

APB ETHICAL STANDARD 4 (REVISED)

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

(Revised December 2010)

<i>Contents</i>	<i>paragraph</i>
Introduction	1 - 4
Fees	5 - 43
Remuneration and evaluation policies	44 - 47
Threatened and actual litigation	48 - 50
Gifts and hospitality	51 - 59
Effective date	60 - 62

PREFACE

APB Ethical Standards apply in the audit of financial statements. They are read in the context of the Statement "The Financial Reporting Council - Scope and Authority of Audit and Assurance Pronouncements" 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 out of fees, economic dependence, litigation, remuneration and evaluation of partners and staff, and gifts and hospitality, which may create threats to the auditor's objectivity or perceived loss of independence. It gives examples of safeguards that can, in some situations, eliminate the threat or reduce it to an acceptable level. In circumstances where this is not possible, either the situation is avoided 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, 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.

- 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 or Ethics Partner ensures that any matter which has given rise to a breach is addressed as soon as possible;
 - (c) safeguards, if appropriate, are applied (for example, 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.

FEES

- 5 **The audit engagement partner shall be satisfied and able to demonstrate that the audit engagement has assigned to it sufficient partners and staff with appropriate time and skill to perform the audit in accordance with all applicable Auditing and Ethical Standards, irrespective of the audit fee to be charged.**
- 6 Paragraph 5 is not intended to prescribe the approach to be taken by audit firms to the setting of audit fees, but rather to emphasise that there are no circumstances where the amount of the audit fee can justify any lack of appropriate resource or time taken to perform a proper audit in accordance with applicable Auditing and Ethical Standards.

- 7 **The audit engagement partner shall ensure that audit fees are not influenced or determined by the provision of non-audit services to the audited entity.**
- 8 The audit fee ordinarily reflects the time spent, the skills and experience of the personnel performing the audit in accordance with all the relevant requirements, and the competitive situation in the audit market. Paragraph 7 is intended to prevent any relationship between the appropriate cost of the audit and the actual or potential provision of non-audit services.
- 9 Paragraph 7 is not intended to prohibit proper cost savings that can be achieved as a result of providing non-audit services in accordance with APB Ethical Standard 5 to the audited entity, for example, where information gained through undertaking a non-audit service is referred to by audit staff when carrying out the audit of the financial statements.
- 10 **An audit shall not 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 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.
- 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. Arrangements under which

estimated audit fees are agreed with the audited entity on terms where the fees may be varied based on the level of audit work required do not constitute contingent fee arrangements.

- 14 Contingent fee arrangements in respect of non-audit services provided by the auditor in respect of an audited entity can 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.
- 15 **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.**
- 16 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.

- 17 Paragraph 15 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.
- 18 For non-audit services provided on a contingent fee basis, other than those prohibited under paragraph 15, 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.
- 19 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 15 above) include:
- 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.
- 20 **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.

- 21 Contingent fee arrangements in respect of non-audit services provided by the auditor may create a threat to the auditor's objectivity and independence. The circumstances in which such fee arrangements are not permitted for non-audit services are dealt with in paragraph 15 of this standard and paragraph 95 of APB Ethical Standard 5.
- 22 **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.**
- 23 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.
- 24 **The actual amount of the audit fee for the previous audit and the arrangements for its payment shall be agreed with the audited entity before the audit firm formally accepts appointment as auditor in respect of the following period.**
- 25 Ordinarily, any outstanding fees for the previous audit period are paid before the audit firm commences any new audit work. Where they are not, it is important for the audit engagement partner to understand the nature of any disagreement or other issue.
- 26 **Where fees for professional services from the audited entity are overdue and the amount cannot be regarded as trivial, the audit**

engagement partner, in consultation with the Ethics Partner, shall consider whether the audit firm can continue as auditor or whether it is necessary to resign.

- 27 Where fees due from an audited entity, whether for audit or for non-audit services, remain unpaid for a long time - and, in particular, where a significant part is not paid before the auditor's report on the financial statements for the following year is due to be issued - a self-interest threat to the auditor's objectivity and independence is created because the issue of an unqualified audit report may enhance the audit firm's prospects of securing payment of such overdue fees.
- 28 Where the outstanding fees are in dispute and the amount involved is significant, the threats to the auditor's objectivity and independence may be such that no safeguards can eliminate them or reduce them to an acceptable level. The audit engagement partner therefore considers whether the audit firm can continue with the audit engagement.
- 29 Where the outstanding fees are unpaid because of exceptional circumstances (including financial distress), the audit engagement partner considers whether the audited entity will be able to resolve its difficulties. In deciding what action to take, the audit engagement partner weighs the threats to the auditor's objectivity and independence, if the audit firm were to remain in office, against the difficulties the audited entity would be likely to face in finding a successor, and therefore the public interest considerations, if the audit firm were to resign.
- 30 In any case where the audit firm does not resign from the audit engagement, the audit engagement partner applies appropriate safeguards (such as a review by an audit partner who is not involved in the audit engagement) and notifies the Ethics Partner of the facts concerning the overdue fees.

- 31 **Where it is expected that the total fees for both audit and non-audit services receivable from a listed audited entity and its subsidiaries audited by the audit firm¹ will regularly exceed 10% of the annual fee income of the audit firm² or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm shall not act as the auditor of that entity and shall either resign as auditor or not stand for reappointment, as appropriate.³**
- 32 **Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audited entity and its subsidiaries audited by the audit firm will regularly exceed 15% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm shall not act as the auditor of that entity and shall either resign as auditor or not stand for reappointment, as appropriate.**
- 33 Where it is expected that the total fees for both audit and non-audit services receivable from an audited entity and its subsidiaries that are audited by the audit firm will regularly exceed 10% in the case of listed companies and 15% in the case of non-listed entities of the annual fee income of the part of the firm by reference to which the audit engagement partner's profit share is calculated, it may be possible to assign the engagement to another part of the firm.

¹ Total fees will include those billed by others where the audit firm is entitled to the fees, but will not include fees billed by the audit firm where it is acting as agent for another party.

² In the case of a sole practitioner, annual fee income of the audit firm includes all earned income received by the individual.

³ Paragraphs 31 to 40 do not apply to the audits of those public sector bodies where the responsibility for the audit is assigned by legislation. In such cases, the auditor cannot resign from the audit engagement, irrespective of considerations of economic dependence.

- 34 Paragraphs 31 and 32 are not intended to require the audit firm to resign as auditor or not stand for reappointment as a result of an individual event or engagement, the nature or size of which was unpredictable and where a reasonable and informed third party would regard ceasing to act as detrimental to the shareholders (or equivalent) of the audited entity. However, in such circumstances, the auditor discloses full details of the position to the Ethics Partner and to those charged with governance of the audited entity and discusses with both what, if any, safeguards may be appropriate.
- 35 **Where it is expected that the total fees for both audit and non-audit services receivable from a listed audited entity and its subsidiaries audited by the audit firm will regularly exceed 5% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 10%, the audit engagement partner shall disclose that expectation to the Ethics Partner and to those charged with governance of the audited entity and consider whether appropriate safeguards need to be applied to eliminate or reduce to an acceptable level the threat to the auditor's objectivity and independence.**
- 36 It is fundamental to the auditor's objectivity that the auditor be willing and able, if necessary, to disagree with the directors and management, regardless of the consequences to its own position. Where the auditor is, to any significant extent, economically dependent on the audited entity, this may inhibit the auditor's willingness or constrain the auditor's ability to express a qualified opinion on the financial statements, since this could be viewed as likely to lead to the auditor losing the audit engagement and the entity as a client.
- 37 An audit firm is deemed to be economically dependent on a listed audited entity if the total fees for audit and all other services from that entity and its subsidiaries which are audited by the audit firm represent

10% of the total fees of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated. Where such fees are between 5% and 10%, the audit engagement partner and the Ethics Partner consider the significance of the threat and the need for appropriate safeguards.

- 38 Such safeguards might include:
- taking steps to reduce the non-audit work to be undertaken and therefore the fees earned from the audited entity;
 - applying independent internal quality control reviews.
- 39 **Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audited entity and its subsidiaries audited by the audit firm will regularly exceed 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 15%, the audit engagement partner shall disclose that expectation to the Ethics Partner and to those charged with governance of the audited entity and the firm shall arrange an external independent quality control review of the audit engagement to be undertaken before the auditor's report is finalised.**
- 40 A quality control review involves discussion with the audit engagement partner, a review of the financial statements and the auditor's report, and consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments the engagement team has made and the conclusions they have reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review includes considering the following:
- Significant risks identified during the audit and the responses to those risks.

- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The appropriateness of the report to be issued.

Where the quality control reviewer makes recommendations that the audit engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the audit firm's procedures for dealing with differences of opinion.

- 41 A new audit firm seeking to establish itself may find the requirements relating to economic dependence difficult to comply with in the short term. In these circumstances, such firms would:
- (a) not undertake any audits of listed companies, where fees from such an audited entity would represent 10% or more of the annual fee income of the firm; and
 - (b) for a period not exceeding two years, require external independent quality control reviews of those audits of unlisted entities that represent more than 15% of the annual fee income before the audit opinion is issued.

The firm might also develop its practice by accepting work from entities not audited by the firm so as to bring the fees payable by each audited entity below 15%.

- 42 A self-interest threat may also be created where an audit partner in the engagement team:
- is employed exclusively or principally on that audit engagement; and

- is remunerated on the basis of the performance of part of the firm which is substantially dependent on fees from that audited entity.
- 43 Where the circumstances described in paragraph 42 arise, the audit firm assesses the significance of the threat and applies safeguards to reduce the threat to an acceptable level. Such safeguards might include:
- reducing the dependence of the office, partner or person in a position to influence the conduct and outcome of the audit by reallocating the work within the practice;
 - a review by an audit partner who is not involved with the audit engagement to ensure that the auditor's objectivity and independence is not affected by the self-interest threat.

REMUNERATION AND EVALUATION POLICIES

- 44 **The audit firm shall establish policies and procedures to ensure that each of the following is true in relation to each audited entity:**
- (a) the objectives of the members of the engagement team do not include selling non-audit services to the entity they audit;**
 - (b) the criteria for evaluating the performance or promotion of members of the engagement team do not include success in selling non-audit services to the entity they audit; and**
 - (c) no specific element of the remuneration of a member of the engagement team is based on his or her success in selling non-audit services to the entity they audit.**

This requirement does not apply to those members of the engagement team from specialist practice areas where the nature and extent of their involvement in the audit is clearly insignificant.

- 45 Where the auditor identifies areas for possible improvement in an audited entity the auditor 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 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.

- 46 The last sentence of paragraph 44 recognises the fact that an engagement team may include personnel from specialist practice areas and that it would be inappropriate to limit the business development activities of such persons where their involvement in the audit is clearly insignificant.
- 47 The policies and procedures required for compliance with paragraph 44 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 engagement team, the Ethics Partner pays particular attention to the actual implementation of those policies and procedures and is available for consultation when needed.

THREATENED AND ACTUAL LITIGATION

- 48 **Where litigation in relation to audit or non-audit services between the audited entity or its affiliates and the audit firm, which is other than insignificant, is already in progress, or where the audit engagement partner considers such litigation to be probable, the**

audit firm shall either not continue with or not accept the audit engagement.⁴

- 49 Where litigation (in relation to audit or non-audit services) actually takes place between the audit firm (or any person in a position to influence the conduct and outcome of the audit) and the audited entity, or where litigation is threatened and there is a realistic prospect of such litigation being commenced, self-interest, advocacy and intimidation threats to the auditor's objectivity and independence are created because the audit firm's interest will be the achievement of an outcome to the dispute or litigation that is favourable to itself. In addition, an effective audit process requires complete candour and full disclosure between the audited entity's management and the engagement team: such disputes or litigation may place the two parties in opposing adversarial positions and may affect management's willingness to make complete disclosure of relevant information. Where the auditor can foresee that such a threat may arise, the auditor informs the audit committee of its intention to resign or, where there is no audit committee, the board of directors.
- 50 The auditor is not required to resign immediately in circumstances where a reasonable and informed third party would not regard it as being in the interests of the shareholders for it to do so. Such circumstances might arise, for example, where:
- the litigation was commenced as the audit was about to be completed and shareholder interests would be adversely affected by a delay in the audit of the financial statements;
 - on appropriate legal advice, the audit firm deems that the threatened or actual litigation is vexatious or designed solely to

⁴ Paragraphs 48 to 50 do not apply to the audits of those public sector bodies where the responsibility for the audit is assigned by legislation. In such cases, the auditor cannot resign from the audit engagement: the auditor reports significant litigation to the relevant legislative authority.

bring pressure to bear on the opinion to be expressed by the auditor.

GIFTS AND HOSPITALITY

- 51 **The audit firm, those in a position to influence the conduct and outcome of the audit and immediate family members of such persons shall not accept gifts from the audited entity, unless the value is clearly insignificant.**
- 52 **Those in a position to influence the conduct and outcome of the audit and immediate family members of such persons shall not accept hospitality from the audited entity, unless it is reasonable in terms of its frequency, nature and cost.**
- 53 Where gifts or hospitality are accepted from an audited entity, self-interest and familiarity threats to the auditor's objectivity and independence are created. Familiarity threats also arise where gifts or hospitality are offered to an audited entity.
- 54 Gifts from the audited entity, unless their value is clearly insignificant, create threats to objectivity and independence which no safeguards can eliminate or reduce.
- 55 Hospitality is a component of many business relationships and can provide valuable opportunities for developing an understanding of the audited entity's business and for gaining the insight on which an effective and successful working relationship depends. Therefore, the auditor's objectivity and independence is not necessarily impaired as a result of accepting hospitality from the audited entity, provided it is reasonable in terms of its frequency, its nature and its cost.

- 56 **The audit firm shall establish policies on the nature and value of gifts and hospitality that may be accepted from and offered to audited entities, their directors, officers and employees, and shall issue guidance to assist partners and staff to comply with such policies.**
- 57 In assessing the acceptability of gifts and hospitality, 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 it is or is likely to be impaired.
- 58 Where there is any doubt as to the acceptability of gifts or hospitality offered by the audited entity, members of the engagement team discuss the position with the audit engagement partner. If there is any doubt as to the acceptability of gifts or hospitality offered to the audit engagement partner, or if the audit engagement partner has any residual doubt about the acceptability of gifts or hospitality to other individuals, the audit engagement partner reports the facts to the Ethics Partner, for further consideration regarding any action to be taken.
- 59 Where the cumulative amount of gifts or hospitality accepted from the audited entity appears abnormally high, the audit engagement partner reports the facts to both:
- the Ethics Partner; and
 - the audit committee (or, where there is no audit committee, the board of directors),
- together with other significant facts and matters that bear upon the auditor's objectivity and independence.

EFFECTIVE DATE

- 60 This revised Ethical Standard becomes effective on 30 April 2011.
- 61 Firms may complete audit engagements relating to periods commencing on or before 31 December 2010 in accordance with existing ethical standards, putting in place any necessary changes in the subsequent engagement period.
- 62 An audit firm may continue to provide non-audit services that would be prohibited under paragraph 15, where these have already been contracted at 31 December 2010, until the earlier of either:
- a. the completion of the specific task or the end of the contract term, where one is set out in the contract; or
 - b. 31 December 2011.