The Consultative Committee of Accountancy Bodies

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The Association of Chartered Certified Accountants
The Chartered Institute of Management Accountants
The Chartered Institute of Public Finance and Accountancy

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Dear Jon

CONSULTATION PAPER: DRAFT ETHICAL STANDARDS FOR AUDITORS

The CCAB welcomes the opportunity to comment on your draft ethical standards for auditors ('ESs'). Integrity, objectivity and independence in auditors is one of a number of key contributors to the actual and perceived quality of financial reporting. It is important that these standards strike the right balance between dealing with external perception and restricting regulation to those areas that raise genuine threats to independence. We believe the APB has had a difficult job to do in preparing these standards.

I attach for your attention the submission of the Consultative Committee of Accountancy Bodies (CCAB). This is in three parts:

- A - highlights what we perceive to be the critical issues;
- B - responds to the specific questions posed in your consultation paper; and
- C - comments on individual paragraphs of the five draft ESs.

We would be pleased to discuss this or any of the other issues in this submission with you.

Yours sincerely.

Neil Lerner
Chairman, CCAB Ethics Group

SUBMISSION OF THE

CONSULTATIVE COMMITTEE OF ACCOUNTANCY BODIES

TO THE

AUDITING PRACTICES BOARD

CONSULTATION PAPER:

DRAFT ETHICAL STANDARDS FOR AUDITORS

Part A – Critical Issues

Part B – Consultation Questions

Part C – Comments on Specific Paragraphs

Part A: Critical Issues

Principles based approach

We note the APB's endorsement of the principles-based threats and safeguards approach, developed in this country and now recommended by international organisations including the International Federation of Accountants (IFAC) and the European Commission (EC). We wholeheartedly endorse the use of this approach, which together with the strengthened regime of monitoring and enforcement will provide a regulatory regime which is robust and flexible enough to protect the public interest in the role of auditors. However, we have significant concerns about the application of the approach in parts of the ESs. In a number of places, the underlying principles are undermined by the detailed guidance, which is phrased not in terms of the underlying key requirement, but as an arbitrary rule. These points are expanded on in part C of this submission but in general terms, the expression of hard and fast rules in this way has two potentially negative effects:

i) The rules obscure the underlying message of adherence to the spirit of the guidance: it will create an environment which may encourage the search for loop-holes.
ii) Those complying with the spirit of the guidance may fall foul of specific requirements in circumstances when alternative safeguards would have been wholly effective and indeed may be preferable.

The demonstration of independence provides reassurance to shareholders that no relationships exist between the audit firm and the audit client which could impair the audit firm's objectivity. In making this demonstration of independence, it is important that audit quality is not impaired.

We believe that some of the measures included in the draft ESs are:

i) unnecessary as the risk to shareholders is minimal or in the case of private companies non-existent, and/or
ii) will pose a serious threat to audit quality.

Impact on small entities

We believe the application of certain arbitrary rules referred to above, will impact particularly on smaller audit entities and thus on the smaller firms who normally provide professional services to them. It is wholly appropriate that any auditor giving a 'true and fair' opinion should be objective and independent. However, in small firm-small client audits, a whole variety of different safeguards can, whilst often more informal, be highly effective in complying with the underlying principles of the guidance. They will satisfy the perceptions of the much more limited number of stakeholders, and provide a cost-beneficial outcome.

Any system of regulation of the audit profession must be proportionate and in the public interest. For many small clients, there is no practical alternative to the auditor providing professional services, as they have neither the contacts nor money to go elsewhere. Many of the detailed requirements of ES5 deal with issues of perception, generally about large listed audits, rather than real threats to objectivity. Accordingly there is a strong argument that they should be restricted to audits of listed and other public interest entities, with others applying the general threats and safeguards approach outlined at the beginning of that standard. For many owner managed entities

with a limited range of stakeholders, disclosure of services provided would in many instances be an effective alternative. We would refer you to our detailed comments on the provisions regarding the role of the ethics partner, the fee dependency rules and the prohibitions in relation to certain non-audit services.

The additional requirements for listed and other public interest entities could be usefully gathered together or at least clearly marked, allowing a more workable document for the majority of users.

Definition of Public Interest Entity
As noted in an earlier CCAB paper on what should constitute a public interest entity, there is a concern that many small entities (e.g. credit unions) will be caught within the definition, with disproportionate consequences. The definition that the APB has used refers to entities of 'significant public concern'. However, the examples include a number of entities (e.g. credit institutions) with no prefix of 'large' as is the case for example for charities. In addition guidance is required on what 'large' might be considered to be, to avoid differences of interpretation. We give indications of our views on what 'large' might be considered to be, in Appendix 1 to this submission .

Alignment with international standards
We note that the APB has sought to ensure that compliance with the ESs will result in compliance with the IFAC and EC codes in all material respects. However, it has also decided in some instances to include additional concepts and requirements. An example of this is the analysis of 'management' threat as a separate category. We see this as being wholly unnecessary. The performance of management functions is an activity where there is generally a high risk of a threat to independence through self-review or advocacy, which are already categorised. The activity has been prohibited throughout the document as the risk is assessed as highly significant. The introduction of a category unique to the ESs does not change the end result, but introduces an unnecessary difference.

Other examples of deviation from the international guidance appear throughout the ESs, in particular ES5. We do not believe there is any evidence that the IFAC and EC requirements will not be effective. It is unhelpful for any national standard setter to issue specific standards and regulations that impose additional requirements from those carefully considered requirements. The more that individual national regulations are created, the more the international regulatory framework becomes a patchwork that imposes significant regulatory compliance burdens that are unjustifiable in the public interest unless overwhelming arguments in their favour can be advanced.

Relationships
We are concerned by the extension in ES2 of the 'cooling off' requirements to partners unlikely to be involved with the client and in ES3 of the rotation requirements. We believe these misunderstand the real threats inherent in client relationships.

Fee dependency
We are very concerned at the bright-line nature of the fee dependency provisions in ES4, in particular the inclusion of a maximum fee level of 10% for all audit clients, whether those of public interest or not. We believe these are wholly at odds with the principles-based approach and will have significant and unnecessary consequences for smaller firms and start-up situations. We are aware of a number of practices which

have audit clients where fee income is above what would now be the 10% limit, but where safeguards such as external hot review have been highly effective.

Non-audit services

We believe the extent to which the detailed prohibitions in ES5 prevent the provision of services is in a number of instances unjustified and unnecessary. The client engages non-audit services from the auditor when the audit firm is the best equipped to act for them. While it is right to ensure that threats to independence are dealt with, in many cases there may be perfectly adequate safeguards available to deal with any such threat.

Our principal concern is that the APB proposal is far too widely drawn, lacks clarity and requires redrafting in respect of the provision of corporate finance, IT, tax, recruitment and accountancy services: furthermore it does not adopt a "threats and safeguards" approach.

As an example, in the case of corporate finance, we believe the APB does not seem to have recognised the extensive safeguards that operate in a corporate finance environment which reduce the advocacy and self-interest threats. We do not believe the real threat to auditor independence arising from an audit firm carrying out corporate finance work to be as broad as anticipated by ES5.

Transitional arrangements

We note that the APB recognises the need for such arrangements. It is important that they are set to ensure that a rapid implementation does not actually diminish audit quality and to allow clients, where necessary, to make alternative arrangements. A number of particular areas will require detailed attention. These are noted in our response to question 5 and where relevant in part C .

Part B: Consultation Questions

The Approach adopted by the APB

Q1: Objectives
We agree with the underlying objectives expressed in the consultation paper.

Any form of regulation should include an underlying objective to avoid unnecessary restriction of choice. We believe that it is important, wherever there can be alternative safeguards, to allow companies flexibility to make their own judgements on whether it is appropriate for them to use their auditor for the provision of non-audit services.

Furthermore, we believe that the decision to override the international guidance of the IFAC and the EC has been taken without sufficient weight of consideration of the resulting effect. The documents issued by those two bodies were prepared after much consideration, and subject to review by independent authorities. That they were prepared separately but contain very similar guidance, is indicative that further variations in guidance should be introduced only after very careful consideration, and in response to local circumstances that demonstrate different threats to those considered internationally. We can find no convincing analysis that the circumstances in the UK and Irish Republic necessitate such variations.

We note that the draft ESs do not contain a statement that compliance with them will result in compliance with the significant requirements of the IFAC code and EC Recommendation, such as is included in Auditing Standards. We understand you are looking at how such a statement might be provided and would urge you to ensure that it is.

Q2: Prohibitions only where no safeguards available.
We agree with such an approach. However, as noted in more detail elsewhere in this submission, we do not believe it has been applied in some parts of the ESs. In particular, what is necessary in the public interest for listed and other public interest entities is different from that needed in the case of smaller, simpler entities. In the latter case, perception is less of an issue

Q3: Principles-based threats and safeguards approach
Again, we agree with such an approach, but consider that it has not always been applied in practice.

We are pleased that the APB has made the important distinction in paragraphs 2.10 and 2.11 of the consultation paper between perceived threats and actual threats, and requires the assessment of whether a reasonable third party, fully-informed of the circumstances, would consider that the matter could have any influence on the audit team's judgement. We believe this to be the appropriate test.

Q4: Small audit firm compliance
We have considerable concern that the standards were written without fully considering the implications on small audit firms and small companies. As a consequence many of the detailed provisions are wholly unnecessary for small firms and the obligations disproportionate to the risk. In most instances other safeguards are much more appropriate than the prohibition approach adopted by the APB.

In particular we refer to the lack of clarity in relation to the role of the ethics partner, the arbitrary 10% rule in relation to fees and the extent of the prohibitions in ES5. Further general comments on this question, are included in our comments in part A of this submission. We have referred to specific points in part C.

Q5: Compliance from 1 September 2004
We note that the consultation commits to honouring existing transitional arrangements, including those of the ICAEW's Best Practice Guidance. Assuming that due consideration is given to setting transitional arrangements to ensure that a rapid implementation does not actually diminish audit quality or create impossible hurdles to compliance, we believe the compliance date is achievable.

Areas that require particular consideration include: the setting up of new internal audit-firm systems; the phasing in of the rotation requirements where they are wider in scope than previously; the new and more onerous fee dependency requirements; and the need to recognise existing contracts for non-audit services.

Aspects of Proposed Ethical Standards 1 to 4

Q6: Approach re Ethics Partner, Independent Partner, and the Combined Code.
We do not believe it unreasonable that a particular partner in the firm should specialise in ethical matters and act as a sounding board for difficult issues. However, the guidance does contain a number of specific requirements, relating to the ethics partner, formal compliance with which may actually achieve little in the case of small practices (particularly sole practitioners).

We believe that provided there are consultation safeguards, the ethics partner requirements should be phrased as being recommended best practice for practices with few partners, rather than compulsory in all circumstances.

The use of an independent partner is already a recommended safeguard in many aspects of the existing guidance and required for listed entities by existing auditing standards. Its extension to public interest entities other than listed companies is reasonable provided common sense is applied in considering what entities fall within this scope. In the case of very small entities of high but local public interest, the application of these additional requirements could only lead to disproportionately expensive audit and accountancy services, if these are deemed to fall within the scope. We see no justification for defining public interest in the narrow confines of local geography. We make suggestions for amendments to the definition of public interest entity in part C.

We support the interaction of the guidance with the Combined Code, in respect of those entities within its scope. The interaction of audit committee oversight with audit firm procedures is a vital element in ensuring the high quality of corporate reporting.

Q7: Approach re relationships
We generally endorse the approach, which is not inconsistent with international guidance. We have included a number of specific points in part C of this submission.

Q8: Approach re long-term relationships
We support the general approach but we believe the omission of an alternative for firms without the capability for rotation of the engagement and other partners is wholly unnecessary, costly and anti-competitive. Such an alternative is included in our existing guidance, that of the EC, of IFAC, and indeed of the US Securities and Exchange Commission (SEC), which deals only with listed entities. This is not because any of these bodies believe in lower standards for small audit firms but the rationale is that as the purpose of independence is enhancement of audit quality, measures that harm such quality should not be required. Whilst rotation might be very much the preferred safeguard to satisfy perception issues, if an audit partner cannot be replaced by someone of high quality, the underlying objective would be defeated. It is therefore better to allow alternative safeguards in the limited circumstances where this applies to the audit of listed and other public interest entities. Such circumstances could be encountered by small firms, or those operating very specialised audits, or in locations where the pool of suitably experienced partners is restricted by practical constraints.

Q9: Approach re contingent fees
We entirely agree with the premise that contingent fees should not be charged in respect of audits. However, we do not agree with the APB's apparent assertion that it is not possible to mitigate the perceived self-interest threats to auditor independence in relation to contingent fees for taxation or corporate finance services in the particular circumstances noted in of ES5. We believe the specific requirements in ES5 go unnecessarily beyond the requirements necessary to address the basic principle and we refer to this in more detail in part C of this submission.

Paragraph 3.9 of the consultation paper states that "the APB's aim has been to address the threat to objectivity and the perceived threat to independence that may exist should the incentive for financial rewards from an audit firm providing a non-audit service exceed the incentive for audit quality". We understand and agree with this principle. However, in paragraph 4.12 the APB states that "the self-interest threat would arise where the generation of fees from the client has become critical to the audit firm as a whole, rather than as a result of the classification of the fees between audit and non-audit in relation to the audit fee of a particular client". We believe that as far as contingent fees are concerned, outright prohibition is necessary only in those circumstances where the fee is material to the auditor (as considered by ES4). In other circumstances, a threats analysis should be required and safeguards applied.

Q10: Approach to fee dependency
We have major concerns about the phrasing and severe consequences of this requirement. The application of an arbitrary bright-line rule is totally at odds with the principles-based approach and will suffer from the problems highlighted earlier, of unnecessary restriction of some, and evasion of the sprit of the guidance by others. The introduction of this rule for all audit clients will cause considerable problems for small firms who will be obliged to relinquish audit clients where there is no actual (or given the small number of stakeholders) perceived risk. It will also seriously restrict the number of firms capable of providing audit services given the difficulties surrounding the ability to set up an audit firm. We have commented on this further in part C of this submission.

The principle that individual audit partners, staff and indeed offices should not be dependent on one audit client is sound. However, in these cases, there are alternative

safeguards to outright prohibition available. This is commented on in part C, as in the basis of remuneration of partners and staff.

The Provision of Non-Audit Services to Audit Clients

Q11: Conceptual approach in ES5
We agree with the conceptual approach, which is not inconsistent with that advocated in international guidance. We see little point, however, in deviating from that guidance in terms of creating a separate category of management threat. This is quite adequately dealt with within the self-review and advocacy threat categories and seems to create a difference for the sake of it.

We are also concerned that the APB appears not to have recognised that the level of advocacy threat varies depending on the specific services being delivered, and that there are instances where safeguards can be applied to reduce the threat to an acceptable level. This is discussed further in part C.

Q12: Approach to internal audit services
We agree with the general approach.

Q13: Approach to IT services
We agree with the approach in terms of systems important to the production of the financial statements where the audit firm has a subjective input to the process. However, we believe the requirement has been phrased too widely and comment further in part C.

Q14: Approach to valuation services
We agree with the underlying approach but have commented on aspects of detailed application in part C.

Q15 & 16: Approach to tax services, and provision to smaller companies
We agree with the underlying approach towards identifying threats inherent in the provision of tax services. However, we believe the requirements have been drawn far too widely and absolutely, and will prohibit a number of valuable services to clients where there is either no threat, or where there are effective alternative safeguards. We comment in more detail in part C.

As regards the provision of services to smaller companies, we believe that distinguishing between public interest and other entities in terms of underlying requirements is only merited where the issue is only one of perception. Where there is an actual significant threat to objectivity, there should always be safeguards. What does vary is what safeguards are the most appropriate and effective and the requirements should be flexible enough to allow for this.

Q17: Approach to legal services
We agree with the approach.

Q18: Approach to recruitment and remuneration services.
We agree with the approach but believe the requirement has been drawn too widely, and will prohibit services where the threat to independence is insignificant. Consideration needs to be given to what threats are created by the provision of remuneration services and the available safeguards. We comment further in part C.

Q19: Approach to corporate finance services
We have major concerns that the APB proposals as drafted have been drawn far too widely, lack clarity and require redrafting. The proposals would prohibit services where there are important benefits to the client in using the audit firm and where threats to independence can be countered by effective safeguards. This particularly applies to ES5, 81a, on which we comment in more detail in part C.

Q20: Approach to accounting services
The UK's and (to an even greater extent) the Irish Republic's audit requirements extend to a large proportion of relatively small companies even allowing for the pending change in the audit threshold. We agree with the underlying approach, but a number of issues arise in terms of how the standard will be implemented in practice. We do not believe it would be in the public interest for small local interest entities to be considered to be public interest entities, as already referred to, or for the other requirements to result in unnecessary disruption to services demanded by small, low risk audit clients. Indeed, in the case of smaller entities, auditor involvement in the accounts usually results in a higher quality output. This area is commented on in detail in part C.

Q21: Other non-audit services
We believe the general requirements in respect of non-audit services in the early part of ES5 are satisfactory to deal with other services. ES5 is not, should not be and indeed cannot be a complete list of non-audit services to be addressed. If it were to be considered so, it could easily be avoided by legalistic interpretation and it would be likely to become outdated as new services emerge.

Part C: Comments on specific paragraphs
(References are to paragraph numbers unless otherwise stated)

ES1: INTEGRITY, OBJECTIVITY AND INDEPENDENCE

Introduction
Preface – This notes that the 'audit firm' includes 'network firm'. This leads to unintended consequences in certain circumstances. As currently drafted, when the term "audit firm" is used with the limitation in the same sentence of the term "audit client", we assume this as applying only to the entity being audited, i.e., the requirements of the ESs are restricted to the network firm's involvement in that particular entity (rather than the group). Where the word "affiliate" is specifically used, this is extended to the whole group. However, where "audit firm" is used in isolation with neither of these other terms, it is unclear whether the standards apply to the whole network or not. For example, in 36, the ethics partner is required to consider the audit firm's compliance with the ESs. Is the ethics partner really required or realistically able to consider this for the whole network? Either each sentence using "audit firm" needs to have one or other client related term linked to it (with a clear explanation to confirm that our assumption above is correct) should be a general statement that states that the standards only apply to the network's direct audit work of the relevant audit client unless otherwise stated, by the use of the word "affiliate".

There is also an issue concerning the inability of the audit firm to impose requirements on other network firms included by the definition but where it is unrealistic to presume they are under the audit firm's control. The EC Recommendation recognises this and clarifies that the audit firm's responsibility in respect of its network is to take "all reasonable measures" to ensure compliance, where they are in a position to extend influence.

3 – This notes integrity as a prerequisite. We believe this understates its importance. Integrity is the prerequisite and it should be stressed that the rest of the document is built upon the underlying assumption that it is being applied.

It does not follow that integrity is necessary in audit just because that is a public interest activity. It is necessary because it is integral to a service to shareholders (the audit report), and because shareholders do not, and should not be expected to have the means to verify that integrity themselves (as explained in 11).

Compliance
14 – This requires policies and procedures to be "appropriately documented …". This could be taken to imply that very small firms will be required to document such matters for the sake of it. 17 rightly notes that the policies and procedures will vary by size and nature of firm. It would be helpful to clarify here that the documentation would also be expected to vary and might be very minimal in the case of, say, sole practitioners.

15(c) – 'Other' seems to be in the wrong place. This should refer to "any other person who, due to any circumstances …."

20 – The requirement is for a specific partner in the firm to be designated as ethics partner. The consultation, at 2.18, indicates that this could be a partner from a

separate firm in the case of small firms. There is an inconsistency to be addressed here. The latter possibility should be allowed for, though in practice we think cost, logistics, competition and confidentiality issues will make it difficult to apply in practice. If that proves to be the case for a very small firm, we are unclear as to how the concept of ethics partner will work in practice for those firms. A little more guidance on how this is expected to operate in such firms would be useful, particularly in the context of the requirements of 22 (q.v.). For example: Would consulting the ethics helpline of the relevant accountancy body be acceptable? Can the ethics partner also be the audit engagement partner or the independent partner? How, in smaller firms, is the ethics partner role feasible?

There are also practical consequences for larger firms. This is because key decisions appear to fall to the appointed individual so there are practical issues about their continuous availability and the ability to cope with peaks in queries. Technical, risk management and other areas of compliance within larger firms tend to be supported by teams (typically headed by one or more partners) so it is to be expected that ethics may be resourced on a similar basis. We believe it should be clarified that there can be more than one ethics partner, or at least alternates.

This is an area where specific transitional provisions are clearly necessary.

22 – A number of issues arise in respect of the policies and procedures expected to be addressed by the ethics partner:

i) The preamble suggests that the ethics partner should establish the policies. We believe the firm should establish the policies: the ethics partner would be responsible for assessing if they were reasonable and changing them if necessary, and for ensuring they are complied with.
ii) The use of "that include:" at the end of the preamble suggests that the list of policies and procedures is an absolute requirement. In small firms, these might be sound aims, but other procedures might be more appropriate. We suggest inserting "might" in front of "include".
iii) We are concerned that the extent of monitoring required in the first bullet point is unclear. It might be helpful to add other examples covering, e.g. whether ethics partners should be obtaining regular confirmations from staff.
iv) We suggest "enforcement" is a more appropriate word than "disciplinary" in the sixth bullet point.

<u>Threats</u>
26 – See comments under Q11 regarding separate identification of the management threat category.

28 – It is clear from 33 that no safeguards are needed in the case of "clearly insignificant threats" but it is unclear here whether any such threats still need to be reported to the appropriate person. Clearly, matters should be reported if there is doubt as to whether a matter was significant. However, it would be helpful to confirm that in determining what is to be communicated, consideration of significance can be made at this stage and matters which are clearly insignificant need not be reported.

29(a) - It is not immediately clear why the public sector should be excluded from considering whether to accept or retain an audit engagement just because the auditor is prescribed by statute: the body may not, for example, have the specialisms required

for the ongoing audit. It would be good practice (and required by our Audit Regulations, to which public sector auditors aspire) that their independence and (technical) competence to do the work are recorded, on accepting and retaining (annually) an audit engagement.

Overall conclusion

32 – This requires the engagement partner to reach a conclusion on independence at the end of the audit process. The implication rightly drawn from 35 is that this is an ongoing process and action should be taken as soon as a problem is identified. The procedure in 37 should therefore be an update of an existing conclusion.

Communication with those charged with governance

43 - In discussing the purpose of communicating with those charged with governance, we believe it would be useful to clarify that consideration by an audit committee may itself be a safeguard in the same way that an independent partner review would be. However, the usefulness of the safeguard will vary with the independence of the audit committee. In the case of an owner-managed business for example, no effective additional safeguard results, so additional communications serves no purpose. Such a comment would lead naturally into explaining why the requirements in 44 are targeted at listed companies and other public interest entities.

ES2: FINANCIAL, BUSINESS, EMPLOYMENT AND PERSONAL RELATIONSHIPS

Introduction

2 – Refers to the standard providing "additional" requirements. If the ESs are to follow the principles-based approach, requirements relating to specific circumstances should follow on from the underlying principles, not be additional to them.

Financial interests

6 – The general requirements in this section are appropriate and, except as noted below, reflective of the general international position.

This does represent a potential relaxation of the current UK and Irish position as guidance presently extends to, inter alia, all partners in a firm. Whilst it is quite appropriate that independence requirements need not apply to those who cannot influence an individual audit, it might be helpful to include an additional paragraph reminding partners who are in such a position that they need to consider perception issues and may be called upon to explain why the requirements do not apply to them.

We are concerned about the impact of the interaction of this requirement with the decision not to carry forward the exception that is in, for example, the ICAEW's current statement 1.201 at 4.38: "Where a provision in the Articles of Association of a company or an Act of Parliament requires the auditor to be a shareholder the auditor should hold no more than the minimum number of shares necessary to comply with that provision in the Articles or with the Act, and the shareholding should be disclosed in the accounts, in the Directors' Report or in the Audit Report."

While there are now few companies with such clauses in their articles, there are many societies and clubs with a share-holding requirement. Conceivably, in circumstances where there is in substance no independence threat, all partners in an office could be barred from membership of these through a requirement to hold one share.

This specific paragraph is not consistent with the IFAC guidance in that it makes no reference to materiality in determining the significance of an indirect interest: it considers only ability to control. The IFAC guidance prohibits indirect interests that are material regardless of other factors.

9 – This paragraph requires disposal of unintentionally acquired interests in clients "as soon as practicable and, in any event, no later than one month after …..". This is illogical. The "in any event" clause would by definition only apply if it is not practicable to dispose of the interest within one month. If it is not practicable, to require it anyway seems unnecessary given the availability of other safeguards referred to in 10.

There is also an issue relating to executorship appointments in families: we believe that this should be allowed for provided other safeguards are adopted as appropriate.

11 – Deals with the situation where, inter-alia, immediate family hold indirect investments which the auditor is unaware of. We believe there could be human rights issues in presuming knowledge by the auditor of direct holdings by immediate family and believe this paragraph should be widened in application by deleting "indirect".

12(a) – It is not clear what "…and, having regard to the nature and objectives of the intermediary, disproportionate", is referring to given that the holding cannot influence investment decisions. This wording seems unnecessary.

14 - We note that this paragraph has been amended to include partners working in the same office as the engagement partner, but it still falls short of the requirements of the IFAC guidance, as it does not extend to immediate family or to staff providing significant non-assurance services.

15 - We believe that safeguards should be applied even where the holding is permitted, such as disclosure of the interest in the relevant accounts.

Loans

18 – The footnote excludes all ordinary trade credit arrangements. These could be pertinent if they were very significant in terms of materiality (and would thus potentially have an impact on the loans allowed in 20 and 21). Similarly in 21, which prohibits loans for individuals, there is no reference to excluding immaterial items (as is the case in 20).

22 – This appropriately caveats the requirements of 19, regarding deposits in the normal course of business. We believe it would be appropriate to extend the paragraph to audit firms as well as individuals, as the same principles apply.

Business relationships

24 – This excludes business relationships where they are in the ordinary course of business and immaterial to either party. We would have thought immaterial items would not need to be prohibited by definition (though they would need to be considered in terms of threats if not in the ordinary course of business).

25 – There is an allowance for a delay in terminating relevant business relationships. This is reasonable, but "necessary" could be inserted in front of "delay".

26 – Here (and indeed in a number of other places), the engagement partner is enjoined to consult with the ethics partner in respect of issues not exactly fitting within the bold type paragraphs, to ensure "that the matter is resolved in accordance with the principles set out" in the ESs. The preface to each standard notes that the bold type paragraphs are the "basic principles and essential procedures". We assume, and hope, that the requirement is to apply the spirit of the guidance. However, it could be interpreted as requiring an extension of all the precise bold-type requirements to these more subjective circumstances. It would be helpful to clarify that this is not what is intended.

28(a) We believe the impact of this paragraph should be limited to those who can directly or indirectly influence the audits carried out by the firm. There may be those who have influence on some of the audit firm's affairs, but pose no actual or potential threat to audits carried out.

Management role with audit client

31(b) - We see no reason why loan staff should not be involved in accounting entries in a 'mechanical' sense (as is allowed for the audit firm in ES5), provided someone else is making the decisions. At the moment, this standard and ES5 are inconsistent. This requirement could be subject to a caveat similar to ES5, 93.

40(a) - This requires notification to the firm of "potential employment with the audit client". It is unreasonable to expect employees to notify the firm of merely a wish to leave. The requirement should be for immediate notification when negotiations to join an audit client in a defined role take place.

The requirement for the firm to have policies to "ensure" notification to the firm by individuals places too absolute an onus: it should be replaced by "provide".

42 – As the issue relates primarily to the familiarity threat, it seems unnecessary, as has been recognised in the EC Recommendation, to extend the 'cooling-off' requirements to partners in the chain of command where they have had no dealings with the audit client. An example of the perhaps unintentionally wide application of this requirement is that at least one major firm includes its partners on a partner remuneration committee on a rotational basis. The interaction of the paragraph and the widely drawn definition of chain of command would seem to cover all of these individuals, however short and indirect their service. We understand that there is a concern within the APB that familiarity between persons formerly in the chain of command and the audit partner might result in a threat. However, we do not believe this is a particular issue for individuals in the chain of command, rather an issue of the character of the audit partner, who needs to have safeguards against intimidation in general. An audit engagement partner has to stand up to the management of the client regardless of the previous relationship. As such, if the partner is able to stand up to, say, the Chief Executive we believe they should also be able to stand up to a client who was previously in the chain of command.

If the extension continues to be included, this area will need to have specific transitional provisions applied. Persons in the chain of command should at most be included in the requirements noted in 43, for reassessment of whether the composition of the audit team remains appropriate. In addition, the definition of the chain of command should be narrowed to include only those UK or Irish firm audit partners

who have had direct management responsibility for the audit, including at all successively senior levels to the accounting firm's senior partner.

The footnote refers to the inability of public sector auditors to resign, and should therefore mention the need for alternative safeguards (as in the subsequent paragraphs). An example might be the use of a sub-contract firm.

This point is also relevant to entities such as voluntary organisations and small charities, where former audit partners or staff are often the best chance they have of acquiring a professionally qualified administrator.

Governance role with audit client
48 - Elsewhere in this standard (and in other places) the requirements have been different where the relevant person is a close family member, compared to situations where the relevant person is an immediate family member. The treatment in this paragraph is inconsistent with that rationale: it should be highlighted that the threat is greater in the latter case.

Family and other personal relationships
54 - Our comment on 11 above regarding knowledge also applies here.

56 - This paragraph does not pick up the IFAC requirement for an individual to be removed from the engagement team where immediate family can exert influence over the subject matter of the audit. We recognise, however, that greater hurdles are imposed with respect to the notification of such relationships.

ES3: LONG ASSOCIATION WITH THE AUDIT ENGAGEMENT

General provisions
5 – We are concerned about the amount of detail needed to satisfy the requirement to monitor the length of time partners and key staff have served on an audit. The underlying purpose of the requirement is to identify potential threats as a result of long service. Some form of exception report might be capable of addressing this issue, rather than the ongoing detailed record implied here. If the latter is considered necessary (which we do not believe), there is a need for specific transitional guidance in this area, to address how far back records need to go.

6 – There is no indication as to what 'long association' means. While precise periods sit uneasily with a principles-based approach, they can usefully be used in the non-mandatory explanatory material as rebuttable, indicative information.

7 – While potential threats to objectivity will arise from long association by definition, loss of independence will not automatically arise. Although this is recognised through use of "may", we believe this is the exception rather than the rule and it would be helpful to clarify this.

The third bullet point seems to imply that the longer the audit term the more significant the threat becomes, hence safeguards will always need to be applied. In our view, if an auditor of a small company acts as auditor for a long period, there is always a familiarity threat, but it will often be 'clearly insignificant', given the stakeholders involved.

8 – This paragraph is effectively the guidance for auditors of unlisted entities: see comment on 6 above regarding use of indicative periods.

Additional provisions

10 – It is unclear why the independent partner needs to rotate as often as the engagement partner. This partner usually has little or no contact with the client and as such the degree of threat is significantly reduced.

10 to 13 - As noted previously, we believe that the omission of an alternative for firms without the capability for quality engagement partner rotation is inappropriate, costly and anti-competitive. Such an alternative is included in our existing guidance, that of the EC, IFAC, and indeed the SEC. All allow alternative and more appropriate safeguards in these circumstances. They rightly recognise that rotation is very much the preferred method of dealing with the perception issue and therefore require that to be implemented where it is possible without compromising audit quality. However, the respective codes recognise that in some circumstances such a requirement can be counterproductive, so they require other safeguards, as they agree that standards of behaviour must be the same for all auditors.

11 – The only rationale for having additional requirements for listed and other public interest clients, is that there are greater perception issues. This paragraph is arguing that there are greater threats to objectivity (which you consider to be the actual behaviour) as well as the more perception-driven concept of independence. We believe the logic behind this paragraph needs to be reconsidered by concentrating on perception.

14, 15 – These should address the acceptability of prior service as a manager on the audit: we believe that such service is acceptable provided the manager has been subject to partner oversight. Indeed with increasing partner rotation, such continuity will become an important means of retaining experience of the client at senior levels.

ES4: FEES, ECONOMIC DEPENDENCE, ETC.

Fees

13 – It may not always be practical to agree the precise amount of the audit fee before re-appointing the auditors. This is preferable, but all that should be necessary is that the basis of determining the fee be agreed (which it would have had to be, following 10).

16 and 18 – It may be helpful to highlight that the threat is particularly heightened if there is a going-concern issue.

19 – We are concerned that this paragraph implies an absolute requirement for an independent partner review. Clarification might be helpful by replacing “such as”, with “for example”.

Economic dependence

20 - We have major concerns about the phrasing of this requirement:

i) The 10% limit should not be an absolute requirement. The underlying requirement is and should be phrased that the auditor cannot be unduly dependent on the income from one audit client. This however has been

expressed as an absolute and inflexible 10% rule, implying that 9.9% is totally acceptable, but 10.1% is not. The use of a percentage is reasonable within principles-based guidance as a rebuttable explanatory guideline, but not as an absolute requirement;

ii) The CGAA report rejected a reduction of the existing 10% limit for listed clients to 5%, as some had proposed, on the grounds that it would achieve little practical change in independence and would increase competition barriers. We believe the same applies to the reduction from 15% to 10% that you are proposing for audits of other entities. We understand from discussion with quality control inspectors that there are a number of firms with low-risk audit clients accounting for 11-12% of fee income, where additional safeguards are applied and where no independence issue has arisen.
We also note that the forthcoming proposed Bilanzrechtsrefromgesetz in Germany, retains a distinction between public interest entity audits and others in thus respect.

iii) This and other paragraphs in this section refer to "annual fee income of the audit firm" We believe a paragraph should be included clarifying that in the case of an individual for whom the firm's fee income is only part of total income (particularly relevant to many sole practitioners) it is the latter that should be relevant in terms of the underlying threat.

iv) If such requirements remain, a long transitional period will be necessary to avoid major disruption to practices and clients.

The proposed standard does not allow for any other safeguards to be applied when a number are possible as an alternative to resignation. These should be carefully considered given the rolling impact that could arise: if a firm were forced to resign from its largest client, the second largest could quickly breach this rule, and then the third, and so on.

21 - It is not at all clear what a profit sharing "business unit" is: we believe that the concept of a profit pool is more appropriate in this respect. As this paragraph is expressed as a hard and fast rule, and an unnecessarily strict one at that, there is a danger that people will seek to use legalistic interpretations to circumvent it. The principle that individual profit pools and indeed audit partners and staff should not be dependent on the client for non-audit work is sound. However, in all of these cases, there are alternative safeguards available, involving use of partners from non-dependent units. As with 20, this requirement should be phrased in terms of the underlying principle.

23 - This requires an assessment of safeguards where fee levels are between 5% and 10%. The initial assessment must be whether there is a threat that needs safeguarding against.

25 – As the underlying objective is (or at least ought to be) to ensure there is no dependency on income from one source, we believe income from affiliates of audit clients should be considered when assessing the significance of the threat.

26, 27 – The commentary in respect of start up situations is wholly unrealistic, as is the failure to address the winding down of practices. This will create a massive barrier to market entry. Existing UK guidance makes allowance for such situations, while requiring additional safeguards (which might include external hot reviews or joint audits) and we are not aware that any significant independence issues have arisen

thereby. We believe that this situation could be allowed for by including commentary from current ethical guidance, referring to safeguards such as those noted above.

Remuneration and evaluation policies

30 – The issue of partner and staff remuneration policies is simple in concept, but very difficult to express as a requirement. Clearly, members of the audit team should be motivated by a desire for high quality audit work, rather than acting as sales representatives. However as 30 is phrased, a number of dangers arise, e.g.

i) Problems arise if it is necessary to co-opt a specialist such as a tax partner into the audit team.
ii) There is a danger that in focussing too much on direct client-related remuneration, other incentives will be ignored. For example, there is nothing in the ESs to ensure that audit partners are not subject to financial disincentives from parting company with audit clients where that is the right thing to do (for example, because of ethical or technical factors or disagreements). Such incentives can be at least as important as incentives to grow the fee income.
iii) The phrasing of (c) is in direct conflict with the explanation in 31. We also feel that 30 (c) will be impossible to comply with and certainly impossible to regulate. When determining a partner's remuneration it cannot be unacceptable that they are rewarded on the basis of the overall fees they generate.

The introduction to 30 should clarify that the fundamental requirement is to address a potential self-interest threat by ensuring that audit staff cannot be unduly influenced by promises or threats relating to non-audit work. The restriction in (c should be that they should not receive specific bonuses based only on the additional services they sell, to distinguish between delivery and pro-active selling.

Litigation

32 - The footnote's last line should read "litigation" not "legislation".

33 – We believe threats arise where litigation is threatened "and probable".

34 – This paragraph follows on better at the end of 33, as the two are directly linked.

Gifts and hospitality

41 – See previous comments on ES1, 22.

43 – Presumably, if the person offered the gift is the engagement partner, he should discuss it with the ethics partner directly. It may be helpful to clarify this.

44 – This refers to cumulative hospitality. It would be helpful to explain to whom this is cumulative. It could be individuals, the team, or the firm. Presumably in terms of threat it is the first of these that is key.

ES5: NON-AUDIT SERVICES PROVIDED TO AUDIT CLIENTS

General approach

The provision of non-audit services will require transitional arrangements to deal with existing contracts, to the extent that ES5 prohibits services hitherto permitted.

7 and 10 – These two paragraphs are inextricably linked. In fact chronologically it is the requirement in 10 to establish policies, that leads to the ability of the engagement partner to consider the issues as required in 7. 10 would be better relocated to the current position of 7, with 7 as a subset of 10.

7 implies that the engagement partner must approve all non-audit services individually. Allowance for a de-minimis level would reduce the bureaucratic consequences for that individual significantly in many cases, without increasing the likelihood of failure to identify the quantity of services: auditors will need to keep a record in any event to verify the non-audit fee disclosures, but that need not necessarily be by the engagement partner.

We assume that in cases of doubt, the engagement partner would be required to consult the ethics partner: it may be helpful to clarify this.

11 - Limiting the decision whether a non-audit service could compromise audit independence and objectivity to the "audit partner" is too limiting. A client will not wait for three weeks for an audit partner to return from holiday to decide whether an acquisition due diligence can be undertaken. The audit firm should be able to have a wider group of partners who can make the determination (e.g. a compliance partner or someone in the assurance services management line). This also applies to 25.

We are also concerned at the comment about considering past non-audit services. We assume that it is not the intention to prohibit firms from taking on engagements because of past activities, except to the extent that the past activity would compromise the independence in respect of a material element of the financial statements being audited. This should be clarified, as the current drafting could imply a limitless timescale for consideration.

12 - This refers to threats to objectivity, but discussions elsewhere refer to objectivity and independence. We suggest including ‘and independence’ for consistency.

24 – We believe this paragraph should be amended to reflect the fact that there are differing levels of advocacy threat in different circumstances. We see no reason why the advocacy threat should be treated differently to the other threats, i.e. that in some circumstances the threat to independence can be reduced to an acceptable level by appropriate safeguards. We suggest inserting "Depending on the circumstances, it may be possible that" before the words "no safeguards can eliminate". The paragraph should also clarify that the advocacy threat arises in respect of items in financial statements yet to be audited, not financial statements which have already been audited and signed off.

25 – We noted in section A of this submission that we believe there is a strong case for the general threats and safeguards approach to be applied for smaller, non-listed or other non-public interest entity audits. To that end (and indeed because this section will be applied generally where the circumstances do not match those specified elsewhere in this standard), it would be useful to give some examples of the general safeguards that might be applied. Examples would include those specified in the EC Recommendation at 7.1(3) (though we would change the order, as the last EC example of external hot review safeguards would be most appropriate for smaller entities).

Documentation

29 – In practical terms, the engagement partner will often conclude and sign off on the work of other members of the team. We are concerned that it is not sufficiently clear that this is acceptable.

Internal audit

36 – We note that the safeguard referred to in the second bullet point as a possible measure is noted as a requirement by the EC Recommendation.

Information technology

37 – We believe this general requirement is drawn far too widely. The threat is effectively one of self-review of information produced under controls implemented by the audit firm. Accordingly we believe there would be no significant threat in situations which involve the selection of a standard, off-the-shelf accounts package, that applies its own non-adjustable system controls.

We also believe the use of "or" between sub-paragraphs (a) and (b) in 37 appears to be inconsistent with 39 which states that auditors can provide these services where they are satisfied that management has the requisite expertise. We believe therefore that "or" should be changed to "and".

We note that the prohibition on IT "services" in 37 is inconsistent with the references to "systems" in 38, 39 and 40 and paragraph 4.30 of the consultation paper which states that ES5 prohibits the design, provision and implementation of Information Technology systems by auditors. We assume, therefore, that the intent is to deal with systems and that this will be clarified.

40 – This refers to the need for knowledgeable management to oversee non-financial IT work. This derives from what has separately been identified as the management threat. As previously noted, we believe this is actually covered by the self-review and advocacy threats. As the issue relates to non-financial systems, the self-review threat cannot arise. We believe this paragraph should therefore be restricted to situations where an advocacy threat arises.

Valuations

General - The EC Recommendation's clarification has not been explicitly included, namely that engagements to review or to issue an opinion on the valuation performed by others or to collect and verify the data to be used in a valuation performed by others, are not regarded as valuation services. Additionally it is assumed that this provision does not cover the 'evaluation' of liabilities, such as tax. We believe these would be helpful points of clarification.

43 – We note that the Annex to the EC Recommendation includes a useful discussion about the nature of the degree of subjectivity (at 7.2.3), which it may be helpful to include here.

44 – We believe that there should be a general requirement for safeguards to be considered in circumstances where valuation work is required by legislation.

47 – This paragraph implies that it is necessary for management to determine all key elements of the valuation. We believe the key point is that the auditor should not have significant subjective input and this should be clarified as the underlying requirement.

An example of the difference would be in determination of methodologies. Management could choose between acceptable industry standard methodologies if the input were explained, but use of a standard industry methodology by the auditors, while apparently prohibited by the standard as drafted, would in practice not involve significant subjective input by the auditor.

Legal services

48 – It should be made clear that this is discussing circumstances involving an estimation "by the audit firm …". In addition, we would expect the materiality consideration to relate to the potential outcome, rather than an assessment of the amount at which the claim might finally be settled.

Tax services

General – We agree with the decision to include a section on tax services, and the key underlying requirement to protect the financial statements treatment from adverse influence by tax schemes, as required in 60. However, we believe the rest of this section has been drawn too widely, in a detailed rules format, and will prohibit services where there is no threat, or where alternative safeguards are available.

53, 54 – Many services on a contingent fee basis will not have any adverse impact on the integrity of financial statements. Examples might be a VAT scheme put to HMC&E and resolved before the audit, or a situation where full provision (verifiable based on legislation) is included in the accounts for what might be payable, but the firm receives a proportion of any subsequent reduction in liability that it manages to negotiate for the client with the Inland Revenue. In this latter situation the final amount is agreed by the Revenue. Provided these services do not relate to schemes rightly dealt with by 60, we believe the threats posed here to be insignificant. Such a situation only results in an unmanageable threat where the success of the service is dependent upon a subjective accounting treatment which would be included in the audited financial statements and this should be added to the paragraph as a limitation.

55, 58 – Again, we believe this is drawn too widely: the issue only poses a threat where the advocacy is in respect of a questionable subjective accounting treatment. In representation before Revenue tribunals or commissioners the accountant is acting as agent and this will frequently not pose such a threat. There will only be a threat where the accountant is required to advocate a position which involves significant subjectivity on matters that the auditor has not yet been able to clear as well as having a material effect on the financial statements. 55 should include issues of relevancy and subjectivity as limiting factors. Even in these cases, alternative safeguards, such as hot reviews, can be implemented and should be allowed for. This is an important issue as the procedure envisaged is just how most tax negotiations are dealt with in practice. It cannot be in the public interest for businesses to be denied fair representation before the Inland Revenue at tax tribunals, which would be the practical effect of the paragraph as drafted in the case of small businesses.

61 - The first two bullets can be combined as the subsequent analysis of these two elements does not differ.

63 – There is an implication that all of these safeguards are required. In practice, the need will vary under each circumstance and we recommend adding "may" in front of "include".

64, 65 – These appear similar to 62 and 63 and could be merged into them.

Recruitment services

69, 70 – The extension of the prohibition on such services to the appointment of any employee is unnecessary. Where such employees do not influence the financial statements and the service is not so widely drawn as to constitute an advocacy threat through management (for example, by ensuring the client makes the final decision based on full information), we do not believe the threat is significant.

75 – Again, this requirement is unnecessarily widely drawn. We agree with the presumed underlying objective of preventing advice on the overall quantum of remuneration, particularly in the case of listed companies and other public interest entities. However, as drawn this would prohibit advice on such matters as the tax consequences of taking remuneration through dividend or salary, set up of ESOP trusts, etc. In such circumstances, we believe an overall threats and safeguards approach is appropriate. 75 might be rephrased as "The audit firm should consider familiarity threats when advising on remuneration packages of directors and senior employees and implement safeguards. The threat is considered particularly high when providing advice on the overall quantum of remuneration, and in the case of listed and other public interest entities, such an activity is prohibited". 76 should be amended accordingly.

Corporate finance

77 – We believe the approach adopted can be misleading in that it tries to include a variety of different services within one heading. With such a broad range of services this is difficult to achieve without leading to unintended consequences. There is a clear distinction between corporate finance advisory services, and investigation and audit related services (reporting accountant work and due diligence). The risks associated with these services are quite different. Therefore, while we accept that 77 is intended as a scene setter, we believe the third and fifth bullet points should be removed to avoid confusion. This would then be in line with international guidance.

78 – It would be useful to highlight that one of the major issues to consider is the nature of the audience for the work and report.

79 – We do not believe the inclusion of "due diligence investigation" is appropriate in this paragraph. It is the responsibility of the directors to determine the accounting entries - the auditors do not audit the due diligence report but rather the financial statements, drawn up by management, which include fair value adjustments determined by the directors and the subsequent business flowing through that business. This is entirely different from a valuation of an item which is then to be carried in the financial statements.

80 – We concur with the analysis that the principal threats arising from the provision of corporate finance services are self-review and advocacy but also, in relation to contingent fees, self-interest. This latter aspect is not addressed.

In addition, as is made clear in the IFAC guidance in this area, there is a distinction between advocacy and the provision of advice. Many corporate finance services involve the latter rather than the former and we do not believe this has been recognised in the drafting.

81a – This proposes a specific prohibition against the provision of corporate finance services to an audit client on a contingent fee basis where the outcome of the services "may be influenced" by financial statements on which the auditors will be required to express an opinion. We are very concerned that the requirement, which has much wider application than that in the IFAC code, is far too broadly drafted. The requirement could be interpreted as a prohibition on the provision of most corporate finance services by auditors under a contingent fee arrangement, as any transaction "may be influenced" by audited financial statements".

Such a potentially wide-ranging prohibition would result in an unnecessary (and maybe unintended) reduction in choice of providers by excluding the auditor, who in many instances is a natural and preferred choice of provider for corporate finance services, particularly in the case of smaller companies. We note that auditors have been acting as providers of corporate finance services to audit clients for many years under existing ethical rules, without giving rise to instances where audit quality has been compromised.

We agree that there are certain types of corporate finance services that it would be wholly inappropriate for the auditor to provide, such as dealing in, underwriting or promoting an audit client's shares. It would be reasonable for these to be specifically prohibited as the advocacy threat is clearly too great.

We would also agree with a prohibition on corporate finance services on a contingent fee basis where there is a direct link between the auditor's adoption of a specific form of audit opinion and the outcome of the transaction to which this corporate finance service relates. However, such a link requires that the auditor be in a position to directly determine the outcome of a corporate finance transaction. In practical terms, such circumstances are very limited, as an audit opinion is an imprecise tool with which to affect the outcome of a transaction.

Furthermore, purchasers take many factors into consideration when acquiring companies, and undertake a variety of due diligence procedures: they do not normally depend solely or directly on the form of an audit opinion.

Contingent fees are commonplace in relation to the provision of corporate finance services and we are not aware of evidence to suggest that it has not been possible to apply effective safeguards. However, where a contingent fee is material to the audit firm as a whole there is a risk which is incapable of mitigation by safeguards.

We believe that 81a should be rephrased so as to prohibit only those corporate finance services where the successful outcome of the service is directly dependent on a specific form of audit opinion by the auditor or where the contingent fee is material to the auditor (as considered by ES4). In other circumstances, a threats analysis should be required and safeguards applied.

82 – We believe that this paragraph should be deleted as it is superfluous and repeats the contents of paragraphs 80 and 81a.

85 – As well as the internal safeguards indicated, the audit client will typically make all decisions as to the terms of any transaction on which corporate finance advice is provided. This should be noted in the examples. In addition, a number of external

factors act to reduce the threats to independence and will therefore act as safeguards when present. These might include:

i) The counter-party deciding on its own price for the transaction;
ii) Review, analysis and due diligence of relevant financial statements and the terms of the sale transaction by the counter-party;
iii) Inclusion in the terms of the transaction of warranty or similar provisions to protect the position of the purchaser.

Accounting services

General – We refer to our comments on Q6 regarding the interpretation of public interest entity. This section is one of the key areas where a sensible, cost-beneficial definition is necessary (see below).

It is unclear whether advice on tax accounts entries to listed and other public interest clients would be prohibited. 86 seems to imply this, though that would in practice have the effect of prohibiting the provision of the most straightforward tax services to all but the largest clients. In fact, as drafted, the draft standard could erode audit quality: if the firm is providing a tax service to an audit client, the accounting treatment advice is more likely to be appropriate (because as auditor it faces serious repercussions if the accounting is flawed) than otherwise. We believe such provision should be acceptable provided safeguards are applied.

92 – We note that the existing exception for listed and other public interest entities for emergency situations is not repeated. The purpose of this exception is to ensure that, in genuine emergency situations the quality of the financial reporting and thus that of the audit, do not suffer as a result of there being no practical alternative. Such an exception should be retained for those limited cases where this would result. There would continue to be oversight by the audit committee as required by corporate governance provisions and ES1.

We also believe that it should be acceptable to perform work for any subsidiary that is not itself a listed or other public interest entity, provided the work falls within that permitted by 93. This would allow the preparation of financial statements from accounting records and information provided by the client, provided there was no significant subjective decision making required by the auditors.

93 to 96 – The UK and Irish audit requirements extend to a large proportion of relatively small companies even allowing for the pending change in the audit threshold. Many smaller entities such as charities, Industrial and Provident Societies, etc, continue to require audits. It is vital therefore, that these requirements can be interpreted sensibly to ensure that only those services are prohibited that pose a self-review threat which cannot be reduced to an acceptable level by the application of safeguards. There is a real concern that otherwise, a very substantial number of private (frequently owner managed) businesses would suffer additional fees or negative commercial consequences without any real benefit to audit quality.

We believe that 94 in particular, is at risk of being interpreted as far more restrictive than is perhaps intended. The use of "without management approval" in the third bullet indicates an intention to permit a sensible case-by-case threats and safeguards approach. However, its absence from the other two bullet points is leading to uncertainty of intent. We believe it should be clarified that the concept of

management understanding of the principles behind the work and approval and ownership of the result, is the key issue and applies to all the examples. Alternatively, the last sentence should be deleted altogether, as the initial sentence expresses the underlying objective well.

We believe it would be helpful to include other examples of technical/mechanical accounting services in 95 and safeguards in 96 and to clarify in the latter (by inclusion of "may") that the example safeguards listed are not required in every circumstance.

An example of the former would be the preparation of statutory accounts from underlying client records, as mentioned under 92 above.

An example of the extra safeguards would be the processing of client-generated originating transactions in a pre-determined and agreed (with the client) form, together with subsequent review, agreement and endorsement by the client.
It may be useful to cross-refer to, or incorporate elements of, Practice Note 13.

DEFINITIONS

Audit engagement partner
This definition rightly includes those who are not entitled partners, but nevertheless assume ultimate responsibility for the conduct of the audit. This might, however, not be clear in general reading of the ESs and an alternative word such as principal might remind readers of its wider application, more effectively.

Listed company
It should be clarified whether other entities such as those listed on AIM and OFEX are included.

Office
The term is used throughout the ESs in a variety of contexts, often relating to individuals in the same office as the audit engagement partner. We do not believe, therefore, that the definition should refer specifically to a location, etc in which particular audit partners practice. This is evident from the context in which the word is used in the main body of the document.

Person in a position to influence the conduct and outcome of the audit
We note that 'external consultants' are now included within the scope, in addition to other disciplines within the audit firm (which are within the scope of the current guidance). There are practical issues to be considered, regarding the extent to which the auditor can actually monitor compliance.

In addition it is questionable whether this definition is appropriate as currently drafted because it does not have regard to the actual influence that the external consultant has on the audit opinion. For example, if the auditor engages a third party actuary to review a client's FRS 17 liability calculations where the resulting deficit is material, there would be valid concerns about the independence of the actuary. However, if the auditor seeks the advice of a third party property valuer to confirm that a client has applied an appropriate valuation method to a property where the degree of variability in the valuation is not great, the actual influence on the audit opinion would be far less and the full weight of the proposed requirements should not be necessary nor be imposed, given the effort needed to achieve them.

Public interest entity

See previous comments under Q6. We have previously submitted a paper on this area, but note that you have chosen not to specify limits. Nevertheless, it needs to be made clear that size is key and not just one of a number of alternatives. This could, for example, be achieved by a) amending the first sentence to include "…. because of their size and because their business, their number of employees or …." b) including "large" in front of each of the examples in the second sentence. We attach, as Appendix 1 to this submission, an extract from the CCAB paper previously submitted to you, indicating our preliminary thoughts on the size of entities that might be considered to be large for these purposes. These are based on conditions in the UK: different level might be appropriate in the Irish Republic.

The definition should also clarify that it is generally referring only to group level entities.

This is a critical area, not only to ensure a proportionate implementation of the ESs but also because the definition may be applied elsewhere in the absence of other definitions (for example, in the UK Companies Bill). It may be helpful if the APB were to issue separate guidance on this, to allow more detailed consideration and possibly consultation, than is possible here. This could include guideline limits for various types of entity as indicative presumptions of public interest, as set out in our paper.

APPENDIX 1

Extract from CCAB Paper: Public Interest Entities, Submitted to the APB in August 2003

The types of entity that should be regarded as public interest and the definitional cut-off points that should apply are as follows:

Credit unions [£1m] or more assets and income derived substantially from private contributions;

Notwithstanding that credit unions only operate at a local level these are still deemed to be of significant public interest due to the nature of their funding and the wide range of stakeholders.

Other deposit takers (including banks, insurance companies, investment firms (that hold investment business clients money) (£100m or more assets);

Unit trusts and equivalent (£100m or more assets);

Pension schemes (5,000 members or more);

Charities (£10m or more income derived substantially from private subscriptions and donations on a national scale);

The above thresholds will require regular, risk-based monitoring to ensure that the levels remain appropriate.

Other entities which have the same, or similar characteristics to any of the above should also be considered to be subject to the requirements applying to public interest entities (as defined for this purpose).

Consistent with the conceptual principles-based approach the guidance should state that if the thresholds are exceeded there is a presumption that the organisation will be a public interest entity unless having regard to the circumstances it can be demonstrated otherwise. This might be the case for example, where it can be demonstrated that the threshold is being exceeded only temporarily and that the entity's future circumstances are such that it will fall below these levels. Similarly, entities falling below these thresholds would be presumed not to be public interest entities unless their specific circumstances indicated otherwise.

It may not be necessary to include public sector organisations in the definition as they are audited under contract with the statutory audit agencies. They could agree their own arrangements for rotation.

(Please note that the materiality limits suggested above still require further debate).