTITIES (REVISED)**

*(Revised ~~April 2008~~ December 2010)*

**EXEMPTIONS**

***ADVOCACY THREAT – ~~TAX~~NON AUDIT SERVICES***

15 **The audit firm of a Small Entity is not required to comply with APB Ethical Standard 5, ~~paragraph~~paragraphs 82 and [AL](b) provided that it discloses the fact that it has applied this Standard in accordance with paragraph 22.**

16 APB Ethical Standard 5, paragraph 82 provides that ‘the audit firm shall not undertake an engagement to provide tax services to an audited entity where this would involve acting as an advocate for the audited entity, before an appeals tribunal or court in the resolution of an issue:

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

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

Such circumstances may create an advocacy threat which it is unlikely any safeguards can eliminate or reduce to an acceptable level.

[AW] APB Ethical Standard 5, paragraph [AL](b) provides that ‘the audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity where the engagement would require the auditor to act as an advocate for the entity in relation to matters that are material to the financial statements’.

[AX] Such circumstances may create an advocacy threat which it is unlikely any safeguards can eliminate or reduce to an acceptable level.

- 17 Where an audit firm auditing a Small Entity takes advantage of the dispensation in paragraph 15, it discloses the fact that it has applied this Standard in accordance with paragraph 22.

**ASSESSMENT OF THREATS – NON-AUDIT SERVICES**

**[AY] The audit firm of a Small Entity is not required to comply with APB Ethical Standard 5, paragraph 18 provided that:**

- a. it discusses objectivity and independence issues related to the provision of non-audit services with those charged with governance; and**
- b. it discloses the fact that it has applied this Standard in accordance with paragraph 22.**

**[AZ] APB Ethical Standard 5, paragraph 18 provides that ‘Where substantial fees are generated from the provision of non-audit services, and the fees for non-audit services for a financial year are, or are expected to be greater than the annual audit fees, the audit engagement partner shall provide details of the circumstances to the Ethics Partner and discuss them with him or her with a view to determining whether there would be an actual loss of independence and objectivity by the engagement team and, if so, whether appropriate safeguards can be put in place. If appropriate safeguards cannot be put in place, the auditor shall not undertake the proposed non-audit service.’**

**[BA] Where an audit firm auditing a Small Entity takes advantage of the dispensation in paragraph [AY], it discusses objectivity and independence issues related to the provision of non-audit services with those charged with governance and discloses the fact that it has applied this Standard in accordance with paragraph 22.**

## APPENDIX: Illustrative disclosures

### *(a) Illustrative disclosure of the fact that the audit firm has taken advantage of an exemption within the auditors' report*

#### *Basis of audit opinion*

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by [the directors] in the preparation of the financial statements, and of whether the accounting policies are appropriate to the [company's] circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

We have undertaken the audit in accordance with the requirements of APB Ethical Standards including APB Ethical Standard – Provisions Available for Small Entities, in the circumstances set out in note [x] to the financial statements.

#### *Opinion*

In our opinion the financial statements give a true and fair view of the state of the [company's] affairs as at ....

[Date of the auditors' report, auditors' signature and address]

### *(b) Illustrative disclosure of relevant circumstances within the financial statements*

Note [x] In common with many other businesses of our size and nature we use our auditors to prepare and submit returns to the tax authorities and assist with the preparation of the financial statements<sup>1</sup>.

Note [x] In common with many other businesses of our size and nature we use our auditors to provide tax advice and to represent us, as necessary, at tax tribunals<sup>2</sup>.

Note [x] XYZ, a former partner of [audit firm] joined [audited entity] as [a director] on [date]<sup>3</sup>.

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<sup>1</sup> Where exemption in paragraph 12 (Management threat in relation non-audit services) is applied.

<sup>2</sup> Where exemption in paragraph 15 (Advocacy threat – tax services) is applied.

<sup>3</sup> Where exemption in paragraph 18 (Partners joining an audited entity) is applied.

Note [x] In common with many other businesses of our size and nature we use our auditors to prepare and submit returns to the tax authorities and assist with the preparation of the financial statements<sup>4</sup>.

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<sup>4</sup> Where exemption in paragraph [AY] (Assessment of threats in relation to non-audit services) is applied.

## Extracts from APB ETHICAL STANDARDS

### GLOSSARY OF TERMS

*(Revised April 2008 [December 2010])*

#### **affiliate**

~~Any undertaking which is connected to another by means of common ownership, control or management.~~

An entity that has any of the following relationships with the audited entity:

(a) An entity that has direct or indirect control over the audited entity if, the audited entity is material, quantitatively or qualitatively, to such entity;

(b) An entity with a direct financial interest in the audited entity if that entity has significant influence over the audited entity and the interest in the audited entity is material, quantitatively or qualitatively, to such entity;

(c) An entity over which the audited entity has direct or indirect control;

(d) An entity in which the audited entity, or an affiliate of the audited entity under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material, quantitatively or qualitatively, to the audited entity and its affiliate in (c); and

(e) An entity which is under common control with the audited entity client (a “sister entity”) if the sister entity and the audited entity are both material, quantitatively or qualitatively, to the entity that controls both the audited entity and sister entity.

Factors that may be relevant in determining whether an entity or an interest in an entity is material to another entity include:

- the extent and nature of the relationships between the audited entity and the other entity

and the impact these have on the relationships of either entity with the auditor of the audited entity, and

- the extent and nature of the relationship(s) between the auditor of the audited entity and the other entity and the impact that this has on their independence as auditor of the audited entity.

**contingent fee basis connected parties**

~~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.~~

An audited entity's connected parties are:

- a. its affiliates;
- b. key members of management (including but not limited to directors and those charged with governance) of the audited entity and its significant affiliates, individually or collectively; and
- c. any person or entity with an ability to influence (other than in the capacity of professional advisors), whether directly or indirectly, key members of management or those charged with governance of the audited entity and its significant affiliates, individually or collectively, in relation to their responsibility for or approach to any matter or judgment that is material to the entity's financial statements.

**non-audit services contingent fee basis**

~~Any engagement in which an audit firm provides professional services to an audited entity other than pursuant to:~~

- ~~(a) the audit of financial statements; and~~
- ~~(b) those other roles which relevant legislation or regulation specify can be performed by the auditor of~~

~~the entity.~~

~~In the case of a group, non-audit services include services provided by the audit firm, to the parent company or to any affiliate. Any arrangement made under which a fee is calculated on a pre-determined basis relating to the outcome or result of a transaction, or other event, or the result of the work performed. A fee that is established by a court or other public authority is not a contingent fee.~~

**entity in distress**

An entity with actual or anticipated financial or operational difficulties that threaten the survival of that entity as a going concern.

**non-audit services**

Any engagement in which an audit firm provides professional services to an audited entity (including, in the case of a group, the parent company) and its connected parties or to another entity in respect of the audited entity, other than the audit of financial statements.

**significant affiliate**

An affiliate identified by the group audit team:

- (i) that is of individual financial significance to the group; or
- (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements<sup>1</sup>.

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<sup>1</sup> Taken from the definition of a significant component in ISA (UK and Ireland) 600

## Appendix 1 - List of respondents

<i>Responses from investor organisations</i>	
Association of British Insurers	Scottish Investment Trust
Hermes Equity Ownership Services	Standard Life Investments
Investment Management Association	Railways Pension Trustee Company Limited
Local Authority Pension Fund Forum	1 confidential response
National Association of Pension Funds	

<i>Corporate respondents</i>	
<i>Companies</i>	
Afren	Management Consulting Group
Anglo American	National Grid
Arriva	Next Group
AstraZeneca	Old Mutual
Aviva	The Paragon Group of Companies
Balfour Beatty	Pennon Group
Barclays	Petrofac
BBC	Petropavlovsk
The Berkeley Group Holdings	Prudential
BG Group	Reckitt Benckiser
British American Tobacco	Redrow plc
BSkyB	Reed Elsevier
BT	Rentokil Initial
Centrica	Rexam
Chemring Group	Royal Bank of Scotland
Compass Group	RSA Insurance
Daily Mail & General Trust	SAB Miller
Development Securities	Scottish & Southern Energy
Diageo	SEGRO
Drax Group	Serco Group
GlaxoSmithKline	Severn Trent
Helical Bar	Smith & Nephew
Hikma Pharmaceuticals	St. Mowden
ICAP	Stagecoach Group
Inchcape	SVG Capital
Inmarsat	Tata Steel Europe
Invensys	Topps Tiles

Appendix 1 – List of Respondents

Johnston Press	Travelport
J Sainsbury	Tullow Oil
Kesa Electricals	Unilever
Laird	United Utilities Group
Land Securities	Vodafone
Latchways	Wolseley
Legal & General Group	Xstrata
Liberty International	9 confidential responses
Logica	
<i>Audit committee chairmen and other directors of corporate entities</i>	
John Arnold	Ian Lee
John Biles	Nick MacAndrew
Chris Bunker	Brendan O'Neill
Sir David Clementi	John Ormerod
John Coombe	Iain Paterson
John Cotter	R M Scott
Hugh Etheridge	Lord Sharman
Patrick Firebrace	Peter Smith
Giles Frost	David Verey
Ross Graham	Roy Waight
Paul Hampden Smith	Simon Webb
Ian Harley	2 confidential responses
Mike Hartley	
<i>Organisations representing the corporate sector</i>	
The 100 Group of Finance Directors	GC100 Group
CBI	Quoted Companies Alliance

<i>Respondents from the accountancy profession</i>	
<i>Audit service providers</i>	
Audit Commission	Kingston Smith
Baker Tilly	KPMG
BDO	Mazars
Deloitte	Moore Stephens
Duncan & Toplis	PKF
Ernst & Young	Price Bailey
Grant Thornton UK	PricewaterhouseCoopers
Horwath Clark Whitehill	RSM Tenon

Appendix 1 – List of Respondents

<i>Representative organisations</i>	
ACCA	ICAEW
Consultative Committee of Accountancy Bodies	ICAEW Audit Quality Forum
Chartered Accountants Ireland	ICAS
Federation of European Accountants (FEE)	London Society of Chartered Accountants

<i>Responses from other individuals and organisations</i>	
Association for Accountancy & Business Affairs	Institute of Internal Auditors
Austin Mitchell MP	Marianne Ojo
CARB	Protiviti
Independent Audit	Vivien Beattie, Stella Fearnley and Tony Hines

## **Appendix 2a – Summary of responses to questions in the October 2009 Consultation Paper**

### **1 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?**

All investor respondents acknowledged that the provision of non-audit services can impair the perception of auditor independence. Three (33%) emphasised that this was especially the case where the size of non-audit fees was high. Two investor respondents took comfort from the fall in non-audit fees during the last decade but it was noted that this should not be a cause for complacency.

Companies and audit committee chairs generally took the view that the provision of non-audit services does not have an impact on audit quality or auditor independence in practice. However some (32%) recognised that there is a perception that the provision of non-audit services adversely impacts auditor independence, especially when the fees for non-audit services exceed the fees for the audit itself.

Many respondents from the profession (65%) accept that there is a perception amongst some investors and others that non-audit services can impact independence, especially when the fees for non-audit services exceed the fees for the audit itself. They suggest that this perception arises from:

- Concerns dating back to 2002 in relation to the closeness of the relationship between Enron and its auditor.
- A lack of visibility of the robustness of company policies on the provision of non-audit services and the safeguards that are put in place by the audit firm to maintain independence.
- Disclosures in the financial statements of fees paid to auditors which do not provide clear information on the nature of non-audit services.

Other respondents also recognised that there is an impact on the confidence in the independence of auditors as a result of the supply of non-audit services. Although many (44%) thought that this was primarily a perception issue, three respondents from this group (33%) thought that where non-audit fees are high in proportion to audit fees, auditor independence will be compromised as interests are aligned with those of the company directors.

### **2 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?**

A significant number (44%) of investor respondents did not believe that there was a correlation between the provision of non-audit services and poor audit quality. However, one investor respondent did think that audit quality is adversely affected by the provision of non-audit services, basing this view on circumstances surrounding the levels of non-audit services provided to banks shortly before they failed, where unqualified audit reports were issued.

Many corporate respondents (52%) thought that the provision of non-audit services does not adversely affect audit quality and some of these (11%) took the view that it

actually strengthens the audit process, as the audit firm has a deeper and better knowledge of the organisation being audited.

*‘The provision of non-audit services by a company’s auditor allows the auditor to better understand the nature of its business and to bring more knowledge to bear on audit matters.’*

*Corporate respondent*

A majority of respondents from the profession (87%) thought that there is no clear evidence that the provision of non-audit services compromises audit quality. Some of these noted that the provision of non-audit services improves audit quality as risk assessments and analyses are assisted by exposure to the audited entity in other work. A number of such respondents also noted that internal and external quality control reviews have not identified any instances where the provision of non-audit services has compromised audit quality. They assert that commercial pressures to maintain high professional standards also serve to ensure that audit quality is not compromised.

Four other respondents (44%) thought that there was no evidence that the provision of non-audit services adversely affects audit quality. However, one respondent believed that there was a link:

*‘In almost every headline scandal relating to real/alleged audit failure, auditors provided consultancy services to the company and were too close to company directors.’*

*Academic respondent*

**3 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.**

Some investor respondents indicated that APB needed to reconsider the current standards in particular areas:

- **Internal audit services.** This was mentioned by five investor respondents who seemed to have been influenced by press coverage in connection with Rentokil which suggested that by outsourcing internal audit to their external auditors there had been a significant reduction in total audit costs. This has led to concerns that auditors undertaking such work may be auditing their own work and taking management decisions.
- **Restructuring services.** Four investor respondents were concerned about auditor independence when a company has taken advice in the form of restructuring services. Concerns were expressed that the auditor’s subsequent decision on going concern is compromised by a significant self-review threat.
- **Contingency fees.** One investor respondent thought that further thought needed to be given to whether, and in what circumstances, contingent fee arrangements should be permissible.

Internal audit was also mentioned as a service where further restrictions would be appropriate by respondents in the accounting profession and other categories.

**4 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?**

Eight investor respondents (89%) concluded that the current regulatory framework has generally been effective in addressing concerns about the provision of non-audit services and does not need to be radically changed. Consequently they did not support a complete prohibition of non-audit services.

*'We believe that [the post-Enron reforms] have addressed the substance of concerns and that it would be wrong to conclude that major changes are required to place further restrictions or prohibitions.'*

*Investor respondent*

The other investor respondent however took the view that the current ethical requirements are not sufficient and that all non-audit services should be prohibited. They argued that a conflict of interest occurs as commercial interests can compromise the likelihood that auditors will confront the directors on difficult issues.

A number of investor respondents and respondents from the profession observed that the approach followed by the APB is consistent with that adopted by other G20 countries. One investor respondent argued that if the UK had more restrictive rules than other developed countries there would be an additional cost attached to listing in the UK.

Many companies and audit committee chairs (69%) believe that there is already sufficient control and regulation of non-audit services and do not support any change in the APB Ethical Standards. They take the view that the principles-based threats and safeguards approach enshrined in them is well-understood and well-managed by many boards which are conscious of the expectations of shareholders. Many believe that further limitations on non-audit services would result in unnecessary bureaucracy, inefficiency and cost.

*'... we believe that the existing standards and guidelines provide a robust framework to enable a company, through its audit committee, to maintain the appropriate level of independence from its auditors while still allowing it to access a wide range of services to the benefit of its shareholders.'*

*Corporate respondent*

A strong majority of respondents from the profession (83%) took the position that the APB Ethical Standards are flexible and proportionate. As such they assert that there does not need to be a fundamental change in approach.

Two respondents from the other category concluded that auditors should only act as auditors and provide no non-audit services of any kind to an audited entity, while another concluded that the level of non-audit services supplied by the Big 4 needs to be curtailed with standards facilitating mid-tier firms from undertaking more such services. However, others (44%) believed that no substantive regulatory change is needed.

*'Our own professional experience ... leads us to the view that the Ethical Standards and the Audit Quality Framework are between them sufficient to address (to a reasonable and realistic level) the real risks to audit objectivity arising from non-audit services.'*

*Consultant respondent*

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

- (a) **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 responses to this question on a complete prohibition of non-audit services have been included under section 4 above.

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

The responses to this question on specific non-audit services or other requirements in the Ethical Standards for Auditors which could be added or amended have been included under section 3 above.

- (c) **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;**

Many investor respondents (44%) took the view that audit committees were best placed to decide which non-audit services the company should purchase from its auditors. There was no suggestion however that the UK Code on Corporate Governance should be strengthened to require, as in the US, the audit committee to approve all non-audit services before they are purchased from the auditors, although some thought that this might be encouraged through revisions to the FRC's Guidance to Audit Committees.

There was considerable support amongst investor respondents (67%) for improvements in the nature and level of detail of information provided within annual reports about policies on the provision of non-audit services by the audit firm. Investor respondents thought that doing this would enable the market to decide the appropriate policy for each individual company and would maintain flexibility so that the auditor can be used in situations where there is a significant benefit for the company and the threats to auditor independence can be safeguarded.

*'... 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.'*

*Investor respondent*

Many companies and audit committee chairs (45%) thought that there may be scope for better disclosure of how companies ensure auditor independence through providing detail of the processes the audit committee applies to approve non-audit services. Best practice was recognised to involve approval of non-audit fees by the audit committee or its chairman (especially in the case of large and unusual pieces of work) and competitive tender in appropriate circumstances. While some (17%) took the view that such a policy could be required in most situations, two respondents thought that requiring audit committees to give specific approval of non-audit services is unnecessary and/or impractical.

*‘I regard the use of auditors for other services as primarily a governance matter. ... my personal experience is audit committees have been taking their responsibilities in this areas seriously and have not been awarding contracts for non-audit services to auditors without due consideration of other providers.’*

*Corporate respondent*

Several respondents from the accounting and audit profession (26%) observed that audit committees have played a role in limiting fees for non-audit services through rigorous and restrictive policies. They believe that audit committees should be able to set their own arrangements for supervising the procurement of non-audit services. However, some (48%) advocated improved disclosure of the policy and procedures adopted by the audit committee in order to give comfort that proper oversight of the procurement of non-audit services had been exercised.

*‘The corporate governance requirements for listed entities recognise the key role for audit committees by requiring them to establish a policy for the approval of NAS and to make appropriate disclosures. The best current practice involves setting out the approval policy and commenting on major NAS provision. We commend this for all listed entities.’*

*Accountancy profession respondent*

There were diverse views amongst respondents in the other category on this topic with one respondent believing that audit committees do not represent stakeholders and others that there were ways in which better disclosure of corporate governance processes could improve confidence in the independence of auditors.

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

Four investor respondents (44%) thought that investor confidence in auditor independence would be enhanced by improved disclosure of non-audit fees.

*‘there is also a considerable lack of clarity about what constitutes a non-audit service’.*

*Investor respondent*

Corporate views on whether disclosure of fees for non-audit services in financial statements needed to be improved differed:

- Some (41% of those expressing a view) thought that the current disclosures already provide clear information and seemed reluctant to add to the amount of detail disclosed by companies, although they did recognise that additional disclosure may be necessary where non-audit services are a high proportion of total fees.

*‘We are not convinced more extensive disclosure of non-audit services within the financial statements would greatly add to improved transparency or a user’s ability to make informed decisions regarding the company.’*

*Corporate respondent*

- Others (59% of those expressing a view) however thought there was an opportunity to provide better and more comprehensive disclosure. They observed that a large proportion of fees currently classified as non-audit are in fact audit related or required by law or regulations. They thought that a better

structure for disclosures would improve consistency and transparency in reporting.

*‘We ... would be happy to see improvements in disclosure requirements of fees paid to auditors to more clearly segregate fees paid pursuant to statutory audits and related services and fees relating to non-audit services.’*

*Corporate respondent*

Respondents from the accounting and audit profession identified a number of difficulties with the current regime of disclosures of auditor remuneration. Some respondents also suggested that greater explanation of the services provided by the auditor may also help to take away the emphasis currently placed on the ratio of non-audit fees to audit fees.

*‘In our view the current disclosure requirements concerning fees for non-audit services provided by a company’s auditor are potentially misleading and have been unhelpful for stakeholders when determining what services an auditor has provided during a financial year.’*

*Accountancy profession respondent*

Few respondents in the other category commented on this aspect of the consultation with one believing that further guidance should recognise that some services could only be provided by the auditor and another believing that existing arrangements are adequate.

## **6 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?**

One investor respondent observed that by engaging the auditor to provide non-audit services the company can save time and money. However, two others noted that any potential cost savings are not sufficient to jeopardise auditor independence.

Two investor commentators noted that non-audit services can lead to cross-subsidisation and ‘low balling’ which can create a barrier for smaller firms and so inhibit competition and choice in the audit market.

Many companies and audit committees (67%) highlighted benefits that could be obtained by engaging the audit firm to carry out certain non-audit services. These included:

- Cost savings, both in terms of fees and in management time (especially important in the current economic climate);
- Higher quality work, with reduced risks, for example where particular advisers in the audit firm are essential advisers due to their industry knowledge and expertise;
- Reduced time to complete the work, which can be important in some cases (for example, where a company needs to raise finance in a timely manner or in bid-defence work);
- Reduced risk of a leak in confidential information.

*‘There are a number of situations where the Group’s auditors are not only well suited to provide certain non audit services (perhaps because of their knowledge of our business and their specific capabilities), but it is essential that we use them for reasons of speed, efficiency and maintenance of confidentiality. This was amply demonstrated during 2009 when the Group undertook a number of corporate transactions ... It simply would not have been realistic to use any firm other than the Group’s auditors for most of the reporting an accounting work needed.’*

*Corporate respondent*

Some companies and audit committees (27%) took the view that further prohibitions of non-audit services would lead to a reduction in choice: it would be more difficult for international groups to change their auditor since arrangements for non-audit services would need to be unwound, with subsequent disruption, so reducing competition for audit. Additionally it may result in audit firms withdrawing from the market and reducing competition further.

*‘I believe it would severely reduce choice if the existing auditor could not compete for this work. Much of the non-audit service provided, certainly for larger listed companies, in investigative work associated with mergers and acquisitions. In many cases this work needs to be carried out by a major firm with an international network. The number of firms able to do this work is restricted, particularly since some of those, who might otherwise be eligible, are often conflicted.’*

*Corporate respondent*

Many of the respondents from the accounting and audit profession (74%) highlighted benefits that could be obtained by engaging the audit firm to carry out certain non-audit services which mirrored those described by companies and audit committees. A number (52%) observed that the balance between cost and benefit differs between the largest listed companies and smaller entities as most non-listed entities (and many AIM and PLUS markets companies) lack the time, inclination and ability to select from a number of advisers, meaning that enforcing the use of multiple advisers could compromise their ability to produce reliable financial information, which would reduce the quality of financial reporting and stakeholder confidence.

## Appendix 2b – Analysis of overall positions taken by respondents to the October 2009 consultation

<i>Summary of position</i>	<i>Investor respondents</i>	<i>Corporate respondents</i>	<i>Accountancy profession</i>	<i>Other respondents</i>
<i>Blanket ban on non-audit services</i>	1	0	0	2
<i>Further restrictions on specific non-audit services</i>	4	0	2	1
<i>Enhanced disclosure and/or more active corporate governance</i>	2	62	18	5
<i>No change necessary</i>	2	47	3	1
<b><i>Sub-total</i></b>	<b>9</b>	<b>109</b>	<b>23</b>	<b>9</b>

<i>Summary of reasons given for no major change</i>	<i>Investor respondents</i>	<i>Corporate respondents</i>	<i>Accountancy profession</i>	<i>Other respondents</i>
The problem is one of perception, rather than a real problem	2	38	15	3
The framework ensures that risk is managed effectively	5	87	19	3
In practice there are robust governance arrangements in place	3	69	6	1
AIU inspections ensure audit quality and auditor independence	1	6	3	1
Change would not be in interests of companies or shareholders	2	84	15	1
Non-audit services can improve audit quality	1	24	11	
Auditor only provides non-audit services if there is business benefit		8		
Change would limit choice of supplier for companies		33	3	
Change would not improve competition in the audit market		4	3	1
Change will reduce the talent available to audit		7	2	

Appendix 2 – Summary of responses

Change would be damaging to small companies		3	10	
Audit Committees need to be able to fulfil their role	2	40	5	2
Focus of change: more active corporate governance	3	17	13	3
Focus of change: better disclosure in financial statements	5	59	18	2
Opportunity could be taken to strengthen corporate governance	2	7	3	1

A number of commentators also raised points in the following areas:

Contingent fee arrangements *	1		1	
Review of 'one-size-fits-all' approach needed			3	
Internal audit services *	5		3	1
Providing non-audit services erodes quality & impairs independence	1		1	3
No perceived benefits to companies				1
Propose ringfencing audit function to allow non-audit services		1		
Link between remuneration and company results undermines confidence in audit	1			
Increase sanctions by 'naming and shaming' in AIU reports		1		
Change would increase competition in the audit market	1		2	3
FRC has no independence from big firms				2
Restructuring services at companies in distress *	4			
Corporate governance guidance to include a ban on non-audit services	1			

\* These topics have been dealt with in more detail by the APB and related considerations are set out elsewhere in this consultation paper.

# **Appendix 3 – Proposed amendment to FRC Guidance on Audit Committees**

## **CONSULTATION DOCUMENT**

### **REVISIONS TO FRC GUIDANCE ON AUDIT COMMITTEES: NON-AUDIT SERVICES**

#### **Introduction**

1. The current version of the FRC Guidance on Audit Committees was issued in October 2008. A number of changes are proposed which arise as a result of work undertaken by the FRC's Auditing Practices Board (APB) on the provision of non-audit services and audit partner rotation. These were highlighted as potential actions in the consultation on the revised UK Corporate Governance Code in December 2009.
2. The changes proposed to the Guidance on Audit Committees are shown in the Appendix of this document and summarised in paragraph 10 below.
3. Comments are requested by 23 October 2010. Subject to the outcome of this consultation, the intention is to publish the updated guidance in December 2010.
4. The FRC will be looking at other aspects of corporate governance, narrative reporting and auditing over the next twelve months, some of which may also have implications for audit committees. It is conceivable that further changes to the Guidance might be necessary as a consequence. If that is the case they will be subject to separate consultation.

#### **Background**

5. In October 2009 the APB issued a Consultation Paper 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. That Consultation Paper provided an analysis of the approach that has been taken to auditor independence since 2004 when the APB was given responsibility for setting ethical standards for auditors. This approach includes an enhanced role for audit committees in approving the purchase of non-audit services from the company's auditor and justifying this to shareholders. This continues to be an important element of the framework surrounding the provision of non-audit services by auditors and the Guidance on Audit Committees is intended to support this role.

6. Responses were received on the APB's October 2009 consultation from 150 commentators representing a wide variety of stakeholder groups. A full list of respondents is given in the Feedback Paper being published concurrently with this consultation. The message from the review undertaken by the APB is that commentators (irrespective of the constituency involved) were overwhelmingly of the view that there should be no outright prohibition of, and no major change to the framework surrounding, the provision of non-audit services by auditors to the entities that they audit.
7. However, there is broad acknowledgement that there is a perception amongst investors that confidence in the audit can be reduced where non-audit services are provided by the auditor. Commentators, including investors, emphasise the need to address this perception issue through improved transparency and governance. This focus on governance reflects a theme of many responses 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.
8. It is thought that one reason for the perception issue is that companies give insufficient disclosure of non-audit services provided by the auditor in their annual reports to enable investors to decide for themselves whether the auditor's objectivity and independence may have been adversely affected by being retained to undertake non-audit services. A number of investor respondents argued that there should be greater disclosure about the nature and level of non-audit services provided by the auditor. Corporate respondents also recognised that there was scope for better disclosure of the type of work being undertaken by the auditor and, where this requires the application of safeguards, how companies ensure that auditor independence is maintained.

*'It is fair to say that reporting by the audit committee is too often boilerplate and uninformative in its approach.'*- Investor respondent

*'...greater clarity and explanation of why audit firms are used and disclosure of non-audit fees would benefit understanding.'* -Corporate respondent

9. As a result of the focus on transparency and governance as potential solutions to the perception issue, the APB has developed a proposal on these improvements which entails changes to both its own Ethical Standards for Auditors and the Guidance on Audit Committees. Additionally it has discussed the disclosure of fees for non-audit services in financial statements the format of which is determined by legislation. There are three aspects of disclosure where respondents felt an improvement could be made:

- The statutory disclosure of auditor remuneration<sup>1</sup> is not always provided on a consistent basis, suggesting that the regulations may not be easy to interpret and/or that the associated guidance<sup>2</sup> has not been followed consistently. In addition the detailed nature of the services provided by the auditors is not always readily apparent, especially as there is a degree of summarisation of the data on non-audit service fees that is carried out;
- Within disclosures in annual reports about compliance with the UK Corporate Governance Code there is often disclosure of the fact that a company has a policy on non-audit services without specifying what this policy is; and
- There is often no explanation of why individual non-audit service engagements have been provided by a company's auditor rather than by another party and how the auditor's independence has been safeguarded.

### **Proposed changes to the Guidance**

10. The changes proposed to the Guidance on Audit Committees are shown as a mark up to the current version in the Appendix of this document. The changes can be summarised as follows:

- More prominence is given to the importance of non-audit services in the assessment of the objectivity and independence of the company's auditor by moving the guidance currently in paragraphs 4.28 and 4.29 to later in the document (revised paragraphs 4.34 and 4.35);
- A number of corporate respondents to the October 2009 consultation suggested that the practice of seeking specific approval from audit committees for particular categories (and values) of non-audit services to be supplied by the auditor is widely followed. This type of policy and procedure is set out in paragraph 4.30.
- Additional guidance is given in paragraph 4.31 to help the audit committee distinguish between those non-audit services which are closely related to an audit and which give rise to a very low threat to auditor objectivity and those where the threats need more careful consideration. This is consistent with the identification of 'audit related services' as a separate category of non-audit services proposed in the APB's Ethical Standards for Auditors. A number of corporate respondents thought that disclosing the nature of the services provided (particularly where they are similar to an audit) would allay fears that

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<sup>1</sup> 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)

<sup>2</sup> ICAEW published TECH 06/06 'Disclosure of Auditor Remuneration' when the regulations were first implemented and this guidance was updated in July 2007.

the auditor is conflicted by the purchase of such non-audit services and therefore help maintain confidence in the quality of the audit.

- It is thought that by identifying audit related services, there will be a greater focus on other non-audit services by both audit committees and investors. There is no presumption that services in this third category are services that the entity's auditor should not provide. A judgment needs to be made by audit committees as to the cost and efficiency benefits and the real or perceived threats to auditor independence which are associated with the auditor providing them. Guidance on such judgments is given in paragraph 4.32.
- Improved disclosures of the audit committee policy, as set out in paragraph 4.38, will give more detail on the nature of services provided by the auditor and will outline the reasons why the audit committee decided to purchase non-audit services, other than audit related services, from the auditor rather than from another party. This increased transparency will enable investors to monitor the judgments made by audit committees and to make it known where they disagree.
- Although not directly linked to greater transparency, there are two other amendments proposed to the Guidance on Audit Committees which are connected with the APB Ethical Standards for Auditors:
  - Additional guidance on factors to take into account when the external auditor is being considered to provide internal audit services is added in paragraph 4.8.
  - Additional guidance on flexibility that is available in respect of the rotation of the audit engagement partner is provided in paragraph 4.36.

### **Further changes to the Guidance**

11. As noted in paragraph 4, the FRC will be looking at other aspects of corporate governance, narrative reporting and auditing over the next twelve months, some of which may also have implications for audit committees. For example, the FRC will be carrying out a review of the Turnbull Guidance on internal control, beginning in the second half of 2010. There is some overlap between the Turnbull Guidance and this Guidance, which addresses the audit committee's role in relation to risk management and internal controls (paragraphs 4.5 to 4.7). If any further changes to the Guidance are proposed as a result of that or other reviews they will be subject to separate consultation.

### **How to Comment**

12. Views are invited from all interested parties on the proposed revisions to the FRC Guidance on Audit Committees. In particular, views are sought on whether the proposed changes to the Guidance reinforce audit committees' responsibility for:

- determining whether a company's auditor should be permitted to provide particular non-audit services, and
- providing information about the non-audit services provided by a company's auditor, and

therefore reduce the perceived threats to auditor objectivity and independence arising from the provision of non-audit services? If not, what further guidance should be given?

**Responses are requested by 23 October 2010 and should be sent by e-mail to:**

**[corporategovernance@frc.org.uk](mailto:corporategovernance@frc.org.uk)**

**or in writing to:**

**Chris Hodge  
Corporate Governance Unit  
Financial Reporting Council  
Fifth Floor, Aldwych House  
71-91 Aldwych  
London WC2B 4HN**

It is the FRC's policy to publish on its website all responses to formal consultations issued by the FRC and/or any of its Operating Bodies unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for nondisclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

## ANNEX

### DRAFT REVISED GUIDANCE ON AUDIT COMMITTEES

*Note: The text of Section 4 of the draft revised Guidance on Audit Committees is provided with a mark up showing all of the changes (except where an existing paragraph is simply moved, in which case the current reference is shown at the end of the paragraph without mark-up). No further changes in other sections are proposed and these have therefore not been provided.*

#### 4 Role and responsibilities

##### Financial reporting

- 4.1 The audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements.
- 4.2 It is management's, not the audit committee's, responsibility to prepare complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations. However the audit committee should consider significant accounting policies, any changes to them and any significant estimates and judgements. The management should inform the audit committee of the methods used to account for significant or unusual transactions where the accounting treatment is open to different approaches. Taking into account the external auditor's view, the audit committee should consider whether the company has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements. The audit committee should review the clarity and completeness of disclosures in the financial statements and consider whether the disclosures made are set properly in context.
- 4.3 Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting by the company, it shall report its views to the board.
- 4.4 The audit committee should review related information presented with the financial statements, including the operating and financial review, and corporate governance statements relating to the audit and to risk management. Similarly, where board approval is required for other statements containing financial information (for example, summary financial statements, significant financial returns to regulators and release of price sensitive information), whenever practicable (without

being inconsistent with any requirement for prompt reporting under the Listing Rules) the audit committee should review such statements first.

### **Internal controls and risk management systems**

- 4.5 The audit committee should review the company's internal financial controls (that is, the systems established to identify, assess, manage and monitor financial risks); and unless expressly addressed by a separate board risk committee comprised of independent directors or by the board itself, the company's internal control and risk management systems.
- 4.6 The company's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the board that it has done so. Except where the board or a risk committee is expressly responsible for reviewing the effectiveness of the internal control and risk management systems, the audit committee should receive reports from management on the effectiveness of the systems they have established and the conclusions of any testing carried out by internal and external auditors.
- 4.7 Except to the extent that this is expressly dealt with by the board or risk committee, the audit committee should review and approve the statements included in the annual report in relation to internal control and the management of risk.
- 4.8 If the external auditor is being considered to undertake aspects of the internal audit function, the audit committee should consider the effect this may have on the effectiveness of the company's overall arrangements for internal control and investor perceptions in this regard. Investor perceptions are likely to be influenced by:
- the rationale set out in the annual report for the work being performed by the external auditor,
  - the nature and extent of the work performed by the external auditor, and
  - whether, in the absence of internal audit work, the audit committee is wholly reliant on the views of the external auditor about the effectiveness of its system of controls relating to core activities and significant locations.

### **Whistleblowing**

- 4.9 **The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.**

### **The internal audit process**

- 4.10 The audit committee should monitor and review the effectiveness of the company's internal audit function. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.**
- 4.11 The need for an internal audit function will vary depending on company specific factors including the scale, diversity and complexity of the company's activities and the number of employees, as well as cost/benefit considerations. Senior management and the board may desire objective assurance and advice on risk and control. An adequately resourced internal audit function (or its equivalent where, for example, a third party is contracted to perform some or all of the work concerned) may provide such assurance and advice. There may be other functions within the company that also provide assurance and advice covering specialist areas such as health and safety, regulatory and legal compliance and environmental issues.
- 4.12 When undertaking its assessment of the need for an internal audit function, the audit committee should also consider whether there are any trends or current factors relevant to the company's activities, markets or other aspects of its external environment, that have increased, or are expected to increase, the risks faced by the company. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.
- 4.13 In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself, the audit committee and the board that the system of internal control is functioning as intended. In these circumstances, the audit committee will need to assess whether such processes provide sufficient and objective assurance.
- 4.14 The audit committee should review and approve the internal audit function's remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors<sup>3</sup>.

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<sup>3</sup> Further guidance can be found in the Institute of Internal Auditors' Code of Ethics and the International Standards for the Professional Practice of Internal Auditing.

- 4.15 The audit committee should approve the appointment or termination of appointment of the head of internal audit.
- 4.16 In its review of the work of the internal audit function, the audit committee should, inter alia:
- ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee;
  - review and assess the annual internal audit work plan;
  - receive a report on the results of the internal auditors' work on a periodic basis;
  - review and monitor management's responsiveness to the internal auditor's findings and recommendations;
  - meet with the head of internal audit at least once a year without the presence of management; and
  - monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

#### **The external audit process**

- 4.17 The audit committee is the body responsible for overseeing the company's relations with the external auditor.

#### *Appointment*

- 4.18 **The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or reappointment, a statement from the audit committee explaining its recommendation and should set out reasons why the board has taken a different position.**
- 4.19 The audit committee's recommendation to the board should be based on the assessments referred to below. If the audit committee recommends considering the selection of possible new appointees as external auditors, it should oversee the selection process.
- 4.20 The audit committee should assess annually the qualification, expertise and resources, and independence (see below) of the external auditors and the effectiveness of the audit process. The assessment should cover all aspects of the audit service provided by the audit firm, and include obtaining a report on the audit firm's own internal quality control procedures and consideration of audit firms' annual transparency

reports, where available. It might also be appropriate for the audit committee to consider whether there might be any benefit in using firms from more than one audit network<sup>4</sup>.

- 4.21 If the external auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.
- 4.22 The audit committee should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.
- 4.23 The audit committee section of the annual report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors. This explanation should normally include supporting information on tendering frequency, the tenure of the incumbent auditor, and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

*Terms and Remuneration*

- 4.24 The audit committee should approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided.
- 4.25 The audit committee should review and agree the engagement letter issued by the external auditor at the start of each audit, ensuring that it has been updated to reflect changes in circumstances arising since the previous year. The scope of the external audit should be reviewed by the audit committee with the auditor. If the audit committee is not satisfied as to its adequacy it should arrange for additional work to be undertaken.
- 4.26 The audit committee should satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee.

*Independence, including the provision of non-audit services*

- 4.27 The audit committee should assess the independence and objectivity of the external auditor annually, taking into consideration relevant UK law, regulation and professional requirements. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services) and any safeguards established by the external auditor. The audit committee

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<sup>4</sup> Guidance on the considerations relevant to the use of firms from more than one audit network can be found in the Appendix.

should consider whether, taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor's independence and objectivity.

4.28 The audit committee should seek reassurance that the auditors and their staff have no financial, business, employment or family and other personal relationship with the company which could adversely affect the auditor's independence and objectivity, taking account of relevant Ethical Standards. The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.

4.29 The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In this context, the audit committee should consider:

- whether the skills and experience of the audit firm make it a suitable supplier of the non-audit service;
- whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
- the nature of the non-audit services ~~the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and;~~
- the fees incurred, or to be incurred, for non-audit services both for individual services and in aggregate, relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

4.30 The audit committee should set and apply a formal policy specifying the types of non-audit ~~work~~service (if any):

- ~~from which the external auditors are excluded;~~
- ~~for which the external auditors can be engaged without referral to the audit committee; and~~
- ~~for which a case-by-case decision is necessary.~~
  - ~~In addition, the policy may set fee limits generally or for particular classes of work<sup>4.31</sup>.~~

4.32 ~~In the third category, if it is not practicable to give approval to individual items in advance, it may be appropriate to give a general pre-approval for certain classes for work, subject to a fee limit determined by the~~

~~audit committee and ratified by the board. The subsequent provision of any service by the auditor should be ratified at the next meeting of the audit committee.~~

- for which the use of the external auditor is pre-approved (i.e. approval has been given in advance as a matter of policy, rather than the specific approval of an engagement being sought before it is contracted);
- for which specific approval from the audit committee is required before they are contracted; and
- from which the external auditor is excluded.

4.31 Pre-approval of the use of the external auditor may be appropriate where the threats to auditor independence are considered low, for example if the engagement is:

- routine in nature and the fee is not significant in the context of the audit fee, or
- for an audit related service<sup>5</sup>

4.32 The non-audit services that fall within the second category in paragraph 4.30 above are likely to be those which, because of their size or nature or because of special terms and conditions (for example, contingent fee arrangements), are thought to give rise to threats to the auditor's independence. As a consequence, careful consideration will be needed when determining whether it is in the interests of the company that they should be purchased from the audit firm (rather than another supplier) and, if so, whether any safeguards to be put in place by the audit firm are likely to be effective, and how this will be disclosed in the annual report.

4.33 In determining the policy, the audit committee should take into account ~~relevant~~the possible threats to auditor objectivity and independence<sup>6</sup> and APB Ethical Standards for Auditors regarding the provision of non-audit services by the external audit firm,~~and in principle should not agree to~~

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<sup>5</sup> Audit related services are those non-audit services specified as such in APB Ethical Standards for Auditors.

<sup>6</sup> APB Ethical Standards for Auditors explain that threats to auditor objectivity and independence may arise from:

- Self-interest,
- Self-review,
- Management,
- Advocacy,
- Familiarity, and
- Intimidation

~~the auditor providing a service if, having regard to the ethical guidance, the result is that:~~

- ~~•the external auditor audits its own firm’s work;~~
  - ~~•the external auditor makes management decisions for the company; a mutuality of interest is created;~~
  - ~~•the external auditor develops close personal relationships with the company’s personnel; or~~
  - ~~•the external auditor is put in the role of advocate for the company.~~
- ~~The audit committee should satisfy itself that any safeguards required by Ethical Standards are implemented.~~

4.34 The audit committee should agree with the board the company’s policy for the employment of former employees of the external auditor, taking into account the APB Ethical Standards for Auditors paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the company, and consider whether in the light of this there has been any impairment, or appearance of impairment, of the auditor’s independence and objectivity in respect of the audit. (*Current paragraph 4.28*)

4.35 The audit committee should monitor the external audit firm’s compliance with APB Ethical Standards for Auditors relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, or relevant part of it<sup>7</sup>, and other related regulatory requirements. (*Current paragraph 4.29*)

4.36 A degree of flexibility over the timing of rotation of the audit engagement partner is possible where the audit committee decides that it is necessary to safeguard the quality of the audit. In such circumstances, the audit engagement partner may continue in this position for an additional period of up to two years, so that no longer than seven years in total is spent in this position. The audit committee should disclose this fact and the reasons for it to the shareholders as early as practicable.

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

4.38 The explanation should:

- describe the work of the committee in discharging its responsibilities;

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<sup>7</sup> Where the audit firm’s profits are not shared on a firm-wide basis, the relevant part of the firm is that by reference to which the audit engagement partner’s profit share is calculated.

- set out the audit committee's policy on the engagement of the external auditor to supply non-audit services in sufficient detail to describe each of the elements in paragraph 4.30;
- set out, or cross refer to, the fees paid to the auditor for audit services, audit related services and other non-audit services<sup>8</sup>; and
- if the auditor provides non-audit services, other than audit related services, explain for each significant engagement, or category of engagements, what the services are, why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor (rather than another supplier) and how auditor objectivity and independence has been safeguarded.

*Annual audit cycle*

4.39 At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit.

4.40 The audit committee should consider whether the auditor's overall work plan, including planned levels of materiality, and proposed resources to execute the audit plan appears consistent with the scope of the audit engagement, having regard also to the seniority, expertise and experience of the audit team.

4.41 The audit committee should review, with the external auditors, the findings of their work. In the course of its review, the audit committee should:

- discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved;
- review key accounting and audit judgements; and
- review levels of errors identified during the audit, obtaining explanations from management and, where necessary, the external auditors as to why certain errors might remain unadjusted.

4.42 The audit committee should also review the audit representation letters before signature by management and give particular consideration to matters where representation has been requested that relate to non-standard issues<sup>9</sup>. The audit committee should consider whether the information provided is complete and appropriate based on its own knowledge.

4.43 As part of the ongoing monitoring process, the audit committee should review the management letter (or equivalent). The audit committee

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<sup>8</sup> A template for the provision of this information by the auditors to the audit committee is set out in Appendix 1 to Ethical Standard 1 (Revised) issued by the Auditing Practices Board.

<sup>9</sup> Further guidance can be found in the Auditing Practices Board's International Standard on Auditing (UK and Ireland) 580: "Management Written Representations".

should review and monitor management's responsiveness to the external auditor's findings and recommendations.

4.44 At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process. In the course of doing so, the audit committee should:

- review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
- consider the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, and in their commentary where appropriate on the systems of internal control;
- obtain feedback about the conduct of the audit from key people involved, e.g. the finance director and the head of internal audit; and
- review and monitor the content of the external auditor's management letter, in order to assess whether it is based on a good understanding of the company's business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.