



Guidance for audit committees

Reviewing auditor independence



November 2003



The Combined Code on Corporate Governance – July 2003

C.3 Audit Committee and Auditors

Main Principle: The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm;

and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

Introduction

This publication is part of a series which has been prepared by the Institute of Chartered Accountants in England and Wales to assist non-executive directors on audit committees to gain an understanding of the provisions of the Combined Code on Corporate Governance – July 2003 (The Combined Code) relating to Audit Committees and Auditors and the guidance set out in Guidance on Audit Committees (The Smith Guidance). The Guidance is based on the proposals set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

Reviewing auditor independence

One of the requirements of the revised Combined Code and its related guidance is that audit committees should take on a more active role in overseeing the external audit. An important part of this oversight relates to the independence of the auditor.

The directors having appointed an independent auditor, the prime responsibility for maintaining independence and objectivity rests with the auditor. However, members of the audit committee will need to familiarise themselves with key elements of the applicable guidance.

This publication takes the form of:

- a summary of the key requirements for audit committees in respect of auditor independence that the Smith Guidance sets out;
- an outline of the approach taken by auditors to achieving independence; and
- appendices giving more information on the approach and setting out some of the general considerations for key areas referred to in the Smith Guidance:
 1. Analysis of threats to independence and available safeguards to be adopted
 2. Advantages of a threats and safeguards approach
 3. Non-audit services by auditors to their clients
 4. Rotation of audit partners
 5. Fee dependence by the auditor on the client
 6. Employment by the client of former audit partners and staff.

This publication is written with audit engagements in mind. Similar independence considerations apply to the provision of other forms of assurance service, though some of the specific requirements referred to in the appendices only apply to providers of audit services.

Each company is unique and audit committees will need to apply the provisions of the Combined Code and the Smith Guidance in a manner that is appropriate to them. This publication does not provide guidance on how to deal with individual situations and reference may need to be made to the various pronouncements mentioned in the text for detailed information.

Summary of key requirements for audit committees in respect of auditor independence

The Smith Guidance requires audit committees to include in their role having ‘procedures to ensure the independence and objectivity of the external auditor annually, taking into consideration relevant UK professional and regulatory requirements’ (para 4.21).

The Combined Code and the Smith Guidance specify the matters to be taken into account in carrying this out. These include (references being to the Smith Guidance except where stated):

- Seeking ‘from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements’ (para 4.22).
These matters are considered in outline below and in more detail in Appendix 1.
- Seeking ‘reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the company (other than in the normal course of business)’ (para 4.22).
- Developing and implementing ‘policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm’ (Combined Code para C.3.2).
The ethical issues in respect of this are complex and are addressed in Appendix 3.
- Discussing with the auditors matters relating to: the provision of non-audit services, including establishing a policy in that respect; the rotation of audit partners; dependence by the auditor on fee income from the client, and employment by the client of former audit partners and staff. The issues in respect of these items are addressed in Appendices 4 to 6.

In considering auditor independence, the audit committee should first question the procedures in place in the audit firm to ensure that they meet best practice and also require some written assurance as to this. In addition it is critical to ask specific questions relevant to the particular auditor and audit assignment.

The approach adopted by the auditor in respect of independence allows outcomes based on the individual circumstances. It is therefore unlikely that audit committees will be able to discharge their responsibilities by using a set checklist to cover all eventualities.

However, to assist audit committees in discharging their responsibilities in this area, examples of the types of questions that they might raise with their auditors are given in the appendices. In addition, audit committees may wish to consider, at least annually, the following general points relating to independence:

- *Has the audit committee developed a policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm? Is it being implemented?*
- *Has the auditor provided written confirmation⁽¹⁾ of any circumstances likely to have a bearing on independence, the safeguards that are in place and confirmation that the auditor is independent? Does this address overseas firms and other UK firms, where they are involved in the audit?*
- *Has the audit committee met and discussed with the auditors their objectivity and independence, taking into account such matters as financial interests, personal and business relationships, employment of former audit partners and staff, partner rotation, undue fee dependence and the provision of non-audit services?*
- *In respect of a particular key issue or service, have discussions been sufficient for the audit committee to understand the main threats to independence, actual or perceived, and the related safeguards? Has this been documented sufficiently to allow the audit committee to explain in the annual report how its policy on auditor independence is effective, and to allow potential future questioning to be dealt with?*

Outline of the approach taken by auditors to achieving independence

The quality of the audit opinion is a vital element in maintaining confidence in financial reporting. A key element is that the audit opinion should be free from bias. If the auditors are to achieve this, they must be objective in reaching their opinion. This requires independence of mind from the company being audited. In addition, particularly in respect of listed and other public interest companies, they need to consider external perception of independence.

Auditors in the UK have to be registered with one of the professional accountancy bodies. As part of their registration undertakings, they agree to abide by the ethics codes of those bodies, which include a requirement to be independent and guidance on how to ensure this.

⁽¹⁾ Statement of Auditing Standard (SAS) 610 requires such a communication. For listed companies this has to be in writing.

The ethics codes in the UK, and increasingly internationally, utilise a principles-based framework approach. This approach is considered to offer a number of advantages over a 'black and white' rules-based approach (considered in Appendix 2) but it is not an easy option.

The approach places the onus on the auditor to consider the particular circumstances and assess whether safeguards can be implemented to reduce threats to independence to an acceptable level. Accordingly, oversight by the audit committee takes on added importance.

In broad outline the approach consists of three elements:

- fundamental principles – principles which must always be observed by the auditor: integrity, objectivity, competence, performance and courtesy. The key fundamental principle in the case of auditor independence is objectivity;
- identification and consideration of the threats to independence – the auditor must conscientiously consider, before taking on audit or other work, whether the work involves threats which would impede observance of the fundamental principles. Actual threats need to be considered, and so do situations that might be perceived as threats by a reasonable and informed observer even if they are not actual threats; and
- consideration of safeguards – where threats to independence exist, the auditor must put in place safeguards that eliminate them or reduce them to clearly insignificant levels. If unable to implement fully adequate safeguards, the auditor must not carry out the work.

Ethical guidance of the UK professional accountancy bodies includes examples of threats that might arise and appropriate safeguards to deal with them. However, these do not comprise a comprehensive checklist and the auditor needs to think more widely.

The onus is firmly on the auditor to demonstrate that, in the particular circumstances under consideration, the fundamental principles have been and are being observed. It is not a sufficient defence to demonstrate that suggested safeguards in the ethics code had been followed to the letter.

Appendix 1 summarises the general categories of threats to independence and discusses the nature of safeguards that can be put in place to reduce those threats to an acceptable level.

Appendix 1: Analysis of threats to auditor independence and available safeguards against those threats

The following analyses of threats and categories of safeguard are included in the ethics codes of the UK professional accountancy bodies. As a result of the government review of the regulation of the accountancy profession,⁽²⁾ responsibility for setting standards on auditor independence is to be transferred to the independent Auditing Practices Board. The structure and requirements of auditor independence guidance are unlikely to change at least in the short term, however.

The threats

The framework identifies the following general categories of threats to independence:

Self-interest threat

This occurs when the audit firm or a member of the audit team could benefit from a financial interest in, or other self-interest conflict with, an audit client. Examples of circumstances that may create this threat include, but are not limited to:

- a direct financial interest or material indirect financial interest in an audit client;
- a loan or guarantee to or from an audit client or any of its directors or officers;
- undue dependence on total fees from an audit client;
- concern about the possibility of losing the engagement;
- having a close business relationship with an audit client;
- potential employment with an audit client; and
- contingent fees relating to audit engagements.

Self-review threat

This occurs when the audit firm, or an individual audit team member, is put in a position of reviewing subject matter for which the firm or individual was previously responsible, and which is significant in the context of the audit engagement. Examples of circumstances that may create this threat include:

- a member of the audit team being, or having recently been, a director, officer or other employee of the audit client in a position to exert direct and significant influence over the subject matter of the audit engagement;
- performing services for an audit client that directly affect the subject matter of the current, or a subsequent, audit engagement; and
- preparation of original data used to generate financial statements or preparation of other records that are the subject matter of the audit engagement.

Advocacy threat

This occurs when the audit firm, or a member of the audit team, promotes, or may be perceived to promote, an audit client's position or opinion to the

⁽²⁾ Review of the Regulatory Regime of the Accountancy Profession: Report to the Secretary of State for Trade and Industry January 2003.

point where objectivity may be compromised. Examples of circumstances that may create this threat include:

- dealing in, or being a promoter of, shares or other securities in an audit client; and
- acting as an advocate on behalf of an audit client in litigation or in resolving disputes with third parties.

Familiarity threat

This occurs when, by virtue of a close relationship with an audit client, its directors, officers or employees, an audit firm or a member of the audit team becomes too sympathetic to the client's interests. Examples of circumstances that may create this threat include:

- a member of the audit team having a close family member who, as a director, officer or other employee of the audit client, is in a position to exert direct and significant influence over the subject matter of the audit engagement;
- a former partner of the firm being a director, officer or other employee of the audit client, in a position to exert direct and significant influence over the subject matter of the audit engagement;
- long association of a senior member of the audit team with the audit client; and
- acceptance of gifts or hospitality, unless the value is clearly insignificant, from the audit client, its directors, officers or employees.

Intimidation threat

This occurs when a member of the audit team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an audit client. Examples of circumstances that may create this threat include:

- threat of replacement over a disagreement with the application of an accounting principle;
- pressure to reduce inappropriately the extent of work performed in order to reduce fees; and
- dominant personality in a senior position at the audit client, controlling dealings with the auditor.

In relation to any engagement undertaken, the auditor should be in a position to articulate which of the above threats to independence apply. The threats and their magnitude will depend on the circumstances, and therefore a considered assessment will require the application of judgement. It is therefore impractical and inappropriate to suggest that any list of threats identified constitutes a complete list. The judgement of the auditor (in the first instance) and the audit committee are of critical importance.

The safeguards

Effective safeguards are key to the success of the framework approach. It is important to recognise that independence can never be absolute because the auditor is appointed and paid by the client or its shareholders. Acknowledging

this, the purpose of safeguards is to reduce the impact of threats to independence to a level that does not impair the auditor's opinion-forming process in fact, or in the perception of a reasonable and informed observer.

When threats are identified, other than those that are clearly insignificant, appropriate safeguards should be identified and applied to eliminate the threats or reduce them to an acceptable level. SAS 610 requires that this should be documented and communicated to the audit committee by the auditor. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration should always be given to what a reasonable third party having knowledge of all relevant information, including safeguards applied, would conclude to be unacceptable. The consideration will be affected by matters such as the significance of the threat, the nature of the audit engagement, the intended users of the audit report and the structure of the firm. If acceptable safeguards cannot be applied, the particular engagement should not be undertaken.

Safeguards fall into three broad categories:

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

Safeguards created by the profession, legislation or regulation

Include the following:

- educational, training and experience requirements for entry into the profession;
- continuing education requirements;
- professional standards and monitoring and disciplinary processes;
- external review of an audit firm's quality control system; and
- legislation governing the independence requirements of the audit firm.

Safeguards within the audit client

Include the following:

- when the audit client's management appoints the firm, persons other than management ratify or approve the appointment;
- the audit client has competent employees to make managerial decisions;
- policies and procedures that emphasise the audit client's commitment to fair financial reporting;
- internal procedures that ensure objective choices in commissioning non-audit engagements; and
- a corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding the audit firm's services.

Safeguards within the audit firm

These may include firm-wide safeguards such as policies and procedures to ensure:

- quality control of audit engagements;

- the identification of threats to independence through interests or relationships, reliance on revenues from one client, and the provision of non-audit services to audit clients – examples may be operation of an investment portfolio, annual confirmations of independence, maintenance of a list of restricted entities, arrangements to ensure partner remuneration is not directly linked to selling of non-audit services;
- prohibition of individuals who are not members of the engagement team from influencing the outcome of the engagement;
- designation of a member of senior management as responsible for overseeing the adequate functioning of the safeguarding system;
- arrangements to ensure physical and virtual separation of staff involved in conflicting transactions;
- operation of disciplinary mechanism to promote compliance with policies and procedures; and
- staff are able to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

Safeguards within the audit firm may also include engagement specific safeguards such as:

- involving an additional accountant to review the work done or otherwise advise as necessary.
- consulting a third party, such as a committee of independent directors, a professional body or another professional accountant;
- rotation of senior personnel;
- disclosing to the audit committee the nature of services provided and extent of fees charged and discussing with it independence issues;
- policies and procedures to ensure members of the audit team do not make, or assume responsibility for, management decisions for the audit client;
- involving another firm to perform or re-perform part of the audit engagement or to re-perform the non-audit service to the extent necessary to enable it to take responsibility for that service; and
- removing an individual from the audit team, when that individual's financial interests or relationships create a threat to independence.

Appendix 2: Advantages of a threats and safeguards approach

The framework approach, properly applied, has been accepted internationally by the European Commission and the International Federation of Accountants as having a number of advantages over other approaches:

- The aim of good guidance should be to require the auditor to identify and address risks, not merely passively to obey the letter of the code. Thus, apart from a number of prohibitions due to an insurmountable threat to independence (real or perceived), the onus is put on the auditor to identify the threats and assess whether appropriate safeguards can be adopted or whether to decline the engagement. The auditor should be able to demonstrate to the audit committee (or others charged with governance), those charged with monitoring the work of audit firms and others that they have weighed up the issues and reached a responsible conclusion.
- Principles are more effective in this regard than rules. A set of principles supported by reasoned guidance avoids the argument that any course of conduct that is not specifically prohibited is permissible, encouraging a search for ways around the rules. Ultimately, substance must prevail over form.
- Although the basic principles of auditor independence are straightforward they may need to be applied to an almost infinite number of circumstances. This is allowed for by the framework approach, which accepts that in some situations there may be appropriate alternative safeguards to those advocated.
- It is economically advantageous for clients and their shareholders to be generally allowed to choose the auditors to perform other work if they believe it is most efficient for them to do so, where adequate safeguards can be put in place. It also allows the auditors to improve their knowledge of the client; an important contributor to audit quality. Nonetheless, where adequate safeguards cannot be put in place, the guidance does include specific prohibitions.

Appendix 3: Non-audit services: examples of the identification of threats and the safeguards which can be applied

The Smith Guidance states, inter alia:

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

- whether the skills and experience of the audit firm make it a suitable supplier of the non-audit service;
- whether there are safeguards in place to ensure that there is no significant threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
- the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit' (para 4.25).

Guidance is set out below with the intention of providing audit committees with a basis for their discussions with the external auditors and management.

Guidance on applying the threats and safeguards approach is currently included in the individual professional bodies' codes using slightly different wording but to similar effect. The CGAA⁽³⁾ has outlined areas for further consideration in its final report. These are referred to where appropriate.

The provision of non-audit services will often result in the audit team obtaining information regarding the audit client's business and operations that is helpful in relation to the audit engagement. The greater the knowledge of the audit client's business, the better the audit team will understand the audit client's procedures and controls, and the business and financial risks that it faces. The provision of such services may, however, create threats to the independence of the firm, a member of the audit firm's network (network firm) or the members of the audit team, particularly with respect to perceived threats to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases, it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases, no safeguards are available to reduce the threat to an acceptable level.

In general terms, the aim of guidance in this area is to ensure that in providing a non-audit service, external auditors do not:

- audit their own work;
- make management decisions for the company;
- create a mutuality of interest; or
- find themselves in the role of advocate for the company (as summarised in the Smith Guidance, para 4.28).

⁽³⁾ Co-ordinating Group on Audit and Accounting Issues: a government group that reviewed, inter alia, auditor independence requirements.

The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the audit engagement would reduce the threats to an acceptable level:

- authorising, executing or consummating a transaction, or otherwise exercising authority on behalf of the audit client, or having the authority to do so;
- determining which recommendation of the firm should be implemented; and
- reporting, in a management role, to those charged with governance.

One or more of the following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-audit services to audit clients:

- policies and procedures to prohibit audit firm staff from making management decisions for the audit client, or assuming responsibility for such decisions;
- discussing independence issues related to the provision of non-audit services with those charged with governance, such as the audit committee;
- policies within the audit client regarding the oversight responsibility for provision of non-audit services by the firm;
- involving an additional professional accountant to advise on the potential impact of the non-audit engagement on the independence of the member of the audit team and the audit firm;
- involving an additional professional accountant outside of the audit firm to provide assurance on a discrete aspect of the audit engagement;
- obtaining an opinion from an independent professional person;
- obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm;
- disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged; or
- making arrangements so that personnel providing non-audit services do not participate in the audit engagement.

Before the audit firm accepts an engagement to provide a non-audit service to an audit client, consideration should be given to whether the provision of such a service would create a threat to independence. In situations when a threat created is other than clearly insignificant, the non-audit engagement should be declined unless appropriate safeguards can be applied to eliminate the threat to audit independence or reduce it to an acceptable level.

The following sections relate to a number of the commonly occurring non-audit services, with the objective of informing those charged with governance of some of the matters to be considered when discharging their oversight responsibilities.

Preparing accounting records and financial statements

A self-review threat exists whenever an audit firm participates in the preparation of the audit client's accounting records or financial statements and those records or statements are subsequently subject to audit by the same firm. The significance of the threat depends upon the spectrum of involvement in the preparation process and upon the level of public interest.

It is the responsibility of client management to ensure that accounting records are kept and financial statements are prepared. Assistance provided by the auditor may result in them influencing management decisions. The guidance advises the auditor that no safeguards are sufficient to mitigate the self-review threat to independence when the auditor is involved in managerial decisions. Examples of such decisions would include the following:

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

Accordingly, services involving these activities should not be undertaken for audit clients (note that taxation services are covered separately in this appendix). However, when reviewing the auditor's involvement in the accounting records and financial statements, it is important to understand that certain activities are integral to the audit and therefore not prohibited.

During the audit, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature is appropriate to promote the fair presentation of the financial statements. Similarly, the audit process may involve assisting an audit client in resolving account reconciliation problems, analysing and accumulating information for regulatory reporting, providing assistance and advice in respect of the preparation of consolidated financial statements (provided this does not involve origination of transactions), suggesting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence provided management takes the decisions.

In general, where auditors provide assistance relating to the accounting records or financial statements, provided they do not take management decisions, the threats can be reduced to an acceptable level through the application of safeguards. However, due to the perception of auditor involvement in this area, the rules make a distinction between listed and other public interest clients, and others:

Audit clients that are not listed or other public interest entities

The audit firm may provide an audit client that is not a listed or other public interest entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level.

Audit clients that are listed or other public interest entities

Because of the greater importance of the perceived threat to auditor independence with such entities, with limited exceptions an audit firm should

not provide accounts preparation services to listed or other public interest entities which are audit clients.

The guidance allows the provision of such services only where they fall within the normal statutory audit mandate, or where there is a genuine emergency situation. In addition, work of a technical, mechanical or informative nature may be undertaken for subsidiaries if the fees earned from the services are immaterial. All services are subject to the general prohibition on taking management decisions.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *Do the services fall within the normal remit of statutory audit work?*
- *(In respect of listed entities themselves) Is there a genuine emergency situation, with no-one else available to do the work, and what safeguards have been put in place?*
- *Do the services involve the exercise of judgement by the auditor?*
- *(In respect of subsidiaries of listed companies) How material are the fees earned?*
- *How will management satisfy itself as to the adequacy of the work so that it, and not the auditor takes managerial, decision making, responsibility?*

Valuations, including actuarial services

A self-review threat may be created when a firm performs a valuation for an audit client that is to be incorporated into the client's financial statements.

If the valuation service relates to items which are both material to the financial statements *and* involve a significant degree of subjectivity, the guidance identifies that the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided to the audit client.

Performing valuation services that are neither separately, nor in the aggregate, material to the financial statements, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. The safeguards may include, for example, ensuring that the audit client takes responsibility for the valuation assumptions and the output and that a separate team performs the non-audit service engagement.

The guidance also sets out examples of matters which should be considered in assessing the adequacy of the safeguards, for example – the extent of management's knowledge around the valuation assumptions; the existence of professional guidelines and the degree of subjectivity.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *Does management have sufficient knowledge of the valuation issue so that it can take the managerial responsibility?*
- *Are the amounts directly material to the accounts being audited?*
- *Is the process highly subjective: for example, to what degree are established*

methodologies and professional guidelines applied, or could future events create significant volatility in the amounts involved?

Provision of taxation services to audit clients

The firm may be asked to provide taxation services to an audit client. Such assignments are generally not seen to create threats to independence though as with other non-audit services, it is necessary to assess and react to potential threats to independence such as participating in management decisions and auditing material, subjective amounts generated by the auditor, particularly where they derive from a risky tax scheme with which the audit firm is associated.

The recent CGAA report has suggested further guidance on safeguards around tax, to clarify the position where a particular piece of advice or position taken is material to the financial statements, and where the outcome is sufficiently uncertain. Such circumstances should be reported to the audit committee and the sufficiency of the safeguards (which might, for example, include obtaining an independent legal opinion) assessed.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *Does management have sufficient knowledge of the issues to be able to take managerial responsibility?*
- *How material is the advice to the financial statements?*
- *Are the amounts highly subjective: for example, is there any precedent for the advice or is this a 'groundbreaking' idea?*
- *How adequate are the safeguards: for example, should there be a third party opinion?*

Provision of internal audit services to audit clients

A self-review threat may be created when an audit firm provides internal audit services to an audit client. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

The scope of internal audit services can be varied and therefore in evaluating any threats to independence, the nature of the service will need to be considered.

It is important that the audit firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management. If this is kept in mind, it may be possible for any self-review threat created to be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by audit client management and the internal audit activities themselves.

The guidance provides that it is only considered acceptable to provide internal audit services where specific safeguards are put in place including a requirement that the audit firm should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and

monitoring the system of internal controls. The safeguards in this area focus on the availability of supervisory resource in the audit client to manage the work and for clarity around management's responsibility for dealing with the recommendations made.

The CGAA has recommended that the guidance should include:

- a strong presumption against the outsourcing of such services. The purpose of this is to ensure that the auditor neither takes part, nor is seen to take part, in management decisions. For example, this would not, prima facie, prohibit ad hoc projects where management determined the scope and procedures of the work to be undertaken and any action consequent on the results; and
- clarification that the audit firm should not provide internal audit services where it also has to form an opinion on management's assessment of internal controls, as is the case with, for example, SEC-registered companies. The Combined Code in the UK does not require auditors to produce an opinion on management's assessment – only that they have conducted a sensible assessment process and explained the process properly.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *How does management discharge its management oversight of the assignment?*
- *Who determines the scope, risk and frequency of the work and who is responsible for evaluating and determining how the recommendations should be implemented?*
- *Does the audit firm rely on its own work for the purposes of forming the audit opinion? Is it possible for the auditor to objectively evaluate the work and, therefore, take account of the work in forming the audit opinion?*

Provision of IT systems services to audit clients

The provision of services by an audit firm to an audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.

As with internal audit, for IT systems work to be undertaken for audit clients, the guidance requires specific safeguards including ensuring that the audit client takes management responsibility for the project. In practice this means having adequate expertise to take and exercise responsibility for all management decisions, and to evaluate the adequacy of both the design and implementation.

In particular, the guidance considers the provision to the audit client of a 'turnkey' project (i.e. a project that consists both of software design, hardware configuration and the implementation of both) to generate a significant threat to independence. By contrast, the provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to independence provided that audit firm personnel do not perform management functions.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *How does management discharge its managerial role in relation to the work, and does it have sufficient expertise to make managerial decisions and take responsibility?*
- *How is the adequacy of the work assessed?*
- *Does the audit firm rely on its own work for the purposes of forming the audit opinion – how does it objectively evaluate the work?*

Temporary staff assignments to audit clients

The lending of staff by a firm, or network firm, to an audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the audit firm's personnel will not be involved in making management decisions; approving or signing agreements or other similar documents; or otherwise exercising discretionary authority to commit the client.

Each situation should be carefully analysed to identify whether any threats are created and whether appropriate safeguards should be implemented. In every case, the audit client should acknowledge its responsibility for directing and supervising the activities of the assignee and the audit firm should ensure that the individual is not given responsibility for auditing any function or activity performed or supervised by that individual during the temporary staff assignment.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *Is the individual in a position to influence the accounts being audited, directly or via management?*
- *How is the individual managed and does management have sufficient knowledge to discharge its managerial role?*

Provision of litigation support services to audit clients

Litigation support services may include such activities as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

As with valuation services, a self-review threat may be created when the litigation support services provided to an audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat will depend on the circumstances and in particular the materiality and subjectivity of the estimate.

Guidance on the safeguards includes ensuring the auditor is not taking managerial decisions, the possibility of using experts separate from the audit team and/or third-party experts.

Where there is a significant advocacy role, the threat to independence is considered to be too high to allow the firm to accept an engagement relating to an amount that would reasonably be expected to be material to the financial statements and where there is a high degree of subjectivity in the case concerned.

If the role undertaken by the firm or network firm involved making managerial decisions on behalf of the audit client, the threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm or network firm should not perform this type of service for an audit client.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *How directly material are the amounts involved to the accounts being audited?*
- *Does the service result in the audit firm acting as advocate in respect of a matter that has a high degree of subjectivity?*

Provision of legal services to audit clients

Legal services are covered in the existing guidance under the provision of litigation support (see above). However, international guidance⁽⁴⁾ includes further discussion in this area and defines legal services as any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided, or have the required legal training to practice law. This definition encompasses a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support and the provision of assistance to clients' internal legal departments. The provision of legal services by a firm, or network firm, to an entity that is an audit client may create both self-review and advocacy threats.

As always, the threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the audit team and the materiality of any matter in relation to the entity's financial statements.

The breadth of services covered under the banner of legal services includes many services that would not be expected to have a material effect on the financial statements. These are not, therefore, considered to create an unacceptable threat to independence, but still may be subject to safeguards.

It is also important to understand the distinction between advocacy and advice. Legal services to support an audit client in the execution of a transaction (e.g. contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level.

In contrast, acting for an audit client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and

⁽⁴⁾ That of the International Federation of Accountants (IFAC) revised in 2001.

self-review threats so significant that no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for an audit client. Further, the appointment of a partner or employee of the audit firm as general counsel for legal affairs to an audit client would create self-review and advocacy threats that are so significant that no safeguards could reduce the threats to an acceptable level.

Where an advocacy role involves amounts which are not material to the financial statements, a safeguards approach may be considered.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *How directly material are the amounts involved to the accounts being audited and how subjective is the matter?*
- *Does the audit firm act as advocate?*
- *How does the audit firm achieve an objective view of the matter?*

Recruiting senior management

The recruitment of senior management for an audit client, such as those in a position to affect the subject of the audit engagement, may create current or future self-interest, familiarity and intimidation threats.

The significance of the threat to auditor independence will depend on the role of the person to be recruited and the nature of the assistance. In all cases, the audit firm should not make management decisions and the decision as to whom to hire should be left to the client. The audit firm may, subject to safeguards, provide assistance in reviewing professional qualifications, considering candidates' suitability for the post and in some cases could produce a short-list of candidates for interview. However, the guidance provides that where audits of listed or other public interest entities are concerned, and the recruitment relates to key financial or administrative posts, the independence risk is perceived to be too high to allow the provision of such a short list.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *What is the role of the person to be recruited and what is the nature of the assistance provided?*
- *Is management independently happy that the job specification is appropriate and that the best person is recruited without having to rely on the audit firm's input?*

Corporate finance and similar activities

The provision of corporate finance services, advice or assistance to an audit client may create advocacy and self-review threats, which the IFAC guidance considers in some detail.

In the case of certain corporate finance services, the independence threats created would be so significant that no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an audit client's shares is not compatible with providing audit services. Moreover, committing the audit client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level. At the other extreme, due diligence work in respect of matters which do not have a direct significant and subjective impact on subsequently audited accounts, would be unlikely to result in significant threats.

Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analysing the accounting effects of proposed transactions.

Possible safeguards must deal with the fundamental requirement that the audit firm does not take managerial decisions.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *Is the auditor taking on a public advocacy role?*
- *How does management discharge its managerial responsibility in relation to the transaction?*
- *Who has the executive authority in relation to the transaction?*

Appendix 4: Current ethics guidance on rotation of audit partners

The Smith Guidance includes the requirement that 'The audit committee should monitor the external audit firm's compliance with applicable United Kingdom ethical guidance relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, office and partner and other related regulatory requirements' (para 4.24).

The key requirement of the ethical guidance is that safeguards be put in place to guard against the familiarity threat to independence. Such safeguards can include rotation of partners and staff, independent oversight, third-party review, etc. This applies to all audit clients and similar considerations apply to senior audit staff below partner level.

Listed entities and other public interest clients

For such clients, there are additional specific requirements for audit partners to rotate off the engagement (that is, to cease acting in a role that has influence over the audit opinion) after a maximum defined period. From 1 January 2003, the ICAEW requirements in this respect are as follows:

- Lead engagement partner – maximum period in the role five years: no return for at least five years.
- Other key audit partners – maximum period in the role seven years: no return for at least two years.

A key audit partner is an audit partner of the engagement team (including the audit engagement partner) who is at group level responsible for reporting on significant matters, such as on significant subsidiaries or divisions of the audit client, or on significant risk factors that relate to the audit of that client.

In the case of a group, key audit partners are generally those principals responsible for making judgements at group level which are significant to the audit opinion on the group accounts. Where there is no group, the definition above is applied to the company in respect of responsibility at head office level for divisions.

Limited flexibility is permitted where continuity at a particular time is vital having regard to, say, client involvement in a take-over or a major restructuring. In addition, sole practitioners and small firms are permitted to implement alternative safeguards where no alternative partner is possible, provided these safeguards include internal review and annual external consultation.

Prior to 1 January 2003, the requirement in respect of listed entity clients was only for the lead engagement partner to rotate, after a maximum period of seven years. Complex transitional arrangements have been developed which allow partners to serve over a greater period than those noted above, up to the end of 2005, in limited circumstances where audit quality would suffer as a result of the new requirements being brought in. These are explained more fully in the additional independence guidance issued by the ICAEW in October 2002.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *What arrangements are there for monitoring the familiarity threat arising from long service for audit partners?*
- *If the transitional arrangements are being taken advantage of, is it clear that audit quality would otherwise suffer?*
- *If partners at group level or those in charge of major subsidiaries are not considered to be key audit partners, what is the rationale for this?*

Appendix 5: Issues in respect of fee dependence by the auditor on a single client

As noted in Appendix 4, the Smith Guidance includes the requirement that the audit committee should monitor, inter alia, the external audit firm's compliance with applicable United Kingdom ethical guidance relating to the overall fee income of the firm, office and partner.

The ICAEW's guidance notes that if the recurring fees from a client company or group of companies constitutes a substantial proportion of the fee income of an audit firm, a self-interest threat is likely to arise. Accordingly the general requirement is that the auditor should not accept an audit engagement from an entity which regularly provides the firm, an office or the individual, with an unduly large proportion of gross practice income.

As a guide, an unduly large proportion would normally be 15 per cent, or, in the case of listed or other public interest companies 10 per cent. The firm should initiate a review of safeguards at 5%. The CGAA report also recommends that where fee income from a single listed client exceeds 5%, that should be at least disclosed to the audit committee, with an expectation that the latter disclose this to shareholders.

Some flexibility is permitted in respect of, for example, start-up or wind-down situations and in respect of individual dependence. In such circumstances, safeguards must be put in place. These might include, for example, a partner from another office taking responsibility.

Note that SAS 240 *Quality control for audit work*, requires an independent partner review for all listed company audits.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *What arrangements are there for monitoring fee dependence at the firm, office and partner level?*
- *Is there an issue in respect of this client and should any disclosures be made?*
- *What safeguards are in place?*

Appendix 6: Current ethical guidance on employment of partners and staff formerly with audit firm

The Smith Guidance proposes that 'the audit committee should agree with the board the company's policy for the employment of former employees of the external auditor, paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. This should be drafted taking into account the relevant ethical guidelines governing the accounting profession. The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the company, and consider whether in the light of this there has been any impairment, or appearance of impairment, of the auditor's judgement or independence in respect of the audit' (para 4.23).

The key requirement of the ethical guidance is that safeguards be put in place to guard against the self-interest and self-review threats to independence arising from employment of former audit partners or senior audit staff. Such safeguards can include:

- (a) notification of intention to join the client, coupled with immediate removal from the engagement and a review of significant audit judgements previously made by that person;
- (b) any person joining the client should no longer derive retirement or other benefits from the audit firm except in accordance with pre-determined arrangements;
- (c) no person joining the client should take part, or appear to take part, in any further business or professional activities for the audit firm.

Key audit partners

Where such individuals (as defined in Appendix 4) join their own clients, additional specific requirements have applied from 1 November 2002. The ICAEW requirements in this respect are that the acceptance by a key audit partner of a key management position in his or her audit client would be considered to cause an unacceptable threat to the appearance of independence unless a period of at least two years has elapsed since the conclusion of the relevant audit.

Thus, if a key audit partner were to join their own client within two years of fulfilling a key partner role on that audit, the audit firm would have to resign from the engagement.

A key management position, for these purposes, is any position at the audit client, which involves the responsibility for fundamental management decisions at that client. This management responsibility should also provide influence on the accounting policies and the preparation of the financial statements of the audit client.

A key management position also includes contractual and factual arrangements which in substance allow an individual to participate in exercising this management function in a different way, e.g. via a consulting contract.

The audit committee may wish to consider asking the auditor questions along the following lines:

- *What arrangements are there for monitoring significant judgements made by someone joining the client?*
- *Does the person joining the client fall within the definition of key audit partner?*
- *If so, should the audit firm not resign the engagements?*
- *If not (where relevant), why not and is the rationale supportable?*

Additional copies may be obtained by calling: +44 (0)20 7920 8634 or downloaded by visiting www.icaew.co.uk/policy.

ISBN 1 84152 221 X

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November 2003

TECPLN2556iv

Guidance for audit committees

The Institute of Chartered Accountants in England & Wales has issued a series of publications to assist non-executive directors on audit committees gain an understanding of the guidance included in the revised Combined Code on Corporate Governance as 'Audit Committees: Combined Code Guidance'. This is closely based on the proposals originally set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

Originally published in May and reissued in November 2003, the first four titles which are not affected materially by the revised Combined Code of July 2003 are:

- Working with your auditors
- Company reporting and audit requirements
- Reviewing auditor independence
- Evaluating your auditors

A further three titles will be published in 2004:

- Monitoring the integrity of financial statements
- The internal audit function
- Whistleblowing arrangements

