CIMA

An independent view on the independence of auditors:

CIMA Review of Auditor Independence

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CIMA REVIEW OF AUDITOR INDEPENDENCE

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CIMA REVIEW OF AUDITOR INDEPENDENCE

I. EXECUTIVE SUMMARY

Since the collapse of the US energy company Enron, in late 2001, there has been considerable public debate about the role of auditors, much of which has focussed on the issue of auditor independence. Pressure for action has been greatest on the audit firms, and many have called for additional regulation.

It is not however the sole responsibility of regulators to arrive at solutions to the problems identified by the current debate. The market itself will generate it's own solutions – recent actions have been the decision of major firms to divest themselves of their consultancy divisions; and the decision by some large corporates such as Unilever, to reconsider buying non-audit services from their statutory auditors.

The purpose of financial reporting is to achieve the provision of financial information of the highest quality to capital markets. There is a network of participants who contribute to this goal, described by FEE[1] as:

- *Preparation of true and fair financial information by an effective and well resourced company accounting function*
- *Internal audit*
- *Informed review by directors, audit committees or supervisory boards*
- *Proper approval procedures for financial information by the body responsible within the company*
- *External audit and external review subject to quality assurance systems that inspire public confidence*
- *Effective enforcement bodies*
- *Stock Exchanges with supportive listing agreements*
- *Sponsors, advisers and investment bankers committed to high quality financial reporting particularly in respect of complex transactions*
- *Investors, analysts, rating agencies and the financial press, all of whom should have clear ethical obligations to raise issues of dubious financial reporting*[2]

CIMA's overarching position is that auditor independence must be viewed within the totality of corporate governance and the accountabilities of organisations to their stakeholders. This implicitly incorporates the public interest, however defined. The external audit is one element of the overall risk management of an organisation. It must be linked with other constituent parts of risk management including the determination of the Board's appetite for risk, an appropriate risk management process, an effective internal audit function, and an open disclosure of –and timely resolution of – conflicts of interest.

A well functioning Audit Committee has to decide the scope of the external audit in the context of risk management and the associated deployment of internal audit. Both the internal and external auditors should consider their primary client to be the Audit

[1] Fédération des Experts Comptable Européens, see Glossary Appendix I
[2] Response to EC consultation paper *A Modern Regulatory Framework for Company Law in Europe: A consultative document of the High Level Group of Company Law Experts,* see Bibliography Appendix H

Committee on behalf of shareholders. The Audit Committee must closely monitor the auditor's relationship with the company's management. To do this effectively requires a membership of the Audit Committee which together is sufficiently independent of executive management, has a minimum level of financial literacy and has the ability to ask perceptive questions which are pursued diligently. CIMA recommends a guide to best practice for Audit Committees and has separately recommended to the Treasury Select Committee[3] for there to be a Code of Best Practice for non-executive directors.

CIMA's perspective is that of an accountant within business rather than that of an external auditor. This review has therefore undertaken a critical survey of existing analysis as concerns the relationship between a business and its external auditors within the context of the totality of corporate governance. This not only includes codes of ethics for the accountancy profession but also Company Law, statements from the APB[4], and relevant codes for corporate governance including the Combined Code. To look at any of these in isolation would miss the interaction of checks and balances between the separate forms of guidance. The review has been expanded to international experience and studies where felt appropriate.

The background to the Conclusions and Recommendations are separately available from www.cimaglobal.com . Set out below are the key conclusions and recommendations of the CIMA Audit Review Working Party (ARWP).

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[3] CIMA's response to the Treasury Select Committee inquiry into The Financial Regulation of Public Limited Companies is downloadable from http://www.cimaglobal.com/downloads/submission_selectcommittee_2002.pdf

[4] Auditing Practices Board, see Glossary Appendix I

1. THE DEFINITION OF INDEPENDENCE

The ARWP reviewed the definitions of independence used by IFAC[5], the EC[6] and the SEC[7].

CONCLUSIONS

The ARWP concluded that

- the approaches of IFAC, the EC and the SEC towards independence are similar, albeit the SEC is more prescriptive;
- the IFAC definitions are sound; and
- the perception, as well as the reality, of independence is fundamental in supporting investor confidence in the integrity and credibility of audited financial statements.

RECOMMENDATIONS in respect of the definition of independence

The ARWP recommends

1.1 that CIMA endorses the IFAC definition of independence.

2.1 INDEPENDENCE OF FIRMS FROM CLIENT - Employment relationships

The ARWP considered whether auditor independence could be compromised if a member of client finance staff was a recent colleague of audit staff; or if current auditors had an expectation that they could obtain an appointment with the client in the near future. The ARWP reviewed guidance from several UK and international bodies and committees.

CONCLUSIONS

The ARWP

- endorsed the approach outlined in the IFAC Code, which was to define the nature of potential threats to independence; and recommend the introduction of additional safeguards rather than prohibit potentially problematic appointments.

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[5] International Federation of Accountants, see Glossary Appendix I
[6] European Commission, see Glossary Appendix I
[7] Securities and Exchange Commission, see Glossary Appendix I

CONCLUSIONS cont.

- Acknowledged that the UK is under pressure to accept the two-year cooling-off period set out in the EC recommendation, but rejected the principle of a cooling-off period which it saw as limiting companies' freedom to choose a former audit partner should this be seen to be in shareholders' interests.

RECOMMENDATIONS in respect of employment relationships

The ARWP recommends

2.1.1 a transparent process of selection and appointment at senior level should one of the candidates be an audit partner in the engagement team. The Audit Committee as well as the Nominating Committee should be involved.

2.1.2 additional scrutiny of the financial statements by the Audit Committee with the support of the Auditors or other independent professionals in cases where there has not been an audit in the period between the partner leaving the audit firm and joining the audit client.

2.1.3 that the Audit Committee monitor the number and trend of appointments of former audit staff, as well as considering the impact of each specific instance.

2.2 INDEPENDENCE OF FIRMS FROM CLIENT - Provision of non-audit services

External auditors can provide a variety of other services to their statutory audit clients, including:

- internal audit;
- design and installation of accounting systems;
- senior executive recruitment and the determination of their remuneration packages; and
- tax planning advice

The provision of any services beyond the statutory audit clearly puts additional pressure on auditor independence. Yet there are particular benefits arising from having the auditors provide some types of service. The ARWP considered some different services, and felt it was necessary to consider the type of non-audit service, rather than make a generalised recommendation. Focussing on internal audit and taxation, it determined whether the benefits of the service being

provided by statutory auditors outweighed the disadvantages of the threat to independence.

CONCLUSION

The ARWP

- supported the general approach of the IFAC Code regarding non-audit services, which is to specify the additional safeguards that might be appropriate under a variety of situations. There are benefits of cost, knowledge and efficiency in auditors providing certain non-audit services and the risks to independence can be minimised through such safeguards.
- felt it was not practical to prohibit the tax computation and tax audit from being undertaken by the statutory audit firm, and agreed with IFAC that such services are not generally those which are regarded as creating a threat to independence.

RECOMMENDATIONS in respect of non-audit services

The ARWP recommends that

2.2.1 that external auditors should not undertake internal audit activities for public interest companies, that is Listed companies, credit institutions, insurance companies and investment firms. These companies would, of course, still be able to outsource internal audit to other suppliers.

2.2.2 companies should not obtain sophisticated tax planning advice (as distinct from computation and compliance work) from their external auditors, particularly where remunerated on a fee-for-results basis.

2.2.3 there should be additional safeguards in respect of tax computation and compliance included in the Code of Ethics. There should also be a requirement to disclose clearly in the financial statements when the audit firm has been involved and to what extent.

2.2.4 there should be a single point of contact in both the audit firm (engagement partner) and the client (authoriser, Group Finance Director) through which all contacts and contracts are agreed. The level and extent of audit and non-audit services should then be routinely reported to the Audit Committee. The Audit Committee should then satisfy itself that the auditor providing non-audit services does not compromise independence.

2.2.5 there should be additional “health warnings” in the financial statements of SME companies which use their external auditors for other non-audit work. More practical than a prohibition, the warning will serve to alert the users of the financial statements of such companies of possible independence issues.

RECOMMENDATIONS in respect of non-audit services cont.

2.2.6 there should be additional disclosure over and above the current requirements set out in UK Company Law. The EC Recommendation is for public disclosure of fees to be broken down by four categories: statutory audit services; further assurance services; tax advisory services and other non-audit services. These could be expanded on in accordance with the general principle of transparency to disclose specific large items such as due diligence work on a significant transaction.

2.2.7 Internal Audit should be provided independently of the external auditor. Provision of Internal Audit by an external supplier who is not the company's external auditor is acceptable, but the participation of the external provider should be limited to the provision of discrete services – the planning, reporting and responsibility should rest with the organisation's own staff.

2.2.8 the Accountancy Foundation should monitor whether firms which have divested themselves of their consulting services, are in fact re-building these consulting services, under an assurance banner.

2.3 INDEPENDENCE OF FIRMS FROM CLIENT - Auditor rotation

The ARWP considered the implications of various proposals suggested by other interested parties, that:

- nothing should interfere with the natural triggers to change auditors – value-for money, desire to compare performance from another supplier or decline in motivation of audit team. Therefore mandatory rotation of firms is to be resisted.
- there should be a periodic rotation of audit partners and/or audit firms to prevent a relationship developing between the firm and the client, of a nature which would inhibit auditor objectivity.
- there should be mandatory rotation.
- that a third party should select and appoint auditors for companies.

CONCLUSIONS

The ARWP

- rejected mandatory rotation *of firms* particularly as there are now four major firms and some may be excluded for competitive reasons. Some may also be debarred by the CIMA recommendation on internal audit services not being undertaken by the audit firm for the audit client (see 2.2.9).

- rejected any notion that a third party have responsibility for appointing auditors.

RECOMMENDATIONS in respect of auditor rotation

The ARWP recommends that

2.3.1 a requirement to rotate *between clients* should be imposed on all senior members of the engagement team. Other than for the engagement partner this could be within the team (for example from one major subsidiary to another).

2.3.2 the time period for this requirement should be cumulative with respect to senior roles held within the engagement team (for example time spent, as the audit manager should be added to time spent as the engagement partner).

2.3.3 a shorter time period of five years should be considered, as opposed to the current generally accepted seven years.

3. ROLE OF AUDIT COMMITTEES

The review was undertaken in the context of the unitary Board as currently exists in the UK. The ARWP stressed that role of the Audit committee encompasses much more than the company's relationship with external audit. In a submission earlier in 2002 to the Treasury Committee's inquiry into the financial regulation of public limited companies, CIMA suggested that companies might consider re-naming the Audit Committee to reflect this.

CIMA has been disappointed previously that in the Combined Code[8] the role of the Audit Committee is now principally associated with the role of the external auditors, that no mention is made of internal audit in the context of the Audit Committee and

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[8] *Principles of Good Governance and Code of Best Practice,* see Bibliography Appendix H

that the wider role of the Audit Committee in corporate governance is not acknowledged.

CONCLUSIONS

The ARWP

- considered that the Audit Committee played a fundamental role in promoting, monitoring and protecting the independence of auditors (internal as well as external). The members, who should be non-executive directors with a majority being independent, must have ample time, experience and training to be robust, ask searching questions and exercise due diligence in finding answers.

- felt that it is critical that the Audit Committee be well versed in issues of ethics and auditor independence, and understand the importance of such issues in maintaining investor credibility in the company's financial statements.

- felt there are benefits to be had in the Chairman of the Audit Committee being on the Remuneration committee and vice versa. This allows an interaction between the committees on performance measurement aspects of remuneration and also allows the committees to understand better the risks of aggressive earnings management resulting from potential performance bonuses.

- felt that the Combined Code seems to have insufficient emphasis on accountability and audit compared with other sections. No mention was made of internal audit in the context of the Audit Committee, the role of the Audit Committee was principally discussed in relation to the role of the external auditors. In its response to the Company Law Review in July 2000, CIMA noted that the Combined Code did not contain the content of notes to the original Cadbury Code, which included a number of Audit Committee recommendations. Had these been included in the Combined Code, this would have strengthened the Code in this area.

RECOMMENDATIONS in respect of Audit Committees

The ARWP recommends

3.1 that the Audit Committee meet regularly with both the external and internal auditors without management present. Both the internal and external auditors should consider their primary direct client to be the Audit Committee on behalf of shareholders.

3.2 that the Audit Committee is regarded as key in appointing external auditors. Whilst management can propose a change/selection of auditors it should be the Audit Committee who makes the final proposal to the Board and subsequently shareholders at the AGM.

RECOMMENDATIONS in respect of Audit Committees cont.

3.3 the Audit Committee should decide the scope of the audit in the context of risk management and the associated deployment of internal audit. The committee needs to understand the statutory minimum requirement and then add to this as it sees fit in the context of the control of risk, particularly as to the validity of the financial statements. This will have consequences on the level of auditor remuneration (see conclusion section 5 Remuneration of Auditors). In this respect there should be a clear, and documented, record of the Boards 'appetite for risk' which should also be summarised in the Operating and Financial Review along with the major risks the company faces and the associated safeguards.

3.4 the Audit Committee must meet reasonably frequently – at least three times a year. It should explore significant accounting issues with management and the external auditors well in advance of the, often time - constrained, requirement to 'sign off' the financial statements

3.5 the Chairman of the Audit Committee should be under a statutory obligation to report to shareholders annually, and this report should include reference to any significant matters brought to the Audit Committee's attention by the external auditor.

3.6 Audit Committees should be aware of the types of questions that should be asked of management and external and internal auditors. Such training should be added to CIMA's proposal to the Treasury Select Committee for a code of best practice for non-executive directors.

3.7 the Audit Committee should review provision of non-audit services on a regular basis and convince itself and document its conclusions on risks to auditor independence. In this context, the Audit Committee should be involved directly, or by delegation, in the provision of any significant non-audit services by the external auditor; should monitor auditor performance on a regular basis; and monitor moves of audit partners/employees to the client (both in terms of frequency and seniority).

3.8 in determining the scope of the audit, the Audit Committee should ensure that enough contextual information in the form of trend analysis and non-financial performance indicators are available from management, internal auditors and/or external auditors.

3.9 companies could consider renaming the Audit Committee given its (potential) wider responsibilities in corporate governance frameworks and risk management. This should not imply any lesser responsibilities of the unitary board. It should be a key responsibility of non-executive directors (typically through the Audit Committee) to understand the risk framework and therefore the context under which the company operates.

RECOMMENDATIONS in respect of Audit Committees cont.

3.10 individuals who have held a senior executive position within the company, should not be categorised as “independent”.

3.11 the Financial Services Authority and/or the soon to be reconstituted Financial Reporting Council to consider guidance notes for best practice for Audit Committees.

4. ROLE OF INTERNAL AUDIT

CONCLUSIONS

The ARWP felt that

- control and risk assessment processes can improve the efficiency and effectiveness of internal audit. These should begin with a high level review of the corporate governance framework that has been established by the Board.
- the Turnbull Report rightly places emphasis on the importance of internal audit and the requirement to review its work or the need for such a function on a regular basis. The ARWP hoped that the spirit of this requirement is respected rather than just the letter.

RECOMMENDATIONS in respect of Role of Internal Audit

The ARWP recommends

4.1 the head of internal audit should have senior status within the organisation, preferably reporting to a Board member, and also be given the right of direct access to the chairman of the Audit Committee.

4.2 the Audit Committee should consider how much, and in what way, it wishes to expand the scope of the external audit, over and above the core minimum assurance required by statute. The additional assurance work should be determined after considering the risk framework specific to the company and the resources available for audit.

5. REMUNERATION OF AUDITORS

Some commentators have argued that audit is being used as a 'loss leader' by which to establish a relationship through which to sell more lucrative services. In addition, concerns are also expressed that too much focus is given to the cost of audit as opposed to its quality.

CONCLUSIONS

The ARWP felt

- that given market pressures resulting from recent corporate failures there should be a renewed focus on robust quality audits and less on the absolute level of the fee.
- a significant cost within the audit is the insurance against liability and the ARWP noted and welcomed the attention that the DTI is giving this issue in the current company law review.

RECOMMENDATIONS in respect of auditor remuneration

The ARWP recommends

5.1 that the Audit Committee should satisfy itself on an annual basis as to the adequacy of the audit scope and the associated level of fees. The evaluation should also be in the context of a minimum for statutory requirements with additional work being set out and agreed in terms of the risk framework for the company and the work of internal audit.

5.2 that the Audit Committee must refocus those involved onto the value of the audit for existing and potential investors as opposed to a singular aim of cost reduction. The current environment represents an ideal opportunity for such a culture change within a company should it be required.

5.3 that similarly audit firms must emphasise and commit sufficient resources to the quality of the audit which is so important in today's capital markets.

6. UNREALISTIC EXPECTATIONS OF AUDIT FROM SHAREHOLDERS AND OTHER STAKEHOLDERS

Some impetus for the current debate about auditor independence springs from an unrealistic expectation of what external audit can provide, generally known as the expectations gap.

In addition, the whole area of aggressive earnings management (AEM) is an area that cannot be countered by auditors alone. It is clearly first and foremost the directors' responsibility to ensure high quality financial reporting. One paper which should have received a lot of attention from the business community was the APB consultation paper of June 2001, and its associated summary of responses published in February 2002.

An extract from CIMA's response to this paper reads *"CIMA believes that manipulation of earnings is an issue which needs to be tackled by the combined efforts of the accounting profession (through accounting and auditing standards), regulators (through the preventative and corrective role of the FRRP), the reporting businesses (through good corporate governance and strong non-executive representation on Boards) and users of accounts such as analysts and institutional investors (through understanding and accepting that a degree of variation from expectation is consistent with the approximate nature of accounts)"*

CONCLUSIONS

The ARWP felt that

- statutory external audit is a valuable and necessary function but its *limitations* (using this word not in a pejorative sense) need to be understood by users.
- the commercial issues raised in the APB consultation on Aggressive Earnings Management (AEM) remain highly relevant. The CIMA response to the APB consultation on AEM is even more pertinent in today's climate.

RECOMMENDATIONS in respect of unrealistic expectations of audit

The ARWP recommends

6.1 that a statement describing the limitations of audit, concepts such as materiality and judgement, should be included as an appendix to the audit report.

6.2 that those responsible for ensuring the quality of financial statements should be encouraged to read the brief APB consultation paper. The APB should consider making the original consultation freely downloadable from their website.

BACKGROUND TO CONCLUSIONS AND RECOMMENDATIONS

INTRODUCTION

The audit independence debate is not solely, or even primarily, an issue for auditors. CIMA felt strongly that the business community should be reminded that it is the company directors, under Company Law, who are responsible for producing the accounts. Following the spirit as well as the letter of the law (having truly independent NED[9]s; and avoiding the temptation of aggressive earnings management) should earn such companies a premium as the market recognises the reliability of their announcements and forecasts.

Auditor independence has been considered by many over the past few years. There is much guidance, many codes and recommendations, and some legislation. The contribution CIMA can make to the debate is not so much another set of guidance as a review of the best of the existing guidance, efficient signposting to these codes and suggestions for supplementary guidance to fill any gaps; from the perspective of accountants in business.

BACKGROUND

In January 2002, the CIMA Council established a working party to review CIMA's position on audit independence in the light of Enron's collapse and the resulting impact this had on the investor community's perceptions of the accountancy profession. CIMA's perspective on these issues is unique in the UK accountancy profession, as its members practise not as statutory auditors but the majority as accountants within business. Membership of the working party, the Audit Review Working Party (ARWP) is shown at Appendix A, together with its methods.

[9] Non-executive directors

KEY AREAS FOR CONSIDERATION

After a review of the issues and the available guidance[10], the ARWP decided the key areas were as follows.

1 THE DEFINITION OF INDEPENDENCE

2 INDEPENDENCE OF FIRMS FROM CLIENT

- **2.1 Employment relationships**
- **2.2 Provision of non-audit services**
- **2.3 Auditor rotation**

3 ROLE OF AUDIT COMMITTEES

4 ROLE OF INTERNAL AUDIT

5 REMUNERATION OF AUDITORS

6 UNREALISTIC EXPECTATIONS OF AUDIT FROM SHAREHOLDERS AND OTHER STAKEHOLDERS

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[10] Appendix B gives background to the current laws and practice. Where references such as O'Toole report, Ramsey report, Blue Ribbon Committee etc are used, the full title is given in a footnote when first used, and these are also described in the bibliography at Appendix H

1. THE DEFINITION OF INDEPENDENCE

The ARWP considered independence in the light of the definitions used by other relevant bodies.

IFAC[11] defines independence as:

- *"**Independence of mind:** state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement- allowing an individual to act with integrity, and exercise objectivity and professional scepticism*

- ***Independence in appearance:** avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude a firm's, or a member of the assurance team's integrity, objectivity or professional scepticism had been compromised."*[12]

IFAC's approach to independence is further explained in Appendix C.

The **EC**[13] states that:

"When carrying out a statutory audit, a statutory auditor must be independent from his audit client, both in mind and in appearance. A statutory auditor should not carry out a statutory audit if there are any financial, business, employment or other relationships between the statutory auditor and his client (including certain non-audit services provided to the audit client) that a reasonable and informed third party would conclude compromise the statutory auditor's independence."[14]

It stresses that objectivity and professional integrity should be the overriding principles underlying an audit opinion and the main way this can be demonstrated to the public is by acting, and being seen to act, independently. It notes that objectivity (as a state of mind) cannot be subjected to external verification, and integrity cannot be evaluated in advance.

Like the EC, the **SEC**[15] states that *"independence is generally understood to refer to a mental state of objectivity and lack of bias"*[16]. It also observes that objectivity is a state of mind and that, except in unusual circumstances, a state of mind is not subject to direct proof. Usually, it is demonstrated by reference to circumstantial evidence.

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[11] See Glossary, Appendix I
[12] pg 4, IFAC *Code of Ethics for Professional Accountants,* see Bibliography Appendix H
[13] See Glossary Appendix I
[14] pg 4, EC's recommendation *Statutory Auditors' Independence in the EC: A Set of Fundamental Principles* see Bibliography Appendix H
[15] See Glossary Appendix I
[16] pg 3, SEC *Final Rule Revision of the Commission's Auditor Independence Requirements* see Bibliography Appendix H

The SEC is prescriptive and sets out a 'bright line test' whereby it specifies certain activities that will mean the auditor will not be seen as independent. For circumstances not set out in the Rule, it has a general standard. Under this standard the SEC

'will not recognise an accountant as independent with respect to an audit client if the accountant is not, or if a reasonable investor knowing all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgement on all issues encompassed within the accountant's engagement'.[17]

CONCLUSIONS

The ARWP concluded that

- the approaches of IFAC, the EC and the SEC towards independence are similar, albeit the SEC is more prescriptive.
- the IFAC definitions are sound.
- the perception, as well as the reality, of independence is fundamental in supporting investor confidence in the integrity and credibility of audited financial statements.

RECOMMENDATIONS in respect of the definition of independence

The ARWP recommends

1.1 that CIMA endorses the IFAC definition of independence.

[17] pg 32, SEC

2. INDEPENDENCE OF FIRMS FROM CLIENT

Appendix D contains a list of specific situations where independence might be compromised. The ARWP considered the following:

2.1 Employment relationships
2.2 Provision of non-audit services
2.3 Auditor rotation

2.1 EMPLOYMENT RELATIONSHIPS

Companies sometimes appoint management, internal audit or other finance staff, from their audit firm. Auditor independence could be compromised if a member of client finance staff was a recent colleague of audit staff, or if current auditors had an expectation that they could obtain an appointment with the client in the near future.

The IFAC Code states that such circumstances may create *self-interest, familiarity* and *intimidation* threats (defined in Appendix B). The significance of these threats will depend on factors such as:

- seniority of the position left and that taken;
- level of involvement with assurance team: and
- length of time since involved with the assurance.

The Code allows such changes of appointment to be made but presents safeguards such as additional review work, quality control, or a new assurance team with sufficient experience in relation to the individual who has moved. There would also have to be a suitable rearrangement of any financial relationships such as capital balances and retirement funds. It also suggests safeguards on individuals where the partner or employee has knowledge that he/she **may** join the audit client.

The EC recommendation also considers the 'potential employment' issue. Its safeguards include removal from the audit team and immediate review of the audit work involved by a more senior audit professional, or an audit partner not previously involved.

With respect to the most senior positions the EC is very specific[18]:

"A Key Audit Partner[19] leaving the audit firm to join the audit client for a Key Management Position, would be perceived to cause an unacceptably high level of independence risk. Therefore, a period of at least two years should

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[18] Section B 3(4), pg 12, EC
[19] Defined in the glossary as "*an Audit Partner of the Engagement Team (including the Engagement Partner) who is at group level responsible for reporting on significant matters, such as on significant subsidiaries or divisions of the Audit Client, or on significant risk factors that relate to the Statutory Audit of that client*".

have elapsed before a Key Audit Partner can take up a Key Management Position[20]".

A two-year "cooling off period" was also considered by the Ramsey[21] report. It recommended that '*there be a mandatory period of two years following resignation from the audit firm before a former partner of an audit firm who is directly involved in the audit of a client can become a director of the client.'*[22] Ramsey felt this achieved a balance between putting in place mechanisms to ensure auditor independence while, at the same time, not unduly impeding professionals in audit firms joining companies and bringing their financial expertise to those companies. The recommendation was said to have the '*support of the big five accounting firms'.*

Interestingly, Ramsey proposed that the cooling-off period be made a legislative requirement. It felt that the rule could not be enforced by the professional bodies as part of their ethical rules, if retired partners were no longer members of the professional bodies.

The SEC's view on the cooling-off period was that *'a cooling off period unnecessarily restricts the employment opportunities of former professionals'.*[23]

The O'Toole[24] report considered there were few issues in the case of relatively junior positions. It did, however, recognise that it can cause difficulties where a significant number of senior management positions such as CEO, Finance Director and the Internal Auditor within a company are taken up by former employees of the audit firm. It recommended that the audit committee should review senior appointments to the top management of the company. If a number of senior managers were previously employed by the audit firm, the Audit Committee should examine the impact on auditor independence from the existence of this close business relationship and, if necessary, propose that a new audit firm be engaged.

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[20] Defined in the glossary as *"Any position at the Audit Client which involves the responsibility for fundamental management decisions at the Audit Client e.g. a CEO or CFO. This management responsibility should also provide influence on the accounting policies and the preparation of the financial statements of the Audit Client…."*

[21] *Independence of Australian Company Auditors: Review of current Australian requirements and proposals for reform,* see Bibliography Appendix H

[22] section 5.33 pg. 38, Ramsey

[23] section IV D 2(c) pg. 51, SEC

[24] *The Report of the Review Group on Auditing*, see Bibliography Appendix H

CONCLUSIONS

The ARWP

- endorsed the approach outlined in the IFAC Code, which was to define the nature of potential threats to independence; and recommend the introduction of additional safeguards rather than prohibit potentially problematic appointments.

- acknowledged that the UK is under pressure to accept the two-year cooling-off period set out in the EC recommendation, but rejected the principle of a cooling-off period which it saw as limiting companies' freedom to choose a former audit partner, should this be seen to be in shareholders' interests.

RECOMMENDATIONS in respect of employment relationships

The ARWP recommends

2.1.1 a transparent process of selection and appointment at senior level should one of the candidates be an audit partner in the engagement team. The Audit Committee, as well as the Nominating Committee should be involved.

2.1.2 additional scrutiny of the financial statements by the Audit Committee, with the support of the Auditors or other independent professionals in cases where there has not been an audit in the period between the partner leaving the audit firm and joining the audit client.

2.1.3 that the Audit Committee monitor the number and trend of appointments of former audit staff, as well as considering the impact of each specific instance.

2.2 PROVISION OF NON-AUDIT SERVICES

It is a commonly held view among the press, the investment community and the public that an auditor's objectivity is compromised when he/she also provides non-audit services to audit clients. Some commentators are particularly concerned when firms earn more from the provision of non-audit services to their clients, than from the statutory audit. Therefore this issue goes to the heart of the 'appearance of independence'.

The ARWP found views on this issue were polarised and both sides cited research to support their side of the argument. On one hand, the provision of any services beyond the statutory audit clearly puts additional pressure on auditor independence. On the other hand, there are particular benefits arising from having the auditors provide some types of service. The ARWP considered the circumstances in which these benefits might outweigh the disadvantages of the threat to independence.

Other services offered by audit firms include

- *internal audit;*
- *valuation;*
- *design and installation of accounting systems;*
- *senior executive recruitment and the determination of their remuneration packages;*
- *pension services;*
- *financial or administrative systems; data processing;*
- *tax planning advice;*
- *computation of tax liabilities;*
- *services connected to mergers and acquisitions;*
- *actuarial services;*
- *financial management advice; and*
- *investment services and advice.*

Further examples are included in the O'Toole and SEC reports.

Many codes, such as the guidance issued by the O'Malley report[25] recognised that considerable judgement might be required to reach a conclusion about the appropriateness of an audit firm's performing a specific non-audit service for a specific public audit client. Extracts relating to non-audit services from various codes are at Appendix E.

The first issue concerns definition. The ARWP felt it necessary to consider the type of non-audit service, rather than make a generalised

[25] *The Panel on Audit Effectiveness,* see Bibliography Appendix H

recommendation. Some services, although not statutory audit services, could also be classified as assurance services.

For some other services, for which information gathered by the external auditor is used, there are efficiency arguments for using the auditors, for example by avoiding the need to perform test checks on the accuracy of the data which would be appropriate if relying on information collected by another firm.

Finally, there are services that could be carried out by any firm that had the appropriate resources. The **ICAEW**[26] took a similar view; and categorised non-audit services as listed below in its submission to the UK Treasury Committee in March 2002[27]:

(1) Services required by legislation or contract to be undertaken by the auditors of the business.

These include:

- *regulatory returns e.g. to the Financial Services Authority*
- *legal requirements in many countries, including the UK, for auditors to report on matters such as share issues for non-cash consideration, expenditure for grant application purposes, etc*
- *contractual requirements, for example to report to lenders or vendors on net assets, covenant requirements, etc.*

(2) Services that are most efficient for the auditors to provide because of their existing knowledge of the business, or because the information required is a by-product of the audit process.

These include:

- *services such as those listed in category (1) above that the auditors are not required by law to undertake, but where the information largely derives from the audited financial records*
- *tax compliance, where much of the information derives from the audited financial records*
- *'short form' or other reports in acquisition or reorganisation situations where completion is necessary in a very short time.*

Note: The ARWP wished to emphasise that many of the services included in (2) could also be considered assurance services, i.e. those which are an objective confirmation of facts, rather than the application of judgement.

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[26] Institute of Chartered Accountants of England and Wales

[27] Treasury Committee *Financial Regulation of Public Limited Companies*, HC 578-i of session 2001-2

(3) Services that could be provided by a number of firms.

In this case, the fact that the firm is the auditor is incidental and it would generally only be chosen because, for example, it had won a tender process. Examples of such services include:

- *management consultancy*
- *tax advice*
- *human resources consultancy.*

The Ramsey report concluded that the provision of non-audit services by audit firms to their clients should be dealt with in several ways, by:

- revised and updated professional ethical rules;
- mandatory disclosure of non-audit services;
- strengthening the role of Audit Committees; and
- establishing an Auditor Independence Supervisory Board, which would have among its functions, the task of monitoring the adequacy of disclosure of non-audit services.

As part of the latter requirement, the financial report for the year must disclose whether the Audit Committee has considered whether the provision of non-audit services is compatible with maintaining the auditors' independence.

Given that many of the major firms have split their consultancy and assurance arms, the ARWP focused on the two areas of **taxation services** and **internal audit services.** However, the ARWP noted that these assurance firms couldn't be said to have entirely given up consultancy, as some appear to be re-building some consulting services, under an assurance banner. This tendency may need monitoring in the future, perhaps by the Accountancy Foundation.

The arguments for outsourcing internal audit are on the grounds of potential cost savings and internal shortage of skills for IT and strategic risk review. The ARWP considered recent research[28] from the Institute of Internal Auditors which found that 13% of those surveyed purchased internal audit services from their external auditor; but that all purchased less than 50% of the total internal audit activity (based on hours worked).

The IFAC Code takes a broad approach and details the risks and relevant safeguards that might be appropriate under a variety of situations (listed in Appendix E). Its provisions relating to taxation services and internal audit are:

- *Taxation services are 'generally not seen to create threats to independence'. These include compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes.*

[28] survey of 62 Heads of Internal Audit, March 2002, see Bibliography Appendix H

- *Internal audit services are permitted with specified safeguards to be applied in all circumstances. These include the audit client acknowledging responsibility for internal audit activities, a member of the clients management being designated responsible, the Audit Committee or equivalent is involved etc.*[29]

The ICAEW's Guide to Professional Ethics[30] makes no reference to taxation services or internal audit services. The EC Recommendation does not mention taxation services, but does consider internal audit services. Audit firms can provide these to their clients only with additional specified safeguards. These include a subsequent reassessment of the relevant statutory audit work by an Audit Partner who is involved neither in the Statutory Audit nor in the internal audit arrangement.

The SEC Rule makes it clear that accountants will continue to be able to provide tax services to audit clients. The SEC felt that an auditor's independence is impaired by performing more than forty percent of the audit client's internal audit work related to the internal accounting controls, financial systems, or financial statements, unless the audit client has $200 million or less in assets. The ARWP considered that the SEC's approach to be somewhat arbitrary in its use of the rigid cut-off point of $200m of assets. There will be clients near this limit, who might be required to change their supplier of audit or other services, as their revalued assets take them over this limit.

The O'Toole report recommended that audit firms should not provide internal audit services.

CONCLUSIONS

The ARWP

- supported the general approach of the IFAC Code regarding non-audit services, which is to specify the additional safeguards that might be appropriate under a variety of situations. There are benefits of cost, knowledge and efficiency in auditors providing certain non-audit services and the risks to independence can be minimised through such safeguards.

- felt it was not practical to prohibit the tax computation and tax audit from being undertaken by the statutory audit firm, and agreed with IFAC that such services are not generally those which are regarded as creating a threat to independence.

[29] sections 8.177 and 8.182 respectively, IFAC
[30] section1.201, ICAEW *Guide to Professional Ethics* see Bibliography Appendix H

RECOMMENDATIONS in respect of non-audit services

The ARWP recommends

2.2.1 that external auditors should not undertake internal audit activities for public interest companies, that is Listed companies, credit institutions, insurance companies and investment firms. These companies would, of course, still be able to outsource internal audit to other suppliers.

2.2.2 companies should not obtain sophisticated tax planning advice (as distinct from computation and compliance work) from their external auditors, particularly where remunerated on a fee-for-results basis.

2.2.3 there should be additional safeguards in respect of tax computation and compliance included in the Code of Ethics. There should also be a requirement to disclose clearly in the financial statements when the audit firm has been involved and to what extent.

2.2.4 there should be a single point of contact in both the audit firm (engagement partner) and the client (authoriser, Group Finance Director) through which all contacts and contracts are agreed. The level and extent of audit and non-audit services should then be routinely reported to the Audit Committee. The Audit Committee should then satisfy itself that the auditor providing non-audit services does not compromise independence.

2.2.5 there should be additional “health warnings” in the financial statements of SME companies which use their external auditors for other non-audit work. More practical than a prohibition, the warning will serve to alert the users of the financial statements of such companies, of possible independence issues.

2.2.6 there should be additional disclosure over and above the current requirements set out in UK Company Law. The EC Recommendation is for public disclosure of fees to be broken down by four categories: statutory audit services; further assurance services; tax advisory services and other non-audit services. These could be expanded on in accordance with the general principle of transparency to disclose specific large items such as due diligence work on a significant transaction.

2.2.7 Internal Audit should be provided independently of the external auditor. A joint provision of Internal Audit with an external supplier who is not the company’s external auditor is acceptable, but the participation of the external provider should be limited to the provision of discrete services - the planning, reporting and responsibility should rest with the organisation’s own staff.

2.2.8 the Accountancy Foundation should monitor whether firms which have divested themselves of their consulting services, are in fact re-building these consulting services, under an assurance banner.

2.3 AUDITOR ROTATION

Under section 384 of the Companies Act 1985, the basic requirements are that a company shall at each Annual General Meeting (AGM) appoint an auditor (or auditors) to hold office until the conclusion of the next AGM. In practical terms, much is left to the company's management and Board as to when to change auditors and also as to the choice of a new auditor.

Some believe that to ensure the appearance of independence, there needs to be a periodic rotation of audit partners and/or audit firms, to prevent a relationship developing between the firm and the client of a nature which would inhibit auditor objectivity.

Others believe that there are natural triggers to the decision to change auditors, which will be interfered with if mandatory rotation is imposed. Those natural triggers are the balance between experience/continuity and freshness/motivation of the audit team; and whether the current audit firm has kept pace with developing practice or whether a competitor can offer an enhanced service. There is also the risk that the audit firm might devote less effort to the audit in the last year of its term, if compulsory rotation was imposed, as the audit staff's efforts might tend to be directed to winning new clients. There is also (albeit somewhat dated) research which indicates audit failure is more likely in the two years following a change in auditor.

Some have advocated mandatory rotation every five years. Others have suggested that a third party should select and appoint auditors for companies. The ARWP felt that the latter idea was both impractical and unhelpful. Impractical because it is the company, not any other party, which has the best information about it's own operations, how these might affect assurance work, and consequently the choice of the most suitable auditor. Unhelpful because it must be better to encourage companies to undertake a critical selection process for external auditors, and remind them of their responsibility for ensuring the adequacy of the assurance work for which they pay, than to simply remove their responsibility for appointment.

The IFAC Code requires that for the audit of listed entities:

- *the lead engagement partner should be rotated after a pre-defined period, normally no more than seven years; and*
- *a partner rotating after a pre-defined period should not resume the lead engagement partner role until a further period of time, normally two years, has elapsed.*[31]

However, this length of time can be exceeded in certain circumstances, when continuity is especially important and other safeguards must then be put in place.

The ICAEW statement is similar in that it recommends rotation after seven years but it is stricter in requiring a five-year gap before return. In the UK,

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[31] section 8.151, IFAC

guidance from the APB requires an independent review for all listed companies and for firms to have policies setting out when this is appropriate for other companies due to public interest or audit risk[32]. The independent review should take place before the issue of the auditors' report in order to provide an objective, independent assessment of the quality of the audit.

The US and EC requirements are very similar. The EC Recommendation states that for public interest entities, as a minimum, to replace the Key Audit Partners[33] of the Engagement Team (including the Engagement Partner) within seven years of appointment with no return until after two years. There should be safeguards on other Engagement Team members with prolonged involvement.

The reviews that rejected mandatory rotation were Ramsey and O'Toole. The former rejected it on the grounds that '*the anticipated cost, disruption and loss of experience to companies is considered unacceptably high, as is the unwarranted restriction on the freedom of companies to choose their own auditors*'[34].

The O'Toole report felt that, although mandatory rotation would improve the appearance of auditor independence and would prevent audit firms from becoming over familiar with the management of individual client companies, these considerations were outweighed by the possible adverse effects on the quality of the audit. O'Toole felt that the quality of the audit could suffer because:

- *the downward pressure on audit fees arising from the competitive aspects of the tendering process could lead to a downward pressure on audit quality;*
- *mandatory tendering on audit contracts could provide a legitimate way to switch to a more 'easygoing' audit firm; and*
- *evidence has shown that audit failure is more likely to occur in the early years of an audit contract and audit tenders might exacerbate this problem.*[35]

It is understood that at the time of writing this, that only Italy has mandatory rotation and Austria is soon to adopt it.

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[32] SAS 240 *Quality Control for Audit Work*
[33] defined above in section 2.1
[34] section 6.100, Ramsey
[35] pg. 188, O'Toole

CONCLUSIONS

The ARWP

- rejected mandatory rotation *of firms* particularly as there are now four major firms and some may be excluded for competitive reasons. Some may also be debarred by the CIMA recommendation on internal audit services not being undertaken by the audit firm for the audit client (see 2.2.9).

- rejected any notion that a third party have responsibility for appointing auditors.

RECOMMENDATIONS in respect of auditor rotation

The ARWP recommends that

2.3.1 a requirement to rotate *between clients* should be imposed on all senior members of the engagement team. Other than for the engagement partner this could be within the team (for example from one major subsidiary to another).

2.3.2 the time period for this requirement should be cumulative with respect to senior roles held within the engagement team (for example time spent, as the audit manager should be added to time spent as the engagement partner).

2.3.3 a shorter time period of five years should be considered, as opposed to the current generally accepted seven years.

3. ROLE OF AUDIT COMMITTEES

The role of the Audit Committee encompasses much more than the company's relationship with external audit. The Audit Committee can play a key role in assisting the Board of directors to fulfil its corporate governance and oversight responsibilities in relation to an entity's financial reporting, internal control structure, risk management systems, and the internal and external audit functions. Within this, it must facilitate and monitor the independence of the external auditor. A critical consideration is how much independent support it receives from an internal audit function, discussed in section 4 of this report.

There are no requirements in the UK Companies Act for companies to establish an Audit Committee. However, Listed companies have to include in their annual reports a statement as to whether they have complied with the principles of good governance in the Combined Code and, if they have not complied, explain why. The principles relating to the composition, responsibilities and reporting arrangements of the Audit Committee, and relevant extracts are included in Appendix F.

The ARWP noted that there is no reference in the Combined Code to the necessary skills and experience for members of the Audit Committee although there is a general comment that all directors should receive appropriate training, and specific references to the role of the Audit Committee.

"The duties of the audit committee should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money."[36]

The APB also outlines the role of the Audit Committee, stating that an Audit Committee's role includes:
- evaluating and, if necessary, challenging the actions of management;
- monitoring management's commitment to internal control; and
- considering the adequacy of external audit arrangements[37].

Auditing Standards require audit engagement partners to consider whether adequate arrangements are in place to safeguard their objectivity and the firm's independence[38]. And to complete the circle, Auditing Standards also require that the auditors should:
- disclose all relationships between the firm and the client (and their respective related entities) which reasonably might affect the independence and objectivity of the audit staff, including the audit partner;
- disclose the related safeguards that are in place; and

[36] Provision 3.2, *Combined Code*
[37] paragraph 2.6, *Communications between external auditors and audit committees,*
[38] paragraph 45, *SAS240 Quality Control for Audit Work*

- where it is the case, confirm in writing to the Audit Committee that *the firm is independent within the meaning of regulatory and professional requirements and the objectivity of the engagement partner and audit staff is not impaired.*

Auditors are required to do these at least annually, and in writing to the Audit Committee, and must discuss these matters as appropriate. [39]

The latter standard also covers other communications with those charged with governance, including unadjusted misstatements detected and material weaknesses in the accounting and control systems identified during the audit. The auditors are also required to report about "*the qualitative aspects of the entity's accounting practices and financial reporting, including items that have a significant impact on the relevance, reliability, comparability, understandability and materiality of the information provided by the financial statements. … Auditors discuss … with those charged with governance, the auditors' views on the quality and acceptability of the entities accounting practices and financial reporting..*"[40]

In the US, both the NYSE[41] and NASDAQ[42] mandate qualified Audit Committees. As an example the NYSE rules specify that requirements include:

- having a formal written charter that has been adopted and approved by the Board
- having at least three independent directors, each of whom is financially literate and at least one of whom has accounting or financial expertise; and
- a number of restrictions to promote independence of the members[43]

The latest rules include amendments arising from the Blue Ribbon[44] committee, which were incorporated into the US listing rules with effect from summer 2001. It should be noted that both the NYSE and NASDAQ have published, or are soon to publish, recommendations for codes to be adopted under their listing requirements.

The Blue Ribbon report also set out some 'Guiding Principles for Audit Committee Best Practices' several of which relate to independence. These are:

1. the Audit Committee's key role in monitoring the other component parts of the audit process.

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[39] paragraph 24, *SAS 610 Communication of audit matters to those charged with governance*
[40] paragraph 41, *SAS 610*
[41] New York Stock Exchange
[42] National Association of Securities Dealers Automated Quotation (system) see Glossary Appendix I
[43] NYSE *Recommendations to NYSE Board of Directors (revised)* June 2002, see Bibliography Appendix H
[44] *Improving the Effectiveness of Corporate Audit Committees* see Bibliography Appendix H

2. independent communication and information flow between the Audit Committee and the internal auditor.
3. independent communication and information flow between the Audit Committee and the outside auditors.
4. candid discussions with management, the internal auditor, and outside auditors regarding issues implicating judgement and impacting quality.
5. diligent and knowledgeable Audit Committee membership[45].

The Blue Ribbon report is focused on the financial reporting process. In the UK however, Audit Committees usually have additional roles, including the critical one of monitoring the risk control framework (which ultimately is the responsibility of the whole Board). In its submission to the Treasury Committee's inquiry into the financial regulation of public limited companies, CIMA recommended that companies should be encouraged to widen the role of the Audit Committee to include a review of governance frameworks. This would extend its role from considering financial reporting and internal control principles. CIMA also suggested that, in many cases, companies might wish to consider the name of this Committee. It is it's belief that the title "Audit Committee" means for some that it's remit is limited to considering financial statements and does not include the other significant areas, such as managing business risk.

The O'Malley panel recommended that Audit Committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with those of the Blue Ribbon Report regarding auditors' services. The threshold should be at a level that ensures that significant services are pre-approved, but not so low that the committee assumes a management function.

The Ramsey report recommended that Australian Listing Rules should mandate the existence of a qualified Audit Committee, which would adopt a written charter. It recommended that Audit Committees include at least three independent members who should be financially literate with at least one having accounting and/or related financial expertise. This is very similar to the US approach. Ramsey went on to specify a number of responsibilities with regard to the relationship with the auditor. The Audit Committee should:

- *state in the annual report whether or not it believes the level of non-audit service provision by the auditor is compatible with maintaining auditor independence, and should include reasons where appropriate;*

- *make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the auditor;*

[45] Blue Ribbon Committee Report, *Guiding Principles for Audit Committees – Best Practices* , see Bibliography Appendix H

- *review and agree on the terms of engagement for the auditor at the start of each audit;*

- *review the scope of the external audit with the auditor including identified risk areas and any additional agreed upon procedures;*

- *review the auditor's audit fee, and be satisfied that an effective, comprehensive and complete audit can be conducted for that fee (this includes reviewing and assessing fees paid for non-audit service provisions);*

- *review with the auditor any significant disagreements between the auditor and management, irrespective of whether they have been resolved;*

- *monitor the number of former employees of the audit firm currently employed in senior positions in the company and assess whether this impairs or appears to impair the auditor's judgement or independence in respect of the company;*

- *consider whether taken as a whole, the various relationships between the company and the auditor impairs or appears to impair the auditor's judgement or independence in respect of the company;*

- *consider whether the compensation of the individuals employed by the auditor who are performing the audit of the company is tied to the provision of non-audit services and, if so, consider whether this impairs or appears to impair the auditor's judgement or independence in respect of the company;*

- *review the economic importance of the company (in terms of fees paid to the auditor for the audit as well as fees paid to the auditor for the provision of non-audit services) to the auditor and assess whether the economic importance of the company to the auditor impairs or appears to impair the auditor's judgement or independence in respect of the company; and*

- *at least annually, meet with the auditor without the presence of management.*[46]

The O'Toole report stated that improvements in corporate governance, in particular enhancing and formalising the role of Audit Committees comprising a majority of non-executive directors, might provide a means of improving auditor objectivity. It suggested that Audit Committees act as a 'buffer' between management and the external auditor. It made a number of similar recommendations to Ramsey and also recommended that these should be set out in legislation for public interest companies[47].

[46] section 6.78, Ramsey
[47] defined in recommendation 2.2.1 above

In summary, the O'Toole recommendations with respect to Audit Committees were:

- *PLCs, financial institutions and public interest companies should be required to have Audit Committees made up of non-executive directors.*

- *Audit Committees should have regular meetings each year.*

- *each Audit Committee should have a formal written charter.*

- *shareholders should approve the appointment of auditors and set their fees, based on a recommendation from the audit committee rather than management as is currently the case. This would include consideration of changing auditors and putting the audit contract out to tender.*

- *the charter should give the Audit Committee the following responsibilities:*
  - *ensuring receipt from the external audit firm of a formal written statement outlining all current and relevant previous business and personal relationships between the audit firm and the company;*
  - *for actively engaging in a dialogue with the audit firm so that all relationships that may impact on the objectivity and independence of the auditor are fully disclosed;*
  - *approving the procedures for the appointment of the audit firm to provide any non-audit services;*
  - *assessing and approving in advance all contracts with the audit firm having regard to all business and personal relationships between the company and its audit firm;*
  - *monitoring the number of former employees of the audit firm having regard to all business and personal relationships between the company and its audit firm;*
  - *monitoring the number of former employees of the audit firm currently employed in senior positions in the company and assessing its impact on auditor independence;*
  - *reviewing the audit firm's statement concerning their general policy to risks to independence;*
  - *approving in advance any contracts with audit firm payment of which will be made on a contingency basis.*

- *Audit Committees should meet their external auditor a number of times each year, both in the presence of management and independent of management.*

- *management letters should refer to any other audit related letters and should be available in advance of approval of financial statements (even if the management letter is only a preliminary draft excluding some management responses)*[48]*.*

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[48] Appendix D, Ramsey

In terms of the Audit Committee and the external auditor, a number of lists of questions to be asked have been published including those compiled by the biggest audit firms, and the investor Warren Buffet. An example of such questions compiled by Professor Ian Percy, former Vice Chairman of the APB is given in Appendix G.

CONCLUSIONS

The ARWP

- considered that the Audit Committee played a fundamental role in promoting, monitoring and protecting the independence of auditors (internal as well as external). The members, who should be non-executive directors with a majority being independent, must have ample time, experience and training to be robust, ask searching questions and exercise due diligence in finding answers.

- felt that it is critical that the Audit Committee be well versed in issues of ethics and auditor independence, and understand the importance of such issues in maintaining investor credibility in the company's financial statements.

- felt there are benefits to be had in the Chairman of the Audit Committee being on the Remuneration committee and vice versa. This allows an interaction between the committees on performance measurement aspects of remuneration and also allows the committees to understand better the risks of aggressive earnings management resulting from potential performance bonuses.

- felt that the Combined Code seems to have insufficient emphasis on accountability and audit compared with other sections. No mention was made of internal audit in the context of the Audit Committee, the role of the Audit Committee was principally discussed in relation to the role of the external auditors. In its response to the Company Law Review in July 2000 CIMA noted that the Combined Code did not contain the content of notes to the original Cadbury Code, which included a number of Audit Committee recommendations. Had these been included in the Combined Code, this would have strengthened the Code in this area.

RECOMMENDATIONS in respect of Audit Committees

The ARWP recommends

3.1 that the Audit Committee meet regularly with both the external and internal auditors without management present. Both the internal and external auditors should consider their primary direct client to be the Audit Committee on behalf of shareholders.

3.2 that the Audit Committee is regarded as key in appointing external auditors. Whilst management can propose a change/selection of auditors it should be the Audit Committee who makes the final proposal to the Board and subsequently shareholders at the AGM.

3.3 the Audit Committee should decide the scope of the audit in the context of risk management and the associated deployment of internal audit. The committee needs to understand the statutory minimum requirement and then add to this as it sees fit in the context of the control of risk, particularly as to the validity of the financial statements. This will have consequences on the level of auditor remuneration (see conclusion at Section 5 Remuneration of Auditors). In this respect there should be a clear, and documented, record of the Boards 'appetite for risk' which should also be summarised in the Operating and Financial Review along with the major risks the company faces and the associated safeguards.

3.4 the Audit Committee must meet reasonably frequently – at least three times a year. It should explore significant accounting issues with management and the external auditors well in advance of the, often time-constrained, requirement to 'sign off' the financial statements

3.5 the Chairman of the Audit Committee should be under a statutory obligation to report to shareholders annually, and this report should include reference to any significant matters brought to the Audit Committee's attention by the external auditor.

3.6 Audit Committees should be aware of the types of questions that should be asked of management and external and internal auditors. Such training should be added to CIMA's proposal to the Treasury Select Committee for a code of best practice for non-executive directors.

3.7 the Audit Committee should review provision of non-audit services on a regular basis and convince itself and document its conclusions on risks to auditor independence. In this context, the Audit Committee should be involved directly, or by delegation, in the provision of any significant non audit services by the external auditor; to monitor auditor performance on a regular basis; and to monitor moves of audit partners/employees to the client (both in terms of frequency and seniority).

RECOMMENDATIONS in respect of Audit Committees cont.

3.8 in determining the scope of the audit, the Audit Committee should ensure that enough contextual information in the form of trend analysis and non-financial performance indicators are available from management, internal auditors and/or external auditors.

3.9 companies could consider renaming the Audit Committee given its (potential) wider responsibilities in corporate governance frameworks and risk management. This should not imply any lesser responsibilities of the unitary board. It should be a key responsibility of NEDs (typically through the Audit Committee) to understand the risk framework and therefore the context under which the company operates.

3.10 individuals who have held a senior executive position within the company, should not be categorised as "independent".

3.11 the Financial Services Authority and/or the soon to be reconstituted Financial Reporting Council to consider guidance notes for best practice for Audit Committees.

4. ROLE OF INTERNAL AUDIT

With respect to Internal Control, the Combined Code states that:

"*The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets."*

"The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management."

"Companies which do not have an internal audit function should from time to time review the need for one."[49]

Further guidance is given on Principle D.2 in the Turnbull report *Internal Control – Guidance for Directors on the Combined Code.*

"*The Board of a company that does not have an internal audit function should assess the need for such a function annually having regard to the factors referred to in paragraphs 43 and 45 above. Where there is an internal audit function, the board should annually review its scope of work, authority and resources, again having regard to those factors*."[50]

In summary, the O'Toole recommendations with respect to internal audit were:

- *All PLCs, financial institutions and public interest companies should have a properly resourced internal audit function set up independently of management and the external auditor.*
- *Audit committees should meet the internal auditors regularly at times without management present.*
- *The internal auditor's appointment should be endorsed by the audit committee and internal audit reports to the Board and the audit committee should be retained for six years.*
- *Internal audit programmes, and all internal audit reports and findings, should be made available to the external auditor at the earliest possible opportunity.*
- *Audit Committees should prepare an annual report for presentation to the shareholders. This should include their view on the Directors' compliance report. Amongst other things this would disclose whether the audit committee had met with the external auditors without management and other such matters.*[51]

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[49] Principle D.2; Provision D.2.1; Provision D.2.2, respectively, *Combined Code*
[50] Paragraph 46, Turnbull. The 'factors' include company specific factors such as complexity, diversity and scale of activities, the number of employees and the company's corporate culture.
[51] Recommendations 13.8 – 13.12, O'Toole

CONCLUSIONS

The ARWP felt that

- control and risk assessment processes can improve the efficiency and effectiveness of internal audit. These should begin with a high level review of the corporate governance framework that has been established by the Board.

- the Turnbull Report rightly places emphasis on the importance of internal audit and the requirement to review its work or the need for such a function on a regular basis. The ARWP hoped that the spirit of this requirement is respected rather than just the letter.

RECOMMENDATIONS in respect of Role of Internal Audit

The ARWP recommends

4.1 the head of internal audit should have senior status within the organisation, preferably reporting to a Board member, and also be given the right of direct access to the chairman of the Audit Committee.

4.2 the Audit Committee should consider how much and in what way, it wishes to expand the scope of the external audit, over and above the core minimum assurance required by statue. The additional assurance work should be determined after considering the risk framework specific to the company and the resources available for audit.

5. REMUNERATION OF AUDITORS

Concern has been expressed that, particularly given the trends in provision in non-audit services, audit is being used as a 'loss leader' by which to establish a relationship through which to sell more lucrative services. When an auditor uses an audit as a loss leader, the auditor, in essence, "low-balls" the audit fee – even to the extent of offering to perform it at a loss. In addition, concerns are also expressed that too much focus is given to the cost of audit as opposed to its quality.

The various codes cover 'low-balling' in a general respect.

The IFAC Code states that:

"*When a firm obtains an assurance engagement at a significantly lower fee than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:*

- *The firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and*
- *All applicable assurance standards, guidelines and quality control procedures are being complied with.*"[52]

Low-balling is not specifically covered in the ICAEW statement.

The EC Recommendation states that:

"*A Statutory Auditor must be able to demonstrate that the fee for an audit engagement is adequate to cover the assignment of appropriate time and qualified staff to the task and compliance with all auditing standards, guidelines and quality control procedures. He should also be able to demonstrate that the resources allocated are at least those which would be allocated to other work of a similar nature*"[53]

The EC Recommendation is stricter than that of IFAC but there may well be competition issues arising in implementing the exact wording.

Professor Ian Percy in a recent presentation[54] suggested that the Accountancy Foundation's Review Board should be tasked with publishing annually the audit fees of companies in various ranges set against benchmarks of turnover, net assets, complexity of business and complexity of international spread. He suggested that the resultant discussion with auditors on why their fee was at variance with market comparators would be enlightening.

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[52] Section 8.206, IFAC
[53] Section 8.4, EC
[54] see Appendix G

CONCLUSIONS

The ARWP felt

- that given market pressures resulting from recent corporate failures there should be a renewed focus on robust quality audits and less on the absolute level of the fee.

- a significant cost within the audit is the insurance against liability and the ARWP noted and welcomed the attention that the DTI is giving this issue in the current company law review.

RECOMMENDATIONS in respect of auditor remuneration

The ARWP recommends

5.1 that the Audit Committee should satisfy itself on an annual basis as to the adequacy of the audit scope and the associated level of fees. The evaluation should also be in the context of a minimum for statutory requirements with additional work being set out and agreed in terms of the risk framework for the company and the work of internal audit.

5.2 that the Audit Committee must refocus those involved onto the value of the audit for existing and potential investors as opposed to a singular aim of cost reduction. The current environment represents an ideal opportunity for such a culture change within a company should it be required.

5.3 that similarly audit firms must emphasise and commit sufficient resources to the quality of the audit that is so important in today's capital markets.

6. UNREALISTIC EXPECTATIONS OF AUDIT FROM SHAREHOLDERS AND OTHER STAKEHOLDERS

To a degree, some of the current debate about auditor independence springs from an unrealistic expectation of the assurance that external audit can provide, generally known as the expectations gap. Statutory audit provides assurance that a robust investigation has been carried out to determine how well an organisation complies with the various legal and regulatory requirements for the treatment and disclosure of accounting transactions, so that its published financial statements represent a "true and fair view" of its current financial position. Statutory external audit is a valuable and necessary function but its *limitations* (not in a pejorative sense) need to be understood by its users.

- An external audit is not a "clean bill of health".
- An external audit cannot guarantee that there has been no fraud. Indeed there are many types of fraud that it is not likely to detect.
- An external audit will not identify that an organisation has made decisions which will expose it to risk and poor future returns.
- An external audit is not a certification that the figures in the financial statements are exact to the last penny and are free of judgement and estimation.
- An external audit is not the conscience of the organisation.

Directors and management have significant responsibilities in relation to stewardship. Yet the other side of the coin is that investors must be prepared to invest time and effort into knowing the business in which they have invested. Investors should recognise that *they* have responsibilities to understand and monitor their investment, and should not consider external audit as a replacement for such activities.

The purpose of involving external auditors is that they ensure, to the best of their ability, that the information presented to shareholders by management accurately describes the performance of the business. If ingenious interpretations of specific regulation (because of flaws in that regulation or otherwise) leads to a different result, then the auditors should have a duty to say so in their report.

The Auditing Practices Board published a consultation paper on Aggressive Earnings Management in June 2001 (16 pages) and it summarised the responses in its Annual Review of Activities in February 2002 (two pages).

An extract from CIMA's response to this paper reads *"CIMA believes that manipulation of earnings is an issue which needs to be tackled by the combined efforts of the accounting profession (through accounting and auditing standards), regulators (through the preventative and corrective role of the FRRP), the reporting businesses (through good corporate governance and strong non-executive representation on Boards) and users of accounts such as analysts and institutional investors (through understanding and accepting that a degree of variation from expectation is consistent with the approximate nature of accounts)."*

The APB consultation paper flagged that improvements in the quality and reliability of financial reporting may be undermined by the increasing commercial pressures on those responsible for preparing financial statements.

It cited examples of these commercial practices as:

- *Adverse market reactions to the share price of a listed entity when results fail to meet the market's expectations (which directors and management may have encouraged), whether or not the expectations were reasonable;*
- *Directors and management's incomes being highly geared to results and/or heavily supported by stock options and other possibilities for large capital gains;*
- *The importance of meeting targets to ensure protection of the jobs of directors, management and other employees;*
- *The desire to understate profits to reduce taxation liabilities;*
- *Legal and regulatory requirements to meet specific financial thresholds or ratios; and*
- *The need to ensure compliance with loan covenants or to pacify bankers*[55]*.*

The Consultation Paper makes the point (which many stakeholders may not appreciate) that there is not a profit and loss account that is 'right' in the sense there is only one possible answer due to such factors as alternative accounting policies and valuations and estimates which inevitably require judgement. The Consultation paper states that:

It is clear, therefore, that, while company law and accounting standards provide the framework for financial statements, the judgement as to what is a true and fair view can be a matter of debate firstly for directors and secondly for auditors[56]

The commercial pressures such as those outlined above, can lead to companies adopting aggressive accounting practices including the selection of inappropriate accounting policies and/or unduly stretching judgements as to what is acceptable when forming accounting estimates. These practices, while presenting the financial performance of the companies in a favourable light, do not necessarily reflect the underlying reality. The APB terms the use of such practices 'aggressive earnings management'.

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[55] para 3, *Aggressive Earnings Management*, APB, see Appendix H
[56] para 19, *Aggressive Earnings Management* , APB, see Appendix H

Such issues are not just of concern to auditors and in the preface, the APB states one of the objectives of issuing the paper was to:

"alert executive directors, non-executive directors, auditors, regulators, and users of financial statements to the potential threat that increasing commercial and economic pressures may cause 'aggressive earrings management' "

The ARWP saw the APB document and related response as being highly topical in today's environment and if not republished it should be made freely available for download from the APB website. The ARWP commended reading of the document to directors and non-executive directors (particularly those on Audit and Remuneration Committees).

CONCLUSIONS

The ARWP felt that

- statutory external audit is a valuable and necessary function but its *limitations* (using this word not in a pejorative sense) need to be understood by users.
- the commercial issues raised in the APB consultation on Aggressive Earnings Management (AEM) remain highly relevant. The CIMA response to the APB consultation on AEM is even more pertinent in today's climate.

RECOMMENDATIONS in respect of unrealistic expectations of audit

The ARWP recommends

6.1 that a statement describing the limitations of audit, concepts such as materiality and judgement, should be included as an appendix to the audit report.

6.2 those responsible for ensuring the quality of financial statements should be encouraged to read the brief APB consultation paper. The APB should consider making the original consultation freely downloadable from their website.

APPENDIX A – CIMA AUDIT REVIEW WORKING PARTY

Membership (*CIMA Council Member)

Chairman:	Roger Boyes*	*previously Group Finance Director, Halifax Group*
	Claire Ighodaro*	*Vice President CIMA* *Vice President Finance, BT Openworld*
	Jim Metcalf	*Chairman of CIMA Accounting Practices Group previously Group Financial Controller of Tate and Lyle*
	Charles Tilley	*Chief Executive, CIMA*
	Richard Mallett	*Director - Technical Development, CIMA*
Secretary:	Louise Ross	*Advisor Accountant, CIMA*

Working methods

An extensive literature review was undertaken by CIMA technical staff with summaries presented to the Group. A bibliography is at Appendix H. There is a substantial amount of analysis/debate already in the public domain, therefore it was not felt necessary to undertake further research.

As a result of this review, the ARWP decided to focus on the key areas:

1. Definition of independence
2. Independence of firms from client - Employment relationships
   Provision of non-audit services
   Auditor rotation
3. Role of Audit Committees
4. Role of Internal Audit
5. Remuneration of auditors

Unrealistic expectations of audit from shareholders and other stakeholders

APPENDIX B – COMPARISON OF CURRENT LAWS AND PRACTICE[57]

Directors' responsibilities (UK)
The Companies Act 1985 requires directors to prepare financial statements for each financial year, which give a true and fair view of the state of affairs of the company. This requires the use of appropriate accounting policies consistently applied and supported by reasonable and prudent judgements and estimates; and requires that all accounting standards that the directors consider to be applicable have been followed. The directors are also responsible for taking reasonable steps to safeguard the company's assets and to prevent fraud and other irregularities. In the UK 'the true and fair' view is key and directors can use this to override GAAP[58] (as long as the specific override and the rationale are disclosed).

Auditor's responsibilities (UK)
The auditors' role is to give an opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with applicable UK law and accounting standards. In doing this they report to the shareholders and not management.

It is therefore fundamental that the auditors are, and are seen to be, independent of the Company's management. In respect of listed companies it is the auditors' opinion that gives investors the assurance that the financial statements have been subjected to rigorous examination by an objective, impartial and skilled professional. Investor confidence in the integrity and credibility of financial statements underpins the effective functioning of the capital markets in their role of resource allocation.

The auditors' responsibilities are established in the UK by statute, the Auditing Practices Board (APB), the Listing Rules of the Financial Services Authority and the profession's own ethical guidance. In the context of maintaining independence these cover such measures as audit partner rotation, independent partner review, annual appointment of auditors, disclosure of audit and non-audit fees etc.

Provisions in the Companies Act 1989 are designed to ensure that only qualified and properly supervised people are appointed as company auditors. A person is not eligible for appointment as a company auditor unless he or she is:

- a member of a recognised supervisory body (RSB); and
- eligible for appointment under the rules of that body (for example, a requirement to update professional knowledge)

For every public limited company (and private companies who have decided accordingly) company law requires that auditors must be appointed at each

[57] full titles of Codes and reports included in Bibliography Appendix H
[58] GAAP – generally accepted accounting practice

general meeting at which accounts are laid before shareholders[59]. Auditors therefore normally serve from one AGM to the next. The auditors' remuneration can be fixed by the company in general meeting or in such manner as the general meeting agrees. Fixing the auditors fees in general meeting is likely to be impractical, so the usual method is for the general meeting to resolve that the directors can settle on the level of the fees.

The Companies Act 1989 includes provisions that require public limited companies and large private companies to disclose in their accounts, fees paid to their external auditors for other services[60].

Ethical codes

For many years the profession has had ethical codes which are enforced by the professional bodies' disciplinary processes. The International Federation of Accountants (IFAC) has now established a code of ethics that will take effect in 2004. That is, the IFAC Code will apply to all assurance reports for the period ending on or after 31 December 2004, but companies will have to sever non-compliant relationships during 2003. The IFAC Code is the benchmark against which any debate over auditor independence must take place.

There are various codes of ethics and rules relating to auditor independence, the main ones being:

The IFAC Code

Relevant extracts at Appendix B illustrate IFAC's overall approach. Over half of this document is dedicated to a section specific to professional accountants in public practice entitled *Independence for Assurance Engagements* which sets out a process for minimising the risks to independence with specific examples. This demonstrates the importance and complexity of the issues surrounding independence. It is also important to note that the Code is principle based – or as IFAC terms it, the conceptual approach - rather than rules based.

After defining its concept of independence, IFAC identifies five generic 'threats'. Examples are given in the Code but not reproduced here.

"Self-interest Threat" *occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client.*

"Self-Review Threat" *occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or (2) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.*

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[59] Companies Act 1985, section 241(1)
[60] Companies Act 1989 s121

"Advocacy Threat" *occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgment to that of the client.*

"Familiarity Threat" *occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.*

"Intimidation Threat" *occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.*[61]

After identifying these "threats" to independence, IFAC outlines the safeguards available, under three categories. Again, examples are given in the Code but not reproduced here:

- safeguards created by the profession, legislation or regulation;
- safeguards within the assurance client; and
- safeguards within the firm's own systems and procedures.

The IFAC Code considers the potential threat to independence in a comprehensive list of situations, only some of which some are considered in this paper. The IFAC list is at Appendix C.

The EC Code

The EC Code, published on 16th May 2002, is a Recommendation rather than binding EC legislation as the Commission considered this to be the quickest and most effective means to bring about improvements. In three year's time the Commission will review how the Recommendation has been applied in practice and will consider whether legislation may then be required.

The EC Code is very similar to the IFAC Code. It is also principles based, which the Commission sees as preferable to guidance based on detailed rules because it creates a robust structure within which statutory auditors have to justify their actions. It uses the same approach as IFAC in setting out threats to independence and systems of safeguards. These include the ultimate safeguard of not entering into certain relationships or not providing certain services additional to the statutory audit. As with the IFAC Code it demonstrates the application of the requirements to a set of specific situations.

[61] IFAC Code 8.29 – 8.33 (part)

The UK codes
All the CCAB bodies have codes of ethics and those that are Recognised Supervisory Bodies under the Companies Act 1989 have sections relating to auditor independence. The ICAEW/ACCA/ICAS codes are very similar in all but small detail and wording. They follow a principles based approach as with IFAC and the EC. A CCAB Working Group (chaired by Roger Boyes with Richard Mallett attending) is currently reviewing the UK codes in the context of the IFAC and the EC codes with a view to aligning the UK code. As part of this alignment, the ICAEW recently undertook a review of the ICAEW Code (statement 1.201) in comparison to IFAC's and the EC recommendation, upon which the following section is based.

Similarities and differences between the codes affecting the UK
The basic conceptual approach and the general threats and safeguards considered are fundamentally the same for the IFAC, EC and UK regimes. The revised IFAC and EC Codes are all inclusive and the threats and safeguards are analysed in relation to each circumstance and relationship whereas the extant ICAEW Code deals with these points separately. In addition, IFAC is wider in its coverage as it addresses assurance engagements with specific comment on audit engagements where there are additional measures.

In summary, the key differences between the three Codes are:

- the EC Code is stricter in terms of former employees of the audit firm joining clients;
- the IFAC and EC Codes consider the scope of those covered in terms of 'ability to influence';
- the IFAC and EC Codes are wider in scope of firms covered as they bring in the concept of network audit firms, affiliates of clients and related entities;
- there is no specific guidance on ownership in the IFAC Code and the ICAEW statement (the UK guidance is in the audit regulations and fairly basic), but there is in the EC Code;
- the ICAEW statement does not specifically include parents and siblings in close relatives whereas the IFAC and EC Codes do.
- the EC Code is generally more specific on what is to be disclosed to, and discussed with, the Audit Committee
- the EC will require non-audit fees to be analysed. In the UK this is a Company Law issue.

Where any of the above are relevant to the issues considered by the ARWP, they will be set out in more detail. In essence the Codes are substantially similar.

It should be noted that the ICAEW is amending its Code with new rules to be recommended as best practice with effect from October 2002. These will be very closely aligned to the EC guidance.

US Code

The SEC Rule was effective from February 2001 although there were transitional arrangements through to August 2002 regarding provision of specified non-audit services. The SEC sees the 'independence requirement ' serving two related, but distinct, public policy goals. One goal is to foster high quality audits by minimising the possibility that any external factors will influence an auditor's judgement. The other related goal is to promote investor confidence in the financial statements of public companies.

The SEC Rule does not use a conceptual framework and is far more prescriptive than the codes summarised above. However, with respect to other services not specifically covered by the Rule there are four factors that are seen to provide guiding principles for the Commission – similar to a conceptual framework.

These are whether a relationship or provision of a service:

- creates a mutual or conflicting interest between the accountant and the audit client;
- places the accountant in the position of auditing his or her own work;
- results in the accountant acting as management or an employee of the audit client; or
- places the accountant in a position of being an advocate for the audit client.

Other codes or guidance

Recent studies into auditor independence have taken place in Ireland and Australia, resulting in two reports respectively referred to in this paper as the O'Toole report; and the Ramsey report. Both proved very useful to the initial stages of the Group's work, and are included in the bibliography at Appendix H.

APPENDIX C – IFAC CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

The IFAC Code is in three parts, applicable to:

A. All professional accountants;
B. Professional accountants in public practice; and
C. Employed professional accountants.

The following extract from the Code illustrates the general approach to independence adopted by IFAC

A Conceptual Approach to Independence[62]

Independence requires:

(a) Independence of mind:

The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

(b) Independence in appearance:

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

The use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

This section is based on such a conceptual approach, one that takes into account threats to independence, accepted safeguards and the public

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[62] section 8.8 –8.12 and 8.20 (part) IFAC Code

interest. Under this approach, firms and members of assurance teams have an obligation to identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate these threats or to reduce them to an acceptable level by the application of safeguards. In addition to identifying and evaluating relationships between the firm, network firms, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.

This section provides a framework of principles that members of assurance teams, firms and network firms should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level, such that independence of mind and independence in appearance are not compromised.

.. In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

APPENDIX D – SPECIFIC SITUATIONS WHERE INDEPENDENCE MAY BE COMPROMISED (IFAC)[63]

Financial Interests

Loans and Guarantees

Close Business Relationships with Assurance Clients

Family and Personal Relationships

Employment with Assurance Clients

Recent Service with Assurance Clients

Serving as an Officer or Director on the Board of Assurance Clients

Long Association of Senior Personnel with Assurance Clients

Provision of Non-Assurance Services to Assurance Clients

- *Preparing Accounting Records and Financial Statements*
- *Valuation Services*
- *Taxation Services to Audit Clients*
- *Internal Audit Services to Audit Clients*
- *IT Systems Services to Audit Clients*
- *Temporary Staff Assignments to Audit Clients*
- *Litigation Support Services to Audit Clients*
- *Legal Services to Audit Clients*
- *Recruiting Senior Management*
- *Corporate Finance and Similar Activities*

Fees and Pricing

- *Fees – Relative Size*
- *Fees – Overdue*
- *Pricing*
- *Contingent Fees*

Gifts and Hospitality

Actual or Threatened Litigation

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[63] page 45, IFAC Code

APPENDIX E – PROVISIONS FROM CODES RELATING TO NON-AUDIT SERVICES

IFAC

- Preparing accounting records and financial statements. There is an obvious self-review threat and auditors must not make 'management decisions'. For audit clients that are not listed entities, the firm may provide an audit client with accounting and bookkeeping services if of a 'routine or mechanical nature'. Doing so for a listed company is not generally acceptable other than if immaterial or in emergencies with appropriate safeguards.

- If a valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity then the IFAC Code states that the self–review threat cannot be reduced to suitable level. Other valuation services may be permitted with appropriate safeguards.

- Taxation services are '*generally not seen to create threats to independence'*. These include compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes.

- Temporary staff assignments are permitted if not involved in management decisions. Particularly high risk if the individual is in a position to influence preparation of accounts.

- Internal audit services are permitted with specified safeguards to be applied in all circumstances. These include the audit client acknowledging responsibility for internal audit activities, a member of the clients management being designated responsible, the Audit Committee or equivalent is involved etc.

- Provision of services involving the design and implementation of financial information technology systems is only permitted with safeguards.

- Litigation and legal services are only permitted where they do not involve making managerial decisions on behalf of management and due attention has to be given to materiality.

- Recruiting senior management is permitted but the firm should not make management decisions.

- Corporate Finance is permitted but certain activities such as promoting shares, or taking management decisions are outlawed. [64]

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[64] sections 8.168–8.202, IFAC Code

O'Malley

….in determining the appropriateness of a particular service, one guiding principle should be whether the service facilitates the performance of the audit, improves the client's financial reporting process, or is otherwise in the public interest. The factors to consider might include:

- *whether the service is being performed principally for the audit committee*
- *the effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process*
- *whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support*
- *whether the service would be performed by audit personnel and, if so, whether it will enhance their knowledge of the entity's business and operations*
- *whether the role of those performing the service (e.g., a role where neutrality, impartiality and auditor scepticism are likely to be subverted) would be inconsistent with the auditor's role*
- *whether the audit firm's personnel would be assuming a management role or creating a mutuality of interest with management*
- *whether the auditors, in effect, would be "auditing their own numbers"*
- *whether the project must be started and completed very quickly*
- *whether the audit firm has unique expertise in the service*
- *the size of the fee(s) for the non-audit service(s)* [65]

[65] section 5.29, O'Malley

APPENDIX F –EXTRACTS FROM CODES RELATING TO AUDIT COMMITTEES

Combined Code
"*The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors*." (Principle D.3)

"the board should establish an audit committee of at least three directors, all non-executive which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non-executive directors, should be named in the report and accounts."

"Every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary" (Provision A.1.6)

"*The duties of the audit committee should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money*." (Provision .3.2)

Auditing Practices Board
States that the role of the Audit Committee includes:
- *appraising and, where appropriate, challenging the actions and judgements of management as they relate to the financial reporting process;*
- *monitoring management's commitment to the establishment and maintenance of a satisfactory control environment and a sound system of internal control (including any arrangements for internal audit);*
- *considering the adequacy of arrangements for external audit, and supporting the independence and objectivity of the external auditors by*
  - *understanding the focus of the audit,*
  - *facilitating discussion of audit findings,*
  - *helping to resolve any differences of view between management and the auditors,*
  - *reviewing the nature and extent of non-audit services, and*
  - *making recommendations in respect of the appointment of auditors*[66].

Also requires audit engagement partners to consider whether adequate arrangements are in place to safeguard their objectivity and the firm's independence[67]; and

[66] Briefing paper **'Communications between external auditors and audit committees'**
[67] SAS240 'Quality control for audit work'

requires that "*At least annually, for all audit engagements where the audited entity is a listed company, auditors should:*

a) disclose to the audit committee, in writing and discuss as appropriate:
- *all relationships between the audit firm and its related entities and the client entity and its related entities that may reasonably be thought to bear on the firm's independence and the objectivity of the audit engagement partner and the audit staff; and*
- *the related safeguards that are in place;*

b) *where this is the case, confirm in writing that, in their professional judgement, the firm is independent within the meaning of regulatory and professional requirements and the objectivity of the audit engagement partner and audit staff is not impaired*."[68]

New York Stock Exchange rules (incorporating Blue Ribbon Committee on *Improving the Effectiveness of Corporate Audit Committees*)[69]
- having a formal written charter that has been adopted and approved by the Board
- having at least three independent directors, each of whom is financially literate and at least one of whom has accounting or financial expertise
- a number of restrictions to promote independence of the members

Blue Ribbon Committee *'Guiding Principles for Audit Committee Best Practices'*

Principle 1. The Audit Committee's Key Role in Monitoring the Other Component Parts of the Audit Process.

Principle 2. Independent Communication and Information Flow between the Audit Committee and the Internal Auditor.

Principle 3. Independent Communication and Information Flow between the Audit Committee and the Outside Auditors.

Principle 4. Candid Discussions with Management, the Internal Auditor, and Outside Auditors Regarding Issues Implicating Judgement and Impacting Quality.

Principle 5. Diligent and Knowledgeable Audit Committee Membership.[70]

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[68] paragraph 24, SAS610
[69] NYSE Corporate Accountability and Listing Standards Committee – *Recommendations to NYSE Board of Directors (revised)* June 2002
[70] Blue Ribbon Committee Report, *Guiding Principles for Audit Committees – Best Practices*

Ramsey report
Audit Committee responsibilities with regard to the relationship with the auditor are to:

- *state in the annual report whether or not it believes the level of non-audit service provision by the auditor is compatible with maintaining auditor independence, and should include reasons where appropriate;*
- *make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the auditor;*
- *review and agree on the terms of engagement for the auditor at the start of each audit;*
- *review the scope of the external audit with the auditor including identified risk areas and any additional agreed upon procedures;*
- *review the auditor's audit fee, and be satisfied that an effective, comprehensive and complete audit can be conducted for that fee (this includes reviewing and assessing fees paid for non-audit service provisions);*
- *review with the auditor any significant disagreements between the auditor and management, irrespective of whether they have been resolved;*
- *monitor the number of former employees of the audit firm currently employed in senior positions in the company and assess whether this impairs or appears to impair the auditor's judgement or independence in respect of the company;*
- *consider whether taken as a whole, the various relationships between the company and the auditor impairs or appears to impair the auditor's judgement or independence in respect of the company;*
- *consider whether the compensation of the individuals employed by the auditor who are performing the audit of the company is tied to the provision of non-audit services and, if so, consider whether this impairs or appears to impair the auditor's judgement or independence in respect of the company;*
- *review the economic importance of the company (in terms of fees paid to the auditor for the audit as well as fees paid to the auditor for the provision of non-audit services) to the auditor, and assess whether the economic importance of the company to the auditor impairs or appears to impair the auditor's judgement or independence in respect of the company; and*
- *at least annually, meet with the auditor without the presence of management.*[71]

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[71] Section 6.78, Ramsey

O'Toole report
Recommendations with respect to Audit Committees were:

- Plc's, financial institutions and public interest companies should be required to have Audit Committees made up of non-executive directors.
- Audit Committees should have regular meetings each year.
- each Audit Committee should have a formal written charter.
- shareholders should approve the appointment of auditors and set their fees, based on a recommendation from the Audit Committee rather than management as is currently the case. This would include consideration of changing auditors and putting the audit contract out to tender.
- the charter should give the Audit Committee the following responsibilities:
    - ensuring receipt from the external audit firm of a formal written statement outlining all current and relevant previous business and personal relationships between the audit firm and the company;
    - for actively engaging in a dialogue with the audit firm so that all relationships that may impact on the objectivity and independence of the auditor are fully disclosed;
    - approving the procedures for the appointment of the audit firm to provide any non-audit services;
    - assessing and approving in advance all contracts with the audit firm having regard to all business and personal relationships between the company and its audit firm;
    - monitoring the number of former employees of the audit firm having regard to all business and personal relationships between the company and its audit firm;
    - monitoring the number of former employees of the audit firm currently employed in senior positions in the company and assessing its impact on auditor independence;
    - reviewing the audit firm's statement concerning their general policy to risks to independence;
    - approving in advance any contracts with audit firm payment of which will be made on a contingency basis.
- Audit Committees should meet their external auditor a number of times each year, both in the presence of management and independent of management.
- management letters should refer to any other audit related letters and should be available in advance of approval of financial statements (even if only a preliminary draft excluding some management responses).[72]

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[72] recommendations 13.1 – 13.7, O'Toole

APPENDIX G – QUESTIONS FOR AN AUDIT COMMITTEE TO ASK THE STATUTORY AUDITORS BEFORE FINALISING THEIR APPROVAL ON THE REPORT AND ACCOUNTS[73]

1 *If you had been preparing the financial statements, would you have used any different accounting policies and do you consider that the accounting policies used are appropriate in the long-term interests of shareholders?*

2 *Are you satisfied that the substance of the accounts reflects the reality of the economic activity of the business and are there any areas which you have come across where the accounting treatment may have transcended the concept of substance over form, even though the area may not be material to this year's financial statements?*

3 *Are there adjustments which you have identified which could have been made in the accounts, but have not been so on the grounds of materiality? Can we see a copy of your schedule of unadjusted differences?*

4 *In reviewing the Operational and Financial Review, Directors' Report and Chairman's Statement, did you believe that they reflected the substance and are presented fairly?*

5 *What were the major judgmental discussions that you had with management in arriving at your opinion and could you describe the points that you have taken into account?*

6 *What new complex issues did you have to grapple with this year during the course of your audit?*

7 *Were there any areas where you felt that there was a lack of candour on behalf of management or pressures that you were under due to lateness of information?*

8 *During your audit did you come across any suspected or any actual instances of non compliance of laws or regulations even although the effect may not have been in your view material to the financial statements?*

9 *Informally, what was your assessment of the integrity and competence of the financial and executive management in each division of the business?*

10 *What are your observations on the effectiveness of the internal audit and control systems and are there any matters of a governance nature which you would wish us to be aware of given our interest in ensuring high standards of governance and risk management?*

At an early stage the auditors should have made presentations to the Audit Committee on the business risks they proposed to focus on and on the scope of the audit, materiality levels, and extent of reliance on internal controls.

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[73] Taken from a presentation given by Professor Ian Percy for a City and Financial conference *Enron and Auditor Independence: The Implications for the UK* 26 April 2002. CIMA is grateful to Professor Ian Percy, for his permission to reproduce this list.

APPENDIX H – BIBLIOGRAPHY

Author	Full title	Details
APB	*Communications between external auditors and audit committees* June 1998 *The Auditor's Code: Fundamental principles of independent auditing* *SAS 240 Quality Control for Audit work* September 2000 *SAS 610 Communication of audit matters to those charged with governance* 2001 Consultation paper *Aggressive Earnings Management* June 2001	A briefing paper setting out the APB's current views on communications between auditors and Audit Committees, with the intention of assisting the working practices of both parties. Statement of Auditing Standard Statement of Auditing Standard
Blue Ribbon	*Improving the effectiveness of Corporate Audit Committees 1999*	www.nyse.com click on NYSE Publications
Combined Code	*Principles of Good Governance and Code of Best Practice*	*The successor to the Cadbury Code, established by the Hampel Committee. The Code consists of a set of principles of corporate governance and detailed code provisions embracing the work of the Cadbury, Greenbury and Hampel Committees. Section 1 of the Code contain the principles and provisions applicable to UK listed companies, while section 2 contains the principles and provisions applicable to institutional shareholders in their relationships with companies*. (Management Accounting Official Terminology, 2000 Edition, CIMA)

EC	*Statutory Auditors' Independence in the EC: A set of fundamental principles* May 2002	Intended to create a benchmark for members' requirements throughout the EU; and provide a level playing field. A principles-based approach was adopted, to cater for the wide variety of circumstances in various member states. The principles are intended to be comprehensive, robust, enforceable and reasonable; and capable of consistent application by statutory auditors, their clients, professional bodies, regulators and other relevant parties. Downloadable from http://europa.eu.int/comm/internal_market/en/company/audit/official/index.htm
ICAEW	*Submission to Treasury Commission* March 2002 *Statement of Ethics*	Response to HM Treasury Select Committee inquiry into The Financial Regulation of Public Limited Companies. Guide to Professional Ethics downloadable from www.icaew.org.uk
IFAC	*IFAC Code of Ethics for Professional Accountants* November 2001	Downloadable free from www.ifac.org
IIA	survey of 62 Heads of Internal Audit, March 2002	Survey results downloadable from ttp://www.iia.org.uk/about/presscentre/pressreleases.cfm?Action=1&ARTICLE_ID=616
NYSE	NYSE Corporate Accountability and Listing Standards Committee – *Recommendations to NYSE Board of Directors (revised)* June 2002	www.nyse.com/pdfs/corp_recommendations_nyse.pdf
O'Malley	*The Panel on Audit Effectiveness* August 2000	A panel chaired by Shaun O'Malley, ex-PWC, established by the US Public Oversight Board in response to a 1998 request from the SEC. The panel's remit was to examine the current audit model. Downloadable from www.pobauditpanel.org/download.html
O'Toole	*The Report of the Review Group on Auditing* July 2000	A review chaired by Senator O'Toole, which makes many recommendations for Irish Company Law, corporate governance and regulation of auditors, partly in response to recent frauds within the Irish banking sector. ISBN 0-7076-6491-8

Ramsey	*Independence of Australian Company Auditors: Review of current Australian requirements and proposals for reform October 2001*	A review led by Professor Ian Ramsey, the purpose of which was to examine the adequacy of current Australian law and regulations in respect to auditor independence and to make appropriate recommendations. Downloadable from www.icaa.org.au/upload/download/Auditor_indep-final_report.pdf
SEC	*US Securities and Exchange Commission - Final Rule: Revision of the Commission's Auditor Independence Requirements Feb 2001*	Downloadable from http://www.sec.gov/rules/final/33-7919.htm

APPENDIX I – GLOSSARY AND ABBREVIATIONS

APB		Auditing Practices Board. Responsible for developing and issuing standards for auditors in the United Kingdom and Republic of Ireland. www.apb.org.uk
CCAB		Consultative Committee of Accountancy Bodies. A forum made up of the major UK accountancy bodies, in which matters affecting the profession as a whole can be discussed and a unified representation made to Government or other policy-makers.
CIMA		Chartered Institute of Management Accountants. A global professional accountancy body for management accountants. www.cimaglobal.com
DTI		Department of Trade and Industry www.dti.gov.uk
EC		European Commission http://europa.eu.int
FEE		Fédération des Experts Comptable Européens www.fee.be
GAAP		Generally accepted accounting practice. *A summary of best practice in respect of the form and content of financial statements, the form and content of auditor's reports and best practice and acceptable alternatives in respect of accounting policies and disclosures adopted for the preparation of financial information. GAAP does not have any statutory or regulatory authority in the UK, unlike in a number of other countries where the term is in use, such as the USA, Canada and New Zealand*. (Management Accounting Official Terminology, 2000 Edition, CIMA)
ICAEW		Institute of Chartered Accountants of England and Wales www.icaew.org.uk
IFAC		International Federation of Accountants www.ifac.org
IIA		Institute of Internal Auditors www.iia.org.uk
NASDAQ		National Association of Securities Dealers Automated Quotation (system). World's largest electronic stock exchange, an interdealer market with more than 600 securities dealers. www.nasdaq.com
NYSE		New York Stock Exchange www.nyse.com
SEC		Securities and Exchange Commission Regulator of US securities market. www.sec.gov
Statutory audit		An audit of a company as required by legislation, e.g. in the UK the Companies Act (1985)

APPENDIX J – FORTHCOMING GUIDANCE AND PRONOUNCEMENTS

At the time of writing, auditor independence is an issue that is the subject of both debate, and regulatory activity. Therefore the most useful method of highlighting guidance and pronouncements which are forthcoming from the various relevant bodies, is to provide links to the main participants who are expected to publish material in the near future; and to suggest one or two websites which can be expected to monitor future developments.

UK GOVERNMENT (DTI) – for the current status of relevant projects and archive of ministerial speeches

- Company Law Review – www.dti.gov.uk/companiesbill/index.htm. New companies legislation is expected later in 2002.

US GOVERNMENT – for the current status of two relevant bills, search by bill number or sponsor on http://thomas.loc.gov/home/thomas.html,

- **Sarbanes** – Bill number S 2673 sponsored by Senator Paul Sarbanes, short title "Public Company Accounting Reform and Investor Protection Act of 2002" . *An original bill to improve quality and transparency in financial reporting and independent audits and accounting services for public companies, to create a Public Company Accounting Oversight Board, to enhance the standard setting process for accounting practices, to strengthen the independence of firms that audit public companies, to increase corporate responsibility and the usefulness of corporate financial disclosure, to protect the objectivity and independence of securities analysts, to improve Securities and Exchange Commission resources and oversight, and for other purposes.*

- **Oxley** – *House-Senate Conference Committee on Corporate Accountability Legislation*, chaired by Michael G. Oxley. The committee oversees the entire financial services industry; and the work of the Federal Reserve, the Treasury, the SEC, and other financial services regulators. Current pronouncements and activities described at http://financialservices.house.gov/

NEWS, ANALYSIS AND SPECIAL REPORTS at www.ft.com.

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