

# ***APB Ethical Standards***

---

## **Consultation Paper**

### **REVISED DRAFT ETHICAL STANDARDS FOR AUDITORS**

**March 2009**

**The Auditing Practices  
Board**

## **THE AUDITING PRACTICES BOARD LIMITED**

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and the Republic of Ireland:

- standards and guidance for auditing;
- standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- standards and guidance for the work of reporting accountants in connection with investment circulars; and
- standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence,

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The APB comprises individuals who are eligible for appointment as company auditors, and those who are not so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

Neither the APB nor the FRC accepts any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying or otherwise using this document or arising from any omission from it.

**© The Auditing Practices Board 2009**

# Consultation Paper

## REVISED DRAFT ETHICAL STANDARDS FOR AUDITORS

---

<i>Contents</i>	<i>Page</i>
Invitation to Comment	4
Consultation Paper	5
Appendix 1 - Exposure Draft of Revisions to APB Ethical Standards for Auditors and ISA (UK and Ireland) 610	21
<ul style="list-style-type: none"><li>• Extracts from ES 2 Financial, business, employment and personal relationships</li><li>• Extracts from ES 3 Long association with the audit engagement</li><li>• Extracts from ES 4 Fees, remuneration and evaluation policies, litigation, gifts and hospitality</li><li>• Extracts from ES 5 Non-audit services provided to audit clients</li><li>• Extracts from ES – Provisions Available for Small Entities</li><li>• Extracts from Glossary of terms</li><li>• Extracts from ISA (UK and Ireland) 610</li></ul>	

## Invitation to Comment

The APB is issuing for public comment an exposure draft of a small number of revisions to their Ethical Standards for Auditors. These draft revisions are shown as mark-up amendments to the current standards which were issued in April 2008.

To assist commentators in appreciating the context for its work and the revisions proposed to the Ethical Standards, the APB has prepared this Consultation Paper to set out the main issues considered in reviewing the Ethical Standards and the approach taken to each of them.

The APB would welcome responses to the specific questions set out in the Consultation Paper and on any other aspects of the Exposure Draft. It would be most helpful if respondents could refer to the relevant paragraphs and give full reasons for their views.

The APB would prefer to receive letters of comment in electronic form. These may be sent by e-mail to [h.osullivan@frc-apb.org.uk](mailto:h.osullivan@frc-apb.org.uk). If this is not possible, please send letters of comment to:

**Hazel O'Sullivan**  
**Project Director**  
**The Auditing Practices Board Limited**  
**5<sup>th</sup> Floor**  
**Aldwych House**  
**71-91 Aldwych**  
**London WC2B 4HN**

In either case, letters of comment should be sent so as to be received no later than **15<sup>th</sup> June 2008**.

All comments will be regarded as being on the public record, unless otherwise requested.

# 1 Background

---

- 1.1 The Auditing Practices Board (APB)'s first Ethical Standards for Auditors (ESs) applied for audits of financial statements for periods commencing on or after 15 December 2004.
- 1.2 The APB undertook a review of the ESs in 2007, after they had applied for two audit cycles. This review indicated that the standards appeared to be meeting the needs of stakeholders and were working in practice. However, a small number of amendments were made to:
  - Implement legislation arising from the EU Statutory Audit Directive<sup>1</sup>;
  - Allow continued adherence to the principles of the International Federation of Accountants' Code of Ethics for Professional Accountants (the IFAC Code);
  - Add to the clarity of the ESs and assist their implementation in practice.
- 1.3 Revised ESs were issued in April 2008. In its feedback paper on this exercise the APB stated that further dialogue was needed on the issue of partner rotation for listed company audits and that a small number of new issues had arisen during the consultation period which required further work to be completed during 2008.
- 1.4 The APB has discussed these issues in detail and its current view on each of them is set out in sections 2 to 9 of this paper. Views of commentators are requested on a number of specific questions in relation to each issue, as well as on the detailed amendments that the APB proposes should be made to the ESs, which are set out as a mark up to the current Revised ESs in Appendix 1 to this paper.
- 1.5 A formal Regulatory Impact Assessment has not been undertaken for the proposed revisions to the ESs. The amendments proposed are largely to clarify the current position or to ease aspects of the ESs. The APB does not therefore believe that the amendments proposed will have an impact on the costs of an audit, but invites the views of commentators on this point.

**Question 1: Do you believe that any of the proposed changes will add to audit costs? If so, which changes and why?**

---

<sup>1</sup> Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts (8<sup>th</sup> Company Law Directive).

## Consultation paper

- 1.6 The APB plans that any changes to the ESs as a result of this review will apply to audits of financial statements for periods commencing on or after 15 December 2009. This timing is expected to broadly align with changes that are currently being made to the IFAC Code<sup>2</sup>.

**Question 2: Are there any changes to the ESs proposed by the APB which will be difficult to implement for audits of financial statements for periods commencing on or after 15 December 2009?**

---

<sup>2</sup> Changes to the auditor independence requirements in the IFAC Code have been finalised, but their effective date is still under discussion within the context of the Drafting Conventions project which is being undertaken by the International Ethics Standards Board for Accountants. It is currently thought that the effective date will be for audit reports issued after 1 January 2011. The ESs apply to audits of financial statements for accounting periods commencing on or after a certain date and therefore both sets of requirements would apply to calendar 2010 audits.

## 2 Partner rotation requirements

---

### *Five or seven year rotation period for the audit engagement partner*

- 2.1 The threats to auditor independence that arise from long association with the audit engagement are addressed in ES 3 (Revised). The APB's approach is to set out general provisions requiring firms to monitor the length of time that staff in senior positions serve as members of the engagement team for each audit and then to assess the threats arising from long association and apply safeguards as necessary. Additionally, for listed companies:
- Paragraph 12 requires audit engagement partners and engagement quality control reviewers to rotate after five years and not then participate in the audit engagement, until a further period of five years has elapsed.
  - Paragraph 18 requires key partners involved in the audit to rotate after seven years and not then participate in the audit engagement until a further period of two years has elapsed.
- 2.2 One of the key issues identified during the APB's review of the ESs in 2007 was the question of whether the rotation periods for partners involved in listed company audits strike the right balance between auditor objectivity and relevant knowledge and experience.
- 2.3 The APB asked for commentators' views on this question as part of the 2007 consultation. This confirmed that stakeholders hold differing views on this issue. Some commentators supported a continuation of the existing requirement for audit engagement partners on listed companies to rotate after five years, while others took the view that this period should be extended to seven years. Many of the arguments for and against a change in the rotation period for audit engagement partners focussed on audit quality. Because of the differing views, the APB made no changes to the rotation periods in the ESs issued in April 2008 but agreed to undertake further work in this area.
- 2.4 A stakeholder meeting was held on 1<sup>st</sup> July 2008 to discuss this issue and the APB has also obtained further input from both investors and audit committee chairs on various options. This work has indicated that the relevant arguments on this issue remain finely balanced:
- (a) *Audit quality.* Some believe that less frequent changes of audit partner increases the overall knowledge of the audited entity within the engagement team about past issues and the scope of the entity's activities, thereby enabling the audit engagement

partner to give greater focus and scrutiny to the key judgments, and contributing to audit quality over the period of tenure. Alternatively, others believe that changing the audit partner can help maintain audit quality as a fresh view is taken on the key judgments and the new partner can be more questioning of management.

- (b) ***Stability in an audit engagement.*** It is argued that a five year rotation period can create difficulties in practice for audit firms, particularly in the provision of audit services to specialised industries, such as banks and insurance companies. Additionally, some in the corporate community argue that frequent rotation of the audit partner can have a disruptive effect on the audited entity. However, others argue that there are ample opportunities for continuity to be maintained by retaining managers on the audit of a listed company and, when they are promoted to partner, involving them at some stage as a key partner involved in the audit or as the audit engagement partner.
- (c) ***International harmonisation.*** There is a growing body of opinion that there should be worldwide harmonisation of ethical standards; however, not all countries adopt a consistent rotation period:
- Both the IFAC Code and the European Statutory Audit Directive have a seven year rotation period for audit engagement partners on listed companies,
  - A five year partner rotation period applies for the audit of listed companies in the USA, South Africa and Australia.

2.5 Investors in particular continue to express the view that they believe that a five year rotation period provides an important bastion for auditor independence and that there needs to be a strong public interest case before changes are made to it.

#### ***Greater flexibility in the rotation period***

2.6 Audit committee chairs of some of the largest listed companies and audit firms believe that more flexibility should be introduced on the largest, most complex listed companies. These audit committee chairs believe that in some circumstances extending the rotation period of the current audit engagement partner could safeguard audit quality. Furthermore they believe that considering this matter would closely link in with their review of audit effectiveness under the Combined Code on Corporate Governance.<sup>3</sup>

---

<sup>3</sup> The review and monitoring of the external auditor's independence and objectivity and the effectiveness of the audit process is included in the role and responsibilities of the audit

- 2.7 Some of the respondents to the 2007 consultation paper who expressed a preference for maintaining the current five year rotation period also recognised that there may be circumstances where mandatory rotation after five years could act against the interests of the audited entity. Although some latitude on audit partner rotation is already provided for in ES 3 (Revised)<sup>4</sup>, the APB understands that this flexibility is rarely used in practice.
- 2.8 It has therefore been suggested that the flexibility currently permitted in ES 3 (Revised) might usefully be extended to more situations provided that any extension of the rotation period is discussed with, and approved by, the audit committee. However, the APB recognises that there are a number of disadvantages to providing such flexibility, including the potential for uncertainty and inconsistency which it may create.
- 2.9 Following extensive discussion with a number of stakeholders on this proposal, the APB has developed a possible amendment to paragraph 16 of ES 3 (Revised) which clarifies the existing options and adds that an audit committee may extend the tenure of an audit engagement partner of a large listed company which is also either complex or diverse where the audit committee is satisfied with the objectivity of the audit engagement partner and considers that the quality of the audit will be safeguarded by extending the rotation period from five to seven years.

**Question 3: The APB would appreciate commentators' views on whether it would be appropriate to provide greater flexibility to ES 3 (Revised) to permit in certain circumstances, and with the prior approval of the audit committee, the rotation period to be extended from five to seven years?**

**Question 4: In addition to large listed companies which are also complex or diverse, are there any other circumstances where some flexibility as regards the rotation period for audit engagement partners on listed companies would be appropriate? If so, please explain the rationale for your views.**

- 2.10 The APB considers that if more flexibility is to be introduced into the ESs relating to partner rotation it would need to be accompanied by disclosure to shareholders where it is utilised, together with the reasons

---

committee as set out in provision C.3.2 of the Combined Code on Corporate Governance, published in June 2008.

<sup>4</sup> ES 3 (Revised), paragraph 15 allows individuals to continue for a further two years when a company becomes listed. ES 3 (Revised), paragraph 16 enables a degree of flexibility where a reasonable and informed third party would regard the audit engagement partner's continuity as being especially important to the shareholders (e.g. where there are major changes to the client's structure or its senior management).

for the extension from five years. In discussions with investors and audit committee chairs, these stakeholders agreed that such disclosure would be essential.

2.11 To achieve this disclosure the APB is exploring possible mechanisms by which such a disclosure might be made a requirement, including a possible change to the Combined Code on Corporate Governance. However any such change is unlikely in the near future. In the meantime a possible amendment to ES 3 (Revised) is illustrated in Appendix 1 which provides that:

- Where the audit committee and the audit firm agree that a rotation period will be extended, it is also agreed that the company will disclose this fact and the reasons for it to the shareholders; and
- If the company does not agree to make this disclosure, then the audit engagement partner does not continue in this role.

2.12 It is anticipated that such guidance on disclosure would be adhered to by companies and audit firms as non-disclosure would be brought to light by any inspections of individual audits and by the fact that the audit engagement partner is now required to sign the auditor's report in their own name.<sup>5</sup>

**Question 5: Do you agree that if an audit committee is able to decide to extend the period of rotation, this fact and the reasons for it should be disclosed to shareholders?**

*Managers with a long association becoming key partners involved in the audit*

2.13 In the feedback paper to the 2007 review of the ESs, the APB noted that some commentators had requested further guidance on the safeguards to be applied when managers with a long association with an audited entity become key partners involved in the audit, in order to promote consistency in approach.

2.14 Currently where a partner or staff member in a senior position has been involved in the audit of a listed company for a continuous period longer than seven years, there is a requirement<sup>6</sup> that the audit engagement partner reviews the safeguards applied to reduce the self-interest, self-

---

<sup>5</sup> Section 503(3) of the UK Companies Act 2006 requires that, where the auditor is a firm, the auditor's report must be signed by the "senior statutory auditor" in his own name for and on behalf of the auditor. Bulletin 2008/06 sets out guidance that the term "Senior Statutory Auditor" has the same meaning as the term "Engagement Partner".

<sup>6</sup> ES 3 (Revised), paragraph 19.

## Consultation paper

review and familiarity threats to an acceptable level. The APB understands that individual firms have adopted their own policies to cover such circumstances, the details of which differ.

- 2.15 The APB does not propose to prevent managers with a long association with an audited entity becoming key partners on the same audit. Indeed the APB is of the view that this practice can be an important mechanism in enabling continuity within the audit firm.
- 2.16 The current guidance on the safeguards to be applied in such situations is brief and additional guidance is proposed, referring to the factors that will affect the significance of the threats and some further examples of safeguards that might be applied where partners and staff are in senior positions on an audit engagement for a continuous period longer than seven years.

**Question 6: Do you agree that the APB should retain the existing requirement and provide additional guidance in respect of partners and staff in senior positions for a continuous period longer than seven years?**

### *Rotation of Engagement Quality Control Reviewer*

- 2.17 This issue was discussed at the stakeholder meeting held on 1<sup>st</sup> July 2008. Most parties at that meeting felt that the requirement for the engagement quality control reviewer (EQCR) on listed company audits to rotate after five years could be relaxed as the familiarity threat associated with their involvement is less than for the audit engagement partner and the other threats to objectivity and independence are less likely to apply. The APB agrees that a seven year rotation period is appropriate for the EQCR. In the draft amendments to the revised ESs, this is effected by switching the requirements relating to EQCRs from the paragraphs relating to the audit engagement partner into the paragraphs relating to the key partners involved in the audit.

**Question 7: Do you support the proposed extension of the rotation period for the EQCR on listed company audits to seven years?**

### 3 Internal audit staff working directly for the audit team

---

- 3.1 The APB understands that there are instances where personnel from a company's internal audit function directly assist the external auditor in carrying out external audit procedures. This situation is not covered in ISA (UK and Ireland) 610, although it would seem that the same threats to independence that might arise would also exist where the auditor:
- relies on work already undertaken by internal audit function; or
  - agrees that the internal audit function should undertake certain work and then places reliance on that work.
- 3.2 However, directly involving individual internal audit staff in the audit means that these individuals fall within the definition of the audit team<sup>7</sup>. Some believe that this results in dual employment which is not permitted under paragraph 36 of ES 2 (Revised).
- 3.3 The APB considered a number of options associated with this issue and believes that including guidance in ISA (UK and Ireland) 610 would be an appropriate response, with a cross reference to this material in ES 2 (Revised). The APB believes that the threats associated with using internal audit staff to carry out external audit procedures are similar to situations where reliance is placed on other work carried out by the internal audit function. Accordingly the proposed amendment to ISA (UK and Ireland) 610 takes a similar approach by requiring members of the audit team to review the work undertaken, as well as agreeing the approach with those charged with governance in advance.
- 3.4 IAASB has announced that it will be reviewing ISA 610 in the near future. One of the issues likely to be addressed as part of this review is internal audit staff working directly for the audit team and the APB intends to promote its approach to this issue to the IAASB at this time. The revision of ISA 610 will also provide an opportunity to explore other issues in connection with placing reliance on work undertaken by the internal audit function.

**Question 8: Do you support the proposed approach of the APB towards internal audit staff working directly for the audit team?**

---

<sup>7</sup> All audit professionals who, regardless of their legal relationship with the auditor or audit firm, are assigned to a particular audit engagement in order to perform the audit task.

## 4 Restructuring services

---

- 4.1 The consultation on revisions to the ESs identified a concern that there is a conflict of interest where the same firm provides both an audit and restructuring advice to the same company. In particular, any decision over whether to include an emphasis of matter paragraph with regard to going concern in the auditor's report could be influenced by the position taken in relation to the restructuring services.
- 4.2 The recent sharp deterioration in economic conditions in the UK and Ireland suggest that in the coming year accounting firms are increasingly likely to be requested to provide restructuring advice to companies, including those to whom they provide audit services.
- 4.3 The APB issued *Bulletin 2008/10: Going Concern Issues during the Current Economic Conditions* in December 2008, which included guidance on the ethical issues associated with the provision of non-audit services in relation to restructuring. These paragraphs were based on material already included in the ESs. The APB considers that there is value in bringing this material together in ES 5 (Revised) so as to clarify how the general approach to non-audit services applies to restructuring services. A new section to ES 5 (Revised) is therefore proposed, providing examples of the type of services included in the category of restructuring services and setting out the requirements and guidance associated with their provision to an audited entity.
- 4.4 In order to meet concerns that a change to ES 5 (Revised) might disadvantage smaller companies in their negotiations with banks, the APB also proposes to make it clear in ES - Provisions Available for Small Entities (Revised) that a similar exemption to the advocacy threat associated with tax services would also apply to restructuring services.

**Question 9: Do you support the proposed approach of the APB towards the provision of restructuring services by the external auditor?**

## 5 Securitisation services

---

- 5.1 During the Treasury Committee's inquiry into Northern Rock questions were asked about the nature of non-audit services provided by its auditor in 2006 and the impact that these had on auditor independence.
- 5.2 The non-audit services in question were described in the Northern Rock accounts as 'verification of historical financial information and the performance of certain agreed upon assurance procedures for securitisation transactions'. The APB understands that such services comprised work to verify that analyses of mortgage characteristics contained in prospectuses or investor presentations had been properly extracted from original documentation and were accurately collated. Additionally the SEC requires further work to be performed to confirm that controls and other administrative procedures have been performed for securitisations marketed in the US. The work is therefore similar in nature to both audit work and the work which a reporting accountant performs on prospectuses used by companies raising external finance by way of bond or rights issues.
- 5.3 The APB considers that such securitisation services are currently covered by the requirements in ES 5 (Revised) relating to transaction related services. In particular ES 5 (Revised), paragraph 119 prohibits transaction related services where:
- There is reasonable doubt as to the appropriateness of a related accounting treatment;
  - Such services are provided on a contingent fee basis and:
    - The fees are material to the firm; or
    - The outcome is dependent on a future or contemporary audit judgment; or
  - The engagement would involve the firm undertaking a management role.
- 5.4 In respect of the securitisation services supplied to Northern Rock, an analysis of the threats to auditor independence would suggest that:
- There do not appear to be any significant accounting judgments impacted by the securitisation process as the mortgages involved were included in the consolidated accounts;

## Consultation paper

- The fees for securitisation services are less than the group audit fees and the APB understands that there were no contingency fee or other special billing arrangements;
- In the prospectus, management made the assertions regarding characteristics of the mortgages in the mortgage pool that were then validated by the auditor. In these circumstances no management threat appears to arise.

5.5 As a result of the above analysis of the threats to auditor independence, the APB believes that there is no need to strengthen the current requirements of ES 5 (Revised) in respect of securitisation services.

**Question 10: Do respondents support the APB's analysis and conclusion in relation to securitisation services?**

**Question 11: ES 5 (Revised) paragraph 119 sets out the circumstances in which securitisation services would be prohibited. Are there other circumstances that should result in a prohibition?**

5.6 In order to make it clear where assurance services on transactions, such as those relating to securitisations are covered, the APB believes that adding a further example to paragraph 116 (and deleting one from paragraph 104) would clarify that any agreed upon procedures in connection with a transaction (including securitisations) are dealt with under transaction related services. These amendments are included in the extracts from ES 5 (Revised) in Appendix 1.

## 6 Financial interests of new partners joining the firm

---

- 6.1 In the feedback paper to the 2007 consultation the APB agreed to give further consideration to the 'all partner' prohibition on financial interests in audited entities<sup>8</sup>. In particular the APB has discussed the concern of some audit firms that they are restricted in their ability to appoint new partners from outside the firm where these individuals have existing financial interests involving entities that the firm audits which they are unable to unwind without significant penalties.
- 6.2 The APB proposes to insert an additional paragraph providing relief in respect of this prohibition, so as to permit financial interests of new partners joining the firm where there is no market for disposal in such financial interests, provided that the new partner is not involved in the provision of any services to the entity concerned and that they work in a different part of the firm to the audit engagement partner.

**Question 12: Do you support the proposed relaxation of the ESs with respect to financial interests of new partners joining the firm?**

---

<sup>8</sup> ES 2 (Revised), paragraph 7

## 7 Amendments to align with agreed IFAC Code revisions

---

### *Governance roles*

- 7.1 In its Scope and Authority of Pronouncements the APB states that it is not aware of any significant instances where the relevant parts of the IFAC Code are more restrictive than the ESs. However, the International Ethics Standards Board for Accountants is currently revising aspects of the IFAC Code and the APB has reviewed the draft revised IFAC Code to identify areas where it appears to be more stringent than the ESs. As a result of this review, the APB believes that it is necessary to make one amendment to the ESs in respect of governance roles.
- 7.2 The subject of governance roles with an audited entity is covered in ES 2 (Revised), paragraphs 52 to 55. IFAC has a prohibition on all partners and employees of the audit firm from serving as a director or officer of an audit client. The prohibition in ES 2 (Revised) is narrower, relating to all partners and employees of the audit firm who undertake audit work. It is proposed that the scope of paragraph 53 of ES 2 (Revised) be extended to all partners and employees of the audit firm.

**Question 13: Do you support the proposed strengthening of the ESs with respect to governance roles with an audited entity?**

### *Definition of an affiliate of an audited entity*

- 7.3 Additionally, in the feedback paper on the 2007 review of the ESs, the APB agreed to reconsider what actions might be taken with a view to bringing the definition of an affiliate more into line with the IFAC Code definition of a related entity<sup>9</sup>.
- 7.4 While the APB believes that its current definition of an affiliate is in substance equivalent to the definition of a related entity in the IFAC

---

<sup>9</sup> Related entity - An entity that has any of the following relationships with the client:

- (a) An entity that has direct or indirect control over the client if the client is material to such entity;
- (b) An entity with a direct financial interest in the client if that such entity has significant influence over the client and the interest in the client is material to such entity;
- (c) An entity over which the client has direct or indirect control;
- (d) An entity in which the client, or an entity related to the client under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material to the client and its related entity in (c); and
- (e) An entity which is under common control with the client (a "sister entity") if the sister entity and the client are both material to the entity that controls both the client and sister entity.

## Consultation paper

Code, it understands that audit firms find the APB definition difficult to apply in practice.

- 7.5 However, the APB is uncomfortable with adopting the IFAC Code definition as it establishes a materiality test for some entities. The APB believes that in some circumstances the materiality test used does not provide an appropriate criterion as to whether an entity should be included in the scope of the definition of an affiliate. For example, in relation to the provision of non-audit services the significance of self-interest threats does not depend on the size of the entity to whom they are provided, but rather on a variety of other factors related to auditor independence, such as the nature of the non-audit service and the amount of fees.
- 7.6 The APB has therefore developed a proposed definition of an affiliate that uses a different term (clearly insignificant in relation to auditor independence), for determining those entities that should be treated as affiliates for the purposes of the ESs. The APB believes that the proposed definition uses clearer language and the clearly insignificant test minimises the scope for subjectivity, since the burden of proof is reversed so as to guide audit firms towards a more cautious approach.
- 7.7 The current APB definition of affiliate does not contain a 'materiality' test. Adding the proposed 'clearly insignificant' test moves the APB definition some way towards the IFAC Code definition.
- 7.8 This proposal not to align the definition for affiliates precisely with that used in the IFAC Code does not detract from the APB's support for the international harmonisation of ethical standards for accountants. Whilst the APB recognises that its proposed definition will result in a tougher standard than the IFAC Code, it believes that its analysis of the issues will be helpful in achieving a common international definition. The APB intends to communicate to the International Ethics Standards Board for Accountants its views on their definition of a related entity with a view to improving the IFAC Code in the future.

**Question 14: Do you support the APB's proposed definition of an affiliate?**

## 8 Remuneration and evaluation policies

---

- 8.1 The requirement for remuneration and evaluation policies in ES 4 (Revised) applies to the audit team, which only includes audit professionals. As part of its inspection work in 2007/08, the FRC's Audit Inspection Unit (AIU) identified that some firms permit senior specialist personnel from outside the audit function who are involved in audits to be rewarded for selling non-audit services to audited entities or for their performance to be evaluated based on their success in selling non-audit services to audited entities.
- 8.2 The APB has considered this matter and agrees with the view of the AIU that, although the ESs do not explicitly address the issue, the inclusion of key partners involved in the audit in such reward and performance evaluation processes is not in line with the underlying principles of the ESs. In the draft amendments to the ESs the APB has therefore extended the requirement for remuneration and evaluation policies and procedures to key partners involved in the audit.

**Question 15: Do you support the proposed change to the ESs with respect to extending the requirements relating to remuneration and evaluation policies to key partners involved in the audit?**

- 8.3 The APB has also considered whether this requirement should be extended to partners (other than key partners involved in the audit) and staff from non-audit disciplines who are assigned to the audit and who undertake a substantial part of some of the audit procedures. However, the APB doubts whether a significant threat to independence arises from this and therefore believes that further restriction through the ESs is likely to be disproportionate.

**Question 16: Do you believe that the requirement for remuneration and evaluation policies should be applied to other partners and staff from non-audit disciplines?**

## 9 Valuation of non-cash consideration for shares

---

- 9.1 During the development of the APB Bulletin, *Miscellaneous Reports by Auditors required by the UK Companies Act 2006*, the APB discussed whether paragraph 60 in ES 5 (Revised)<sup>10</sup> and the footnote to it remained appropriate.
- 9.2 Further exploration of this topic suggested that the material in ES 5 (Revised) seemed to provide more encouragement for a company's auditor to undertake a valuation required by Section 593 of the Companies Act 2006 than is offered by the law. This seems to conflict with international developments which are generally becoming more restrictive with regard to auditors undertaking valuations.
- 9.3 The APB therefore proposes that ES 5 (Revised) should be amended, so that the auditor is only permitted to undertake a valuation that is otherwise prohibited under ES 5 (Revised), where this is required by legislation or regulation.
- 9.4 The amendments associated with this change apply not only to valuations, but to other non-audit services. Amendments are therefore also proposed to the general approach to non-audit services and where specific reference is made to this provision.

**Question 17: Do you support the proposed strengthening of the ESs with respect to valuations and other non-audit services where legislation provides that the auditor is eligible to carry out a non-audit service, but does not require the auditor to undertake such work?**

---

<sup>10</sup> This paragraph states: 'In circumstances where the auditor is designated by legislation or regulation as being eligible to carry out a valuation... such a valuation would not be a non-audit service, ...' A footnote gives Section 593 of the Companies Act 2006 as an example of a circumstance when this guidance might apply.

## Appendix 1 – Exposure Draft of Revisions to APB Ethical Standards for Auditors and ISA (UK and Ireland) 610

---

### Extracts from ES 2 (Revised): Financial, business, employment and personal relationships

- 7 Save where the circumstances contemplated in paragraphs [\[A\]](#), 9, 11, 18 or 20 apply, the audit firm, any partner in the audit firm, a person in a position to influence the conduct and outcome of the audit or an immediate family member of such a person shall not hold:
- (a) any direct financial interest in an audited entity or an affiliate of an audited entity; or
  - (b) any indirect financial interest in an audited entity or an affiliate of an audited entity, where the investment is material to the audit firm or the individual, or to the intermediary; or
  - (c) any indirect financial interest in an audited entity or an affiliate of an audited entity, where the person holding it has both:
    - (i) the ability to influence the investment decisions of the intermediary; and
    - (ii) actual knowledge of the existence of the underlying investment in the audited entity.

[\[A\]](#) Where a person joins the audit firm as a partner, he or she is not required to dispose of financial interests held where there is no market for such interests, or the individual has no entitlement to sell the interest, and the individual is not able to influence the affairs of the entity, provided:

- [\(a\) The financial interests were acquired before the individual joined the audit firm; and](#)
- [\(b\) The partner in question:](#)

- is not in a position to influence the conduct and outcome of the audit;
- does not work in the same part of the firm as the audit engagement partner; and
- is not involved in the provision of a non-audit service to the audit client.

Such a financial interest is disposed of as soon as possible after the individual becomes able to make a disposal. The audit firm maintains a record of individuals with such financial interests containing a description of the circumstances.

**36 An audit firm shall not admit to the partnership, or employ a person to undertake audit work, if that person is also employed by the audited entity or its affiliates ('dual employment').**

[B] This requirement is not intended to preclude internal audit personnel directly assisting the external auditor in carrying out external audit procedures provided that appropriate quality control arrangements are established, as described in ISA (UK and Ireland) 610.

**53 A partner, or employee of the audit firm ~~who undertakes audit work~~, shall not accept appointment:**

- (a) to the board of directors of the audited entity;
- (b) to any subcommittee of that board; or
- (c) to such a position in an entity which holds directly or indirectly more than 20% of the voting rights in the audited entity, or in which the audited entity holds directly or indirectly more than 20% of the voting rights.

**Extracts from ES 3 (Revised):  
Long association with the audit engagement**

**ADDITIONAL PROVISIONS RELATED TO AUDITS OF LISTED  
COMPANIES**

**The audit engagement partner and the engagement  
quality control reviewer**

- 12 In the case of listed companies, save where the circumstances contemplated in paragraph 15 and 16 apply, the audit firm shall establish policies and procedures to ensure that:
- (a) no one shall act as audit engagement partner ~~or as engagement quality control reviewer for a period longer~~more than five years;
  - (b) ~~where an engagement quality control reviewer becomes the audit engagement partner, the combined period of service in these positions shall not exceed five years;~~ and
  - (be) anyone who has acted as the audit engagement partner ~~or the engagement quality control reviewer, or held a combination of such positions,~~ for a particular audited entity for ~~a period of five years, whether continuously or in aggregate,~~ shall not subsequently participate in the audit engagement until a further period of five years has elapsed.
- 13 The roles that constitute participating in an audit engagement for the purposes of paragraph 12(be), ... This is not intended to preclude partners whose primary responsibility within a firm is to be consulted on technical or industry specific issues from providing such consultation to the engagement team or client after a period of two years has elapsed from their ceasing to act as audit engagement partner ~~or engagement quality control reviewer,~~ provided that such consultation is in respect of new issues or new types of transactions or events that were not previously required to be considered by that individual in the course of

- acting as audit engagement partner ~~or engagement quality control reviewer~~.
- 14 Where an audit engagement partner ~~or engagement quality control reviewer~~ continues in a non-audit role having been rotated off the engagement team, ...
- 15 When an audited entity becomes a listed company, the length of time the audit engagement partner has served the audited entity in that capacity is taken into account in calculating the period before the audit engagement partner is rotated off the engagement team. However, where the audit engagement partner has already served for four or more years, that individual may continue to serve as the audit engagement partner for not more than two years after the audited entity becomes a listed company.
- 16 In circumstances where the audit committee (or equivalent) of the audited entity and the audit firm have agreed that a~~Some~~ degree of flexibility over the timing of rotation ~~may be~~would safeguard the quality of the audit necessary, the audit engagement partner may continue in this position for an additional period of up to two years, so that no longer than seven years in total is spent in the position of audit engagement partner~~in circumstances where a reasonable and informed third party would regard the audit engagement partner's continuity as being especially important to the shareholders of the audited entity.~~ For example, An audit committee and the audit firm may consider that such flexibility safeguards the quality of the audit, for example, where:
- the audited entity is so large and either complex or diverse that the audit partner's cumulative knowledge of the business is critical to the audit; or
  - major substantial change has recently been made or will soon be made to the nature or audited entity's structure of the audited entity's business; or

- there are unexpected changes in the its senior management of the audited entity are expected that would otherwise coincide with the rotation of the audit engagement partner.

In these circumstances alternative safeguards are applied to reduce any threats to an acceptable level. Such safeguards may include ensuring that an expanded review of the audit work is undertaken by an audit partner, who is not involved in the audit engagement.

[C] Where it has been determined that the audit engagement partner may act for a further period (not to exceed two years), this fact and the reasons for it, are to be disclosed to the audited entity's shareholders, (preferably in the corporate governance statement within the annual report). If the audited entity is not prepared to make such a disclosure, the audit firm does not permit the audit engagement partner to continue in this role.

- 17 In the case of joint audit arrangements for listed companies, audit firms will make arrangements for changes of audit engagement partners ~~and engagement quality control reviewers~~ over a five-year period so that the familiarity threat is avoided, whilst also taking into consideration factors that affect the quality of the audit work.

### **Key partners involved in the audit**

- 18 In the case of listed companies, the audit firm shall establish policies and procedures to ensure that:
- (a) no one shall act as the engagement quality control reviewer or a key partner involved in the audit for a **continuous** period longer than seven years;
  - (b) where an engagement quality control reviewer or key partner involved in the audit becomes the audit engagement partner, the combined period of service in these positions shall not exceed seven years; and
  - (c) anyone who has acted:

(i) as an engagement quality control reviewer or key partner involved in the audit, or held a combination of such positions, for a particular audited entity for a period of seven years, whether continuously or in aggregate, shall not participate in the audit engagement until a further period of two years has elapsed;

(ii) in a combination of roles as:

- an engagement quality control reviewer or a key partner involved in the audit, and
- the audit engagement partner for a particular audited entity for a period of seven years, whether continuously or in aggregate, shall not participate in the audit engagement until a further period of five years has elapsed.

### **Other partners and staff in senior positions**

19 In the case of listed companies, the audit engagement partner shall review the safeguards put in place to address the threats to the auditor's objectivity and independence arising where partners and staff have been involved in the audit in senior positions for a continuous period longer than seven years and shall discuss those situations with the engagement quality control reviewer. Any unresolved problems or issues shall be referred to the ethics partner.

20 The significance of the threats arising where partners and staff have been involved in the audit in senior positions for a continuous period longer than seven years will depend on:

- the total period of time that the individual has been involved in the audit;
- changes in the nature of the work and the role performed by the individual during that period; and

- the portion of time the individual has spent on the audit and non-audit engagements with the audited entity during that period.

[D] Following the assessment of any such threats, appropriate safeguards are applied where necessary. Safeguards that address these threats arising from such a situation might include: the removal of the member of staff from, or

- the rotation of changes in the roles within, the engagement team;
- an additional review of the work done by the individual by the audit engagement partner or other partners in the engagement team;
- additional procedures carried out as part of the engagement quality control review.

If such safeguards do not reduce the threats to an acceptable level, the partner or member of staff is removed from the engagement team.

**Extracts from ES 4 (Revised):  
Fees, remuneration and evaluation policies, litigation, gifts  
and hospitality**

38 The audit firm shall establish policies and procedures to ensure that, in relation to each audited entity:

(a) the objectives of the members of the audit team and key partners involved in the audit do not include selling non-audit services to the audited entity;

(b) the criteria for evaluating the performance or promotion of members of the audit team and key partners involved in the audit do not include success in selling non-audit services to the audited entity;  
and

(c) no specific element of the remuneration of a member of the audit team and key partners involved in the audit is based on his or her success in selling non-audit services to the audited entity.

## Extracts from ES 5 (Revised): Non-audit services provided to audit clients

6 In this Standard, 'non-audit services' comprise any engagement in which an audit firm provides professional services to an audited entity other than:

- (a) the audit of financial statements; and
- (b) pursuant to those other roles which are required by legislation or regulation specify ~~canto~~ be performed by the auditor of the entity (for example, considering the preliminary announcements of listed companies, complying with the procedural and reporting requirements of regulators, such as requirements relating to the audit of the audited entity's internal controls and a report in accordance with Section 714 of the Companies Act 2006).

In the case of a group, non-audit services include services provided by the audit firm, to the parent company or to any affiliate.

60 In circumstances where the auditor is designated by legislation or regulation as being eligible ~~required~~ to carry out a valuation<sup>4</sup> the restrictions in paragraph 56 do not apply as such a valuation would not be a non-audit service, as provided by paragraph 6. In such circumstances, the audit engagement partner applies relevant safeguards.

---

<sup>4</sup>For example, Section 593 of the Companies Act 2006 requires a public company to obtain an independent valuation on assets to be received in full or part payment for shares to be allotted from a person who is eligible for appointment as a statutory auditor.

## **CORPORATE FINANCE SERVICES**

104 The range of services encompassed by the term ‘corporate finance services’ is wide. For example, the audit firm may be engaged:

- to identify possible purchasers for parts of the audited entity’s business and provide advisory services in the course of such sales; or
- to identify possible ‘targets’ for the audited entity to acquire; or
- to advise the audited entity on how to fund its financing requirements, ~~including advising on debt restructuring and securitisation programmes~~; or
- to act as sponsor on admission to listing on the London Stock Exchange, or as Nominated Advisor on the admission of the audited entity on the Alternative Investments Market (AIM); or
- to act as financial adviser to audited entity offerors or offerees in connection with public takeovers.

115 These restrictions do not apply in circumstances where the auditor is designated by legislation or regulation as being ~~eligible~~ required to carry out a particular service, since such a service would not be a non-audit service, as provided by paragraph 6. In such circumstances, the audit engagement partner establishes appropriate safeguards.

## **TRANSACTION RELATED SERVICES**

116 In addition to corporate finance services, there are other non-audit services associated with transactions that an audit firm may undertake for an audited entity. For example:

- investigations into possible acquisitions or disposals (‘due diligence’ investigations); or

- investigations into the tax affairs of possible acquisitions or disposals; or
- the provision of information to management or sponsors in relation to prospectuses and other investment circulars (for example, long form reports, comfort letters on the adequacy of working capital); or
- agreed upon procedures or reports provided to management in relation to particular transactions (for example, securitisations).

122 These restrictions do not apply in circumstances where the auditor is designated by legislation or regulation as being ~~eligible~~ required to carry out a particular service, since such a service would not be a non-audit service, as provided by paragraph 6. In such circumstances, the audit engagement partner establishes appropriate safeguards.

### **RESTRUCTURING SERVICES**

[E] The potential for the auditor's objectivity and independence to be impaired through the provision of non-audit services in relation to a refinancing or restructuring engagement varies depending on the nature of the service provided. The main threats to auditor objectivity and independence arising from the provision of restructuring services are the self-review, management and advocacy threats.

[F] Examples of restructuring services that the audit firm may be requested to undertake and which may give rise to threats to the auditor's independence and objectivity include:

- Undertaking a review of the business with a view to advising the audited entity on restructuring options.
- Advising on forecasts or projections, for presentation to lenders and other stakeholders, including assumptions.
- Advising the audited entity on how to fund its financing requirements, including debt restructuring programmes.

[G] The audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity where:

- (a) the engagement would involve the audit firm undertaking a management role in the audited entity; or
- (b) the engagement would require the auditor to act as an advocate for the entity in relation to matters that are material to the financial statements.

[H] When providing restructuring services to an audited entity, there is a self-review threat associated with any advice provided to assist the audited entity in that regard and the auditor's assessment of whether it is appropriate for the financial statements to be prepared on a going concern basis. Appropriate safeguards are applied to reduce the self-review threat to an acceptable level.

[I] Examples of safeguards that may be appropriate when restructuring services are provided to an audited entity include:

- The restructuring advice is provided by partners and staff who have no involvement in the audit of the financial statements.
- A review by a partner or other senior staff member with appropriate expertise who has no involvement in the audit of the financial statements of the assessment as to whether it is appropriate for the financial statements to be prepared on a going concern basis.
- Additional procedures undertaken as part of an Engagement Quality Control Review.

[J] Where the audit firm is engaged to provide restructuring services to an audited entity there is a threat that the audit firm undertakes a management role, unless the audit firm ensures that the entity has informed management<sup>11</sup> capable of taking responsibility for the decisions to be made.

---

<sup>11</sup> 'ES – Provisions Available for Small Entities' provides exemptions relating to informed management for auditors of small entities.

[K] If the audit firm attends meetings with the entity's bank or other interested parties it takes particular care to avoid assuming responsibility for the entity's proposals or being regarded as negotiating on behalf of the entity or advocating the appropriateness of the proposals such that its independence is compromised.

## Extracts from ES - Provisions Available for Small Entities (Revised)

15 The audit firm of a Small Entity is not required to comply with APB Ethical Standard 5, paragraphs 82 and [G](b) provided that it discloses the fact that it has applied this Standard in accordance with paragraph 22.

16 APB Ethical Standard 5, paragraph 82 provides that 'the audit firm shall not undertake an engagement to provide tax services to an audited entity where this would involve acting as an advocate for the audited entity, before an appeals tribunal or court in the resolution of an issue:

—(a) that is material to the financial statements; or

(b) where the outcome of the tax issue is dependent on a future or contemporary audit judgment'.

[L] APB Ethical Standard 5, paragraph [G](b) provides that 'the audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity where the engagement would require the auditor to act as an advocate for the entity in relation to matters that are material to the financial statements'.

[M] Such circumstances may create an advocacy threat which it is unlikely any safeguards can eliminate or reduce to an acceptable level.

17 Where an audit firm auditing a Small Entity takes advantage of the dispensation in paragraph 15, it discloses the fact that it has applied this Standard in accordance with paragraph 22.

## Extracts from Glossary of terms

### affiliate

Any entity undertaking which, directly or indirectly:

(a) is connected to another by means of common ownership, controlled or significantly influenced by the audited entity;

(b) has control or significant influence over the audited entity;

(c) is under common control with the audited entity;

except where, in (b) or (c) above, the relationship between the audited entity and the other entity, or between the audit firm and the relevant entity, is clearly insignificant<sup>12</sup> in relation to auditor independence or management.

---

<sup>12</sup> Whenever there is any uncertainty about whether a relationship is 'clearly insignificant', then the presumption would be that the relevant entity should be included as an affiliate.

## Extracts from ISA (UK and Ireland) 610

1 The purpose of this International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) is to establish standards and provide guidance to external auditors in considering the work of internal auditing. This ISA (UK and Ireland) ~~does not deal with~~ provides guidance on instances when personnel from internal auditing assist the external auditor in carrying out external audit procedures. The audit procedures noted in this ISA (UK and Ireland) need only be applied to internal auditing activities which are relevant to the audit of the financial statements.

**16 When the external auditor intends to use specific work of internal auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.**

17 The evaluation of specific work of internal auditing involves consideration of the adequacy of the scope of work and related programs and whether the assessment of the internal auditing remains appropriate. This evaluation may include consideration of whether ...

17-1 In addition to using specific work of an internal audit function, the external auditor may obtain direct assistance from individuals from the internal audit function. In addition to the considerations set out in paragraph 17, when direct assistance is provided by individuals from the internal audit function, the external auditor:

(a) obtains a written confirmation from such individuals that they agree to follow the instructions of staff of the audit firm in relation to the work performed and that, where applicable, they will keep confidential specific matters as instructed by the audit team;

(b) directly supervises, reviews and evaluates the work performed;

(c) ensures that such individuals are only involved in work where self-review or judgment is not an important part of the audit procedure; and

(d) communicates the details of the planned arrangements with those charged with governance at the planning stage of the audit, so as to agree this approach, as described in paragraph 11-9 of ISA (UK and Ireland) 260.