

APPENDIX H

EUROPEAN COMMISSION CONSULTATIVE PAPER ON AUDIT INDEPENDENCE

INTRODUCTION

Statutory auditors' independence is fundamental to the reliability of statutory auditors' reports. Independence of EU statutory auditors implies adding credibility to published financial information and adding value and protection to European and non European investors, creditors and other stakeholders in EU companies, particularly in such companies which are public interest entities (e.g., listed companies, credit institutions, insurance companies, investment firms, UCITS, pension funds). Independence is also the profession's main means of demonstrating to the public and regulators that statutory auditors and audit firms are performing their task at a level that meets established ethical principles, in particular those of integrity and objectivity.

In order to enhance the efficient functioning of EU capital markets, a common European approach to statutory auditors' independence is needed, which provides statutory auditors, regulators and the interested public with a common understanding of what is meant by the independence requirement, and which ensures that facts and circumstances threatening a statutory auditor's independence will be interpreted and addressed consistently throughout the EU.

This issue has been extensively discussed between the Commission and representatives of the Member States and the European audit profession in the EU Committee on Auditing. Based on these discussions, the Commission intends to issue a Recommendation on statutory auditors' independence in the EU which will recommend to Member States that their independence rules should at least meet the fundamental set of principles provided therein.

Objectives

The objectives of a Commission's Recommendation on statutory auditors' independence are to provide a fundamental set of principles that

- (1) contributes to provide EU capital markets with the assurance that statutory audits of financial information provided by European companies are carried out at uniformly high levels of audit quality;
- (2) ensures that facts and circumstances threatening statutory auditors' independence will be interpreted and addressed consistently throughout the EU;
- (3) helps to provide a level playing field for the provision of statutory audit services within the single market; and
- (4) contributes to the ongoing development of international ethical standards in order to achieve that published financial information is audited at an equivalent level throughout the world.

The European Commission and the members of the EU Committee on Auditing considered a Recommendation to be the fastest way to achieve these objectives without preparing new legislation. However, if the Recommendation does not bring about the desired harmonisation on independence rules within the EU, the Commission might have to reconsider the need for legislation.

Current Situation

The requirement for statutory auditors to be independent is provided in Council Directive 84/253/EEC 1 (Eighth Directive) "on the approval of persons responsible for carrying out the statutory audits of accounting documents" which lays down the minimum conditions for the qualification of the persons who are allowed to carry out statutory audits. Articles 24 and 25 of this Directive require Member States to prescribe that statutory auditors do not carry out statutory audits, neither on their own nor on behalf of an audit firm, if they are not independent in accordance with the law of the Member State which requires the audit. According to Article 26 of the Directive, Member States are also required to ensure that statutory auditors are liable to appropriate sanctions when they do not carry out a statutory audit in an independent manner. Furthermore, Article 27 of the Eighth Directive provides for Member States to ensure at least that the members and shareholders of an audit firm, and those members of the administrative, management and supervisory body of the audit firm who are not personally approved as statutory auditors, do not intervene in the conduct of statutory audits in any way which jeopardises the independence of the natural persons performing the statutory audit on behalf of that audit firm.

At the time of adoption of the Eighth Directive, it was impossible to agree on a common definition of statutory auditors' independence and, as a consequence, this issue has been dealt with differently in Member States, based on different traditions and experiences. Current national rules on statutory auditors' independence differ in several aspects such as the scope of persons, within and outside an audit firm, to whom independence rules should apply, the kind of financial, business or other relationships with an audit client, the type of non-audit services to audit clients that are permitted or prohibited, and the safeguards which need to be put in place.

This situation makes it difficult to provide investors and other stakeholders in EU companies with a uniform high level of assurance that statutory auditors perform their audit work independently throughout the EU.

This issue was already addressed by the 1996 Commission's Green Paper 2 on "The Role, Position and Liability of the Statutory Auditor in the EU", which was supported by the Council, the Economic and Social Committee and the European Parliament. Following from the 1998 Commission's Communication "The Statutory Audit in the European Union, the way forward"³ the EU Committee on Auditing was established which decided to put statutory auditors' independence as one of the priorities on its agenda. Finally, the Commission's Communication "EU Financial Reporting Strategy: the way forward"⁴ underlines the importance of a statutory audit carried out to uniformly high levels across the EU which includes a common approach to professional ethics standards.

As far as international developments are concerned, the Commission has recognised that there is at present no internationally accepted standard for statutory auditors' independence which could be used as a benchmark for national independence rules throughout the EU. The International Federation of Accountants (IFAC) has recently issued an Exposure Draft to modify the independence section of its Code of Ethics proposing a framework approach to address auditor independence, but at present this Code is lacking a world-wide endorsement by public authorities. The U.S. stock market regulator, the Securities and Exchange Commission (SEC) recently issued its new rules governing auditors' independence, but these rules are only designed for the statutory auditors of SEC registrants, and generally do not apply to statutory auditors of non-listed companies, and in particular not to those of SME's.

The Approach

To order to address statutory auditors' independence, the Commission proposes to issue a Recommendation providing a principles-based approach which requires auditors and audit firms to consider the expectations of those directly affected by their work, the public interest, the threats to independence which may arise in practice and the safeguards which are available to eliminate those threats or to reduce them to an acceptable level. This framework is then complemented by specific requirements which provide guidance on the application of the general principles to specific situations, including prohibitions where no other safeguard would be acceptable. Such a principles-based approach to statutory auditors' independence is preferred to detailed rules because it provides greater flexibility to react promptly and effectively to new developments in business and the audit environment than is possible with a rigid, regulation-based regime, and will therefore better serve the needs of European capital markets, as well as those of SMEs.

The proposed principles are considered to be comprehensive, rigorous, robust, enforceable and reasonable. They should be consistently interpreted and applied in letter and in spirit by professional bodies, supervisors and regulators, as well as by statutory auditors, their clients and other interested parties. To promote public confidence in the audit process, continuous monitoring is necessary in order to check whether the principles are properly applied by statutory auditors. In this regard the Commission Recommendation on "Quality Assurance for the Statutory Auditor in the EU"¹ provides for quality reviews on statutory auditors to include a review of compliance with independence rules.

The Commission Recommendation on statutory auditors' independence will provide a framework which outlines the general issues of statutory auditors' independence. It includes overall requirements for statutory auditors and the scope of persons to which independence rules should apply (Section A) as well as a set of specific requirements which a statutory auditor should apply in relation to a particular statutory audit (Section B) and a definition of important terms in a glossary (Appendix). The basic principles and essential safeguards which are identified in the Recommendation by bold type lettering are to be interpreted and implemented in the context of the explanatory and other material that provides related guidance.

PROPOSED SET OF FUNDAMENTAL PRINCIPLES ON STATUTORY AUDITORS' INDEPENDENCE

A. Framework

The basic test for the effectiveness of the approach adopted by a statutory auditor to mitigate threats and risks to his independence in respect of a particular audit engagement will be whether a reasonable and informed third party, knowing all the relevant facts and circumstances about a particular audit engagement, will conclude that the statutory auditor has neither mutual nor conflicting interests with the audit client, and is exercising objective and impartial judgement on all issues brought to his attention. The statutory auditor should have a precise understanding of what is meant by objectivity and independence, as matters both of fact and of appearance, and the approach he adopts should consider (a) the variety of persons who, besides himself, may influence the result of the audit in question, (b) all existing and potential threats and risks which may impair his independence from a stakeholder's point of view, and (c) a system of safeguards which would eliminate or mitigate these threats and risks and demonstrate his independence by, for example, declining certain relationships with the audit client.

1. OBJECTIVITY, INTEGRITY & INDEPENDENCE

- (1) Objectivity and professional integrity should be the overriding principles behind a statutory auditor's audit opinion on financial statements. The main way in which the Statutory Auditor 1 can demonstrate to the public that a Statutory Audit 2 is performed in accordance with these principles is by acting, and being seen to act, independently.**

- (2) **Objectivity (as a state of mind) cannot be subjected to external verification, and integrity cannot be evaluated in advance.**
- (3) **Principles and rules on statutory auditors' independence should allow a reasonable and informed third party to evaluate the procedures and actions taken by a Statutory Auditor to avoid or resolve facts and circumstances that pose threats or risks to his objectivity.**

Public understanding of the ethical requirements which apply to statutory auditors, and of how compliance with such requirements can be monitored, is a prerequisite for the public confidence in the public interest role of statutory audits, the reliability of audited financial statements, and the ability of the audit profession to play its proper part in the audit process. It is therefore important that there should be a common understanding of what is meant by the "statutory auditor's independence requirement",³ how it relates to the ethical requirements of "objectivity" and "integrity"¹, and how, and to what extent, compliance with these requirements can be objectively assessed.

The ultimate goal of the Statutory Audit is to express an objective audit opinion. The main means by which the Statutory Auditor demonstrates that he can express such an opinion is by demonstrating that he performs the audit process in an objective manner – that is to say with fairness, with intellectual honesty and without any conflict of interest – and with integrity, which implies fair dealing and truthfulness too.

Neither objectivity nor integrity can easily be tested or subjected to external verification, but both Member States and the audit profession have accepted rules and guidance which uphold the pre-eminence of these principles and clarify the ethical responsibilities of statutory auditors, such as those provided in Section 1 of the IFAC Code of Ethics.

The requirement that a Statutory Auditor should be independent addresses both:

- Independence of mind, i.e. the state of mind which has regard to all considerations relevant to the task in hand, but no others; and
- Independence in appearance, i.e. the avoidance of facts and circumstances which are so significant that a reasonable and informed third party would question the Statutory Auditor's ability to act objectively.

The concept of statutory auditor independence requires a test which looks first at the relevant circumstances in which the Statutory Auditor finds himself, especially at any relationship or interest which has any relevance to his task.

Independence is not an absolute standard which Statutory Auditors must attain, free from all economic, financial and other relationships which could appear to entail dependence of any kind, since this state is manifestly impossible as every person has some dependency and relationship with another.

Nevertheless, it is possible objectively to test a Statutory Auditor's compliance with the concept of independence through a monitoring process: This would look first at the relevant circumstances in which the Statutory Auditor finds himself, and especially at any relationship or interest that he may have with respect to his task. Secondly, it would look at whether such an interest or relationship would cause a reasonable and informed third party, knowing all these circumstances, to conclude that the Statutory Auditor is independent, i.e. is capable of exercising objective and impartial judgement on all issues encompassed within the statutory audit engagement. In this sense, independence could be seen as a proxy for integrity and objectivity and be verified by a reasonable and informed third party.

2. RESPONSIBILITY AND SCOPE

- (1) **It is the responsibility of the Statutory Auditor to ensure that the requirement for statutory auditors' independence is complied with.**
- (2) **The independence requirement applies to**
 - (a) **the Statutory Auditor himself; and**
 - (b) **those who are in a position to influence the outcome of the Statutory Audit.**
- (3) **Those in a position to influence the outcome of the Statutory Audit are**
 - (a) **all persons who are directly involved in the Statutory Audit (the Engagement Team), including**
 - (i) **the Audit Partners, audit managers and audit staff (the Audit Team);**
 - (ii) **professional personnel from other disciplines involved in the audit engagement (e.g., lawyers, actuaries, taxation specialists, IT-specialists, treasury management specialists);**
 - (iii) **those who provide quality control or direct oversight of the audit engagement;**
 - (b) **all persons, who form part of the Chain of Command for the Statutory Audit within the Audit Firm or within a Network 6 of which the firm is a member;**
 - (c) **all persons within the Audit Firm or its Network who, due to any other circumstance, may be in a position to exert influence on the Statutory Audit.**

Responsibility

It is the responsibility of statutory auditors, whether natural or legal persons, generally to comply with national law and national professional rules in respect of Statutory Audits, including those on independence.

In the case of a particular Statutory Audit, it is the appointed Statutory Auditor who is responsible for ensuring that the requirement for statutory auditors' independence is complied with, not only by himself and – if it is not the same legal person as the Statutory Auditor – the organisational entity forming the Audit Firm, but also by any other person who is in a position to influence the outcome of the Statutory Audit.

A Statutory Auditor, or – if the Statutory Auditor is an individual – the Audit Firm which carries out the audit work, should have adequate systems (e.g., internal organisation, employment contracts, sanctions) to guarantee that individuals within the firm comply with its independence policies and procedures (see also A. 4.3).

If a Statutory Auditor is a member of a Network, he should ensure that, in as far as they are in a position to exert influence on the Statutory Audit, the entities within this Network, their owners, shareholders, partners, managers and employees all comply with the independence rules which are applicable in the jurisdiction where the audit opinion is to be issued. This could, for example, be achieved by:

- contractual agreements which allow the Statutory Auditor to impose independence rules on his Network member firms, their Partners 1, managers and employees with regard to his particular Audit Clients 2, including inter-firm quality review procedures, and external quality assurance access;
- providing his Network member firms with regular information on Audit Clients, and requiring these firms to provide regular information on their own business and financial relationships with such clients;
- obligatory intra-firm consultation procedures in any case where there are doubts as to whether his or his Audit Client's relationship with one of the Network member firms could impair his independence as Statutory Auditor.

These instruments may also be appropriate to safeguard independence in situations where subcontractors or agents of the Statutory Auditor or the Audit Firm other than its Network member firms are involved in the audit.

For any particular audit engagement of an Audit Firm which is the Statutory Auditor, the responsibility for determining the scope of persons to whom the independence requirement applies, and what instruments and rules it may be appropriate to apply to them, generally lies with the audit Engagement Partner 3, who will need to exercise adequate professional judgement in order to fulfil this task. Since it is his responsibility to assess whether or not the independence requirement is complied with, he also should be informed on any audit and non-audit relationship which the Statutory Auditor, the Audit Firm or the Network has with the client.

Determination of the Scope

A Statutory Auditor must recognise that threats to his independence may arise not only from his own relationships with the Audit Client but also from other direct or indirect relationships with other individuals and firms within his practice and in the audit environment. The Statutory Auditor has to assess actual and potential threats arising from relationships with the natural and legal persons within the Engagement Team, within the Audit Firm and any Network of which it is a member, and with other persons, such as sub-contractors or agents for the Audit Firm or the Audit Client, including those engaged on non-audit matters, with relationships to another. He therefore has to identify any person who is in a position to influence the outcome of the Statutory Audit.

When considering the range of persons to whom independence requirements should apply, the Statutory Auditor must be sensitive to a variety of factors, such as the size and legal and organisational structure of the Audit Client, the size, structure and internal organisation of the Audit Firm and of any of the Networks of which it is a member, and the volume and nature of services provided to the Audit Client by the Audit Firm or any of its Network member firms.

For example, for a small Audit Firm of four or five Partners which is the Statutory Auditor to a company with, say, three branches all in the same state, the independence rules would probably apply to:

- the Engagement Partner, the Audit Team, and any Partner in their Chain of Command;
- any Partner with responsibility for non-audit services to the same client; and
- any other person within the firm who is, or might be seen to be, in a position to influence the outcome of the Statutory Audit;

whereas when the Statutory Auditor of a medium-sized multinational company is one firm in a Network, the scope of the rules might extend to:

- the Engagement Partner and Audit Team in the Statutory Auditor;

- any Partner and Audit Team member in the same firm or in another firm in the Network who is responsible for audit of the client's overseas entities, including any in centralised services or specialist discipline units which contribute to such work;
- any Partner in the same firm or in another firm in the Network who is responsible for providing non-audit services to the client;
- any Partner in the Chain of Command, either in the jurisdiction where the audit opinion is to be delivered or in an overseas country where audit or non-audit work is done for the Audit Client; and
- any other person within the firm or another firm in the Network who is in a position to influence the outcome of the Statutory Audit.

In either case, the independence requirements which apply to everyone within the scope are the same, the difference lies in the number of people the Statutory Auditor may need to consider for inclusion within it.

Persons Other than Members of the Engagement Team or the Chain of Command

The Statutory Auditor should give further consideration to other persons who, even if they are not part of the Engagement Team or the Chain of Command, might influence the outcome of the Statutory Audit such as , for example,

- owners or shareholders of the Audit Firm with potential influence by virtue of the significance of their voting rights. Where, for example, there are only a few owners or shareholders of an Audit Firm, all owners/shareholders might be considered as being in a position to influence the outcome of the Statutory Audit;
- individuals who have supervisory or direct management responsibility for the audit function at successive levels in any location where members of the Audit Team are employed;
- other audit and non-audit Partners with potential influence by virtue of their working relationship with a member of the Audit Team (e.g., physical proximity, shared secretarial staff etc.). Depending on factors like the size and the internal organisation of an office, practice unit, Audit Firm, or even Network, all Partners of such an entity might be considered as being in a position to influence the outcome of the Statutory Audit.

The Statutory Auditor must also consider whether, there might be persons outside the Audit Firm or its Network who, due to their relationship with persons within the firm or group, have or appear to have an ability to influence the outcome of the Statutory Audit. Examples might include family members or other close personal contacts of members of the Engagement Team or Chain of Command who hold significant financial interests in the Audit Client or who hold a key position with the client or an entity with significant interests in it (see B. 6); individuals or entities with financially significant commercial relationships with either the Statutory Auditor and his firm or the Audit Client, such as major suppliers, customers or contractors. The Statutory Auditor will need to identify those individuals in the Audit Firm or the Network whose involvement in the audit engagement might be affected by such an external influence, either in fact or in appearance, taking into account the fact that he would not be able to impose his independence rules on persons outside the Audit Firm or its Network.

3. INDEPENDENCE THREATS AND RISK

- (1) Statutory auditors' independence can be affected by different types of threats, including self-interest, self-review, advocacy, familiarity or trust, and intimidation.**
- (2) The level of risk that a Statutory Auditor's independence might be impaired will be determined by the significance of any of these threats in specific circumstances.**

In order to avoid or resolve facts and circumstances which might impair a Statutory Auditor's independence it is essential to identify the threats to independence which arise in specific circumstances, to evaluate their significance, and to determine the level of risk that a Statutory Auditor's independence may be impaired.

The more clearly a Statutory Auditor is able to identify the nature of the threats, the more clearly he can judge the level of risk to his independence that they create. Based on their general nature the following types of threats to independence have been recognised:

- Self-interest threat: the Statutory Auditor's independence may be threatened by a financial or other self-interest conflict (e.g., direct or indirect financial interest in the client, dependence on the client's audit or non-audit fees, the desire to collect outstanding fees, fear of losing the client);
- Self-review threat: relates to the difficulty of maintaining objectivity in conducting self-review procedures (e.g., when taking decisions, or taking part in decisions, which should be taken wholly by the Audit Client's management; or when any product or judgement of a previous audit or non-audit assignment performed by the Statutory Auditor or his firm needs to be challenged or re-evaluated to reach a conclusion on the current audit);
- Advocacy threat: the Statutory Auditor's independence may be threatened if the Statutory Auditor becomes an advocate for, or against, his client's position in any adversarial proceedings or situations (e.g. dealing in or

promoting shares or securities in the client; acting as an advocate on behalf of the client in litigation; when the client litigates against the auditor);

- Familiarity or trust threat: a risk that the Statutory Auditor may be over-influenced by the client's personality and qualities, and consequently become too sympathetic to the client's interest through, for example, too long and too good knowledge of the client's issues, which may result in excessive trust in the client and insufficient objective testing of his representations.
- Intimidation threat: covers the possibility that the auditor may be deterred from acting objectively by threats or by fear of, for example, an influential or overbearing client.

The significance of a particular threat depends on a variety of (quantifiable and non-quantifiable) factors such as its force, the status of the person(s) involved, the nature of the matter causing the threat, and the overall audit environment. When evaluating the significance of a threat the Statutory Auditor also has to consider that different kinds of threats may arise in one set of circumstances. With regard to one certain set of circumstances a threat can be considered significant if, considering all of its quantitative and qualitative aspects, it increases the level of independence risk to an unacceptable high level.

4. SYSTEMS OF SAFEGUARDS

- (1) **Different types of safeguards – including prohibitions, restrictions, other policies and procedures, and disclosures – have to be established in order to mitigate or eliminate threats to statutory auditors' independence (see A. 3).**
- (2) **The existence and the effectiveness of various safeguards affect the level of independence risk.**

Where threats to statutory auditors' independence exist, the Statutory Auditor should always consider and document whether safeguards are appropriately applied to negate or reduce the significance of threats to acceptable levels. The safeguards to be recognised relate to different responsibilities in the audit environment, including the governance structure of the Audit Client (see A. 4.1), the entire system of self-regulation, public regulation and oversight of the audit profession (see A. 4.2), and the Statutory Auditor's system of internal quality control (see A. 4.3).

4.1 Audited Entities' Safeguards

4.1.1 Governance Structure's Impact on Independence Risk Assessment

The Statutory Auditor should consider whether the governance structure of the audited entity provides for safeguards to mitigate threats to his independence and how these safeguards are operated. Such safeguards include:

- (1) **the appointment of the Statutory Auditor by persons other than the audited entity's management; and**
- (2) **oversight and communications within the audited entity regarding the Statutory Audit and other services provided to it by the Audit Firm or its Network.**

When analysing governance responsibilities in the Audit Client which may help to safeguard its Statutory Auditor's independence, it is appropriate to differentiate between the governance structure of a public interest client (e.g., listed companies, credit institutions, insurance companies, investment firms, UCITS, pension funds) and that of an Audit Client with relative little public interest. This differentiation is relevant to the corporate governance task, which is to particularly protect actual and potential investors, and to the appearance of the Statutory Auditor's independence.

Audit Clients of Public Interest

Concerning the appearance aspect of independence in relation to a public interest client, the Statutory Auditor has to consider the whole variety of possible perceptions of the national, regional or even international public. In this respect corporate governance plays an important role in safeguarding statutory auditors' independence.

Statutory auditors are formally appointed by a majority vote of the shareholders at the Annual General Meeting. Shareholders often appoint the Statutory Auditors recommended to them by management, particularly if no additional approval by any Governance Body 1 of the Audit Client other than management (e.g. supervisory board, non-executive directors, audit committee) or by any regulatory body (e.g. regulatory authority of a certain industry) is required. This does not necessarily protect the interests of minority shareholders or potential investors, nor does it ensure statutory auditors' independence.

Governance structures within an entity being audited therefore should ensure that the appointment of the Statutory Auditor is made in the interests of its shareholders, and that during the engagement the Statutory Auditor performs his work in the same interests. If, for example, a supervisory board or an audit committee is effectively to accomplish its task of over-seeing the financial reporting process, it must rely in part on the work, guidance and judgment of the Statutory Auditor. Integral to this reliance is the requirement that the Statutory Auditor performs his service independently.

In order to determine the significance of a threat to statutory auditors' independence and to evaluate the level of the independence risk (see A. 3), the Statutory Auditor should carefully consider whether the audited entity's governance provides an appropriate infrastructure to generally safeguard its statutory auditor's independence. The analysis of such an infrastructure may include issues such as:

- the involvement of a Governance Body in the Statutory Auditor's appointment (e.g., formal approval of management's recommendation vs. active participation in negotiations with the potential Statutory Auditor);
- the duration of the Statutory Auditor's appointment (one audit vs. long-term contract);
- the involvement of a Governance Body in commissioning non-audit services from the Statutory Auditor, the Audit Firm or to any entity within the Network of which it is a member (e.g., no involvement vs. participation when negotiating significant engagements);
- the existence of oversight and communications regarding the Statutory Audit and other services provided to the audited entity by the Statutory Auditor, the Audit Firm or its Network, and the frequency of such communications with the Statutory Auditor.

Other Audit Clients

When auditing clients other than public interest entities, the Statutory Auditor should also analyse whether the governance infrastructure of the Audit Client provides general safeguards to his independence. However, when auditing an entity of relative little public interest (e.g., a small manager-owned production company) the Statutory Auditor may be able to identify certain groups of his Audit Client's stakeholders (e.g., employees, actual and potential creditors, local authorities), their specific expectations, and, as a result thereof, specific threats to his independence which can be appropriately addressed by particular safeguards within the audited entity, other than those generally provided by corporate governance. Such safeguards, for example, could include

- the Audit Client's employment of a sufficient quality and quantity of staff to ensure that the Statutory Auditor does not make managerial decisions; and
- appropriate internal procedures for objective choice in commissioning non-audit engagements.

4.1.2 Involvement of the Governance Body

- (1) **Where a public interest entity has a Governance Body (see A. 4.1.1), the Statutory Auditor should at least annually:**
 - (a) **disclose to the Governance Body, in writing:**
 - (i) **all relationships between himself, the Audit Firm and its Network member firms, and the Audit Client and its Affiliates 1 that may reasonably be thought to bear on the independence and the objectivity of the Statutory Auditor; and**
 - (ii) **the related safeguards that are in place;**
 - (b) **confirm in writing that, in his professional judgement, the Statutory Auditor is independent within the meaning of regulatory and professional requirements and the objectivity of the Statutory Auditor is not impaired; and**
 - (c) **discuss these matters with the Governance Body of the Audit Client.**
- (2) **Where Audit Clients other than public interest entities have a Governance Body, the Statutory Auditor should consider whether similar measures are appropriate.**

As stated under A. 4.1.1, to some extent it is the responsibility of the Audit Client to safeguard the independence of its Statutory Auditor. Discussions between the Statutory Auditor and the Governance Body of the client are the main means to establish a link between the Statutory Auditor's own safeguards and those of the Audit Client. To protect himself and to allow the quality assurance regime (see A. 4.2) to verify his compliance with this requirement, the Statutory Auditor should initiate the process by writing to the Audit Client to invite him to discuss these issues.

4.2 Quality Assurance

Quality assurance systems which meet the minimum requirements of the Commission Recommendation on "Quality Assurance for the Statutory Audit in the EU"¹ are required mechanisms contributing to safeguard statutory auditors' compliance with the independence requirement at a Member State level.

To ensure that professional standards, including the independence requirement, are complied with by Statutory Auditors, a control or enforcement system is needed. Safeguards and procedures to be considered include an overall control environment, starting with a professional approach towards matters of quality and ethics and taking into account the assurance provided by a regularly monitored and evidenced control system. One way to enforce independence requirements is the Member State system for quality assurance on Statutory Audits. The Commission Recommendation

on “Quality Assurance for the Statutory Audit in the EU” recommends that statutory auditors’ compliance with ethical principles and rules, including independence rules, should be subjected to quality review procedures. As the recommended systems of quality assurance include public oversight they are also able to address the public perception of independence issues.

4.3 The Statutory Auditor’s Overall Safeguards

4.3.1 Ownership of and Control over Audit Firms

- (1) **If the Statutory Auditor is an Audit Firm, the majority of the firm’s voting rights (50% plus one vote) must be held by persons who are authorised to perform Statutory Audits within the European Union (statutory auditors 2). The Statutory Auditor’s legal statutes should contain provisions to ensure that a non-auditor owner could not gain control over the Audit Firm.**
- (2) **Neither the Audit Firm nor any of its Network member firms should provide statutory audit services to a non-auditor owner or its Affiliates where the voting rights which the non-auditor owner holds in the Audit Firm exceed 5% of the total voting rights.**

Need to Safeguard Control over the Audit Firm

For an Audit Firm to be authorised to carry out Statutory Audits, Article 2.1 b) ii) of the 8 th Company Law Directive requires the majority of the Audit Firm’s voting rights to be held statutory auditors who have been approved by a competent authority of any of the EU Member States, i.e., natural persons or firms who satisfy at least the minimum conditions of that Directive.

Without any further restrictions, this would allow Audit Firms to raise capital on capital markets by either private or public offerings. Some Member States regard such funding as raising serious concerns about statutory auditor independence and have imposed more restrictive rules on the ownership of Audit Firms (e.g. allowing a maximum of 25% ownership by individuals who are not statutory auditors, or restricting minority ownership to members of certain regulated professions only).

There is a concern about whether holding majority voting rights is sufficient to ensure that statutory auditors control the firm. For example, if one non-auditor held 49% of voting rights and the other 51% were divided among a number of statutory auditors, the non-auditor owner could have effective control of the Audit Firm. In this respect, careful attention should be paid to the threats to statutory auditors’ independence which can result and consideration should be given to the safeguards needed to avoid such situations. These might include, for example, limiting the voting rights of a single non-auditor owner to 5% or 10% of the whole. Where only a few statutory auditors hold the majority of voting rights in an Audit Firm, it may be appropriate to allow certain individuals to hold a higher proportion than this, in particular if these individuals are members of a regulated profession (e.g., lawyers, notaries), or other persons (e.g., management or other professional consultants) whose professional activities rest with the Audit Firm or with one of its Network members.

The risks that relationships between the Statutory Auditor, the Audit Firm and a non-auditor owner of the Audit Firm and an Audit Client might impair the Statutory Auditor’s independence should be addressed by reference to A. 2, which sets out the scope of persons to which the independence requirement applies, and B. 1 and B. 2, which consider the financial and/or business links which may exist between them. The threat to independence is however considered too high, to permit a Statutory Auditor, an Audit Firm or any member of its Network to provide statutory audit services to a non-auditor owner who holds over 5% of the voting rights in the Audit Firm.

4.3.2 The Audit Firm’s Internal Safeguarding System

- (1) **A Statutory Auditor should be required to set up and maintain a safeguarding system which is an integral part of his firm-wide management and internal control structure.**
- (2) **The functioning of such a system should be properly documented so that it can be subject to quality assurance systems (see A. 4.2).**
- (3) **Generally, the safeguarding system of an Audit Firm would include:**
 - (a) **written independence policies which address current independence standards, threats to independence, and the safeguards related thereto;**
 - (b) **active and timely communication of the policies, and any changes to them, to each Partner, manager and employee, including regular training and education thereon;**
 - (c) **appropriate procedures to be applied by Partners, managers and employees in order to meet independence standards, both on a regular basis and in response to particular circumstances;**
 - (d) **designation of top-level audit professionals (Partners) responsible for updating the policies, timely communication of those updates, and overseeing the adequate functioning of the safeguarding system;**

- (e) **documentation for each Audit Client to show whether or not there were circumstances and facts which might have threatened the Statutory Auditor's independence, how potential threats were evaluated, and, if significant threats were noted, what steps were taken to avoid, negate, or at least reduce the independence risk to an appropriate level; and**
- (f) **internal monitoring of compliance with safeguarding policies.**

As far as the Statutory Auditor is concerned, he has to comply with independence standards, regardless of whether those are imposed by law or regulators, or by professional bodies as part of a self-regulatory regime, or adopted voluntarily as part of the Audit Firm's own policy. In order to ensure his compliance the Statutory Auditor needs to set up a system of related safeguards, or – if the Statutory Auditor and the Audit Firm are not identical legal persons – at least require the Audit Firm to do so.

Audit Firm's Independence Policies

An Audit Firm should develop independence policies covering activities which are acceptable and not acceptable when performed for Audit Clients or their Affiliates.

Regardless of how detailed independence standards are developed, the objective is to enforce appropriate implementation and maintenance of Statutory Auditors' safeguards and to encourage their continuous improvement. This is why the Audit Firm's independence policies should be flexible enough to be regularly updated when either circumstances and facts or, even due to a change in public expectations, independence standards change.

The design and documentation of the Audit Firm's independence policies should reflect the immediate practice environment (e.g., size and organisational structure of the Audit Firm) and the audit environment (e.g., client and business portfolio of the Audit Firm, others outside the Audit Firm who are involved in Audit Firm's assignments) as well.

An Audit Firm must have in place appropriate policies and procedures to ensure that the relevant Engagement Partner is notified of any other relationship which exists between the firm and its group member firms, and the Audit Client and its Affiliates. This includes the requirement that the Engagement Partner has to be consulted prior to acceptance of any assignment from the Audit Client or its Affiliates. It is then the responsibility of the Engagement Partner to assess whether any such relationship may reasonably be thought to affect the independence of the Statutory Auditor. In cases where the Audit Client has a Governance Body (see A. 4.1), it might be appropriate to involve that body in this process.

Where persons others than the Audit Firm, its Partners, managers and employees are involved with the Audit Client or in the audit assignment (e.g.; subcontracted specialists, Network member firms), the Audit Firm's independence policies should also address requirements and consultation processes needed to prevent these persons from causing an unacceptable level of independence risk for the Statutory Auditor.

In order to ensure that its Partners, managers and employees comply with its independence policies the Audit Firm will need to communicate its policies appropriately, and to educate and train these individuals on a regular basis. This should also include informing them about sanctions for independence policy violations.

Procedures to be Applied

In accordance with the independence policies adopted by an Audit Firm and depending on its size, the procedures to be applied by Partners, managers and employees may vary. While for a small Audit Firm it might be appropriate to consider its independence only on a case by case basis, and then to decide on certain procedures to mitigate the independence risk, a large Audit Firm might need to establish routine procedures in order to detect even hypothetical threats to the Statutory Auditor's independence. For example, to detect a self-interest threat resulting from financial or business relationships it might be necessary for such an Audit Firm to maintain a regularly updated database (e.g., restricted entity list) which provides all its Partners, managers and employees who are or are likely to be in a position to influence the outcome of any Statutory Audit the Audit Firm is performing or going to perform, with information on all Audit Clients which may give rise to a self-interest threat if they fulfil certain criteria. The operation of this safeguarding system will require these individuals to regularly provide the Audit Firm with certain personal and client information.

Depending on its size and structure, it might also be adequate for an Audit Firm or Network to establish internal procedures to ensure that there is appropriate consultation across the firm or Network about any client where the significance of an independence threat is unclear. This consultation would involve experienced Partners who are not involved in the Audit Client's affairs and who are not impacted by the independence threat in question.

Documentation of Independence Assessment

The main purpose of the Statutory Auditor's documentation of his independence assessment on a certain Audit Client is to provide evidence that he performed his assessment properly. It is considered appropriate that such documentation should be included in the audit files.

Internal Monitoring of Compliance

The monitoring of compliance with the Audit Firm's independence policies should be an integral function of the Audit Firm's quality review structure. Where large Audit Firms may designate this task to quality control specialists, or even independence specialists, small and medium sized Audit Firms, which generally assess their independence only on a case by case basis, should at least have their individuals' compliance reviewed by a Partner who is not a member of the particular Engagement Team. In the case of sole practitioners and of small partnerships where either all Partners are in the Engagement Team or the involvement of any other Partner outside the Engagement Team would increase the level of independence risk (e.g., when this Partner provides significant non-audit services to the Audit Client), the Statutory Auditor should either seek advice from his professional regulatory body or ask for a review by another statutory auditor.

B. Specific Requirements

1. FINANCIAL INVOLVEMENT

- (1) **An actual or impending, direct or indirect financial interest in the Audit Client or its Affiliates, including any derivative directly related thereto, may threaten the Statutory Auditor's independence, if it is held by the Statutory Auditor or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2).**

The Statutory Auditor has to assess the significance of any such threat, identify whether any safeguards would mitigate the independence risk it presents, and take any action necessary, such as refusal of or resignation from the audit engagement or exclusion of the relevant person from the Audit Team. Where applicable, the Governance Body of a public interest client should be involved in this process.

- (2) **Financial involvement in the Audit Client or its Affiliates will be incompatible with the Statutory Auditor's independence, if**
- (a) **the Statutory Auditor, the Audit Firm, or any member of the Engagement Team or the Chain of Command, or any Partner of the firm or its Network who is working in an "Office"¹ which participates in a significant proportion of an audit engagement, holds**
 - (i) **any direct financial interest in the Audit Client; or**
 - (ii) **any indirect financial interest in the Audit Client which is significant to either party; or**
 - (iii) **any (direct or indirect) financial interest in the client's Affiliates which is significant to either party;**
 - (b) **any other person within the scope of A. 2, holds any (direct or indirect) financial interest in the Audit Client or its Affiliates which is significant to either party.**

The persons concerned should not therefore hold any of such financial interests. Where such an interest is acquired as a result of an external event (e.g. inheritance, gift, merger of firms or companies) it must be disposed of at the earliest practicable date. In the meantime, additional safeguards are needed to ensure the Statutory auditor's independence, such as secondary review of the relevant person's audit work or exclusion of the relevant person from any substantive decision making concerning the Statutory Audit of the client.

- (3) **The Statutory Auditor's independence may also be threatened by an apparently insignificant financial interest in an Audit Client or its Affiliates. The level of threat will be higher, and likely to be unacceptable, if the interest is acquired or held on other than standard commercial terms. It is the responsibility of the Statutory Auditor to assess the level of risk that such an interest presents and to ensure that any necessary mitigating action is taken.**

The term "financial interest" would comprise of, in a broad sense, the whole variety of financial interests which the Statutory Auditor himself, his Audit Firm or any other person within the scope of section A. 2 may have in an Audit Client or in any Affiliate of the client. It includes "direct" and "indirect" financial interests such as

- direct or indirect shareholding in the Audit Client or its Affiliates,
- holding or dealing in securities of the Audit Client or its Affiliates,
- accepting pension rights or other benefits from the Audit Client or its Affiliates.

Commitments to hold financial interests (e.g. contractual agreements to acquire a financial interest) and derivatives which are directly related to financial interests (e.g., stock options, futures, etc.) should be dealt with in the same way as would an already existing financial interest.

Direct Financial Interests

When the persons who are directly involved in the conduct of the statutory audit (the Statutory Auditor, the Audit Firm, an individual of the Engagement Team or within the Chain of Command) hold a direct financial interest in the Audit Client, such as shares, bonds, notes, options, or other securities, the significance of the self-interest threat is considered to be too high to enable any safeguards to reduce the Statutory Auditor's independence risk to an acceptable level.

In such a case the Statutory Auditor either has to withdraw from the engagement or, if an individual of the Audit Firm holds the direct financial interest, has to exclude this individual from the engagement.

Where Partners of the Audit Firm or its Network who are working in an office or operational unit which participates in a significant portion of an audit engagement ("Office"), have a direct financial interest in the Audit Client, the perception of self-interest is also considered as too high to allow this situation to be maintained.

Indirect Financial Interests

The term "indirect financial interest" refers to situations where, for example, a person within the scope of A. 2 has investments in non-client entities that have an investment in the Audit Client, or in companies in which an Audit Client also has invested.

A person within the scope of A. 2 should not hold such an indirect financial interest, where the self-interest threat resulting from this financial involvement is significant. This is particularly the case when an indirect shareholding in the Audit Client allows or appears to allow that person to influence management decisions of the Audit Client (e.g., by significant indirect voting rights), or when the direct shareholder due to any circumstance can or appears to be able to influence the outcome of the Statutory Audit. In addition, an unacceptable level of independence risk would also arise from situations where the Statutory Auditor or any other person within the scope of A. 2 serves as voting trustee of a trust or executor of an estate containing securities of an Audit Client, provided that no appropriate safeguards exist to mitigate this risk, such as supervision and control by beneficiaries, governmental authorities or courts.

On the other hand, the potential self-interest threat to the Statutory auditor's independence may be regarded as insignificant to the independence risk if, for example, when holding indirect financial interests in the Audit Client

- the financial interest is directly held by an investment fund, pension fund, UCITS or an equivalent investment vehicle, and
- the person holding the indirect interest is not directly involved in the audit of the fund manager, nor can influence the individual investment decisions of the fund manager.

External Events

If a financial interest that would create a significant threat to the Statutory Auditor's independence is acquired as a result of an external event (e.g. inheritance, gift, merger of firms or companies), it must be disposed of at the earliest practicable date. If the interest were shares in a listed company, for example, this would mean that the shares should be sold at the earliest opportunity in accordance with applicable stock exchange regulations that govern the disposal or sale of shares by those with insider knowledge.

Until the financial interest is disposed of, additional safeguards are needed to ensure the Statutory auditor's independence. For example, where a Statutory Auditor becomes aware that a member of the Engagement Team has acquired shares in a client as the result of inheritance, that individual should not continue to be a member of the Engagement Team until the shares have been sold, or, if this individual cannot be replaced by another individual of equal competence, a secondary review has to be carried out on the audit work of the individual concerned.

Inadvertent Violations

There will be occasions where the Statutory Auditor becomes aware that an individual in his Audit Firm inadvertently holds a financial interest in an Audit Client or in one of its Affiliates which, in general, would be regarded as a violation of independence requirements. Such inadvertent violations will not impair the Statutory Auditor's independence with respect to an Audit Client, provided that the Statutory Auditor

- has established procedures that require all professional personnel to report promptly to him any breaches of the independence rules resulting from the purchase, inheritance or other acquisition of a financial interest in an Audit Client by such individuals (see also A.4.3.2);
- promptly notifies the individual to dispose of the financial interest at the earliest opportunity after the inadvertent violation is identified; and
- takes particular care when reviewing the relevant audit work of this individual.

Where it proves impossible to compel the individual to dispose of the financial interest, the individual should be removed from the Engagement Team and/or excluded from any substantive decision making concerning the Statutory Audit of the client.

Whatever financial involvement exists, it is primarily the Statutory auditor's safeguarding system (see A. 4.3) which should provide evidence that the threats to independence have been identified and investigated, have been discussed with the client's Governance Body where appropriate, and that a decision has been taken about whether or not they are significant and the reasons behind that decision have been recorded.

2. BUSINESS RELATIONSHIPS

- (1) Business relationships between the Statutory Auditor, the Audit Firm or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2) on the one hand, and the Audit Client, its Affiliates, or its management on the other hand, may cause self-interest, advocacy or intimidation threats to the Statutory Auditor's independence.**
- (2) Business relationships, or commitments to establish such relationships, should be prohibited unless the relationship is in the normal course of business and insignificant.**

With regard to public interest clients, and where applicable, any cases where doubt arises whether or not a business relationship is in the normal course of business and insignificant this should be discussed with the Governance Body of the Audit Client.

Business Relationships

Business relationships are considered to mean relationships which involve a commercial or financial common interest between the Statutory Auditor, the Audit Firm or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2) on the one hand and the Audit Client, an Affiliate of the client, or the management thereof on the other. The following are examples of such relationships that may, if significant to the auditor or conducted outside the normal course of business, cause a self-interest, advocacy or intimidation threat:

- having a financial interest in a joint venture with the Audit Client, or with an owner, managing director or other individual who performs senior management functions of that client;
- having a financial interest in a non-audit client that has an investor or investee relationship with the Audit Client;
- giving a loan to the Audit Client or guarantees for the Audit Client's risks;
- accepting a loan from an Audit Client or having borrowings guaranteed by the Audit Client;
- providing services to a managing director or another individual performing a senior management function of the Audit Client in respect of the personal interest of such individual;
- receiving services from the Audit Client or its Affiliates which concern underwriting, offering, marketing or selling of securities issued by the audit firm or one of its group member firms.

Commitments to establish such relationships should be dealt with in the same way as would an already established relationship.

In the Normal Course of Business

In the normal course of its business, a Statutory Auditor might not only render audit or non-audit services to the Audit Client or to its Affiliates, but might also purchase goods or services provided by these entities (e.g. insurance and bank services, commercial loan agreements, purchase of office equipment, EDP software, or company cars). If these transactions are performed at arm's length (as between third parties), it is considered that they generally do not threaten the Statutory Auditor's independence (e.g. purchase of goods which are offered under normal wholesale discount terms, and are available to the whole of the client's other customers). However, the Statutory Auditor should carefully consider the risk that even an arm's length transaction could reach a magnitude which threatens his independence by creating financial dependencies, either in fact or at least in appearance.

Accepting any goods or services from an Audit Client on favourable terms is not considered as being within the normal course of business, unless the value of any benefit is insignificant.

Significance of Independence Risk

Whether a business relationship would be regarded as a significant threat to the Statutory Auditor's independence depends on whether a reasonable and informed third party would assume that such a relationship could have an influence on the outcome of the Statutory Audit. Objective criteria are therefore needed in order to evaluate the significance of a relationship to the Statutory Auditor, as well as to the Audit Client. With regard to the financial statements and the audit task, the relationship should neither enable the Statutory Auditor, the Audit Firm or one of its Network members to influence management decisions of the Audit Client nor allow the Audit Client, or one of its Affiliates to influence the outcome of the Statutory Audit, nor appear to enable such influences.

Whatever business relationship exists, it is primarily the task of the Statutory Auditor's safeguarding system (see A. 4.3) to provide evidence that the threats of such transactions have been identified and investigated, have been discussed

with the client's Governance Body, where appropriate, and that a decision has been taken about whether or not the risk to independence is significant and the reasons behind that decision have been recorded.

3. EMPLOYMENT WITH THE AUDIT CLIENT

- (1) **Dual employment of any individual who is in a position to influence the outcome of the Statutory Audit both in the Audit Firm (a person within the scope of A. 2) and in the Audit Client or its Affiliates should be prohibited. Loan staff assignments 1 to an Audit Client or any of its Affiliates are also regarded as dual employment relationships. Where an Audit Firm's employee has worked with an Audit Client under a loan staff assignment and is to be assigned to the audit Engagement Team of that client's Statutory Audit, this individual should not be given audit responsibility for any function or activity that he was required to perform or supervise during the former loan staff assignment (see also B. 5 below).**
- (2) **Where a member of the Engagement Team is to leave the Audit Firm and join an Audit Client, policies and procedures of the Audit Firm (see A 4.3) should provide:**
 - (a) **a requirement that members of any Engagement Team immediately notify the Audit Firm of any situation involving their potential employment with the Audit Client;**
 - (b) **the immediate removal of any such Engagement Team member from the audit engagement; and**
 - (c) **an immediate review of the audit work performed by the resigning or former Engagement Team member in the current and/or (where appropriate) the most recent audit by an Audit Firm's audit professional at least one level higher. If the individual was an Audit Partner or the Engagement Partner, the review should be performed by an Audit Partner who was not involved in the audit engagement. (Where, due to its size, the Audit Firm does not have a Partner who was not involved in the audit engagement, it may seek either a review by another statutory auditor or advice from its professional regulatory body.)**
- (3) **Where a former Engagement Team member or an individual within the Chain of Command has joined an Audit Client, policies and procedures of the Audit Firm should ensure that there remain no significant connections between itself and the individual. This includes:**
 - (a) **regardless of whether the individual was previously involved in the audit engagement, that all capital balances and similar financial interests must be fully settled (including retirement benefits) unless these are made in accordance with pre-determined arrangements that cannot be influenced by any remaining connections between the individual and the Audit Firm;**
 - (b) **that the individual does not participate or appear to participate further in the Audit Firm's business or professional activities.**

Policies and procedures to be included in the overall safeguarding system of the Audit Firm (see A. 4.3) should recognise that different treatments may be required, depending on (a) the position of the departing individual at the Audit Firm (e.g. Partner vs. senior or other professional), (b) the circumstances which lead to the departure (e.g. retirement, termination, voluntary withdrawal), (c) the position the departing individual is taking at the client (e.g., managerial position vs. position with insignificant influence on the financial statements), (d) the length of time that has passed since the individual left the Audit Firm, and (e) the length of time that has elapsed since the departing individual performed services related to the audit engagement.

Where the individual leaving the Audit Firm was an Engagement or Audit Partner, the required secondary partner's review should also consider the risks that the former partner might be perceived as, for example, having been influenced by the client during the previous audit; or having established close relationships with other Audit Team members which might threaten the independence of those staying on the Audit Team; or using his knowledge of the current audit approach and testing strategy to circumvent the audit designs.

A small Audit Firm which is not able to perform a secondary partner's review might appropriately seek either a secondary review performed by another statutory auditor or, at least, advice from its professional regulatory authority.

4. MANAGERIAL OR SUPERVISORY ROLE IN AUDIT CLIENT

- (1) **An individual who is in a position to influence the outcome of the Statutory Audit (a person within the scope of A. 2) should not be a member of any management (e.g. board of directors) or supervisory body (e.g. audit committee or supervisory board) of an Audit Client. Also, he should not be a member of such a body in an entity which holds directly or indirectly more than 20% of the voting rights in the client, or in which the client holds directly or indirectly more than 20% of the voting rights.**
- (2) **When a person who was formerly a member of the Engagement Team takes a managerial or supervisory role in an Audit Client, B. 3(3) will apply.**

In addition to the risks in taking a managerial or supervisory role in an Audit Client, membership of a managerial or supervisory body of an entity which is not an Audit Client (non-client entity), but is in a position to influence the Audit

Client, or where the Audit Client is in a position to influence the non-client entity, creates an unacceptably high level of independence risk due to intimidation and self-review threats and should therefore be prohibited.

Where national law requires members of the audit profession to undertake supervisory roles in certain companies, safeguards must ensure that such professionals do not have any responsibility with regard to the Engagement Team.

B. 4 (2) recognises that a former member of an Engagement Team who leaves the Audit Firm, whether to retire or to take up a post with a non-client entity, might be invited to take a non-executive post on a management or supervisory body of the Audit Client. In such cases, the Audit Firm will need to ensure that requirements at B. 3 (3) are met.

5. ESTABLISHING EMPLOYMENT WITH AUDIT FIRM

Where a director or manager of the Audit Client has joined the Audit Firm, this person should neither become a member of the Engagement Team nor, as a member of the Chain of Command, take part in any substantive decisions concerning this client or its Affiliates at any time in the two year period after leaving the Audit Client. This requirement also applies to a any former employee of the Audit Client unless the responsibilities he held and the tasks he performed at the Audit Client were insignificant in relation to the statutory audit function.

When a director or manager of an Audit Client joins the Audit Firm, the self-review threat is considered as too high to be mitigated by any other safeguard than to prohibit such a person from becoming a member of the Engagement Team or from taking part in any substantive decisions concerning the client's audit for a two-years period of time. Where a former employee of the Audit Client joins the Audit Firm, the significance of the self-review threat will relate to the responsibilities and tasks this employee had at the Audit Client and those he is going to take at the Audit Firm. For example, if the former employee prepared accounts or valued elements of the financial statements, the same safeguards would apply as for a director or manager; on the other hand, when the former employee held, for example, a non-management position in a branch of the Audit Client, the self-review threat may be mitigated if his activities as a member of the Engagement Team do not relate to that branch.

6. FAMILY AND OTHER PERSONAL RELATIONSHIPS

- (1) An individual who is a Statutory Auditor should not accept an audit engagement if one of his close family members**
 - (a) holds a senior management position with the Audit Client;**
 - (b) is in a position to exert direct influence on the preparation of the Audit Client's accounting records or financial statements;**
 - (c) has a financial interest in the Audit Client (see B. 1) unless it is insignificant; or**
 - (d) has a business relationship with the Audit Client (see B. 2) unless it is in the normal course of business and insignificant.**
- (2) Within an Audit Firm or Network an individual should not be assigned to the Engagement Team if one of his close family members meets any of the criteria under (1) (a) to (d) above, nor should an Audit Partner who is working in an "Office" where any of the other Partners in it has a close family member who meets these criteria.**

Appropriate safeguards should ensure that a member of the Chain of Command does not participate in any substantive decisions concerning the audit engagement if one of his close family members meets any of the criteria under (1) (a) to (d) above, or if he is working in an "Office" where any of the Partners in it has a close family member who meets these criteria.

- (3) The Statutory Auditor should consider whether he or any other individual in the Engagement Team or Chain of Command, or any person working in an "Office" which includes himself or such an individual, has any other close non-family personal relationships where similar safeguards would be needed.**
- (4) Assessment of the facts of a relevant individual's close family or non-family personal relationship should be based upon the best knowledge of the Statutory Auditor and the individual concerned, and the individual should be responsible for disclosing to the Statutory Auditor any fact and circumstance which might require safeguards to mitigate an unacceptable level of independence risk.**

The Statutory Auditor must be able to assess the risk to his independence when he or any member of the audit Engagement Team or the Chain of Command, or anyone in an "Office" which includes himself or such an individual, has any close family member or a close non-family relationship with anyone who meets the criteria under 1(a) to (d). His consideration of the facts should be based on his best knowledge of the circumstances of all relevant individuals, and he should have policies and procedures in place which require such individuals to disclose any fact or circumstance which he should take into account. The Statutory Auditor should evaluate all such information, determine whether any of the criteria are met and take any necessary mitigating action within a reasonable period of time. Such action might include refusal of the engagement, or exclusion of an individual from the Engagement Team or the "Office".

Close family members

The term “close family members” normally refers to parents, siblings, spouses or cohabitants and children and other dependants. It may extend to other family members who may have less immediate but not necessarily less close relationships with the relevant individual, such as former spouses or cohabitants and the spouses and children of family members.

Close non-family relationships

Other close relationships are hard to define but would include those with any person other than a family member which entail frequent or regular social contact.

Inadvertent Violations

There will be occasions where the Statutory Auditor becomes aware that an individual in his Audit Firm inadvertently has not reported to the firm a family or other personal relationship with an Audit Client which, in general, would be regarded as a violation of independence requirements. Such inadvertent violations will not impair the Statutory Auditor’s independence with respect to an Audit Client, provided that the Statutory Auditor

- has established procedures that require all professional personnel to report promptly to him any breaches of the independence rules resulting from changes in their family or other personal relationships, the acceptance of an audit sensitive position by their close family members or other close persons, or the purchase, inheritance or other acquisition of a significant financial interest in an Audit Client by such family members or persons;
- promptly removes the individual from the Engagement Team and/or excludes the individual from substantive decisions concerning the Statutory Audit of the relevant client, or, in case of significant financial interests, notifies the individual to ensure that the financial interest is disposed of at the earliest opportunity after the inadvertent violation is identified; and
- takes particular care when reviewing the relevant audit work of this individual.

7. NON-AUDIT SERVICES**7.1 General**

- (1) **Where a Statutory Auditor, an Audit Firm or one of its Network member firms provides services other than statutory audit work (non-audit services) to an Audit Client, the overall safeguarding system (A 4.3) of the Statutory Auditor has to ensure that**
 - (a) **the individuals employed by either the Audit Firm or its Network member firm neither take any decision nor take part in any decision-making on behalf of the Audit Client, or its management, either in the course of the statutory audit assignment or while providing a non-audit service; and**
 - (b) **where, due to specific threats which may result from the nature of a non-audit service, an independence risk remains, this risk is reduced to an acceptable level.**
- (2) **Even if not involved in the Audit Client’s decision-making, the Statutory Auditor should consider, among others, which of the following safeguards in particular may mitigate a remaining independence threat:**
 - (a) **arrangements to reduce the risk of self-review by compartmentalising responsibilities and knowledge in specific non-audit engagements;**
 - (b) **routine notification of any audit and non-audit engagement to those in the Audit Firm or Network who are responsible for safeguarding independence, including oversight of ongoing activities;**
 - (c) **secondary reviews of the Statutory Audit by an Audit Partner who was not involved in the provision of any services to the Audit Client; or**
 - (d) **external review by another statutory auditor or advice by the professional regulatory body.**

Independence from Audit Client’s Decision-Making

The self-review threat is always considered too high to allow the provision of any services other than statutory audit work which would involve the Statutory Auditor in any decision-making of either the Audit Client or its management. Therefore, if the Statutory Auditor or a member within his Network intends to provide non-audit services to an Audit Client, the Statutory Auditor has to ensure that any individual acting for or on behalf of the Audit Firm or its Network member does not take any decision for, nor take part in any decision-making on behalf of, the Audit Client or its management. Any advice or assistance related to any service provided by the Statutory Auditor or the Audit Firm should give the Audit Client or its management the opportunity to decide between reasonable alternatives. If the Audit Client is seeking advice where, due to legal or regulatory provisions, only one solution is available, the Statutory Auditor should ensure that its documentation refers to the relevant provisions (e.g. quotes the relevant law, includes advice from external professionals).

7.2 Examples – Analysis of Specific Situations

Due to ongoing developments in business and financial markets and rapid changes in information technologies, and to the consequences for management and control, it is not possible to draw up a comprehensive list of all those situations where the provision of non-audit services to an Audit Client would create a significant threat to statutory auditors' independence, nor of the different safeguards which may exist to mitigate such threats. The examples which follow describe specific situations that could impair a Statutory Auditor's independence and discuss the safeguards which may be appropriate to reduce the independence risk to an acceptable level in each circumstance. In practice, the Statutory Auditor will need to assess the implications of similar, but different circumstances, and to consider what safeguards would satisfactorily address the independence risk in the judgement of an informed third party.

7.2.1 Preparing Accounting Records and Financial Statements

- (1) **A self-review threat exists whenever a Statutory Auditor, an Audit Firm, an entity within a Network of firms or a Partner, manager or employee thereof participates in the preparation of the Audit Client's accounting records or financial statements. The significance of the threat depends upon the spectrum of these persons' involvement in the preparation process and upon the level of public interest.**
- (2) **The significance of the self-review threat is always considered too high to allow a participation in the preparation process unless the assistance provided is solely of a technical or mechanical nature or the advice given is of an informative nature only.**
- (3) **However, where Statutory Audits of public interest clients are concerned, the provision of any such assistance other than that which is within the statutory audit mandate would cause an unacceptable high level of independence risk, and should therefore be prohibited.**

Spectrum of Involvement in the Preparation Process

There is a spectrum of involvement by the Statutory Auditor (including his Audit Firm, Network member firms, or any employees thereof) in the preparation of accounting records and financial statements. At one end of the spectrum, the Statutory Auditor may prepare prime accounting records, do the bookkeeping and prepare the financial statements, as well as performing the Statutory Audit of these financial statements. In other cases, the Statutory Auditor helps his Audit Client in the preparation of the financial statements on the basis of the trial balance, assisting his Audit Client in the calculation of the closing entries (calculation of accruals, bad debts, depreciation, etc.). At the other end of the spectrum, the Statutory Auditor does not participate in any part of the preparation process. Even in the latter case, the Statutory Auditor who detects shortcomings in the Audit Client's proposed disclosures will normally suggest and draft the amendments required. This is part of the Statutory Audit mandate and should not be considered as the provision of a non-audit service. While management always has responsibility for the presentation of the financial statements, the end result is that it is uncommon for a set of financial statements to appear where the Statutory Auditor has had no hand whatsoever in the presentation or drafting.

Nature of Assistance and Advice

The Audit Client and its management must be responsible for the financial statements and the maintenance of accounting records, and the Statutory Auditor's safeguards must at least ensure that in any assistance he gives towards preparing these, the accounting entries and any underlying assumptions (e.g. for valuation purposes) are originated by the client, and that he is not involved in the decision-making of the Audit Client or its management in respect of the entries or assumptions.

The Statutory Auditor's assistance should therefore be limited to carrying out technical or mechanical tasks and to providing advisory information on alternative standards and methodologies which the Audit Client might wish to apply.

Examples of assistance which impair independence include the following:

- determining or changing journal entries, or the classifications for accounts or transactions, or other accounting records without obtaining the client's approval;
- authorising or approving transactions; or
- preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

Examples of assistance which would not necessarily impair independence could include:

- performing mechanical tasks of bookkeeping, such as recording transactions for which the Audit Client's management has determined the appropriate account classification; posting coded transactions to a client's general ledger; posting client-approved entries to a client's trial balance; or providing certain data-processing services;
- informing the client about applicable accounting standards or valuation methodologies for the client to decide which should be adopted.

Level of Public Interest

Listed companies, credit institutions, insurance companies, investment firms, UCITS (Undertakings for Collective Investments in Transferable Securities) and pension funds are regarded, among others, as entities with such a high level of public interest that the perception of the Statutory Auditor's independence is considered to cause a self-review threat too high to be mitigated by safeguards other than the prohibition of any assistance in the preparation of accounting records and financial statements which goes beyond the statutory audit mandate (i.e., which exceeds the suggestion and drafting of amendments during the due course of the Statutory Audit, after having detected shortcomings in the Audit Client's proposed disclosures).

However, whenever the Statutory Auditor is asked to participate in the preparation of an Audit Client's accounting records or financial statements, he should carefully consider whether, taking into account the Audit Client's business environment, the public interest reaches a level where this would create public perception of a significant self-review threat if he accepted the engagement. This may depend on the size and structure of the Audit Client as well as on the local, regional or national environment in which this client operates.

Emergency Situations

In an emergency case, where, for example, due to external and unforeseeable events, the Statutory Auditor would be the only one who has the necessary knowledge of the Audit Client's systems and procedures, and can provide sufficient resources to assist the client in a timely preparation of accounts and financial statements, and where the Statutory Auditor's refusal to provide these services would result in a severe burden for the Audit Client (e.g., withdrawal of credit lines), or would even threaten its going concern status, a Statutory Auditor may participate in the preparation process to an extent which would not be acceptable under normal circumstances (see (2) and (3)). In such an emergency situation, however, the Statutory Auditor should take no part in any final decisions, seek client's approvals wherever possible, and consider any additional safeguard which would allow him to minimise the level of his independence risk. Where appropriate, he should also ensure that the services he provided and the reasons for this are disclosed in the financial statements.

7.2.2 Design and Implementation of Financial Information Systems

- (1) The provision of services by the Statutory Auditor, the Audit Firm or an entity within its Network to an Audit Client that involve the design and implementation of financial information technology systems used to generate information forming part of the Audit Client's financial statements may give rise to a self-review threat.**
- (2) The significance of the self-review threat is considered too high to allow the provision of such services a Statutory Auditor, an Audit Firm or one of its group member firms to provide such services unless**
 - (a) any design services provided involve the design of information technology systems to specifications made by the Audit Client's management; and**
 - (b) the services do not constitute a turn key project consisting of software design, hardware configuration and the implementation of both; and**
 - (c) the Audit Client or its management takes responsibility for**
 - (i) the design and implementation process, including any decision thereon; and**
 - (ii) the operation of the system, including the data used or generated by the system.**
- (3) In cases not prohibited under (2) the Statutory Auditor should consider whether additional safeguards are needed to mitigate a remaining self-review threat, in particular where services which involve the design and implementation of financial information technology systems should only be provided by an expert team with different personnel (including engagement partner) and different reporting lines to those of the audit Engagement Team.**

Financial Information

Statutory audit work includes the testing of those hardware and software systems which are used by the Audit Client to generate the financial information which is to be disclosed in its financial statements. Where a Statutory Auditor (including his Audit Firm, Network member firms, or any employees thereof) is involved in the design and implementation of such a financial information technology (FIT) system, a self-review threat may arise. In this respect, financial information does not only include those figures which are directly disclosed in the financial statements, but also comprises any other valuation or physical data to which the financial statements' disclosures relate. Such information is generated by either integrated IT-systems or a variety of stand-alone systems (e.g., systems for bookkeeping, cost-accounting, payroll, or cash management as well as those systems which may only provide physical numbers, such as some warehousing and production control systems, etc.).

Spectrum of Involvement

There is a spectrum of involvement by the Statutory Auditor in the design and implementation of FIT-systems:

At one end of the spectrum, there are engagements where the Statutory Auditor takes on a management role or responsibilities for the FIT-systems design and implementation project as a whole, or for the operation of the FIT-system and the data it uses or generates. Such an engagement would clearly result in an unacceptable level of independence risk.

In other cases, the Statutory Auditor must carefully assess the independence risk which his involvement in client's systems design and implementation might cause, and whether or not there are appropriate safeguards to reduce it to an acceptable level, for example, where the Statutory Auditor's role is to contribute advice to a consortium retained by the client to carry out the design and implementation project, or to tailor a standard (off-the-shelf) accounting system to meet the needs of the client's particular business. When assessing the independence risk in these kind of situations, the Statutory Auditor should also consider the level of public interest and the Audit Client's IT-resources. Since a public interest client or a large company is often expected to maintain sufficient in-house IT-resources to carry out certain tasks, the provision by the Statutory Auditor of IT-services other than advisory ones might result in an unacceptable independence threat. On the other hand, particularly in the case of smaller companies, the Statutory Auditor's understanding of his client's business may make him the person uniquely qualified to provide such services, without impairing his independence.

At the other end of the spectrum, the Statutory Auditor might be engaged to provide his Audit Client with a review of alternative systems based on which the client himself decides which to install. The provision of such a service would generally not impair the Statutory Auditor's independence, provided that cost and benefits of the systems reviewed are properly documented and discussed with the Audit Client, and that the Statutory Auditor neither has a significant financial interest (see B.1) nor a significant business relationship (see B.2) with any of the systems' suppliers.

7.2.3 Valuation Services

- (1) **A self-review threat exists whenever a Statutory Auditor, an Audit Firm, an entity within a Network or a Partner, manager or employee thereof provides the Audit Client with valuation services that result in the preparation of a valuation that is to be incorporated into the client's financial statements.**
- (2) **The significance of the self-review threat is considered too high to allow the provision of valuation services which lead to the valuation of amounts which are material in relation to the financial statements and where the valuation involves a significant degree of subjectivity inherent in the item concerned.**
- (3) **In cases not prohibited under (2) the Statutory Auditor should consider whether additional safeguards are needed to mitigate a remaining self-review threat, in particular where a valuation service should only be provided by an expert team with different personnel (including engagement partner) and different reporting lines to those of the audit Engagement Team.**

Valuation Services

A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or a range of values, for an asset, a liability or for a business as a whole. The underlying assumptions of such a valuation may relate to interpretations of the present or expectations of the future, including both general developments and the consequences of certain actions taken or planned by the Audit Client or anybody within its close business environment.

Engagements to review or to issue an opinion on the valuation work performed by others (e.g. engagements under Articles 10 and 27 of the 2nd Company Law Directive [77/91/EEC], Articles 10 and 23 of the 3rd Company Law Directive [78/855/EEC], or under Article 8 of the 6th Company Law Directive [82/891/EEC]), or to collect and verify data to be used in a valuation performed by others (e.g., typical "due diligence" work in connection with the sale or purchase of a business), are not regarded as valuation services under this principle.

Materiality and Subjectivity

Valuation services leading to the valuation of amounts which neither separately nor in aggregate are material in relation to the financial statements are not considered to create a significant threat to independence.

The underlying assumptions of a valuation and the methodologies to be applied are always the responsibility of the Audit Client or its management. Therefore, as part of its decision-making process, the Audit Client or its management has generally to determine the underlying assumptions of the valuation, and to decide on the methodology to be applied for the computation of the value. This is of particular importance when the valuation to be performed requires a significant degree of subjectivity, either in relation to the underlying assumptions or regarding the differences in applicable methodologies.

However, with regard to certain routine valuations (e.g., depreciation of assets, calculation of pension schemes, certain valuation for tax purposes), the degree of subjectivity inherent in the item concerned may be insignificant: for example,

when the underlying assumptions are determined by law (e.g., tax rates, depreciation rates for tax purposes), other regulations (e.g., provision to use certain interest rates), or are widely accepted within the Audit Client's business sector, and when the techniques and methodologies to be used are based on general accepted standards, or even prescribed by laws and regulations. In such circumstances, the result of a valuation performed by an informed third party, even if not identical, is unlikely to be materially different. The provision of such valuation services might therefore not impair statutory auditor's independence, even if the value itself could be regarded as material to the financial statements, provided that the Audit Client or its management has at least approved all significant matters of judgement.

Additional Safeguards

When valuation services are provided where the degree of subjectivity is insignificant, such as the application of standard techniques or methodologies or where the service is a review of the valuation methods used by a third party, but where the resulting valuation is material in relation to the financial statements, the Statutory Auditor should consider whether there remains a self-review threat which should be mitigated by additional safeguards. It may be appropriate to address such a threat by setting up a valuation service team separate from the Engagement Team, with different reporting lines for both.

7.2.4 Participation in the Audit Client's Internal Audit

- (1) Self-review threats may arise in certain circumstances where a Statutory Auditor, an Audit Firm or an entity within a Network provides internal audit services to an Audit Client.**
- (2) To mitigate self-review threats when involved in an Audit Client's internal audit task, the Statutory Auditor should**
 - (a) satisfy himself that the Audit Client's management or Governance Body is at all times responsible for**
 - (i) the internal audit function (i.e., the establishment and maintenance of internal controls, including the day to day controls and processes in relation to the authorisation, execution and recording of accounting transactions);**
 - (ii) determining the scope, risk and frequency of the internal audit procedures to be performed; and**
 - (iii) considering and acting on the findings and recommendations provided by internal audit or during the course of a Statutory Audit.**

If the Statutory Auditor is not satisfied that this is the case, neither he, nor the Audit Firm nor any entity within its Network should participate in the Audit Client's internal audit.

- (b) not accept the outcomes of internal auditing processes for statutory audit purposes without adequate review, including a reassessment of the relevant statutory audit work by an Audit Partner who is involved neither in the Statutory Audit nor in the internal audit engagement.**

Internal Audit is an important element of an entity's internal control system. In companies, particularly small and medium sized ones, which cannot afford an internal audit department or where such a department lacks certain facilities (e.g. access to specialists in information technology or treasury management), participation by the Statutory Auditor in the internal audit may strengthen management control capacities.

However, self-review threats can arise if, for example, there is not a clear separation between the management and control of the internal audit and the internal audit activities themselves, or if the Statutory Auditor's evaluation of his Audit Client's internal control system determines the kind and volume of his subsequent statutory audit procedures. To avoid such threats, the Statutory Auditor, the Audit Firm or its Network member must be able to show that it is not involved in management and control of the internal audit, and that it has not relied on the results from the internal audit in which it has participated in its statutory audit work. To ensure that, in this respect, his statutory audit work is adequate in all circumstances, the Statutory Auditor should have it reassessed by an Audit Partner who is not involved in any of the statutory audit or internal audit engagements concerned.

In companies where the internal audit department reports to a Governance Body rather than to management itself, the internal audit function performs a role that is complementary to the statutory audit function and can therefore be seen as a separate element of the corporate governance framework. If the Statutory Auditor is asked to perform internal audit work in these circumstances, he must still be able to demonstrate that he has adequately assessed any threats to his independence, and has applied any necessary safeguards.

7.2.5 Acting for the Audit Client in the Resolution of Litigation

- (1) An advocacy threat exists whenever a Statutory Auditor, an Audit Firm, an entity within a Network or a Partner, manager or employee thereof acts for the Audit Client in the resolution of a dispute or litigation. A self-review threat may also arise where such a service includes the estimation of the Audit Client's**

chances in the resolution of litigation, and thereby affects the amounts to be reflected in the financial statements.

- (2) **The significance of both the advocacy and the self-review threat is considered too high to allow a Statutory Auditor, an Audit Firm, an entity within a Network or a partner, manager or employee thereof to act for an Audit Client in the resolution of litigation which involves matters that, in the aggregate, would reasonably be expected to have a material impact on the client's financial statements and a significant degree of subjectivity inherent to the case concerned.**
- (3) **In cases not prohibited under (2) the Statutory Auditor should consider whether additional safeguards are needed to mitigate a remaining advocacy threat. This could include using personnel (including engagement Partner) who are not connected with the audit Engagement Team and who have different reporting lines.**

In certain circumstances the Statutory Auditor, the Audit Firm, an entity within a Network or a Partner, manager or employee thereof assists the Audit Client in the resolution of a dispute or litigation. The representation of an Audit Client before the court or the tax administration for tax litigation is a typical example of such Statutory Auditor's assistance which is generally not seen to impair independence.

Advocacy and Self-review Threats

A Statutory Auditor acting for the Audit Client in resolution of a dispute or litigation is generally perceived to take on an advocacy role which is incompatible with the responsibility of a Statutory Auditor to give an objective opinion on the financial statements. This advocacy threat is accompanied by a self-review threat when the assistance in the resolution of litigation also requires the Statutory Auditor to estimate chances of his Audit Client succeeding in the action if this could affect amounts to be reflected in the financial statements. A Statutory Auditor who is involved in the resolution of litigation has therefore to consider the significance of both the advocacy threat and the self-review threat.

Materiality and Subjectivity

Legal services relating to actions for the Audit Client in a resolution of a dispute or litigation which involves matters that, either separately or in aggregate, would not be expected by a reasonable and informed third party to have any material impact on the financial statements are not considered to create a significant threat to independence.

In terms of the inherent subjectivity which arises when acting as an advocate of the Audit Client, the Statutory Auditor has to take into account that, while performing the audit, he usually has the choice either to evaluate the outcome of a legal proceeding himself, or to rely on a confirmation provided by an external lawyer engaged by the client. The degree of subjectivity in both cases relates to factors such as the competence of the lawyer, his compliance with ethical rules of the lawyers' profession, and the given evidence, rather than to whether or not the lawyer is an employee of the Audit Firm or of a third party law firm. With respect to legal situations where the outcome of legal proceedings can be reasonably estimated on given evidence, the estimation of amounts affected by litigation should not lead to material differences between services provided by the Audit Firm or a third party law firm (e.g. litigation regarding employment contracts with staff, or certain tax proceedings).

On the other hand, there might be situations which bear inherent subjectivity or which, due to the nature of the business relationship between the Statutory Auditor and the Audit Client, do not even allow the evaluation of evidence in an objective manner (e.g. personal involvement of former or present management, non-executive directors, or shareholders). In such cases, the Statutory Auditor should ensure that he is not involved in the Audit Client's actions in the resolution of litigation, except in minor cases where the matter concerned would not reasonably be expected to have a material impact on the financial statements.

Additional Safeguards

In circumstances not covered under (2), the Statutory Auditor should consider whether there remain threats to independence which have to be mitigated by additional safeguards. It might be appropriate to avoid the audit Engagement Team being involved in the litigation process by setting up different engagement teams with different reporting lines for the Statutory Audit and the legal services related to the litigation.

7.2.6 Recruiting Senior Management

- (1) **Where a Statutory Auditor, an Audit Firm, an entity within a Network or a Partner, manager or employee thereof is involved in the recruitment of senior or key staff for the Audit Client, different kind of threats to independence may arise, such as self-interest, trust or intimidation.**
- (2) **The Statutory Auditor should assess the current and future threats to his independence which may arise from any engagement to assist in the recruitment of senior or key staff before accepting the assignment, and consider appropriate safeguards to mitigate such threats.**

- (3) **When recruiting key financial and administrative staff, the significance of the threats to his independence increases, so the Statutory Auditor should consider whether there might be circumstances where even the provision of a list of potential candidates may cause an unacceptable level of independence risk.**
- (4) **In any case, the decision as to who should be engaged should always be taken by the Audit Client.**

A Statutory Auditor who is asked to assist an Audit Client to recruit senior or key staff should first assess the threats to his independence which might arise from, for example, the role of the person to be recruited and the nature of the assistance sought. The need for careful assessment is highest where the person recruited is likely to have a significant role in the client's financial management processes and hence to have regular contact with the Statutory Auditor, but threats such as self-interest and familiarity may arise from other appointments too.

With regard to the nature of the assistance sought, examples of acceptable services might include to review the professional qualifications of a number of applicants and give an objective opinion on their suitability for a post, or to provide a short-list of candidates for interview, provided that it has been drawn up using criteria specified by the client, rather than on the Statutory Auditor's own judgement. In either case, care would be needed to ensure that any opinion given about the candidates did not pre-empt the Audit Client's decision. If the Statutory Auditor concludes that he could not give the assistance requested without directly or indirectly participating in the Audit Client's decision as to who should be appointed, he should decline to provide it.

8. AUDIT AND NON-AUDIT FEES

8.1 Contingent Fees

- (1) **Fee arrangements for audit engagements in which the amount of the remuneration is contingent upon the results of the service provided raise self-interest and advocacy threats which are considered to bear an unacceptable level of independence risk. It is therefore required that**
- (a) **audit engagements should never be accepted on a contingent fee basis; and**
 - (b) **in order to avoid any appearance of contingency, that the basis for the calculation of audit fees must be agreed each year in advance, including scope for variation so as to take account of unexpected factors in the work.**
- (2) **Threats to independence may also arise from contingent fee arrangements for non-audit services which the Statutory Auditor, the Audit Firm or an entity within its Network provides to an Audit Client or to one of its Affiliates. The Statutory Auditor's safeguarding system (see A. 4.3.2) should therefore ensure that**
- (a) **such an arrangement is never concluded without first assessing the independence risk it might create and ensuring that appropriate safeguards are available to reduce this risk to an acceptable level; and**
 - (b) **unless the Statutory Auditor is satisfied that there are appropriate safeguards in place to overcome the independence threats, either the non-audit engagement must be refused or the Statutory Auditor must resign from the Statutory Audit to allow the acceptance of the non-audit work.**

Audit Fee Arrangements

Statutory audit work performed in the public interest is inherently unsuitable for fee arrangements where the Statutory Auditor's remuneration depends on either any performance figure of the Audit Client or the outcome of the audit itself. Audit fees that are fixed by any court or governmental body do not constitute contingent fees.

Non-audit Fee Arrangements

Fee arrangements in respect of non-audit engagements between the Statutory Auditor, the Audit Firm or an entity within its Network, and the Audit Client or any of its Affiliates in which the remuneration of the former similarly depends on a contingent event also present self-interest, self-review and advocacy threats to the Statutory Auditor's independence. By dependency on a contingent event is meant, for example, that the fee depends in some way on the progress or outcome of the project or the attainment of a particular performance figure by the Audit Client (or its Affiliate).

In assessing the extent to which contingent fee arrangements pose a threat to statutory auditor independence, and the availability of suitable safeguards, the Statutory Auditor should consider amongst other factors: the relationship between the activity, for which the contingent fee is to be paid, and the conduct of any current or future audit; the range of possible fee amounts; and the basis on which the fee is to be calculated.

In performing this assessment, the Statutory Auditor should consider, inter alia, whether the amount of the contingent fee is directly determined by reference to an asset or transaction value (e.g., percentage of acquisition price) or a financial condition (e.g., growth in market capitalisation) the measurement of which will be subsequently exposed to an audit examination and whether this increases the self-interest threat to unacceptable levels. On the other hand,

independence threats will generally not arise in situations where there is no direct link between the basis of the contingent fee (e.g., the starting salary of a new employee when a recruitment service is provided) and a significant aspect of the audit engagement.

8.2 Relationship Between Total Fees and Total Revenue

- (1) **The rendering of any (audit and non-audit) services of a Statutory Auditor, an Audit Firm or a Network to one Audit Client or its Affiliates should not be allowed to create a financial dependency on that Audit Client or client group, neither in fact nor in appearance.**
- (2) **A financial dependency is considered to exist when the total (audit and non-audit) fees which a Statutory Auditor, an Audit Firm, or a Network receives from one Audit Client and its Affiliates make up an unduly high percentage of the total revenues in each of the last 5 years.**
- (3) **The Statutory Auditor should also consider whether there are certain fee relationships with one Audit Client and its Affiliates which may appear to create a financial dependency in respect of a person who is in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2).**
- (4) **In any case, the Statutory Auditor, the Audit Firm or the Network should be able to demonstrate that no financial dependency exists in relation to a particular Audit Client or its Affiliates.**

Excessive dependence on audit and non-audit fees from one Audit Client or one client group clearly gives rise to a self-interest threat to the Statutory Auditor's independence. The Statutory Auditor or the Audit Firm has not only to avoid the existence of such a financial dependency, but also to consider carefully where there might be an appearance of such dependency which would create a significant threat to independence.

Appearance of Financial Dependency

From a public perspective, the Statutory Auditor, the Audit Firm or a Network might be perceived to be financially dependent on a single Audit Client or client group when the total sum it receives from that client or client group as audit and non-audit fees exceeds a critical percentage of its total income. Public perception of the critical point at which the percentage of total fees from one client or client group creates a significant self-interest threat depends upon different factors within the audit environment. For example, the level might be different depending on the size of the firm, whether it is well established or newly created, whether it operates locally, nationally or internationally, and on the general business situation in markets in which it is operating.

These circumstances have to be carefully considered by the Statutory Auditor when he assesses the significance of the self-interest threat to his appearance of independence. If an analysis of all fees received for audit and non-audit services from a particular client or client group compared to the firm's or Network's total income indicates a level of dependency and a need for safeguards, an Audit Partner who has not been engaged in any of the audit or non-audit work for the client should carry out a review of all of the work done for the client and advise as necessary. Where doubts remain, or where, because of the size of the firm, no such partner is available, the Statutory Auditor should seek advice of his professional regulatory body or a review by another statutory auditor.

Certain Other Fee Relationships

The Statutory Auditor should also consider whether there are or appear to be fee relationships other than the direct ones between a single Audit Client or client group and himself or the Audit Firm (as a legal entity) which may cause a self-interest threat. For example, an Audit Partner within an office or branch might be perceived to be dependent on fees from a certain Audit Client, if most of that office's services were provided to that Audit Client, or if the same individual was responsible for the acquisition of both audit and non-audit engagements with the Audit Client. To mitigate such self-interest threats, an Audit Firm may reconsider its organisational structures and the responsibilities of certain individuals, or, where applicable, discuss the way services are provided and charged with the Audit Client's Governance Body.

Independence may particularly be compromised when significant fees are generated from an Audit Client or its Affiliates for non-audit services. The Statutory Auditor should therefore assess this risk to his independence in terms of the nature of the non-audit services provided, the different fees generated from the statutory audit engagement and the non-audit engagements, and their respective relationship to the total fees received by the Audit Firm or Network. If the analysis indicates the need for safeguards, particularly when the non-audit fees exceed the audit fees, an Audit Partner who is not involved in any of the audit and non-audit engagements should carry out a review of the work done for the client under both or otherwise advise as necessary.

8.3 Overdue Fees

A Statutory Auditor should not accept reappointment or should resign from the current audit engagement if fees for audit or other work become overdue and the sum outstanding, or that sum together with fees for current assignments could be regarded as a significant loan (see also B. 2). The situation should be reviewed by a Partner not involved in the provision of any services to the client or, where such a review could not be performed, subjected to either external review by another statutory auditor or advice by a professional regulatory body.

Unpaid fees for audit or other work could appear to be in effect a loan from the Statutory Auditor to the Audit Client, and thus to create a mutual financial interest which could be a threat to the Statutory Auditor's independence. In such circumstances, a Statutory Auditor must assess the level of the threat and take any action that may be necessary such as, for example, disclosing the extent of the potential mutual interest to all relevant third parties.

Where the Statutory Auditor is an Audit Firm, the circumstances may be reviewed by another Audit Partner who has not been involved in the provision of any services to the Audit Client. In the case of a sole practitioner, or a small partnership where all Audit Partners have been involved with the Audit Client, the Statutory Auditor should either seek advice from his professional regulatory body or ask for a review by another statutory auditor.

8.4 Public Disclosure

- (1) **Where an Audit Client's audited financial statements have to be published in accordance with national law, Member States or their regulatory bodies should provide for the (audit and non-audit) fees which a Statutory Auditor or, if not being the Statutory Auditor, his Audit Firm has received from the Audit Client for the services provided to him during the reporting period, to be publicly and appropriately disclosed.**
- (2) **The total fee income should be broken down by statutory audit and non-audit services, and categories of non-audit services should be further broken down in so far as items in them differ substantially from one another. In respect of each category item, the figure relating to the corresponding category item for the preceding reporting period should be shown as well.**
- (3) **Where a Statutory Audit of consolidated accounts is concerned, the fees received by the Statutory Auditor and his Network members for the services they provided to the Audit Client and its consolidated entities should be disclosed accordingly.**

A Statutory Auditor should be able to demonstrate that his independence has not been compromised by providing non-audit services to an Audit Client for which the remuneration he received has been disproportionate to the fees he was paid for the Statutory Audit. Since this should also be in the interest of the relevant Audit Client in order to add credibility to its published financial information, public disclosure requirements imposed by Member States through national law or their relevant regulatory bodies will ensure that a reasonable and informed third party is able to take a view on the extent of any imbalance between statutory audit and other fees. To assist such assessment, non-audit fees should be broken down into broad categories (e.g., assurance, tax advisory and other non-audit services) reflecting the different kinds of services which may have been provided. It may also be appropriate to identify particular engagements which make up a significant proportion of a particular category.

8.5 Pricing

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, and that the resources allocated are at least those which would be allocated to other work of a similar nature.

A Statutory Auditor must be able to demonstrate that the fee he charges for any audit engagement is reasonable, particularly if it is significantly lower than that charged by a predecessor or quoted by other firms bidding for the engagement. He must also be able to demonstrate that a quoted fee is not dependent on the expected provision of non-audit services, and that a client has not been misled as to the basis on which future fees would be charged. The Statutory Auditor should have policies and procedures in place to be able to demonstrate that his fees meet these requirements.

9. LITIGATION

- (1) **Both a self-interest and an advocacy threat may arise where litigation takes place, or appears likely to take place, between the Statutory Auditor, the Audit Firm or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2) and an Audit Client or its Affiliates. All of the audit and non-audit services provided to the client have to be considered in order to assess these threats.**
- (2) **These threats may become significant in relation to the independence risk where there is a serious likelihood of litigation which is material to any of the parties being involved, or which challenges a prior Statutory Audit, or where material litigation is in progress, and the Statutory Auditor should cease to act as soon as such circumstances become evident. The Statutory Auditor's actions in these circumstances may include discussions with the Audit Client's Governance Body or with his professional regulatory body, or even resignation from the statutory audit engagement.**

Whilst it is not possible to specify precisely for all cases the point at which it would become improper for a statutory auditor to continue as Statutory Auditor of an Audit Client, the following criteria should be considered:

- if an Audit Client’s management alleges deficiencies in statutory audit work for the Audit Client, and the Statutory Auditor concludes that it is probable that a claim will be filed, the level of independence risk is too high to be mitigated by safeguards other than that the Statutory Auditor should discuss all aspects of the litigation with the Governance Body of the Audit Client, or where such body does not exist, with his professional regulatory body, or should resign;
- if the Statutory Auditor alleges fraud or deceit by current management of an Audit Client, the level of independence risk and the decision as to whether or not he should resign also depends on safeguards such as discussion of all relevant aspects with the Governance Body of the client, or, where such a body does not exist, with the Statutory Auditor’s professional regulatory body. (In some countries, however, the national law safeguards the independence of the Statutory Auditor in case of alleged fraud by requiring the Statutory Auditor to report the detected fraud to a national authority and to continue his audit work on behalf of that authority which represents the national public interest. In any case the Statutory Auditor should consider seeking legal advice, giving due consideration to his responsibility to the public interest.);
- threatened or actual litigation relating to non-audit services for an amount not material to the Statutory Auditor or to the Audit Client (for example, claims out of disputes over billing for services, results of consultancy services) would not impair the Statutory Auditor’s independence.

10. SENIOR PERSONNEL ACTING FOR A LONG PERIOD OF TIME

- (1) **Trust or familiarity threats may arise where certain members of the Engagement Team work regularly and for a long period of time on an Audit Client engagement, particularly where public interest Audit Clients are concerned.**
- (2) **To mitigate these threats, where the audit of a public interest client is concerned, the Statutory Auditor is required at least to replace the Audit Partners (including the Engagement Partner) within a reasonable period of time (5 to 7 years). The replaced Audit Partners should not be allowed to return to the Audit Client engagement until a two-year period of time has elapsed after the date of their replacement.**
- (3) **Where Audit Clients other than those of public interest are concerned, the Statutory Auditor should consider whether, besides internal rotation, there might be other safeguards which would reduce the threats to independence to an acceptable level.**

To mitigate a familiarity or trust threat to the independence of a Statutory Auditor who is engaged to audit an Audit Client of public interest, the requirement to replace the Engagement Partner and/or Audit Partners within a reasonable period of time cannot be replaced by other safeguards. In addition, the Statutory Auditor or Audit Firm should ensure that the replacement requirement is not circumvented by situations like, for example, that of an Audit Team member who worked on the audit engagement for six years as senior accountant before being promoted to Audit Partner of that engagement for one year. In this case, the team member should be replaced as having served seven years on the audit in total.

With regard to Audit Clients which are of relatively little public interest, the Statutory Auditor should assess the impact of trust or familiarity threats on his independence, having regard to the perceptions of his Audit Client’s stakeholders. Where such perceptions are that the level of independence risk is significantly high, the Statutory Auditor should also consider an internal rotation, or, if this would not be a possible or viable safeguard due to the size of the Audit Firm (e.g., the Audit Firm is a sole practitioner’s practice, or, the day to day relationship between a limited number of Audit Partners is too close for internal rotation to constitute an appropriate safeguard), he should ensure that other safeguards are put in place within a reasonable period of time, such as coverage of the relevant audit engagement by an external quality review which was performed in accordance with the Commission Recommendation on “Quality Assurance for the Statutory Audit in the EU”, a secondary review by another statutory auditor, or, at least, seeking advice by his professional regulatory body.

Glossary

Affiliate	an undertaking within the meaning of Article 41 (1),(2) and (3) of the 7 th Company Law Directive (83/349/EEC) which, in general and regardless of its legal form, is any entity connected to another by means of common ownership, control or management.
Audit Client	the company or firm whose annual accounts are subject to Statutory Audit, or the parent undertaking in the meaning of Article 1 of the 7 th Company Law Directive (83/349/EEC) whose consolidated accounts are subject to Statutory Audit.
Audit Firm	the organisational – generally legal – entity that performs a Statutory Audit (e.g., a sole practitioner’s practice, a partnership or a company of professional accountants). The Audit Firm and the Statutory Auditor who is appointed for the Statutory Audit might be identical legal persons, but need not be (e.g., where an individual who is a member of a partnership practice is appointed as the Statutory Auditor, the partnership as such forms the Audit Firm).

Audit Partner	an audit professional within an Audit Firm or Network who himself is an approved person in the meaning of Article 2 (1) of the 8 th Company Law Directive (= statutory auditor) and, as an individual, takes on ultimate responsibilities for the audit work performed during a Statutory Audit; he, generally, is authorised to sign audit reports on behalf of the Audit Firm which is the Statutory Auditor. He may also be a shareholder/owner or principal of the Audit Firm.
Audit Team	all audit professionals who, regardless of their legal relationship with the Statutory Auditor or Audit Firm, are assigned to a particular Statutory Audit engagement in order to perform the audit task, such as Audit Partner(s), audit manager(s) and audit staff.
Chain of Command	Comprises all those persons on office, country, regional or global levels, who have a supervisory, management, compensation or other oversight responsibility over either any Audit Partner of the Audit Team or over the conduct of the Statutory Audit. This includes all Partners, principals and shareholders who may prepare, review or directly influence the performance appraisal of any Audit Partner of the Audit Team or otherwise determine their compensation as a result of their involvement with the audit engagement.
Engagement Partner	the Audit Partner who has ultimate responsibilities for the of the Statutory Audit of a particular Audit Client, who co-ordinates the work of the Audit Team and that of professional personnel from other disciplines involved ensures that this work is subject to quality control, and, if applicable, co-ordinates all statutory audit activities of a Network which relate to a Statutory Audit, particularly on consolidated accounts where different Audit Partners have different responsibilities for the audits of the entities to be consolidated.
Engagement Team	All persons who, regardless of their legal relationship with the Statutory Auditor or Audit Firm, are directly involved in the acceptance and performance of a particular Statutory Audit. This includes the Audit Team, employed or subcontracted professional personnel from other disciplines involved in the audit engagement (e.g., lawyers, actuaries, taxation specialists, IT-specialists, treasury management specialists), and those who provide quality control or direct oversight of the audit engagement.
Governance Body	A body or a group of persons which is embedded in the Audit Client's corporate governance structure to exercise oversight over management as a fiduciary for investors and, if required by national law, for other stakeholders such as employees, and which consists of or, at least, includes individuals other than management, such as a supervisory board, an audit committee, or a group of non-executive directors or external board members.
Network	Includes the Audit Firm which performs the Statutory Audit, together with its Affiliates and any other entity controlled by the Audit Firm or under common control, ownership or management or otherwise affiliated or associated with the Audit Firm through the use of a common name or through the sharing of significant common professional resources.
"Office"	<p>The term "Office" means a distinct sub-group of an Audit Firm or Network, whether distinguished along geographical or practice lines, which participates in a significant portion of the audit engagement.</p> <p>A main criteria for identifying this sub-group should be the close working relationship between its members (e.g. working on the same kind of subjects or clients). In particular, it should be taken into account, that, due to technical developments and the increasing multinational activities of Audit Clients, such working relationships are more and more evolving by means of a "virtual" office, and that physical co-location is not necessarily an essential factor in this definition.</p> <p>In the case of smaller partnerships, the "Office" may encompass the whole firm, in which case all of the Partners and employees will be subject to the relevant requirements.</p>
Partner	a professional within an Audit Firm or Network who, as an individual, takes on ultimate responsibilities for the work performed during an (audit or non-audit) engagement; he, generally, is authorised to sign on behalf of the Audit Firm, and may also be a shareholder/owner or principal of the Audit Firm.
Statutory Audit	<p>the audit service which is provided by an approved person in the meaning of Article 2 (1) of the 8 th Company Law Directive (= statutory auditor) when</p> <p>(a) carrying out an audit of the annual accounts of a company or firm and verifying that the annual report is consistent with those annual accounts in so far as such an audit and such a verification is required by Community law; or</p> <p>(b) carrying out an audit of the consolidated accounts of a body of undertakings and verifying</p>

	<p>that the consolidated annual report is consistent with those consolidated accounts in so far as such an audit and such a verification is required by Community law.</p> <p>For the purpose of this Recommendation, the term “statutory audit” would also include an attest service which, dependent on national law, is provided by a statutory auditor when companies are required to have financial reporting information other than the above (e.g. companies’ interim financial accounts and reports) reviewed by a Statutory Auditor who has to give an opinion on this information.</p>
Statutory Auditor	<p>the approved person in the meaning of Article 2 (1) of the 8 th Company Law Directive (= statutory auditor) who, either being a natural or a legal person, is appointed for a certain Statutory Audit engagement by means of national law and – as a consequence – in whose name the audit report is signed.</p>