

Briefing Paper

Standing for trust and integrity

June 2011



The Provision of Non-Audit Services to Audit Clients

One of the issues raised by the recent European Commission Green Paper on Audit Policy focused on the provision of non-audit services to audit clients and its potential impact on the independence of an auditor.

The principle of objectivity is imposed on all auditors and for all services they perform, which is the obligation not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others. The concept of independence is a proxy to deal with objectivity in a regulatory, practical and measurable way.

In the current debate, services other than audit have been discussed as if they were all the same and as having the same impact on the independence of the auditor, thus questioning whether all non-audit services should be prohibited. In reality, there are different types of services.

Some non-audit services can indeed compromise an auditor's independence and should ultimately be prohibited, which is already the case in most EU Member States. Other services do not pose a threat to auditors' independence and can thus be allowed.

In order to assess whether the provision of a particular non-audit service will, may, or will not compromise the auditor's independence, the non-audit services can be categorised as follows:

- To be generally prohibited;
- To be permitted only if, following rigorous analysis, appropriate safeguards are in place to mitigate or even eliminate any threat to auditor independence to an acceptable level; or
- To be generally permitted.

Public interest entities

Public interest entities (PIEs) are under heightened public scrutiny, governance, transparency and other requirements. The independence requirements imposed on their auditors are more rigorous which results in more prohibitions of non-audit services for auditors auditing PIEs than for those auditing other companies, as depicted below in Figure 1.

Non-public interest entities

Such rigorous requirements are less justifiable or relevant for other entities or non-PIEs, including Small and Medium-sized Entities (SMEs). This, compared to audits of PIEs, results in less prohibitions of non-audit services and more permitted services for auditors auditing non-PIEs, as illustrated below in Figure 2.

Further explanation on the differences between the three types is given below. Most EU Member States have used a similar approach to regulate the provision of non-audit services by auditors and their audit firm network, although there are local differences as far as the categorisation of individual services is concerned.

Prohibited non-audit services

Certain non-audit services represent such a significant threat to the independence of the auditor that the only possible solution is to prohibit the provision of such services to audit clients, if they have an impact on the financial statements to be audited; in some cases even if the service has no such impact. These include for example:

Prohibited non-audit services for auditors of all entities:

- Assuming a management responsibility;
- Serving as General Counsel and negotiating for the audit client;
- Promoting, dealing in, or underwriting client shares;
- Bookkeeping and accounting services beyond routine and mechanical;
- Valuation services involving subjectivity;
- Corporate finance advice that depends on a questionable particular

Figure 1 : Non-audit services in public interest entities

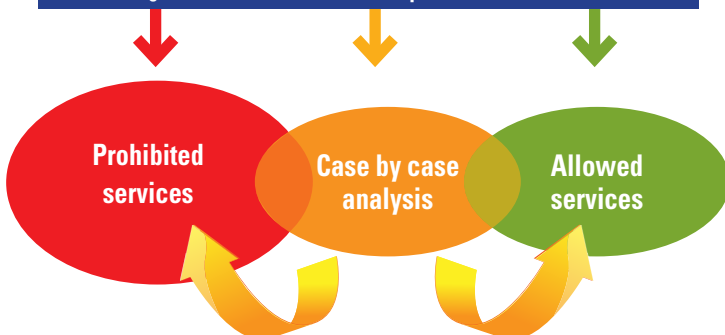
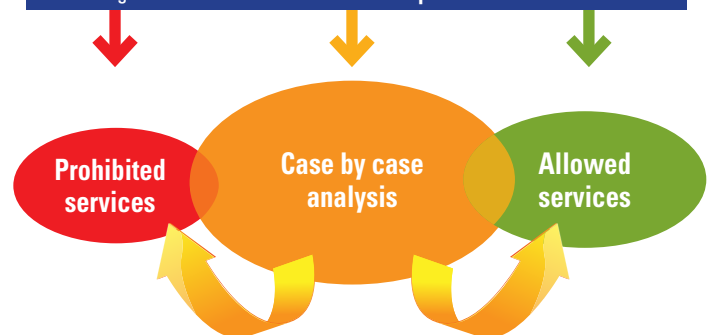


Figure 2 : Non-audit services in non-public interest entities



- accounting treatment and financial statement presentation;
- Acting as an advocate before a public tribunal or court.

For auditors of public interest entities additional non-audit services are prohibited:

- The preparation of financial statements and related financial information;
- Payroll services;
- Valuation services;
- Calculations of current and deferred taxes;
- Internal audit services relating to internal controls over financial reporting or systems;
- Designing and implementing financial reporting IT systems.

It should also be noted that evaluating or compensating a key audit partner based on that partner's success in selling non-audit services to the partner's audit client is always prohibited.

Case by case analysis - for non-audit services creating a potential threat to auditor independence

Certain non-audit services *potentially* pose a threat to the independence of the auditor. It may be possible to reduce such threats to an acceptable level by introducing specific measures to safeguard auditor independence. This requires a deeper and individualised analysis by the auditor and those charged with governance to understand if the provision of these services may and to what extent they could compromise the auditor's objectivity.

It is clear that, for example, assisting the client with a litigation on an *insignificant* matter does not affect the auditor's objectivity and independence as there will be no conflict of interest at the time of performing the audit and formulating conclusions. This would thus become an allowed service.

However, determining the value of an asset for an audit client will raise an independence issue when the value of such asset has a *significant* impact on the financial statements to be audited. This would thus become a prohibited service.

Certain other services like consultancy, advisory and some tax services also require an in-depth analysis. There are many different types of tax services like tax advice, tax planning, advocating the resolution of a tax matter before a public tribunal or court, etc. Therefore, the provision of such tax services by an auditor should be considered case by case as it will depend on the specific type of tax service, its dependence on an accounting treatment, the significance of its impact on the financial statement as well as the tax regime in a particular country whether the auditor can or cannot perform a certain tax service.

These assessments are not black or white in practice and will require a deep and objective assessment of the services on a case by case basis. This analysis is based on a solid rationale for applying criteria to determine which safeguards would be appropriate (or not) to mitigate the identified threats. In PIEs, the audit committee also often plays a determining role in the procurement of significant non-audit services from the auditor. This case by case analysis results in the auditor being prohibited or allowed to perform the service under consideration in that specific situation.

Allowed services

Some other non-audit services are audit-related, assurance, or advisory services. The performance of such services by the auditor may either be required due to legal, regulatory or contractual reasons, or the auditor is best placed to provide them to the audit client because the service is closely connected to the audit work.

A prohibition for the auditor to provide these types of non-audit services to an audit client would be unnecessary to preserve auditor independence. A ban would also seriously undermine the ability of companies and stakeholders to timely and cost-effectively enter into transactions where currently the assurance provided by the auditor on any element of the transaction is considered to be relevant. It would also affect part of the supervisory system in certain key sectors of the economy.

Some typical examples of these services are:

- Review of interim financial statements;
- Assurance provided to lenders on compliance with certain contractual agreements of a loan;
- Due diligence services on potential mergers and acquisitions;
- Assurance on corporate governance statements;
- Assurance on or attestation of regulatory reporting provided to regulators in certain sectors (i.e. bank regulators) beyond the scope of the audit and designed to assist regulators in fulfilling their role, such as on capital requirements or specific solvency-related ratios determining how likely a company will be to continue meeting its debt obligations;
- Providing comfort letters for investors in the context of the issuance of a company's securities;
- Assurance on a company's pro-forma financial information, anticipating the result of a planned transaction as a merger, an acquisition or a disposal;
- Assurance on Corporate Social Responsibility (CSR) matters;
- Tax compliance work, such as assistance in preparing tax returns.

The way forward: harmonised European independence requirements

Non-audit services provided by auditors should not be treated as a monolithic bloc endangering the auditor's independence and thus be prohibited as a whole. Certain services are not just permissible but are required to be performed by the auditor. The provision of other services to audit and especially non-audit clients may enhance the quality of the audit as well as its effectiveness and efficiency. Indeed, in performing auditing, advisory, assurance and even other non-audit services, members of the audit profession obtain complementary and specialised knowledge and competence. Also, it is a reality that this variety of work attracts talented young graduates and other highly skilled resources which is crucial for the provision of high quality audit services.

Further harmonisation of these matters at European level could be achieved if the adoption of relevant sections of the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board of Accountants (IESBA) in July 2009 would be considered. Such common standards would also be a prerequisite for an EU passport for auditors.