

APB Ethical Standards

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

6 October 2009

**The Auditing Practices
Board**

THE AUDITING PRACTICES BOARD LIMITED

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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1 Introduction

1.1 In its report entitled *'Banking Crisis: reforming corporate governance and pay in the City'*, published in May 2009, the Treasury Select Committee called for the appropriateness of the provision of non-audit services by auditors to the entities that they audit to be revisited, stating:

"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".

1.2 The Treasury Select Committee made this recommendation based on their assessment of views expressed by:

- certain representatives of the investor community who remain sceptical that audit independence can be maintained when non-audit services are provided; and
- particular commentators who argue that audit firms face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that fees from non-audit work could be jeopardised.

1.3 In response to the Treasury Select Committee's recommendation, the Auditing Practices Board (the 'APB') is issuing this Consultation Paper. As the Treasury Select Committee made its recommendation in the context of investor confidence, this Consultation Paper focuses primarily on the provision of non-audit services to listed companies.¹

1.4 This Consultation Paper includes an analysis of

- the nature of non-audit services provided by auditors;
- the reasons why the provision of such services can have the potential to impact the independence, and therefore the objectivity, of the auditor;
- the approach to auditor independence that has been taken by the APB since 2004 - when it was given responsibility for setting ethical standards for auditors;
- developments in the provision of non-audit services in the UK since the APB issued Ethical Standards for Auditors in October 2004;
- information on the approach taken internationally; and
- the issues in relation to which the APB invites views.

¹ The APB will address the position of companies and entities other than listed companies in any further consultation that it undertakes as a result of the responses that it receives to this Consultation Paper.

- 1.5 If, in the light of the responses to this Consultation Paper, the APB considers that there may be grounds for making changes to its existing Ethical Standards for Auditors, including any further prohibitions on the provision of non-audit services to audited entities, it will undertake a further detailed consultation on those particular proposals.
- 1.6 This Consultation Paper focuses exclusively upon the recommendation made by the Treasury Select Committee. The APB continually keeps the Ethical Standards for Auditors under review and considers issues that it becomes aware of, including those highlighted in regulatory reports and the press. If the APB concludes that further action is required in relation to such matters, it will do so as and when appropriate.
- 1.7 The APB invites responses to the questions set out in section 7. 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. 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 *29 January 2010*.

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 Different services that audit firms have the capability to provide.

2.1 Any discussion of the appropriateness of audit firms providing non-audit services to the entities that they audit requires a clear understanding of:

- the nature of the services that audit firms have the capability to provide; and
- where they are undertaken by the same firm, the relationship between the work involved in providing those services and the work undertaken in the course of an audit.

2.2 There are various ways in which non-audit services can be categorised². For the purposes of this consultation, the APB has categorised non-audit services in the manner set out in the table below. Under APB's Ethical Standards for Auditors those services indicated with an asterisk can only be provided by auditors to the entities they audit under certain conditions. These conditions were established to avoid significant threats to auditor objectivity that might otherwise have had adverse effects on the conduct of the audit (see Appendix 1).

	Nature of non-audit services	Examples of services that audit firms sometimes provide, subject to compliance with APB Ethical Standards, to listed company audit clients.
1	Activities arising directly from an audit of a company's financial statements	<ul style="list-style-type: none"> • Advice on compliance with accounting standards • Advising on adjustments required to be made to financial statements as a result of matters arising from an audit • Advice on internal controls arising from weaknesses identified in the audit • Particular assignments that audit committees ask auditors to undertake directly connected with an audit
2	Services required to be provided by the auditor by law / regulations	<ul style="list-style-type: none"> • Reporting on regulatory returns (e.g. for insurance companies) • Reporting on internal controls for US registrants (Sarbanes Oxley) • Reports relating to government grants. • Reporting on half yearly statements under the Disclosure and Transparency requirements

² Different categorisations exist for different purposes, for example, in legislation for disclosures in different countries.

3	Services provided by auditors because of their familiarity with the client and, as a consequence, their ability to perform them in a timely and cost effective manner.	<ul style="list-style-type: none"> • Reporting on prospectuses relating to either equity or debt issues (including securitisations of assets) • Reports for sponsors and companies issued pursuant to the requirements of capital markets regulators (e.g. working capital reports) • Assisting with tax compliance*
4	Services provided because of the pool of accounting and related financial skills available to accountancy firms	<ul style="list-style-type: none"> • Internal audit* • Tax planning advice* • Transaction services (including undertaking due diligence and related investigations)* • Advice and assistance with corporate restructuring projects*
5	Services provided because of the pool of consulting and general business skills available to accountancy firms	<ul style="list-style-type: none"> • Corporate Finance advice and transaction management* • Design of IT systems* • Implementation of IT systems* • Human resource services (e.g. recruitment)* • Legal services* • Actuarial services* • Management consultancy services*

2.3 A number of points arise from this analysis:

- (a) Some non-audit activities derive directly from the audit;
- (b) Some non-audit services are provided by auditors because that is what is required by legislation or regulation. A total prohibition of non-audit services would require changes in legislation and regulation;
- (c) There are considerable variations in the extent to which there is an interaction between the conduct of an audit and the provision of other services.

3 Issues related to the provision of non-audit services to audited entities

- 3.1 Having analysed the types of non-audit services provided by auditors, it is appropriate to describe the reasons why:
- the provision of such services gives rise to issues on the part of some investors, regulators and certain other commentators; and
 - most companies and auditors contend that there are benefits in engaging auditors to provide non-audit services.
- 3.2 The sorts of views that some investors, regulators and certain other commentators have expressed are that:
- (a) the nature of some services increases the possibility that the views of the auditor will become aligned with the views of the company's management (e.g. where the auditor has extensively advised on a corporate restructuring or a strategic acquisition);
 - (b) the greater the volume and financial significance of the non-audit services provided by the auditor, the greater the risk that the auditor will have relationship and economic reasons not to challenge management's views and positions with the requisite degree of energy and scepticism;
 - (c) prohibitions on auditors providing audit services to their listed clients could enhance the opportunities for mid-sized accountancy firms to provide those services, thereby enhancing their profile and, in turn, leading to greater competition and choice in the accounting services and audit market;
 - (d) auditors cannot be relied upon to assess objectively whether a particular non-audit service engagement gives rise to threats to auditor independence and objectivity and apply appropriate safeguards.

Such commentators also comment that a number of the arguments advanced by accountancy firms do not recognise that a prohibition of non-audit services to audited entities would not preclude the provision of such services to other clients and therefore they do not jeopardise the continued existence of multi-disciplinary firms.

- 3.3 Arguments advanced by companies include that:
- (a) the provision of non-audit services provides a valuable means of a company benefiting from external expertise, so enabling management to focus on key business activities;
 - (b) auditors have the confidence of management and already know the company well and so do not need the same degree of briefing and oversight as would be required by firms unfamiliar with the company. This can result in cost, quality and consistency benefits, which in turn benefits shareholders;

- (c) the corporate governance regime ensures that non-audit services are purchased without jeopardising auditor independence; and
- (d) it is incorrect to assert that investor's interests are not properly considered and protected when auditors provide non-audit services as management act as an agent for investors.

3.4 Accountancy firms argue that they should be allowed to provide non-audit services to audit clients because:

- (a) participation in some services, such as acquisition reviews, allows the audit team to understand their clients' business and risks better and to obtain insights into management's objectives and capabilities which are useful in an audit context;
- (b) the development of multi-disciplinary accountancy firms aids the recruitment and retention of skilled partners and staff available to perform audits. In particular it aids the recruitment of specialists, who are often necessary for an audit, but who need to perform non-audit work to maintain their skills and knowledge. If such firms were not allowed to sell any non-audit services to audit clients, their markets would be restricted inhibiting their ability to attract such talented people;
- (c) their position as auditors can bring both quality and efficiency benefits to the delivery of non-audit services. This is because their role with their clients may give them greater insight into the matters being considered and they do not need to spend time getting to know the client's background before commencing work. The latter can be particularly useful if the non-audit work needs to be done urgently;
- (d) the environment in which non-audit services is offered protects the auditor's independence. In particular the provision of non-audit services is subject to review by audit committees, who check to ensure that the provision of these services does not compromise independence.

3.5 It is appropriate to note that these views are based predominantly on the perceptions and opinions that different stakeholders hold, and not a proven track record linking audit failure with a lack of objectivity and independence as a result of a desire to increase or retain non-audit service engagements. The strength of views also vary depending on the importance placed on 'pure' audit independence as opposed to the potential benefits to the business, in terms of cost and efficiency, of non-audit services being provided by the auditor.

3.6 In an attempt to address these issues, guidance was developed by the profession both in the UK and internationally. This guidance was often structured as Codes of Ethics that adopted a so-called 'threats and safeguards' approach under which auditors were required to assess whether particular engagements gave rise to threats and, if so, whether those threats could be addressed by putting in place particular safeguards. However, such Codes of Ethics rarely prohibited the provision of any specific non-audit services – it was left to the auditors concerned to decide when it was inappropriate to provide any particular non-audit service.

- 3.7 In more recent years action has been taken in many countries to strengthen corporate governance and financial reporting regimes and to introduce independent regulation of the audit profession. A number of national audit regulators have issued standards or regulations relating to the provision of non-audit services. In some countries (such as the UK) these standards incorporate a threats and safeguards approach but also establish a number of specific prohibitions. In other countries (such as the US, where Securities & Exchange Commission (SEC) and Public Company Audit Oversight Board (PCAOB) regulations prohibit the auditor from providing certain non-audit services to listed companies) such regulations tend to the ‘rules-based’ and not based on an underlying threats and safeguards approach.
- 3.8 Views vary about the relative merits of adopting a ‘principles-based’ or ‘rules-based’ approach to regulating the provision of non-audit services. As more fully explained in Section 4, the APB favours a principles-based approach as this:
- Allows the standards to apply in a wide variety of different circumstances; and
 - Allows proportionate enforcement.³

³ The effectiveness of a rules-based approach is related to the effectiveness and practicality of the actions that can be taken to deal with breaches. The lack of flexible enforcement powers can lead to disproportionate responses such as where a minor breach of a rule requires an audit to be completely re-performed by a second independent audit firm.

4 The approach taken in the UK to the provision of non-audit services since 2000

CGAA review of the arrangements for audit and accountancy in the UK

- 4.1 In late 2001 public confidence in auditing was severely shaken by events relating to Enron and some other important US companies. The concerns arising from the collapse of Enron reflected, in part, an over-close relationship between the company and its auditors and brought into sharp focus whether there should be greater restrictions on the provision of non-audit services. These concerns resonated in the UK where investors had observed a rapid growth in the provision of non-audit services to audit clients over the preceding decade.
- 4.2 Whilst there had not been comparable audit failings in the UK for many years, the Government set up the 'Co-ordinating Group on Audit and Accounting Issues'⁴ ('CGAA') to review the UK's arrangements for audit and accountancy in the light of these developments. The CGAA decided against an outright ban on the provision of non-audit services to an audit client, but concluded that tougher mechanisms were needed to ensure that auditors were not only independent, but that they were perceived to be independent.
- 4.3 In particular the CGAA recommended that, while UK requirements should continue to be based on principles rather than rules, there needed to be tougher and clearer safeguards to ensure that the joint provision of audit and non-audit services would not undermine auditor independence in fact or appearance. This was to be achieved through:
- Regulation of the audit firms by:
 - independent setting of auditor independence standards;
 - tougher requirements governing the supply of non-audit services to audit clients;
 - emphasis within the monitoring system on the application of these requirements in the major audit firms.
 - Action by listed companies involving:
 - an enhanced role for the audit committee in approving the purchase of non-audit services and justifying this to shareholders;
 - new guidance for audit committees;
 - fuller disclosure in the financial statements of the value and nature of non-audit services bought from the auditor.

⁴ The CGAA was set up by the Chancellor of the Exchequer and the Secretary of State for Trade and Industry. It was led by the Minister for Competition, Consumers & Markets and the Financial Secretary to the Treasury.

4.4 Action has been taken on all elements of this framework:

- In early 2003, the Government concluded that the APB should take over the professional bodies' responsibilities for setting standards for the integrity, objectivity and independence of auditors and the APB issued such standards in 2004 (see below);
- The Audit Inspection Unit has monitored the application of the APB Ethical Standards by those audit firms involved in public interest audits;
- The July 2003 update of the Combined Code on Corporate Governance contained important new provisions for audit committees to:
 - review and monitor the external auditors' independence, and
 - develop and implement policy on the engagement of the external auditor to supply non-audit services;
- Guidance for audit committees (The Smith Guidance) was published in July 2003;
- For financial years beginning on or after 1 October 2005 company law requires listed companies to disclose in the notes to the annual accounts the amounts paid to auditors in respect of the provision of non-audit services.

Development of the APB Ethical Standards for Auditors

4.5 Following the transfer of responsibility for setting of standards for integrity, objectivity and independence of auditors to the APB, the APB published a complete set of standards in October 2004 (known as ES 1 to 5).

4.6 The Ethical Standards for Auditors applied to audits of financial statements for periods commencing on or after 15 December 2004. In meeting its new responsibilities, the APB gave particular attention to the provision of non-audit services by auditors to entities they audited, and to communications with the audit committee on matters relating to auditor independence.

4.7 In developing standards on the provision of non-audit services, the APB faced three general challenges:

- Non-audit services vary depending on the needs of the company (for example, some need tax assistance, others need support for their corporate finance activities) and within each activity, the remits of particular non-audit engagements differ significantly.
- The nature and magnitude of the non-audit services, and therefore their possible impact on auditor objectivity, vary significantly; and
- It would be necessary to allow for the fact that the types of non-audit services provided to clients are constantly evolving in response to evolving business needs.

4.8 For these reasons, when developing the Ethical Standards for Auditors, and in particular ES 5 'Non-audit services provided to audited entities', the APB sought to develop general principles which would inform the auditor's approach to a

variety of different situations. This approach was consistent with the recommendations of the CGAA.

Concepts applied in the APB Ethical Standards for the provision of non-audit services

- 4.9 The draft Ethical Standards for Auditors published in November 2003 required auditors to take steps to identify any threats to their objectivity and independence and to apply safeguards to reduce them to an acceptable level or, where such threats could not be mitigated by any available safeguards, to avoid the situation giving rise to the threats (for example, by not providing a particular non-audit service).
- 4.10 The draft Ethical Standards for Auditors were widely supported by stakeholders, although auditors of smaller entities raised concerns regarding the impact on smaller entities of the proposed requirements on the provision of non-audit services.⁵

Assessing threats and safeguards

- 4.11 The conceptual framework enshrined in the Ethical Standards for Auditors requires auditors to:
- assess whether an engagement to provide a non-audit service might cause the audit firm to serve interests or seek an objective inconsistent with its responsibility as auditor⁶. If the objective of a non-audit service is inconsistent with that of an audit it is prohibited;
 - consider the extent to which the provision of a specific non-audit service may give rise to threats to objectivity and independence (these threats are discussed in more detail below);
 - assess the significance of the threats identified and whether effective safeguards could be implemented to reduce the threats to an acceptable level⁷; and

⁵ The APB addressed the concerns of auditors of smaller entities by issuing in December 2004 an additional standard ES – Provisions Available for Small Entities which provides relief in certain situations for auditors of those entities for which the decision to have an audit is voluntary.

⁶ For example, certain non-audit services may have the effect of improving the perception of the company's financial position in a way that is not consistent with the underlying reality. In such circumstances, the provision of non-audit services could result in a conflict of interest by causing the auditor to view the client company from the point of view of the management as opposed to that of the shareholders. As a consequence, the APB concluded that auditors should not accept non-audit service engagements where the objectives of non-audit service engagements are inconsistent with the objectives of an audit.

⁷ One factor that this assessment should take into account is whether the audit client has in place person(s) capable of making relevant management decisions in relation to the non-audit services to be provided. Such person(s) need to have the ability and experience, having regard to the nature of the non-audit service and the scale of the entity concerned, to exercise judgment and to make decisions as to how the non-audit assignment should proceed and be implemented.

- consider whether safeguards exist that could be introduced to avoid any threat that has been identified or reduce such a threat to a level at which it can reasonably be disregarded.

4.12 The Ethical Standards for Auditors provide that if no effective safeguards are available to address any threats that have been identified, the audit firm must decline the engagement to provide the non-audit services in question.

Prohibitions

4.13 In addition to requiring auditors to undertake a threats and safeguards assessment and to decline any engagement where effective safeguards could not be put in place to address any identified threats, the APB identified a number of situations where it concluded that the threats arising from a particular service were likely to be insurmountable and specifically prohibited the provision of non-audit services in those situations. The prohibitions included in ES 5 are set out in Appendix 1. Certain of these prohibitions apply only to listed companies.

The quantum of fees for non-audit services

4.14 The magnitude of the aggregate fees gives rise to a possible self-interest threat, especially where the fees received by the audit firm from non-audit services (whether globally or within a specific office or region) substantially exceed those fees received from the audit work undertaken.

4.15 The APB concluded that it would not be appropriate to impose a limit on the fees receivable from non-audit services. Its views were:

- that any such limit would be arbitrary; and
- that the self-interest threat would be most likely to arise where the total fees (audit and non-audit) from a particular client became too large a proportion of the income of the audit firm as a whole.⁸

Communication

4.16 The conceptual framework requires the auditor to communicate to those charged with governance of the audit client (e.g. the directors or, if one exists, the audit committee) all significant facts and matters that bear upon the auditor's objectivity and independence which it has identified in relation to the provision of any non-audit services. This requirement is intended to ensure that the responsibilities of auditors are complimentary to the obligations of directors and audit committees under the Combined Code on Corporate Governance – in particular the responsibility to review and monitor the external auditor's independence and objectivity and to develop a policy on the supply of non-audit services by a company's external auditor.

⁸ The concerns that arise when the fees receivable from particular clients become significant to an audit firm are addressed in the Ethical Standards for Auditors (paragraphs 25 to 34 of ES 4).

Documentation

- 4.17 The final element of the conceptual framework requires auditors to document any threats identified and the safeguards implemented. Proper documentation of decisions relating to compliance with the Ethical Standards for Auditors provides transparency to those involved in internal and external monitoring of audit quality. This is a key element in the structure to address the complex issues raised by the provision of non-audit services.

Culture

- 4.18 The APB was also concerned to ensure that the principles underlying these requirements were reflected in the culture of the accountancy firms and so the Ethical Standards for Auditors provide that:
- The objectives of the members of the audit team must not include selling non-audit services to the audited entity;
 - The criteria for evaluating the performance of members of the audit team must not include success in selling non-audit services to any audited entity; and
 - No specific element of the remuneration of a member of the audit team and no decision concerning promotion within the audit firm should be based on his or her success in selling non-audit services to the audited entity.

Threats that may arise through the provision of non-audit services

- 4.19 The APB Ethical Standards for Auditors focus on four categories of threat:

1. A **self-interest threat** arises when auditors have financial or other interests which might cause them to take actions (or not take actions) that would be adverse to the interests of the audit firm. The concern underlying the Treasury Select Committee's recommendation focuses on the self-interest threat – as evidenced by their concern that audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that fee income from non-audit work could be jeopardised.

The APB considered this issue carefully when developing the Ethical Standards for Auditors. It concluded that contingent fees, which are relatively common for some tax and corporate finance related services (but not for other non-audit services), were likely to give rise to the most extreme forms of the self-interest threat and prohibited them for some tax and corporate finance services.

2. A **self-review threat** which arises where, as a result of the audit firm having provided the non-audit service, the auditor may be reluctant to evaluate objectively the non-audit work that has been undertaken even though the auditor relies upon it in order to reach an opinion on the

financial statements during the statutory audit.

Whether it will be necessary to review the subject matter of the non-audit engagement when forming an opinion on the financial statements and, if so, the extent to which it will be relevant to the audit are central to whether a potential self-review threat arises and, if a threat does arise, to the significance of that threat.

The APB took the position that if the subject matter and consequences of the non-audit services will not be material to the financial statements, or a high degree of reliance is not placed on them for audit purposes, the audit firm can establish effective safeguards to address the threats to objectivity. However, in such situations, the nature of the threat and the safeguards that have been established should be discussed with those charged with corporate governance.

3. A **management threat** which arises when, as a result of the nature of the engagement, an audit firm becomes involved in making important decisions or judgments that should be the prerogative and responsibility of management. Such a situation calls into question the auditor's ability to apply a proper degree of professional scepticism in reviewing those items or matters, as they relate to the financial statements, which were the subject of their own actions or decisions. Secondly, it raises the prospect that the auditor will be closely aligned with management and its interests, with similar consequences.
4. An **advocacy threat** arises where the audit firm undertakes work that involves acting as an advocate for an audit client in relation to matters that are material to the financial statements. The concern arises primarily from the fact that the audit firm may, for the purpose of an advocacy assignment, adopt a position closely aligned to that of management. The threat is that the auditor's objectivity may thereafter be compromised, or may appear to be compromised, if he or she adopts a partisan position in support of the management.

4.20 The approach that the APB took should be seen in the context of:

- the Combined Code on Corporate Governance (which had been supplemented by the Smith Guidance) which recommends that audit committees develop policies for the provision of non-audit services; and
- legislation requiring companies to provide a detailed analysis of non-audit fees within the statutory accounts.

4.21 Such a regime should ensure that decisions in relation to the engagement of auditors to undertake non-audit service engagements would be properly made and disclosed. The APB concluded that these requirements, in conjunction with the significant changes in the ethical standards governing the provision of non-audit services by auditors were adequate to address the concerns that had existed.

APB Ethical Standards in relation to certain non-audit services undertaken by accountants

- 4.22 In October 2006, the APB published the Ethical Standard for Reporting Accountants ('ESRA') because it recognised that those accountants undertaking engagements in relation to documents to be issued to the public in connection with transactions involving the raising of equity or debt or in the context of a take-over should act with the same objectivity and independence as those undertaking audits.
- 4.23 The ESRA is based to a very considerable degree on the Ethical Standards for Auditors. There are no equivalent standards anywhere else in the world.

5 Developments since 2004

- 5.1 Since the APB issued the Ethical Standards for Auditors in October 2004, there have been a number of developments, all of which are relevant to any new assessment of the approach to be taken to the regulation of the provision of non-audit services by accountancy firms to entities that they audit.
- 5.2 When undertaking its review of its Ethical Standards for Auditors in 2007, the APB concluded that there had been a number of helpful developments since the standards had first been introduced which had served to decrease the threats to auditor independence. In particular, there had been a material reduction in the value of non-audit services provided to FTSE 100 companies by their auditors and research had shown that audit committees were actively involved in the consideration of auditor independence. Consultations on the Ethical Standards for Auditors undertaken in October 2007 and March 2009 have not shown any pressure for a change to the APB's overall approach to the regulation of non-audit services.

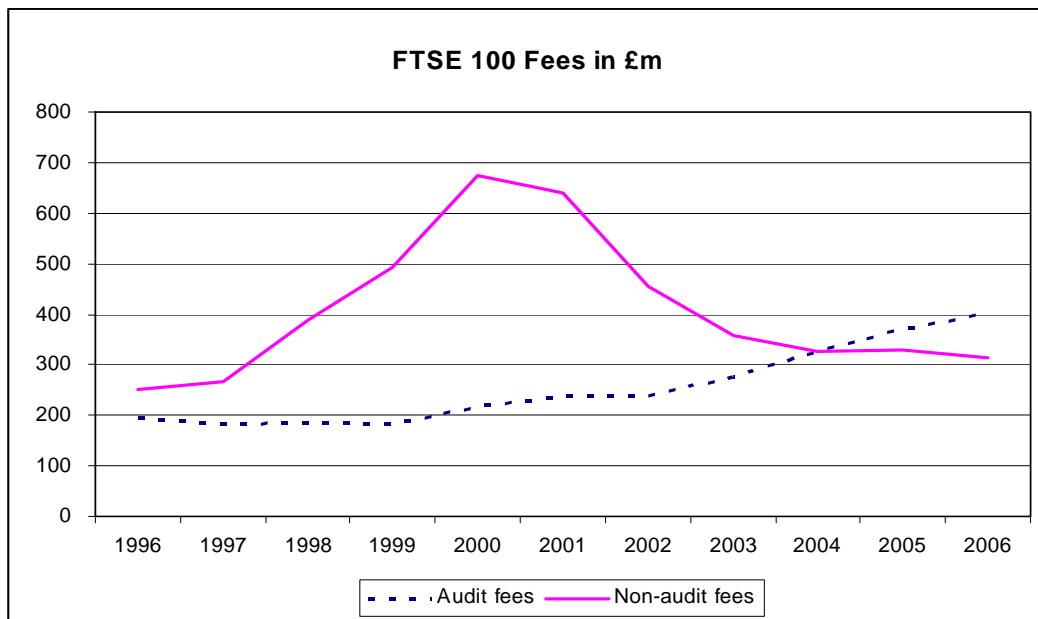
Non-audit services fees

- 5.3 There are a number of different data sets relating to fees for non-audit services. These data sets consistently demonstrate that there appears to have been a marked change in the fees profile of accountancy firms in respect of their larger audit clients since the APB Ethical Standards for Auditors were first introduced as draft standards in 2003. Fees for audit services have increased, while fees for non-audit services have decreased both in absolute terms and when expressed as a percentage of audit fees.
- 5.4 Until 2006 such fees were analysed in an annual survey of FTSE 100 companies undertaken by Financial Director magazine. This analysis was not published for 2007 but an exercise has been undertaken to extract data for 2008 from company financial statements.

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

- 5.5 This table shows that fees for non-audit services provided by auditors to their FTSE 100 company clients between 2002 and 2008:
- in absolute terms, reduced by 16.5%; and
 - as a percentage of audit fees, fell from 191% to 71%.

- 5.6 It is arguable that fees relating to services provided pursuant to legislation should be included with audit fees. If that approach is adopted for the 2008 data for the FTSE 100 companies, fees attributable to non-audit services would average 46% of audit fees.
- 5.7 Prior to 2005 the allocation of fees for some services as between audit and non-audit fees was not always done consistently by one company compared to another or from one year to the next. While the Companies (Disclosure of Auditor Remuneration) Regulations 2005 and associated guidance have led to greater consistency, some services may still be categorised differently by different companies.
- 5.8 When shown graphically over a longer period of time, it can be seen that there was a peak in the fees for non-audit services in 2000. Since then a number of factors have contributed to the fall in fees for non-audit services including:
- more active audit committee involvement;
 - disposal of consulting businesses by several of the large accountancy firms;
 - more demanding ethical standards both in the UK and overseas.



Involvement of audit committees

5.9 The Combined Code on Corporate Governance was updated in 2003 to recommend that audit committees should:

- Review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- Develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and
- Report to the board, identifying any matter in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

5.10 Additionally in 2003 the Smith Guidance on audit committees was published. This provided guidance on how these roles and responsibilities might be undertaken, including in relation to the assessment of the independence and objectivity of the external auditor, taking into consideration all relationships between the company and the audit firm (including the provision of non-audit services).

5.11 The APB undertook a questionnaire survey of company directors⁹ in 2007 which included a section on communications with those charged with governance. The results of questions in this area indicated that both the amount of information provided by the auditors relating to auditor independence and the amount of time spent by the audit committee on discussing matters relating to auditor independence have increased over the previous three years.

5.12 Responses to a question on the factors that had caused changes in fees paid to external auditors for non-audit services were as follows:

Factors	% of respondents
A change in the company’s demand for non-audit services	57%
The activities of and decisions within the audit committee concerning the purchase of non-audit services	36%
The debate and decisions within the executive management concerning the purchase of non-audit services	26%
The impact of the APB Ethical Standards for Auditors	23%
The impact of regulatory requirements relating to auditor independence from another country e.g. the US	19%
A change in the audit firm’s ability to provide non-audit services	11%

⁹ A total of 47 responses were received from a sample of audit committee chairs and finance directors of FTSE 350 listed companies, representing a response rate of 19%.

- 5.13 32% of listed company respondents to the survey reported that there had been instances where the audit committee concluded that the external auditor would not be an appropriate supplier of certain non-audit services for reasons of auditor independence. Examples of the type of non-audit service where this was concluded included forensic and receivership investigations, treasury support, acquisition due diligence and reviews of tax planning schemes. A number of responses also described policies that had been set by audit committees on the provision of non-audit services by the external auditor. For example, some audit committees had restricted the type of non-audit services that could be provided by the external auditor and others had set limits for the fees earned from non-audit services, either as an absolute amount, or as a proportion of the audit fees.

Legislation on disclosure of non-audit fees

- 5.14 The Companies (Disclosure of Auditor Remuneration) Regulations 2005¹⁰ required companies to disclose in the notes to the annual accounts the remuneration paid to a company's auditors for non-audit services split between:
- (a) any remuneration receivable by the company's auditors for the auditing of the accounts, and
 - (b) any remuneration for the supply of other services to the company or its associates.
- 5.15 Information on other services must be disclosed for the following categories, which broadly reflect the categories of non-audit services in ES 5:
- (i) The auditing of accounts of associates of the company pursuant to legislation (including that of countries and territories outside Great Britain).
 - (ii) Other services supplied pursuant to such legislation.
 - (iii) Other services relating to taxation.
 - (iv) Services relating to information technology.
 - (v) Internal audit services.
 - (vi) Valuation and actuarial services.
 - (vii) Services relating to litigation.
 - (viii) Services relating to recruitment and remuneration.
 - (ix) Services relating to corporate finance transactions entered into or proposed to be entered into by or on behalf of the company or any of its associates.
 - (x) All other services.
- 5.16 The ICAEW has provided guidance¹¹ on which services should be disclosed under the various categories - however anecdotal evidence suggests that companies have some difficulty in determining what services need to be disclosed under the different categories and that category (ii) (other services supplied pursuant to such legislation) is especially troublesome as it is not clear to what legislation the

¹⁰ Regulations on audit fee disclosure were first introduced in 1991 and required disclosure in the annual accounts of the aggregate remuneration paid to the auditor for non-audit services as well as the amount spent on the audit itself. The 2005 regulations were amended slightly in 2008, although the categorisations of non-audit services remained unchanged.

¹¹ Tech 06/06 (Revised) - Disclosure of Auditor Remuneration

‘such’ refers to.

Research into competition and choice

- 5.17 In 2005/6, the Financial Reporting Council, in conjunction with the then Department of Trade and Industry, undertook an examination of the level of competition and choice in the market for the provision of audit services¹². It noted that the provision of non-audit services by the company’s auditor may inhibit competition and choice in relation to the provision of audit services.
- 5.18 Those who hold this view argue that a prohibition on non-audit services would help mid-sized accountancy firms secure additional non-audit work with major clients and assist them to build their brands. The effect of this, over time, could be to increase competition for audit services.

Academic research

- 5.19 Appendix 2 gives a summary of approaches that have been followed in academic research investigating the possible effects of the joint provision of audit and non-audit services on the independence of the auditor and hence on the quality of financial reporting.
- 5.20 Taken together, research has not provided consistent evidence of any generalised link between the actual level of fees for non-audit services provided by external auditors and the quality of financial information reaching the market, although some studies have reported a potentially problematic association in certain contexts.
- 5.21 However, research consistently shows that the joint provision of audit and non-audit services negatively influences the perceptions of key groups about the level of independence of the auditor. Recent studies are significant in demonstrating the potential that these perceptions can have when they are carried through into real decisions, affecting market transactions and values.

¹² The Market Participants Group developed a number of recommendations in relation to increasing competition and choice. One of these was that firms that audit public interest entities should comply with the provisions of a Combined Code-style best practice guide. In response to this recommendation, in July 2009, the ICAEW published a consultation paper containing a draft Audit Firm Governance Code which proposes, inter alia, the appointment of non-executives who would take an interest in overriding issues affecting audit firm independence.

6 The international environment

- 6.1 It is important to recognise that the approach taken to the provision of non-audit services by accountancy firms has a significant international dimension – because many, if not most large companies operate in multiple jurisdictions.
- 6.2 As a result, there is growing momentum for standards for auditors to be set on an international basis. Much progress has been made internationally in relation to Auditing Standards and the European Commission is consulting on whether the International Standards on Auditing (ISAs) should be adopted throughout the European Union. Less progress has been made internationally in relation to the convergence of ethical standards for auditors, although the International Federation of Accountants' Code of Ethics for Professional Accountants (the IFAC Code) forms the basis of the standards applied by the auditing profession in many countries. The International Ethics Standards Board for Accountants has recently updated the IFAC Code and the extensive consultation which has been undertaken as part of this process supports the approach followed in the APB Ethical Standards for Auditors.
- 6.3 This section of the Consultation Paper summarises the approach to non-audit services provided by auditors in a number of important jurisdictions.

Europe

- 6.4 Article 22 (1) of the Statutory Audit Directive requires that Member States shall ensure that when carrying out a statutory audit, the statutory auditor is independent of the audited entity and is not involved in the decision-taking of the audited entity.
- 6.5 Article 22 (2) states that:
- The statutory auditor shall not carry out a statutory audit if there are any direct or indirect relationships (including the provision of non-audit services) from which an objective, reasonable and informed third party would conclude that the auditor's independence is compromised.
 - If the auditor is affected by threats, such as self-review, self-interest, advocacy or familiarity, the auditor must apply safeguards in order to mitigate these threats.
 - If the significance of the threats compared to the safeguards is such that the auditors' independence is compromised, the statutory auditor shall not carry out the statutory audit.
 - In addition, where the audit is of a Public Interest Entity, where appropriate to safeguard the statutory auditor's independence, Member States shall ensure that a statutory auditor shall not carry out an audit in cases of self-review or self-interest.

- 6.6 In addition in 2002 the EC issued a Recommendation '*Statutory auditors' independence in the EU: A set of fundamental principles*'.
- 6.7 In the UK and Ireland, the APB's Ethical Standards for Auditors are considered to be consistent with both the Statutory Audit Directive and the EC Recommendation. A similar threats and safeguards approach is adopted by most other EU Member States (other than France) which follows a different approach.

France

- 6.8 In France, legislation¹³ prohibits the auditor from providing all services other than reporting on prospectuses and those that are directly relevant to the audit. Furthermore services that are directly relevant to the audit can only be provided if they are performed in accordance with approved standards. The French profession has developed standards for:
- Agreed upon procedures,
 - Attestation of specific financial information,
 - Contractual audits or reviews,
 - Consultation on different accounting treatments,
 - Vendor or Acquirer due-diligence,
- and is in the process of developing standards for:
- Reporting on environmental information,
 - Consultation on internal controls,
 - Forensic audits.
- 6.9 Certain audit firms have expressed concerns that the French legislation does not properly reflect the idea of proportionality embedded in the Statutory Audit Directive and unduly restricts the freedom to provide services by overseas network firms of French firms. This matter is under discussion between the French Ministry of Justice and the European Commission. This suggests that the impact on European network firms of further prohibitions of non-audit services in the UK would need to be considered in light of the Statutory Audit Directive and relevant treaties, including the freedom to provide services.

United States of America

- 6.10 US independence requirements that apply to the audits of listed entities are established by the SEC. The SEC rules were strengthened in 2003 and, in more recent years, have been supplemented by PCAOB standards. The US rules, apart from the description of four principles in a general guidance paragraph, are

¹³ The "Loi de sécurité financière" was issued in August 2003; the provision of the law concerning the prohibition of non audit services is now codified in the Code of Commerce under article L 822-11. r

written as a series of prohibitions and are not based on a threats and safeguards approach¹⁴.

6.11 In relation to non-audit services the US rules prohibit:

- Bookkeeping*
- Financial information systems design and implementation*
- Appraisal and valuation services*
- Actuarial services*
- Internal audit outsourcing services*
- Acting temporarily or permanently as a director or employee of the audit client or performing any decision making, supervisory or ongoing monitoring function for the audit client.
- Recruitment activities
- Broker dealer, investment adviser or investment banking services
- Legal services where the service requires a licensed, admitted or otherwise qualified law practitioner
- Expert services unrelated to an audit
- Tax services related to planning, or opining on the tax treatment of a transaction that is a listed or confidential transaction or where a significant purpose is tax avoidance
- Tax services for an officer in a financial reporting oversight role.

* These services can be provided if it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.

6.12 In 2003 the US rules were strengthened¹⁵ to require all audit and non-audit services provided by the auditor to be pre-approved by a company's audit committee and disclosed to investors. Since 2003 fees for non-audit services provided by auditors to their large public company clients have reduced from 51% of the total fees to 21% in 2007¹⁶, although the rate of decline has levelled off in the past two years.

6.13 The scope and requirements of the US rules on the provision of non-audit services are more restrictive than APB's standards. In particular the US rules appear to be more stringent than the Ethical Standards for Auditors in the following respects:

¹⁴ Ethical guidance for the audit of non-listed companies in the US is provided by the American Institute of Certified Public Accountants. This guidance does utilise a threats and safeguards approach.

¹⁵ This was consistent with the direction of Section 208(a) of the Sarbanes-Oxley Act of 2002.

¹⁶ Figures reported from a study of public disclosures made by 3,390 companies between 2002 and 2007 which was undertaken by Audit Analytics, a US research firm.

- Many non-audit services in categories 4 and 5 of the table in paragraph 2.2 are prohibited even if the services are not material to the financial statements;
- US restrictions on contingent fees extend to all non-audit services, whilst the APB Ethical Standards for Auditors require the audit firm to consider the implications of any contingent fees and only prohibits certain tax and corporate finance services that are provided under a contingent fee;
- US rules require a pre-approval of non-audit services by audit committees. By contrast, the UK's Combined Code on Corporate Governance recommends that audit committees develop policies to govern the future provision of non-audit services.

6.14 The APB Ethical Standards for Auditors are more stringent than the US requirements in relation to corporate finance and transaction related services and having a wider restriction as to those within the audit team who can be rewarded for selling non-audit services¹⁷.

¹⁷ The SEC prohibition only applies to audit partners.

7 Issues on which the APB seeks views

In response to the Treasury Select Committee's recommendation, and against the background information provided in this Consultation Paper, the APB is seeking the views of all stakeholders – investors, companies and their directors and management, accountants and other interested parties – on the following questions.

In respect of listed companies¹⁸:

- 1 (a) **Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?**

(b) **Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality?**

Please give the reasons for your views.
- 2 **If you do consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors please identify which non-audit services are of concern. Please give the reasons for your view.**
- 3 **In the light of your answers to questions 1 and 2, do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit? Please give reasons for your view.**
- 4 **If you think that there should be a change in the current arrangements, would you advocate:**
 - **Complete or more extensive prohibitions on the provision of non-audit services by accounting firms to their audit clients within the Ethical Standards for Auditors;**
 - **The imposition of other requirements through the Ethical Standards for Auditors (and if so which);**
 - **More active corporate governance – e.g. so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee;**
 - **Better (and more extensive) disclosure in financial statements.**

Please provide reasons for your views and any suggested solutions.

¹⁸ The APB will address the position of companies and entities other than listed companies in any further consultation that it undertakes as a result of the responses that it receives to this Consultation Paper.

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

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

The APB invites responses to the specific questions set out above. 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. If this is not possible, please send letters of comment to:

**Hazel O'Sullivan
Project Director
The Auditing Practices Board Limited
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN**

In either case, letters of comment should be sent so as to be received no later than **29 January 2010**.

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.

Appendix 1

Summary of the requirements in ES 5 (Revised) ‘Non-audit services provided to audited entities’

GENERAL PROVISIONS

- 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.
- 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.
- 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.
- 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.
- 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 for Auditors and the company’s policy for the supply of non-audit services by the audit firm and any apparent breach of that policy.²

- 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.

SPECIFIC NON-AUDIT SERVICES

INTERNAL AUDIT SERVICES

- 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.

INFORMATION TECHNOLOGY SERVICES

- 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.

VALUATION SERVICES

- 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.

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 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.

TAX SERVICES

- 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 the related accounting treatment involved, having regard to the requirement for the financial statements to give a true and fair view in accordance with the relevant financial reporting framework.
- 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:
 - (i) The application of tax law which is uncertain or has not been established; and
 - (ii) A future or contemporary audit judgment relating to a material matter in the financial statements of an audited entity.
- 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.
- 78 For 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 preparing accounting entries that are material to the relevant financial statements, save where the circumstances contemplated in paragraph 131 apply.
- 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 court⁵ 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.

LITIGATION SUPPORT SERVICES

- 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.

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.

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.
- 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.
- 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.

CORPORATE FINANCE SERVICES

- 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 an accounting treatment that is related to the advice provided, 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
 - (c) 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
 - (d) the engagement would involve the audit firm undertaking a management role in the audited entity.

TRANSACTION RELATED SERVICES

- 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 an accounting treatment that is related to the advice provided, 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.

ACCOUNTING SERVICES

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.

Appendix 2

Research on the joint provision of audit and non-audit services

This appendix outlines different research approaches to the effect of non-audit service provision on auditor independence and summarises the main findings of some recent research studies. More comprehensive reviews of the literature on this subject can be found elsewhere.¹⁹ This analysis classifies research into the following three categories:

- Studies that have investigated the link between joint provision and the quality of financial reporting (both company reports and auditor reports):
- Studies that have investigated the impact of joint-provision on perceptions of auditor independence;
- Studies that have investigated the impact of non-audit services on the overall contract position between the auditor and the client company.

1. Joint audit and non-audit service provision and the quality of financial reporting

A central question in the debate on non-audit services is whether the reliability of financial information that companies provide to the market is affected by their purchase of non-audit services from the incumbent auditor. As more data has become available regarding the nature of the relationship between auditors and client companies and the quality of databases on financial information has improved, research approaches have developed to investigate whether differing levels of non-audit service provision are associated with the quality of financial reporting. This approach rests on the argument that if provision of non-audit services undermines the auditor's independence then this will be observable in indicators associated with financial reporting quality. For example, if auditors are less independent they may be more inclined to accept questionable management choices on reporting without qualifying their audit opinion. In order to test the general proposition empirically, three elements have to be built into the research design:

- Some measure of the potential threat to independence – for example the relative amount of audit and non-audit fees;
- An indicator of financial reporting quality – for example measures of “earnings management”.
- A setting to provide the data to test the link – most studies have used actual accounting disclosures, although there is some work in artificial, experimental settings.

A number of studies have investigated whether there is a link between non-audit services and three aspects of the quality of financial reporting:

(a) measures of potential earnings management;

¹⁹ Broad reviews of research can be found in Beattie and Fearnley (2002) and Schneider et al (2006) and a commentary on the findings of extant research can be found in Francis (2006).

- (b) the need for companies to correct published financial statements; and
- (c) the willingness of the auditor to issue a modified opinion.

(a) Measures of earnings management

There are significant measurement difficulties associated with this type of work which are discussed here, in particular how the concept of earnings management can be operationalised for testing. However, the studies use what have become well-established methods for trying to measure the exercise of management discretion in the reporting of annual financial statements through measures which are typically referred to as “discretionary accruals” or “abnormal accruals”.

Although one initial US study (Frankel et al, 2002) reported a positive association between the level of non-audit services and measures of potential earnings management this has been challenged by subsequent studies using different model specifications or including additional variables (e.g. Chung and Kallapur, 2003; Asbaugh et al, 2003). Other studies incorporating governance variables have found only limited evidence of any association between non-audit services and the reliability of financial reporting for small subsets of companies (Larker and Richardson, 2004). Investigation into Australian companies has also reported no adverse impact from non-audit services on financial reporting quality (Ruddock et al, 2006) although this is based on 1990s data.

In the UK, one study (Ferguson et al, 2004) has reported a statistically significant association between non-audit service levels and discretionary working capital accruals. However, this research is also based on reporting during the 1990s.

(b) Restated financial statements (Restatements)

A second approach takes restatements as an indicator reflecting low quality financial reporting quality and tests for association with the level of non-audit services.

Studies have either found no evidence or only limited evidence that restatements are more likely among company with higher levels of non-audit services, and have generally concluded that there is no substantive evidence of a link between sub-standard reporting and non-audit services (Ragunandan et al 2003, Kinney et al 2004)

In the UK, the Ferguson et al (2004) study mentioned above using 1990s data found a positive association between non-audit service levels and two further proxies for quality - public criticism or regulatory action, and restatements or adjustments specifically linked to FRS 12.

(c) Auditors’ reports

The argument underlying this strand of research is that if auditors’ independence is compromised through the joint provision of audit and non-audit services then this is likely to result in auditors being less willing to issue modified audit reports than would otherwise be the case. To test for this possibility, researchers have generally looked at going concern modifications as that represents a sensitive situation where a reduction in independence might be most likely to be exhibited.

These studies have generally reported no evidence that auditors are less willing to modify their report for going concern in financially distressed companies because of high levels of non-audit service fees (Defond et al, 2002; Geiger and Rama, 2003).

There has been limited research on this issue in the UK. One study (Lennox, 1999) examined financially stressed companies between 1988 and 1994 and found a weak relationship between qualified audit reports and higher levels of non-audit services. More recently, a study based on matched samples of 29 UK firms receiving a going concern modified audit report in 2003 and 29 other companies subject to similar conditions of financial distress but with unmodified audit reports found that companies with higher levels of non-audit service fees were less likely to receive a modified opinion (Basioudis et al, 2008).

2. Joint audit and non-audit service provision and perceptions of auditor independence

Surveys and hypothetical tests of perception effects

Researchers have investigated the question of whether the joint provision of audit and non-audit services affects perceptions of auditor independence for many years. Initially much of this research was based on surveys of different categories of persons connected to the audit, such as investment analysts, bank officers, management and auditors themselves, and comprised:

- Opinion surveys asking participants to indicate whether they felt that a particular type or level of non-audit service adversely affects auditor independence. As well as work specifically on independence issues, general surveys looking at the expectations gap in auditing have often included questions connected to non-audit services and independence.
- Experimental tasks in which participants are presented with a hypothetical setting and asked to make some kind of decision or evaluation. Some studies have employed a “between subjects” design, where different samples are given slightly different information and their responses compared as a means of identifying the effect of variation in non-audit service provision, and some a “within subject” approach where the participants are each presented with a series of cases in order to identify if changes in the non-audit services purchase are associated with changed decisions.

Although there are differences in the emphasis and strength of results of different studies, overall such research has tended to suggest:

1. Joint provision of audit and non-audit services does affect perceptions of auditor independence for at least some participants;
2. Non-auditors are more sceptical about the impact of joint provision than auditors themselves;
3. Perceptions of an adverse impact on independence vary between different types of non-audit service and with the degree of involvement of the audit team in the non-audit service.

A recent UK study in this tradition (Dart, 2009) involving a 2005 survey of investors provides evidence that:

- Economic dependence and provision of non-audit services are perceived as greater threats to independence than a long auditor-client relationship.

- In terms of specific non-audit services, institutional investors perceive internal audit services, valuation of assets and liabilities, investment advice, bookkeeping and actuarial advice as posing the greatest threats to independence;
- Investors are more concerned when audit personnel provide the non-audit services than when a separate division from the same firm provide the services.
- Both individual and institutional investors perceive the current APB Ethical Standards for Auditors as sufficient safeguards.

Experimental studies using MBA students as surrogate investors and experienced directors as surrogate audit committee members and investors have found the non-audit service provision does affect perceptions of independence and, interestingly, that disclosure related to non-audit services influences certain behaviours (Dopuch et al 2003, Gaynor et al 2006).

Perceptions reflected in market transactions

Rather than collecting opinions or hypothetical decisions via surveys and experimental instruments, a contrasting research approach is to use actual market transactions as the basis for proxy measures to establish whether perceptions of auditor independence are affected by joint audit and non-audit service provision. Data from both the equity and debt markets has been tested in a number of recent studies.

For debt, a statistically significant negative association has been reported between the level of non-audit service fees and new bond ratings (Brandon et al, 2004) i.e. higher non-audit service fees were associated with lower new bond ratings.

Investors' perceptions of the impact of non-audit services have been tested by looking at the response of market prices to company results (through an "earnings response coefficient"). This approach reasons that if investors doubt auditor independence in the presence of higher levels of non-audit services, they will place less reliance on the audit, regard the financial information as less credible and, accordingly, their response to earnings information will be less positive than in companies with lower non-audit services. The earnings response coefficient is effectively used as a measure of how credible investors perceive the financial information, or the quality of the earnings information, to be. The results of studies of this nature have generally provided evidence of a negative association between non-audit service levels and earnings response, i.e. that investors value new information less in the presence of high levels of non-audit services (Krishnan et al, 2005; Francis and Ke, 2006; Higgs and Skantz, 2006).

These findings are potentially significant in that they suggest the possibility not simply that investors prefer less rather than more non-audit services but that they place less trust in information produced by a company that also purchases high levels of non-audit services from its auditors and that this may affect market behaviour.

3. The impact of non-audit services on the overall relationship between the auditor and the client company

Evidence based on fees disclosed in company financial statements indicates that there have been major changes in the pattern of audit and non-audit service purchased in recent years. Looking at reporting periods before and for a number of years after the time in 2001 and 2002 when Enron and other similar cases led to particular concerns about the level of non-audit service provision, Siddiqui et al (2006) have concluded that UK companies that were more exposed to a possible threat to perceived independence before Enron, due to relatively high levels of non-audit services, have subsequently reduced their purchases of these services and also increased voluntary disclosure explaining the nature of the non-audit service relationship. The most marked changes occurred for companies that also have an SEC registration. This suggests that the early regulatory response in the US had an impact beyond what would otherwise have occurred voluntarily.

Much of the research noted above employs measures based on the level of non-audit fees received by the auditor to represent the threat to auditor independence from non-audit services. While most studies have treated the non-audit service fees as being separately determined, a further line of research takes the perspective that both audit and non-audit services should be analysed as though they are jointly determined. This could reflect the existence of 'knowledge spillovers', whereby the non-audit services benefit from being jointly provided with the audit and/or vice-versa. McMeeking et al (2006) analyse UK data over the period 1985-2002 to demonstrate a positive association between the level of audit and non-audit fees and suggest that joint provision may be valued by companies, influencing the fees they are willing to pay. The existence of knowledge spillovers in both directions between audit and non-audit services has also been reported in another study (Antle et al, 2006) which used fee data for UK companies between 1994 and 2000.

4. Other factors

Although each of the different research approaches are subject to certain limitations, there are a number of general caveats that are worth highlighting that are relevant to both the interpretation of the research findings and reliance on them as a basis for policy making:

1. Only a limited amount of research has been conducted in the UK, particularly involving tests based on actual financial reporting by companies. The large majority of studies have been undertaken in other environments, notably the US, and care is needed in extrapolating the results to the UK.
2. In practice the joint provision of audit and non-audit services is only one of a large number of factors that have the potential to influence audit outcomes and the way in which they are evaluated by other parties. Judgements on individual engagements are not divorced from the legal, regulatory and ethical context in which they are taken. Consequently it cannot easily be assumed that results from several years ago continue to apply in the current environment and there may be a need to replicate and update past research. This also means that testing which seeks to isolate the non-audit service variable from all other aspects of the context must be interpreted with care.

3. Many of the studies look for results that are in some sense systematic, that is the tests are conducted in a manner to identify whether there is any generalised statistical association between variables of interest. From a policy making perspective, however, it may not be acceptable simply to conclude that “on average” there isn’t a problem. If market participants are concerned about the potential loss of independence, even in extreme cases, then regulations based on the average may not be satisfactory to allay those concerns.
4. As is often the case, it must be acknowledged that the studies do not provide universally consistent results. To some extent this may simply emphasise the importance of context, as noted above.

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