

APB ETHICAL STANDARDS: KEY REQUIREMENTS

(This should not be used as an exhaustive checklist of all requirements of the Ethical Standards (ESs) but seeks only to highlight items of note, C/F current requirements)

Overview

- ESs will apply to all audits, aiming to give “true and fair” or “present fairly” opinions on financial statements. Some exemptions for smaller audits (see “EASES” notes).
- The new Companies Act requires adoption of the ESs. They will be brought into effect by a revision to 1.201.
- They apply to audits of periods **beginning** on or after 15 December 2004.
- The ESs are written in same style as audit standards: key requirements being in bold, with explanatory paragraphs underneath.
- The APB asserts that these ESs comply with the requirements of the IFAC independence code, in ISA (UK&I) 200. We reproduce the APB’s assertions in the new Statement 1.201.
- Numeric references below are to specific paragraph numbers.

ES1 – Integrity, Objectivity & Independence

- ES1 sets basic independence requirements which are to adopt a threats and safeguards approach. The effect is very similar to current requirements though the analyses is subtly different.
 - It requires, over a number of paragraphs, policies and procedures to deal with independence (essentially a current requirement).
 - There are some extra requirements for listed entities. It **and the other ESs** suggest applying to other Public Interest Entities but they do not require it. This is a relaxation from the AG.
- 16 The scope of persons is similar to these in place post the Additional Guidance (AG) in 2002, except that the previous 1.201 blanket coverage of all partners, has been dropped except for certain specific requirements.
- 21 The firm needs to designate an ‘ethics partner’ unless it is a ‘small audit firm’ (3 or fewer R.I.s).
- 41 Listed audits need an independent partner: Audit Standards require this anyway.
- 43 There is a need to reach an overall conclusion about independence at end of the audit process but before issuing the report.
- 46 The group auditor needs to be satisfied that other auditors within the group are objective, and must document the rationale: the APB does not seek extra-territorial application, but does expect at least the requirements of the IFAC to apply.
- 49 Those charged with governance should be informed of all key independence issues. This only needs to be in writing for listed entity audits (para. 52).

- 54 Independence considerations must be documented: this is effectively required by e.g. Audit Regulations anyway.
- 58 General transitional provisions are included (repeated in all other ESs), allowing any new requirements in the ESs to be put in place during the first period covered.

ES2 – Financial, Business, Employment and Personal Relationships

- The basic principles in ES2 have similar effect to those in the existing guidance, but there is a lot of detail, particularly re scope.
 - Requirements generally extend to immediate (spouse or dependent) family. Close family relationships 'need to be considered'.
- 7 No direct financial interest, or material (to anyone) indirect (i.e. held through intermediaries) interest in client or affiliates (undertaking connected by common ownership, control or management). Immaterial indirect interests are also prohibited if knowledge and ability to influence.
 - 16 There are detailed rules re trustees: a series of hurdles need to be passed.
 - 21/22 Loans from clients are acceptable only if by banks or similar institutions, in the ordinary course of business and material (materiality is considered only in the context of the client, in the case of individuals).
 - 25 Business relationships to be avoided unless they relate to an immaterial purchase of goods or services, in the ordinary course of business. The 'definition' of BRs in para. 24 is quite widely drawn, but not greatly different in effect from existing requirements.
 - 29 An auditor cannot audit anyone able to influence the auditor's affairs: this is already in the AG, as it derives from the EC Recommendations.
 - 31 Dual employment by auditor and client is prohibited, as at present.
 - 32/35 There are restrictions on loaning staff: they cannot be involved in auditing the work they were involved in, afterwards.
 - 37/39 The audit firm must have procedures to deal with auditors joining the client, as at present.
 - 43/44 There is a two year cooling off period needed for partners joining an audit client, where they were previously an audit engagement partner, key audit partner, independent partner or partner in the chain of command re that client. The net is drawn a little wider than in the existing AG. There is also a need to consider whether any action is required if other staff move across. Note that the cooling off period is exempted for smaller entity audits in the EASES (see below).
 - 46 There are requirements re family members in a position to influence the accounts. The requirement applies to those in a position to influence the audit and to partners in the firm. There is an absolute prohibition on being in a position to influence the audit if there are immediate family members in such a position at the client. The matter needs 'to be considered' for close family members.

- 48-50 There are restrictions on serving on client boards as presently, but this specifically extends the requirement to associate entities of the client.
- 52 No director or other influential client individual, when joining the auditor, can be in a position to influence that audit for two years.
- 57/58 There is a general requirement to consider family relationships in the context of threats, as at present.
- 61 External consultants involved in the audit (i.e. employed as experts) need to be objective. The engagement partner is responsible for ensuring this.
- 65/66 Transitional arrangements allow existing interests / relationships to be held for a further twelve months if they were currently permissible but would not be under the ES provisions.

ES3 – Long Association with the Audit Engagement

- 5/6 The audit firm must have policies and procedures to monitor the length of time partners and senior staff have served on an audit. The auditor should apply safeguards where there is a familiarity threat, as has always been the case.
- 9 For all clients, where the engagement partner has been in place for ten years, the auditor must particularly consider the issue, apply safeguards and document rationale where rotation is not considered necessary. **This is not a requirement or even a presumption that rotation must take place.**
- 12/16 For listed audits, the engagement partner and independent partner must rotate after 5 years (with five years off) and other key audit partners after 7 years (with two years off). The effect is as required in the current AG, though there are some detailed differences, notably the explicit inclusion of the independent partner.
- 17 The possibility of familiarity threats needs to be considered for senior staff other than partners, for listed clients.
- 22 Transitional arrangements allow an extension to the end of 2006 before rotation is necessary, if the arrangement would be permitted by current guidance.

ES4 – Fees, Remuneration and Evaluation Policies, Litigation, Gifts and Hospitality

- ES4 is quite long and covers a variety of subjects that do not fit in elsewhere. The key difference from current guidance is in economic dependency (see 23 et seq. below).
- 5 The auditor may need to be able to demonstrate that appropriate time and skills to do the job has been assigned regardless of the fee: this is in line with existing requirements.
- 7 Audits cannot be conducted on a contingency fee basis: this is in line with current guidance.

- 14 For listed audit clients, any contingent fee arrangements for the provision of non-audit services to audit clients should be disclosed to the audit committee in writing.
- 16 The previous period audit fee and payment arrangements relating to it should be agreed before accepting re-appointment.
- 23/26 A firm cannot act as auditor where total fees from a client (and its subsidiaries) **regularly** exceed 10% of the income of the audit firm or relevant part thereof. Where the amount is over 5%, this must be disclosed to the ethics partner and those charged with governance. This is an absolutely rigid rule, unlike the current guidance, but note the use of 'regularly'. There is a limited exception re start-ups in para. 30 and the ES-EASE includes an exemption for audits of small entities by small audit firms.
- 33 There must be policies and procedures to ensure audit team objectives do not include: selling non-audit services (NAS) to the audit client; the evaluation of a person on the team does not relate to selling NAS; and no **specific** element of a team member remuneration (or promotion) is based on selling NAS. This is not a prohibition on selling NAS and does recognise the reality that partners income is based on total fees.
- 36 An auditor should not continue with an audit if significant litigation is in place between the auditor and the client.
- 39/40 Gifts should only be accepted if their value is clearly insignificant. Hospitality should not be accepted unless it is reasonable in terms of frequency, nature or cost. This is in substance, as current guidance.
- 51 Transitional arrangements allow economic dependency rules not to take effect for a year, if acceptance is allowed by current guidance.

ES5 – Non-audit services provided to audit clients

- ES5 is a long, detailed standard. It derives from the general threats and safeguards premise, that existing guidance does. It does not prohibit NAS outright but does include a series of detailed prohibitions over and above current guidance and that in the IFAC and EC codes.
- 12/14/33 A general threats and safeguards approach is set out, including consideration of what a reasonable and informed third party would think.
 - 28 Presumption that if management is not 'informed' then it is unlikely that any management threat can be circumvented. This has been changed to a much lower hurdle: 'knowledgeable' was referred to in earlier drafts.
 - 35 The auditor must inform those charged with governance of independence issues re the provision of NAS to audit clients.
 - 43 **Internal audit:** Such work cannot be undertaken if auditors would place significant reliance on the internal audit work or if the audit firm would take a management role. It is clarified that normal observations on controls as part of the audit do not count as internal audit work.
 - 51 **IT Services:** The audit firm cannot design, provide or implement IT systems if the auditors would place significant reliance on this or if the audit firm would take

on a management role. There is a presumption that it would take on such a role, if management does not have the expertise. However, off the shelf packages are noted as being unlikely to be a problem (a change from the original consultation).

- 54 **Valuation Services:** The auditor cannot provide such services if they involve highly subjective judgements and are material to the financial statements being audited. This is much as the current AG. There are some carve outs, including legal / regulatory valuations, accounting advice during the audit, and verification of data to be used in a valuation performed by others.
- 59 **Actuarial valuation services:** These cannot be provided unless management make all significant judgements or the amount is immaterial to the financial statements.
- 66 **Taxation:** This is a new area for independence guidance, with four separate requirements. An auditor cannot promote tax products or give advice where the audit partner ought to doubt the accounting treatment.
- 68 The auditor cannot provide tax services on a contingency fee basis if material to the audit firm (or relevant part thereof) or the outcome is dependent on uncertain application of laws or on audit judgements relating to a material balance.
- 70 The audit firm cannot take on a management role, but can provide advice on tax accounting entries, with some restrictions.
- 73 The auditor cannot be an advocate before a tax tribunal or court, if the issue is material to the financial statements or dependent on a future or contemporary audit judgement. The provision of information to the tax authorities and explanation of basic arguments is considered acceptable.
- 78/81 **Litigation support, legal services:** Similar provisions arise to those for valuations (q.v.)
- 83/85 **Recruitment and remuneration services:** The auditor cannot take responsibility for the appointment of a client employee, or in case of listed audit clients, provide recruitment services for key management positions at the client.
- 89 The audit firm may not provide advice on the **quantum** of a remuneration package for a director or key employee. Advice can be given on how to take an amount (e.g. salary or dividend).
- 98 **Corporate Finance:** This is a largely new area. The underlying requirements are similar to those for tax: the auditor cannot provide services which depend on a questionable accounting treatment, or on a contingent fee basis if material or dependent on the outcome of an audit judgement. In addition, as is already the case, the audit firm cannot take responsibility for dealing in, underwriting or promoting the shares. There is a carve out for work required by legislation or regulation.
- 108 **Transaction Related Services:** Similar restrictions apply to those for Corporate Finance (see above).
- 118 **Accounting Services:** The auditor cannot provide accountancy services (maintenance of accounting records or preparation of financial statements subject to audit) to listed company audit clients or significant subsidiaries thereof.

It may provide such services to others, with safeguards, unless it would involve taking on a management role (see 123 below). There are carve outs for accounting advice given as a by-product of the audit and for emergency situations. The overall effect is much as at present, though there is a higher hurdle for what is an emergency.

123 Accountancy services may be provided to other clients provided such services do not involve initiating transactions or taking management decisions and are of a technical, mechanical or informative nature. There is some discussion which is actually less restrictive than it appears (e.g. 124 refers to not determining journal entries, but the key words are 'without management approval'). The requirements are not greatly dissimilar to those in the existing guidance.

128 Transitional arrangements allow existing contracts for NAS to audit clients, that would be prohibited under the new requirements, to run on for another year if undated, or to the end of the contract if dated.

Exemptions Available for Smaller Entities (*currently being reconsidered by the APB*)

- 6 The 10% economic dependency rule will not apply to small auditors (3 or less RIs) auditing small entities (below £5.6m turnover, for companies. Various other limits are specified for other entities).
- 11 The 'informed management' presumption re NAS does not have to be applied to audits of small entities.
- 16 The prohibition on representation before a tax tribunal does not have to be applied to audits of small entities.
- 19 The two year cooling off requirements do not apply have to be applied to audits of small entities (this is a relaxation: they do apply to all audits under the existing AG).
- 23 Where the ES-EASE has been taken account of, this must be noted in the audit report.
- In all cases, the auditor is required to determine that there is no significant threat to independence.