

THE CONCEPTUAL APPROACH TO PROTECTING AUDITOR INDEPENDENCE

Background

This paper has been prepared by members of the Ethics Working Party of the Fédération des Experts Comptables Européens (FEE). It is intended to foster understanding of the conceptual approach to the setting and enforcement of ethical requirements in the current international debate on auditor independence.

Audit provides stakeholders with an expert and impartial analysis of the financial position of organisations in which they have an interest. The reliability and credibility of the financial information it provides determines, among other things, the ability of investors to make rational choices and thus underpins the efficient functioning of capital markets. Poor information will therefore act as a brake on economic progress as well as harming the interests of individuals. Hence governments regard audit quality as a public interest matter.

The key concern is whether the objectivity of an audit is likely to be affected by extraneous factors, in particular by factors that might affect the auditor's independence such as a personal financial interest in a company he is auditing. National systems of audit regulation have different approaches to imposing requirements on auditors to avoid situations where their independence would be threatened. The current debate is largely concerned with whether such requirements should be "conceptual" (i.e. based on broad statements of principle) or "rule-based" (i.e. a list of prohibitions of specific activities).

Public interest protection systems

The regulatory and disciplinary arrangements of professional bodies are part of a wide range of systems designed to protect and promote the public interest against the self-interested actions of individuals. The justice system itself is one example, with roots going back to antiquity. Governments have developed a wide variety of systems to deal with matters as diverse as tax evasion and public health, sometimes implemented by special-purpose statutory bodies such as the regulators.

The professions' arrangements are unusual in that, in many countries, they were developed on the initiative of the bodies themselves, not in response to external pressures. This was not a purely altruistic initiative. The ability to demonstrate that a profession has rigorous systems for ensuring high standards of conduct is a powerful "marketing tool". It was, and remains, strongly in the interests of a professional body to have demonstrably effective arrangements for rooting out behaviour by any of its members which is against the public interest.

Public interest protection systems involve four main elements:

- ◆ **the "law"** – a clear statement of what is not permissible;

- ◆ **education** – although "ignorance of the law is no excuse", it is incumbent on those imposing complex requirements to ensure that those affected by them are fully aware of their obligations;
- ◆ **detection** – means of ensuring, through receipt of complaints or structured systems of inspection, that infractions come to light;
- ◆ **discipline** – penalties, proportionate to the offence, which are designed to deter infractions and punish them when they occur.

All four are strongly represented in the regulatory and disciplinary systems of the professional accountancy bodies

Ethical requirements

For auditors, the "law" takes the form of ethical requirements imposed both by their own professional bodies and by external regulators. They may be more or less conceptual or rule-based in their expression.

To some extent, the distinction between a conceptual and a rule-based approach is a false dichotomy. In a rule-based system the conceptual framework may not be explicitly stated, but if the rules are consistent, they must be following an underlying common principle. For example, a rule that auditors may not own shares in a client company is one means of seeking to achieve the underlying aim that an auditor's independence must not be, or appear to be, compromised.

However the way in which the ethical requirements are expressed can have significant consequences for their enforceability. In the case of auditor independence, there is broad agreement on the underlying objectives. The real issue in the current debate is whether enforcement will be more effective if the "law" is the conceptual framework itself or is a series of discrete rules derived from the framework.

Proponents of the rule-based approach argue that black and white requirements leave no room for misunderstanding or evasion. However, precisely defined rules can be evaded through arrangements that adhere to the letter but offend against the spirit. An example may help to illustrate the point. A financial institution in Australia offers a derivative instrument that closely tracks companies' performance. A literally interpreted rule that forbade an auditor to have an ownership interest in his clients would not prevent him from holding such an instrument even though his financial interest would be equivalent to that of a shareholder. Furthermore, in a rule-based system new rules must constantly be developed to meet new circumstances.

Proponents of the "conceptual" approach argue that, by focusing on the underlying aim rather than detailed prohibitions, it combines flexibility with rigour in a way that is unattainable with a rule-based approach. In particular, it:

- ◆ allows for the almost infinite variations in circumstances that arise in practice;
- ◆ can cope with the rapid changes of the modern business environment;
- ◆ prevents the use of legalistic devices to avoid compliance;

- ◆ requires auditors to consider actively, and to be ready to demonstrate the efficacy of, arrangements for safeguarding independence.

How the conceptual approach works

In broad outline, the conceptual approach works as follows.

- ◆ Fundamental principles are set out which must always be observed by a professional accountant. (In the case of audit, the relevant fundamental principle is objectivity, which necessarily requires the auditor to be independent.)
- ◆ An accountant must conscientiously consider, before taking on a piece of work, whether it involves threats which would, either in fact or in appearance, impede the observance of the fundamental principles.
- ◆ Where such threats exist, he must put in place safeguards that eliminate them or reduce them to clearly insignificant levels.
- ◆ If he is unable to implement fully adequate safeguards, he must not carry out the work.

The ethical guidance of bodies that use the conceptual framework approach includes examples of threats that might arise and appropriate safeguards to deal with them. But these are clearly stated to be illustrative and not comprehensive. If an auditor were to appear before a disciplinary tribunal charged with a breach of ethical requirements, it would not be a sufficient defence to demonstrate that particular examples of threats and safeguards in the ethical code had been addressed. He would need to be able to demonstrate that, in the particular circumstances under consideration, the fundamental principles had in fact been observed – a far more rigorous test of compliance.

In particular cases, the conceptual approach can be virtually indistinguishable from rule making. For example, FEE's Common Core of Principles for statutory auditors¹ states that holding or dealing in securities of an audit client constitutes such a severe actual or apparent threat to independence that there are no adequate safeguards. This amounts to a prohibition of the activity.

The safeguards

The key to the success of the conceptual approach is the effectiveness of the safeguards. These apply at three levels: safeguards in the work environment, safeguards that increase the risk of detection, and specific safeguards to deal with particular cases.

Safeguards in the work environment

The FEE professional bodies' concern for the reputation of their members has led them to take great care that their **educational requirements**, both in the initial training for their qualifications and in subsequent compulsory continuing professional education, include a thorough understanding of ethical matters (this is assisted by the nature of guidance produced using the

¹ **Statutory Auditor Independence and Objectivity**: Common Core of Principles for the Guidance of the European Profession, Initial Recommendations July 1998

conceptual approach, which has more explanation but less total volume than rule-based statements). There is therefore no risk that a qualified member of a professional accountancy body could reasonably claim to be unaware of the ethical code that he must observe.

Systems of **corporate governance** are playing a growing role in ensuring that threats to independence do not arise. Most FEE member countries have legal or regulatory requirements for the involvement of persons independent of companies' management in decisions on audit. Audit committees are increasingly involved in the selection and reappointment of auditors and the award to auditors of non-audit work.

Transparency is also an important factor. In several FEE member countries it is now a legal requirement for auditors to publish information on the scale of audit and non-audit fees received from audit clients. There are pressures in some countries to go further and publish a breakdown of non-audit services, distinguishing between those which are most effectively and economically provided by the company's auditor and those which could equally well be provided by other firms. All of this is intended to help to ensure that there is a better public understanding of how heavily an audit firm depends on income from particular clients.

Disciplinary penalties are severe. Auditors in all FEE member countries are aware that if they breach the ethical requirements of their professional bodies they may be subject to a public reprimand (damaging to their business reputation), heavy fines, and ultimately withdrawal of their entitlement to practise.

Safeguards affecting the risk of detection

Accountancy is a principled profession, and for the great majority of accountants a knowledge and understanding of the ethical code will in itself be sufficient to prevent infractions. In any group of people, however, there will be those who wish to overstep the boundaries. For them, the risk of detection is of key importance.

Members of many professional accountancy bodies are subject to an explicit **duty to report** breaches of ethical requirements. The failure to report such a breach is itself a disciplinary offence that could attract severe penalties. Those contemplating unethical behaviour therefore do so in the knowledge that if a colleague learned of their activities he would be under great pressure to ensure that they came to light.

All the FEE professional bodies have effective **complaints systems**, which enable clients and members of the public to draw attention to unprofessional behaviour. The arrangements are publicised, and the complaints are dealt with by highly qualified staff. Many of the bodies require firms to inform clients explicitly and in writing of their right to complain and how to do so.

For firms practising in statutorily regulated areas such as audit, there are special arrangements for **monitoring by the professional bodies**. Detailed arrangements vary, but the underlying purpose is the same: to provide independent verification of compliance with the professional bodies' requirements.

In the United Kingdom and the Republic of Ireland, for example, the professional bodies with practising accountant members have monitoring units, staffed by professionally qualified inspectors, which visit each of the biggest accountancy firms every year and other firms at a frequency determined by a risk-based analysis. Inspection visits to audit firms include questions specifically designed to establish the effectiveness of procedures for preserving auditor independence and the inspectors examine the firm's records and files to establish the accuracy of the response. This procedure is assisted by the requirement in the relevant auditing standards that the practitioner should be able to demonstrate his consideration of independence issues in each case.

Monitoring by the professional bodies is itself subject to **external supervision**. There is a variety of arrangements in FEE member countries for oversight by governments or regulators. In the United Kingdom the monitoring units report through the professional bodies to the Department of Trade and Industry (a government department) and the Financial Services Authority (a regulatory body) on visits to different categories of statutorily regulated firms. The United Kingdom professional accountancy bodies have recently agreed to finance a new Accountancy Foundation, independent of both government and the profession, that will oversee the full range of their regulatory and disciplinary activities, including their ethical codes.

Specific safeguards

The FEE Common Core of Principles includes examples of specific safeguards that must always be considered and safeguards that apply to particular cases.

Safeguards that must always be considered when conducting an audit include:

- a high-quality overall control environment
- provision for staff to communicate any concerns to a separate principal in the firm
- arrangements for a partner not involved in the conduct of the audit to act as reviewer or reviser
- involvement of a third party (such as a committee of directors independent of the management of the company being audited, a professional body, or another auditor)
- compartmentalisation of responsibilities and knowledge
- explanation of the steps taken to deal with the risk of conflicts.

Examples of **additional safeguards that apply to particular cases** include the following.

Where a principal or senior employee of the firm is to take up a post with an audited client:

- immediate notification to the firm of any substantive discussions covering the possibility of joining the client
- immediate withdrawal of the individual from the audit team coupled with a review of the judgements made by him.

Where an auditor is acting for a client in litigation:

- consideration of the materiality of the amounts and the degree of subjectivity involved (if the amounts are material and the degree of subjectivity is high, the auditor must not act)
- careful demonstration of the safeguards put in place
- additional safeguards including, at least, the involvement of separate teams and extra review procedures.

Where an auditor is involved in the preparation of financial statements:

- a general injunction not to participate in the preparation of a company's accounts and accounting records unless the work is of a routine clerical nature or is necessary to respond to an emergency
- in countries where there is a long-established tradition of auditor participation in the preparation of financial statements for smaller companies, a considered and carefully recorded analysis of the work to establish what additional safeguards might be appropriate.

In all cases, unless the auditor is satisfied that safeguards will be sufficient to eliminate the threats to independence, or reduce them to clearly insignificant levels, he should not undertake the work.

The Common Core of Principles offers a wide range of examples of safeguards dealing with a variety of circumstances in which threats might arise. But, as mentioned earlier, they are not intended to be comprehensive. In the modern, rapidly evolving business environment new threats to independence are constantly arising and new safeguards must be developed to address them. It is a major strength of the conceptual approach that it allows new circumstances to be dealt with without impossibly long lists of rules and without running the risk that ethical requirements will be evaded because the new circumstances do not precisely match any previously specified prohibitions.

The current state of play

The conceptual approach to enforcement of ethical requirements is gathering momentum throughout the world.

Both FEE and the International Federation of Accountants, a world-wide body, are strong advocates of the conceptual approach to auditor independence.

The Independence Standards Board, established jointly by the American Institute of Certified Public Accountants and the Securities and Exchange Commission, issued an exposure draft in November 2000 ("Statement of Concepts – a Conceptual Framework for Auditor Independence") which is intended to provide a basis for evaluating rule-based systems.

The European Commission's December 2000 consultation paper ("Statutory Auditors' Independence in the EU: a Set of Fundamental Principles") is firmly based on the conceptual approach to enforcement of ethical requirements.

All of these bodies now see the combination of rigour and flexibility of the conceptual approach as the most satisfactory way of ensuring that ethical requirements for accountants are fully observed in the rapidly evolving modern global economy.