

# Statutory Audit Independence and Objectivity

Common Core of Principles For the Guidance of the European Profession

Initial Recommendations

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The English text of this document is the definitive one, being that approved by the FEE Council.  
For convenience, however, French and German translations are also included.

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## Introduction

The statutory audit requirement was introduced in the legal framework at European level to protect the interests, not only of shareholders, but also of other stakeholders in enterprises and more generally of the public at large. The statutory audit, therefore, is not a service the specifications and provision of which may be freely negotiated between the provider and purchaser. Professional safeguards are necessary to ensure that the interests of other users of the audit report are respected. Primary amongst these safeguards is the requirement that the statutory auditor must possess the competence, integrity, independence and objectivity needed to perform his task. The Eighth Directive, in Article 24, requires Member States to lay down rules on the independence of statutory auditors, and this has been done through a mixture of legislation, professional rules and other requirements. The method has varied between countries, depending on the different approaches of the public authorities towards self-regulation, a concept with different meanings in the different Member States, covering different levels of delegated authority and monitored self-regulation. However national laws and regulations, pursuing the common objective of ensuring the independence and objectivity of the statutory auditor, have sometimes put in place different obligations, prohibitions and incompatibilities to deal with the same threats.

The purpose of the present document, expanding on FEE's previous position paper "Audit Independence and Objectivity" of 1995, as well as its study "The Role, Position and Liability of the Statutory Auditor in the EU" of January 1996 and its response to the Commission's Green Paper of that same name in October 1996, is to present a common core of principles of audit independence and objectivity. Once accepted by the European Commission and the Member States, this common core of principles would be incorporated by national authorities (both internal to the profession and external) in charge of regulating the profession and its independence, into their national requirements governing statutory audit independence and objectivity with the aim of enhancing the functioning of the single market for statutory audit.

This common core of principles should help achieve a single market for statutory audit in several respects:

- By providing a common set of rules throughout Europe which would be accepted by both the public authorities and the profession and would be implemented at national level, it would increase public understanding of the ethical requirements of the profession throughout Europe and would therefore increase the public confidence in the profession and its ability to play its proper role in the public interest. The term "public interest" relates to matters of public concern. It extends to the concerns of clients, public authorities, financial institutions, employees, investors, the business and financial community and others who rely upon the statutory auditor's independence and objectivity. The profession has always recognised these responsibilities to the public interest. For example, statutory audit helps to ensure the integrity of the financial statements presented to financial institutions in support for loans and to stockholders for obtaining capital.
- By increasing the reliance on the work of statutory auditors from other European jurisdictions, it should increase the reliance which can be placed on audited accounts, with welcome effects on EU welfare and competitiveness.
- By dealing with the question of ownership and control of statutory audit firms, and with the addition of further specific work undertaken by FEE in the area of liberalisation, it should help the free movement of audit firms, easing their provision of cross-border services and their establishment through branches and subsidiaries in another Member State.
- By highlighting conflicts of rules where individual statutory auditors and audit firms are practising in more than one jurisdiction (to which the further specific work being undertaken by FEE in the area of liberalisation will also be relevant) it should also help the free movement of statutory auditors and therefore the completion of a true single market for statutory audit. At present, certain ethical rules are linked to the professional title in certain countries, and continue to apply to the holder of this title even when he practises in a country which does not have a similar rule. A statutory auditor practising in several jurisdictions could therefore find himself in an unfavourable competitive position in a certain country, by virtue of the rules attaching to one of his titles.

A common core of essential principles will provide an environment in which any additional independence rules existing in a Member State would be of purely national application and could not be imposed on the statutory auditors of foreign subsidiaries. In the context of the statutory audit of consolidated accounts, for example, it would allow the reliance on the work of a statutory auditor of a foreign jurisdiction by a statutory auditor of any EU Member State in the context of group audit.

The present document therefore outlines in its first part the concepts governing statutory audit independence and objectivity. It explains the notions of independence of mind and independence in appearance and the expectations of those directly affected. It considers the different kinds of threats which arise with respect to statutory audit independence and objectivity and the possible safeguards, including incompatibilities, to offset these threats.

Because most of the specific situations in which statutory audit independence and objectivity are at risk, or perceived to be so, are common in most of the Member States, the document in its second part applies this approach to the most important circumstances in which the independence of mind or in appearance of the statutory auditor is at risk. It therefore defines a minimum set of requirements which must apply to these specific cases throughout Europe. Beyond this minimum common set of requirements, any additional independence rules imposed by Member States at national level should respect the principle of proportionality and should not constitute insurmountable barriers to the completion of the single market.

Whilst it can be expected that the first part of this document dealing with the concepts would vary very little over time, the second part of the document dealing with specific issues should be expected to evolve and to be subject to continuous review. Because of the importance of independence in appearance in the setting of rules, because of the changes in the practice of statutory audit in a continuously changing environment (new business developments interlinked with the development of new technologies and the evolution of global financial markets) to which the statutory auditor must adapt, it must be expected that the rules set out in the second part of the document will require continuing development. For statutory auditors as for any other profession, ethical standards - of which the requirement to be independent is a main component - must be continuously re-examined in the light of unchanged principles, in order to adapt and respond to changing circumstances.

For the purpose of applying this common core of principles, the statutory auditor, whether an individual or a firm, must recognise that each of the threats and therefore the incompatibilities set out below may arise either:

- in relation to himself in person;
- in relation to a close intermediary such as a member of his immediate family (spouse or dependent);
- in relation to a partner in his audit firm or a person who is close to him for some other reason (such as some past or present association or obligation or indebtedness) and/or
- in relation to an interest in the company to be audited ( for example an undertaking in which the company owns, direct or by way of control, 20% or more of the voting rights or capital).

The statutory auditor should not employ any person on the statutory audit who would be excluded from the role of statutory auditor by any of the prohibitions set out in this paper.

Although this common core of principles was developed in the context of statutory audit, it should also apply to other audit engagements. Indeed, the term "audit" should not be used to describe engagements which have not been carried out respecting those principles.

Finally, FEE considers it the task of the profession, in a properly functioning system of monitored self-regulation, to provide quality assurance systems which will ensure compliance with and respect for the ethical requirements of the profession, including independence. As a matter of record, the quality assurance systems developed in almost all the Member States of the European Union include procedures to ensure that the statutory audit work they monitor and review has been conducted in compliance with ethical and independence requirements.

## I. Underlying concepts

The expression of an objective opinion should always be the ultimate goal of the statutory audit. Independence is the main means by which the statutory auditor demonstrates that he can perform his task in an objective manner. In dealing with independence, one must address both:

- Independence of mind, i.e. the state of mind which has regard to all considerations relevant to the task in hand but no other; and
- Independence in appearance, i.e. the avoidance of facts and circumstances which are so significant that an informed third party would question the statutory auditor's objectivity.

Objectivity is essential for any professional person exercising professional judgement. This is particularly so for statutory auditors, whose professional opinions are likely to affect rights between parties.

In order to safeguard their objectivity, statutory auditors contemplating any work or engagement requiring objectivity of judgement should consider certain matters before deciding whether to accept a new contract or appointment, or whether to continue an existing appointment. The matters to be considered fall under the following headings:

The expectations of those directly affected by the work and entitled to have a legal interest in its results.

The public interest and its bearing on the work. This must include applicable EU Directives or Regulations and the laws and regulations of Member States. The requirement for an independent, external, statutory audit for companies, as provided by Article 51 of the Fourth Directive and Article 37 of the Seventh Directive, reflects the desire of Member States to provide protection to shareholders and third parties. It was therefore judged of special importance to establish, throughout the EU, minimum equivalent legal requirements for the financial information to be made available to the public by companies competing in the single market. These requirements have been elaborated and implemented to assure the confidence of financial statement users in the audit process and in the market. This process needs to consider independence issues not only from the statutory auditor's point of view but also from the user's. Auditors need not only to be independent but also to appear independent.

The environment in which the work is to be conducted. This includes the environment within the statutory audit practice and the profession, as well as in the wider community.

The threats to objectivity which may actually arise or may appear to arise because of the expectations and the environment.

The safeguards which can be put in place to offset the risks and threats.

Threats to objectivity can arise in a number of ways, some general in nature and some related to the specific circumstances of an assignment. In identifying threats, a statutory auditor should consider them in the light of the professional environment in which he is working. He should take into account the countervailing factors and the safeguards discussed below which assist him to withstand threats to his objectivity.

The risks or threats include the following:

- The Self-Interest Threat or Risk. A threat to the statutory auditor's objectivity stemming from a financial or other self-interest conflict.
- The Self-Review Threat or Risk. The apparent difficulty of maintaining objectivity in conducting what is effectively a self-review, if any product or judgement of a previous statutory audit assignment or a non-audit assignment needs to be challenged or re-evaluated in reaching statutory audit conclusions.

- The Advocacy Threat or Risk. A risk to the statutory auditor's objectivity, if he becomes an advocate for (or against) his client's position in any adversarial proceedings or situation.<sup>1</sup>
- The Familiarity or Trust Threat or Risk. A risk that the statutory auditor may become over-influenced by the client's personality and qualities, and consequently too sympathetic to the client's interest.
- The Intimidation Threat or Risk. The possibility that the statutory auditor may become intimidated by a threat, by a dominating personality, or by other pressures, actual or feared, by the client or an associate of the client or by some other party.

Where threats exist, statutory auditors should always consider the use of safeguards and procedures which may negate or reduce them. In certain countries, safeguards are provided for by law or professional rules. In those cases, the statutory auditor must also consider his compliance with the existing rules. Failure to comply with these rules leads to professional disciplinary proceedings, whose sanctions include removal of the right to practise. Safeguards and procedures which must always be considered include:

- Internal steps taken by the statutory audit practice, which are required and monitored by the professional regulatory authorities, to ensure that threats of conflict are recognised, documented and mitigated, e.g.:
  1. An overall control environment, starting with a professional approach towards matters of quality and ethics and taking into account the assurance provided by a regularly monitored and evidenced control system.
  2. Arrangements to ensure that staff are adequately aware and empowered to communicate any issue of independence and objectivity that concerns them to a separate principal.
  3. The involvement of an additional partner who did not take part in the conduct of the audit to carry out reviews or otherwise advise.
  4. The involvement of a third party such as a committee of independent directors, or the consulting of a professional regulatory body or another statutory auditor.
  5. Arrangements to reduce the risk of conflict by compartmentalizing responsibilities and knowledge in specific cases.
- Publicly visible steps, possibly including a public statement, to explain in a specific situation how the risk of conflict is recognised and mitigated.
- Refusal to act where no other appropriate course can abate the perceived problem.

## II. Specific threats and requirements

The issues described in this section represent the most common situations in which the statutory auditor's independence and objectivity are at risk or are perceived to be so.

### 1 Personal, business or financial links between statutory auditors and clients

#### 1.1 Personal or business relationships

##### **Description - situations which give rise to threats**

Close personal or business relationships may arise between the audit client or its management and the statutory auditor even where no close relatives are involved. A "business relationship" means a commercial and/or financial common interest between the statutory auditor and the audit client, such as for example participating in joint ventures, investing together in property, or other similar activities.

Having too close a personal or business relationship with the audit client or its management gives rise to obvious over-familiarity threats as well as to self-interest threats.

If a close relative of the auditor is either involved in senior management or in a position to exercise direct influence on the preparation of the accounts of an audit client or if the auditor has any financial interest in the latter, the position is likely to lead to major real or perceived threats of self-interest. Additionally, third parties might think that the statutory auditor's appointment is due to his close connection with one or more manager(s) in the client company.

In certain countries it is common for retired statutory auditors to become non-executive directors on the Board of former clients. Their professional competence and knowledge of the business as well as their status as retired from professional activities usually makes them well suited to the independent status required for the position of non-executive director. However, the statutory auditor must be aware that part of the role of the non-executive director is to act as a safeguard to ensure statutory auditors' independence and objectivity, so that having a former partner in that position might be perceived as impairing the role of non-executive directors. In such a situation doubts might arise as to whether the non-executive directors had achieved the necessary separation from their former professional activities. Equally they might have to give opinions on issues on which they had previously given their opinion as statutory auditor.

Accepting goods and services on favourable terms (i.e. below what the open market would offer for such goods and services) gives rise to self-interest threats.

##### **Requirements**

- a) Business relationships, defined as commercial and/or financial common interests such as for example participating in joint ventures, investing together in property, or other similar activities, between the statutory auditor and the audit client outside the normal rendering of professional services, give rise to self-interest threats real or perceived which are in practice too great to be over-ridden by possible safeguards. They must therefore be prohibited.
- b) Where a close relative is involved in senior management of a client company or is in a position to exercise direct influence on the preparation of the accounts or has a material financial interest, the threats of real or perceived lack of objectivity are in practice too high and too numerous to be over-ridden by possible safeguards. An individual statutory auditor should therefore not personally accept or continue an appointment in such a situation.
- c) In the case where a retired former partner of a statutory auditor serves as a non-executive director of an audit client or on the audit committee of an audit client, the statutory auditor will have to put in place safeguards to his independence and objectivity other than the use of the audit committee or non-executive directors.

- d) The self-interest threat, real or perceived, is so high that no goods or services should be accepted on favourable terms by the statutory auditor unless the value of any benefit is modest.

## **1.2 Financial relationships**

### **Description - situations which give rise to threats**

Certain types of financial relationships between the statutory auditor and the entity to be audited may lead to threats which are either in practice too great to allow objective judgement by the statutory auditor, or likely to appear so to interested parties. Holding or dealing in securities of any audit client is one of these financial relationships. It includes holding or dealing in any direct or indirect shareholdings of any size in the entity to be audited. It also includes giving a guarantee for a client's risk such as a debt or engaging in other close financial relationships such as giving or receiving loans (except from recognised financial institutions in the normal course of their business) or accepting pension rights or other benefits from a client.

Such financial relationships give rise to major self-interest threats from which could follow a temptation to become involved in the decision-making and management of the client.

### **Requirements**

- a) The self-interest threat implied in situations where there is a financial relationship, as described above, between the statutory auditor and his audit client is in practice too great to be over-ridden by safeguards. They must therefore be prohibited<sup>2</sup>.
- b) If the statutory auditor receives by way of external events such as inheritance, or gift or as a result of a take-over any beneficial interest in a client entity, he must dispose of it at the earliest practicable date, and at the latest within the first year, or resign from the audit assignment. In the meantime, additional safeguards are needed to ensure the statutory auditor's objectivity.

## **1.3 Employment relationships between the statutory auditor and the client company - the statutory auditor joins the client**

### **Description - situations which give rise to threats**

It is common practice in the business world for statutory auditors to join their former clients, because traditionally in a number of countries, audit firms have been considered as a source of trained young professionals, whom the client had the chance to judge during the time they were carrying the audit, and who at one point or another will usually have to leave the audit firm because of the structure of the latter. The objectivity of a firm reporting on a company (or other entity) may be threatened if an officer of the audit client has been a principal or senior employee of the firm. Additionally, the firm's objectivity may be threatened because of participation in the conduct of the audit by a principal or senior employee in the knowledge that he is to join the client.

Such circumstances may give rise to self-interest threats where there remain significant connections between the officer and his former firm. Similarly, there might be self-interest threats if a principal or senior employee planning to leave the audit firm wished to ensure best relationships with the client he intended to join.

### **Requirements**

- a) Where a principal or senior employee of the audit firm has joined an audit client, in order to make sure that there remain no significant connections between the officer and its former firm, the firm should take steps to ensure that the officer:
- i) derives no retirement or other benefits from the firm unless these are made in accordance with pre-determined arrangements that cannot be influenced by any remaining connections between the officer and his former firm. In addition, any amount owed should not be such as to appear likely to threaten the firm's objectivity; or
  - ii) does not participate or appear to participate in the firm's business or professional activities<sup>3</sup>.



b) Additionally, to avoid the threat that would arise from the participation of a principal or a senior employee in the conduct of an audit while knowing that he is to join the client, the statutory auditor should therefore make appropriate provision in his procedures for further safeguards:

i) a requirement for immediate notification to the firm by a principal or senior employee on the client audit of any substantive discussions concerning the possibility of joining the client.

ii) where the individual is to join the client or is involved in substantive negotiations with the client, the removal from the audit team of any such principal or senior employee, coupled with a review of any significant audit judgements made by such principal or senior employee.

#### **1.4 Employment relationships between the statutory auditor and the client company - an officer from the audit client joins the statutory auditor**

##### **Description - situations which give rise to threats**

A former officer of an audit client may join the statutory auditor. The newly recruited statutory auditor is normally not involved in the audit of his former company.

The involvement as statutory auditor of a former director or employee of an audit client would give rise to major self-review threats where he might audit, for example, accounts he had prepared or elements of the financial statements he had valued. It might also give rise to over-familiarity threats where he knows and trusts former colleagues who have prepared the accounts.

##### **Requirements**

In the case where a director or former employee of the audit client has joined the audit firm, the threats, whether perceived or real, are in practice too high and too numerous to be over-ridden. In consequence, a statutory auditor should not personally take part in the conduct of the audit of a company if he has, during the period upon which the report is to be made, or at any time in the two years prior to the first day thereof, been an officer or employee of that company<sup>4</sup>.

## **2 Holding a managerial or supervisory role in an audit client**

### **2.1 Being a member of the Board of Directors of an audit client, or a member of a client audit committee**

#### **Description - situations which give rise to threats**

In most corporate governance systems, the Board of Directors exercises the managerial and decision-making power within the company. In the absence of an audit committee, it is generally the Board of Directors which proposes the appointment of the statutory auditor and the level of its remuneration. Where appropriate to the size of the company and the particular corporate governance system in place, the audit committee (with the majority of members being drawn from outside the management) is a useful and efficient organ to elaborate proposals for the appointment, remuneration and dismissal of the statutory auditor. Even in the absence of audit committees, proposals for the appointment and the fixing of remuneration of statutory auditors should be the responsibility of persons independent of management, exercising a supervisory function within the audited company.

For the statutory auditor to be a member of the Board of Directors would entail extremely high threats, real or perceived, of involvement in the management and decision-making process of the client. In most countries it is against the law. Similarly, for the statutory auditor to be a member of the audit committee would entail extremely high real or perceived self-interest and self-review threats when the audit committee discusses technical issues with the statutory auditor.

#### **Requirements**

The threats entailed in situations where the statutory auditor is a member of the management or of the audit committee of an audit client would in practice be too high to be over-ridden by safeguards. The statutory auditor may not therefore be a member of the Board of Directors of an audit client, or a member of a client audit committee.

### 3 Audit and other services

#### 3.1 General principles

##### **Description - situations which give rise to threats**

Crucial to the issue of the simultaneous provision of non-audit services to audit clients is the question of independence in appearance. Perceived independence gives a reasonable interested third party confidence that the independent statutory auditor puts the interests of shareholders and other interested third parties first, responding to his duty towards the public interest. It gives confidence that those interests will not be compromised by any conflicting interest of the statutory auditor or the statutory auditor's client. However, because of the way audit has developed in the different Member States, and because of its perceived objectives in the different Member States in relation to the economic environment, the perception of independence in appearance itself varies throughout Europe. Practical experience of new developments in business, the evolution of financial markets, and the consequences for the company management and control of rapid changes in information technologies has demonstrated that in view of the wide range of possible situations, it may not be possible or appropriate to draw up a comprehensive list of all those situations where the provision of consultancy services to an audit client would no longer be compatible. This is certainly one reason why the Eighth Directive delegated the Member States to lay down the rules on independence for statutory auditors. However, as mentioned in the introduction, differences in independence rules have an impact in terms of the single market in the sense that they might impair reliance on audited accounts on a pan-European basis. The purpose of this common core is to allow a convergence of independence rules where there is an international or single market dimension i.e. for companies which are required to be audited within the legal framework at European level laid down in the Fourth and Seventh Directive.

The provision of other services to an audit client brings benefits to both the client and financial statement users as it increases the statutory auditor's understanding of the client's business and may result in a better audit. Many companies would be adversely affected if they were denied the right to obtain other services from their statutory auditors. A statutory auditor can therefore provide services beyond the performance of the audit, provided that the provision of such services does not impair the statutory auditor's objectivity by, for example, placing him in a position where he plays a managerial role and provided that it is not forbidden by the national law or by national professional rules.

Any management role undertaken by the statutory auditor would give rise to every one of the types of threat listed in the first part of this document. The statutory auditor should therefore not take any decision on behalf of the company or its management in the course of the audit assignment or in the provision of other services to the audit client. He should neither play any managerial role in the audited company, nor hold any managerial position in it. In situations where the statutory auditor advises or assists the audit client on any matter, including by way of outsourcing, he should make clear that full responsibility for the decisions taken and for the financial statements remains with the management of the audited company.

There are various ways in which objectivity may be threatened or appear to be threatened by provision to an audit client of services other than the audit. The simultaneous provision of non-audit services to audit clients may give rise to self-review threats where the statutory auditor might review work directly prepared by himself or by some of his colleagues or by a firm related to his firm. The sections that follow describe safeguards to be considered in response to self-review threats. There will be occasions when the circumstances surrounding the self-review work will give rise to a real and perceived threat of such magnitude that the auditor will need to refrain from performing certain additional services. There may also be a self-interest threat. The nature of the threat sometimes perceived is that the statutory auditor's objectivity might be impaired by a need to remain on good terms with the directors of the audited company in order to preserve a working relationship. The perceived threat grows with the size of the fees and is thus increased by work or services additional to the audit. A particularly significant dimension of any threat, real or perceived, is likely to reside in the size of the total fees earned from a client in relation to the whole fees of the firm. This issue is dealt with below.

Other services might also give rise to advocacy threats if a situation arose where the statutory auditor might take a protagonist position on any issues having an impact on the financial statements. Finally, providing certain types of other services could, as mentioned above, either place or be perceived to place the statutory auditor in a position where he played a managerial role and took managerial decisions on behalf of the client company. The statutory auditor must be particularly cautious not to cross the line of management responsibility, even in cases where formally the decisions remain within the management, when he knows that in practice the management

will systematically follow his advice without further consideration. In such a case, his independence will be judged by appearance, and safeguards are necessary.

### **Requirements**

Each one of the safeguards described in this document may have an application to the provision of other services.

By way of internal steps within the firms, statutory auditors should consider which of the following steps in particular may help to safeguard objectivity during the audit:

- i) Develop and maintain an overall control environment, starting with a professional approach towards matters of quality and ethics and taking into account the assurance provided by a regularly monitored and evidenced control system.
- ii) Make arrangements to reduce the risk of conflict by compartmentalizing responsibilities, and knowledge in specific cases.
- iii) Make arrangements to ensure that staff are adequately aware and empowered to communicate any issue of independence and objectivity that concerns them to a separate principal.
- iv) Involve an additional partner who did not take part in the conduct of the audit to carry out reviews or otherwise advise.
- v) As external steps, within the client company, the statutory auditor should consider which of the following steps in particular may help to safeguard objectivity during the audit:
  - vi) Communicate when and wherever possible with the appropriate organ of the company independent from the management such as a committee of independent non-executive directors or an audit committee.
  - vii) Reinforce his own independence by using the support of the client company's internal procedures for objective choice in purchasing non-audit services. It is particularly useful if documentation of the results of these procedures can be supplied, where applicable, to the audit committee and/or supervisory board and/or all persons and organs responsible for proposing the appointment of the statutory auditor.

As an external step, outside the client company, in cases of particular difficulties the statutory auditor should consider consulting his professional regulatory body or another statutory auditor.

### **Note**

As publicly visible steps, one specific safeguard is often discussed when dealing with the issue of non-audit services: the disclosure of audit and non-audit fees. It is sometimes advocated as a possible means to improve transparency in the provision of audit and non-audit services. The argument is based on the assertion that the proportion of fees for audit and non-audit services, if unbalanced in favour of non-audit services, could be indicative of a threat to the quality of audit, a service carried out in the public interest.

FEE believes that statutory audit is to be considered within the global context of corporate governance systems. Additional guarantees would be provided in this regard if client companies were to have, as mentioned above, internal procedures for documentation, which would be available, where applicable, to the audit committee and/or supervisory board and/or persons and organs responsible for proposing the appointment of the statutory auditor, and which would establish clearly the procedures for purchasing non-audit services, be it from the statutory auditor or from other providers who may be retained. This documentation would demonstrate that the choice of providers of other services is made on the basis of objective criteria, and could be expanded to cover the statutory audit appointment as well.

This solution, combined with enhanced oversight by the audit committee and/or supervisory board of the nature and the volume of non-audit services provided by the statutory auditor, would help in ensuring the objectivity and independence of the statutory auditor, both in fact and in appearance.

Such a solution is preferable to introducing rules on the disclosure of fees paid to the statutory auditor because a simple calculation of the relationship between audit and non-audit fees does not give a real picture of the risks to the objectivity and independence of the statutory auditor.

Beyond these general principles on the simultaneous provision of non-audit services to audit clients and besides the fact that practical experience has demonstrated the difficulty and the inefficient rigidity of drawing up a list, which would in any case be arbitrary, of situations where objectivity may be threatened, some specific issues require particular attention because of their sensitivity in terms of independence in appearance.

### **3.2 Preparing financial statements**

#### **Description - situations which give rise to threats**

In principle, the processes of keeping the prime records or preparing the financial statements from prime records of an audit client entail self-review and although not intrinsically damaging to audit objectivity, pose a severe threat to it, especially in terms of independence in appearance.

There is a spectrum of involvement by the statutory auditor in the preparation of accounting records. It ranges from the situation where the statutory auditor may maintain prime accounting records, do the bookkeeping and prepare the financial statements from prime records as well as auditing them, to the case where the statutory auditor helps his client in the preparation of the accounts, on the basis of the trial balance, assisting him in the calculation of the closing entries (calculation of accruals, bad debts, depreciation etc.). In situations such as these, positive safeguards are required (see below). At the other end of the spectrum the statutory auditor does not participate in any part of the preparation process. Even in the latter case, the statutory auditor who detects omissions in the company's proposed disclosures will normally suggest and draft the amendments required. While this is part of its statutory audit mandate and should not be considered as the provision of another service, the end result is that it is uncommon for a set of financial statements to appear where the statutory auditor has had no hand whatsoever in the presentation or drafting.

For historical reasons, deeply enshrined in their legal and economic environment, certain countries had in place, before the implementation of the Fourth and Seventh Directives, extensive audit requirements. When implementing the Directives, these countries kept audit requirements for companies much below the thresholds of the Directives and evaluated the importance of a breach of the above mentioned principle in proportion to the public interest in the entity being audited. This leads to prohibition in cases where the public interest might be perceived as being particularly at risk. In other cases, the public interest need for protection by means of independence in appearance is considered less at risk. In relation to SMEs and especially to smaller companies it is, in the context of these countries, considered at least outweighed by the convenience and cost savings of facilitating a greater degree of involvement by the statutory auditor. However, safeguards are still necessary. As mentioned above, the statutory auditor must especially make sure that he will not be in a position to take any decision on behalf of the audit client.

#### **Requirements**

- a) Subject to what follows in paragraph (b) below, the statutory auditor should not participate in the preparation of the company's accounts and accounting records save in relation to assistance of a routine clerical nature or in emergency. Such assistance might include, for example, work on the finalisation of statutory accounts, including consolidations and tax provisions.
- b) In those countries where the public interest is not seen as being at risk in relation to smaller companies through the process of self-review and where the statutory auditor may prepare much of the accounting records and the financial statements, the safeguards reside in a considered analysis by the statutory auditor of the work done in preparation of records and statements and careful consideration as to what separate audit procedures and scope are thus required. The statutory auditor should always remain extremely cautious in such situations and document clearly the position he has adopted. All the other safeguards as described above in 3.1. should be considered.

#### **Note**

As mentioned in the introduction, the quality assurance systems in place in almost all the Member States have procedures to ensure compliance with ethical requirements. Such procedures provide additional safeguards, especially in the case of sole practitioners for whom the other safeguards are sometimes difficult to implement.

Above all, the financial statements and the maintenance of accounting records always remain the responsibility of the management of the audited company. In some countries explicit disclosure is required of the responsibilities of the statutory auditor and separately of those of the directors, management and other organs of the company. The extension of the use of such disclosures could improve transparency of the responsibilities of the statutory auditor with respect to the information provided in the accounts.

### **3.3 Valuing assets or liabilities for recording them in the financial statements - expert services**

#### **Description - situations which give rise to threats**

The provision to an audit client of expert services by an audit firm, which directly affect amounts and disclosures in the financial statements of an audit client, gives rise to a self-review threat to objectivity. These services may include reports, opinions, valuations or statements made by an expert. An expert for this purpose possesses special skill, knowledge and experience in a particular field other than auditing. The term "expert services" is not intended to apply to advice, discussions or procedures inherent in the audit process concerning the adequacy of provisions or the valuation of assets or liabilities which are to be determined by the directors or others.

A major issue affecting the self-review threat, which should be carefully considered by the statutory auditor, is the materiality of the amounts involved in relation to the financial statements. In addition to the amounts involved, the issue of materiality is likely to be influenced, to a considerable extent, by the degree of subjectivity inherent in the items concerned.

In evaluating the extent of the threat, the statutory auditor should also consider the following matters in relation to the amounts included in the financial statements:

- the extent of the directors' knowledge and experience and ability to evaluate the issues concerned and the extent of their involvement in determining and approving significant matters of judgement;
- the degree to which established methodologies and professional guidelines are utilised in the type of expert services;
- the reliability and extent of the underlying base data;
- the degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved;
- the extent and clarity of related disclosures in the financial statements including disclosure of the underlying assumptions, and the identity of the provider of the expert services.

#### **Requirements**

- a) Where a statutory auditor has identified a threat, he should carefully consider whether the threat is so great that the firm should either withdraw from the audit of the financial statements concerned or advise the client to seek an alternative source for the particular expert services.
- b) A statutory auditor should not provide to his audit client expert services which lead to the valuation of amounts material in relation to the financial statements and the valuation of which involves a significant degree of subjectivity inherent in the item concerned.
- c) In cases not prohibited under b) where the statutory auditor decides to accept such an engagement, he should determine what appropriate safeguards should be added to address the threat. To ensure that careful consideration has been given to the key aspects of the threat, the statutory auditor should record the basis of his decisions and document the safeguards. He should consider the matters set out in paragraph 3.1 (above) in relation to the audit team and take any necessary steps to safeguard its objectivity. Such steps will at

least include the use of different partners and separate teams each having separate reporting lines and additional review procedures sufficient to ensure that objectivity is preserved.

### **3.4 Acting for the client in the resolution of litigation**

#### **Description - situations which give rise to threats**

In certain countries, professional accountants are allowed to assist their clients in the resolution of litigation. The representation of a client before the courts or the tax administration for tax litigation is a typical example of such assistance.

Acting for the client in the resolution of litigation may give rise to self-review threats, as the statutory auditor might be tempted to overestimate or underestimate the chances of his client in the resolution of litigation and this can affect the amounts which should be reflected in the financial statements in relation to this litigation. It also gives rise to perceived advocacy threats by interested third parties who could see the statutory auditor as defending the management of the company in highly litigious cases, for example.

Audit techniques include procedures of confirmation from the clients' lawyers which seek to obtain information on actual or threatened litigation. The statutory auditor usually has to rely on such confirmations to form his opinion on the correct valuation of amounts affected by this litigation. Being charged with conducting or assisting the conduct of the case gives the statutory auditor greater awareness of the elements of the case so that he is better equipped to judge the valuation of amounts affected. In that sense, his position may add value to the audit.

#### **Requirements**

Because the perceived advocacy threat is high, safeguards should be put in place:

- a) When choosing to act for the client in the resolution of litigation, the statutory auditor should as in the case of expert services give particular attention to:
  - i) the materiality of the amounts involved in the litigation in relation to the financial statements,
  - ii) the degree of subjectivity inherent to the case concerned.

In cases where the amounts involved are material in relation to the financial statements or the degree of subjectivity inherent to the case concerned is too high, the auditor must refrain from acting for the client in the resolution of the litigation.

- b) In cases not prohibited under a) and where the statutory auditor decides to accept such an engagement, he should determine what appropriate safeguards should be added to address the threat. To ensure that careful consideration has been given to the key aspects of the threat the statutory auditor should record the basis of his decisions and document the safeguards. He should consider the matters set out in paragraph 3.1 (above) in relation to the audit team and take any necessary steps to safeguard its objectivity. Such steps will at least include the use of different partners and separate teams each having separate reporting lines and additional review procedures sufficient to ensure that objectivity is preserved.

#### **Note**

In most countries, typically, acting for the client before the courts or the tax administration for tax litigation is an area where the appearance of independence would normally not be at risk, because interested third parties understand that the statutory auditor has the most appropriate technical expertise and is better placed to defend his client in cases which are generally not significantly subjective.

### **3.5 Recruiting senior management for the client**

#### **Description - situations which give rise to threats**

Recruiting senior management on the labour market is generally not a regulated activity and can therefore usually be performed by anybody. The statutory auditor must be aware that if he helps in recruiting senior

management for audit clients, he might find himself in a situation very similar to that of having one of his employees joining an audit client or being closely connected with someone involved in the management of an audit client. He might find himself in a situation where his objectivity may be perceived to be threatened.

The recruitment of senior management for an audit client might give rise to self-interest threats if the statutory auditor were tempted to demonstrate the quality of the person he helped to recruit. It might lead to an over-familiarity threat if he had helped in recruiting a close relative, someone with whom he is otherwise closely connected, or one of his employees.

**Requirements**

Recruitment of key financial and administrative staff for an audit client company is a situation where a statutory auditor should proceed with care. Whilst it is acceptable for the statutory auditor to advertise for and interview prospective staff and to produce a "short list", the decision in every case as to whom to engage should be left to the client.



## **4 Audit fees**

### **4.1 Contingent fees**

#### **Description - situations which give rise to threats**

Contingent fees are fees whose calculation is based on the result of work such as the handling of litigation for example.

Contingent fees clearly give rise to major real or perceived self-interest and advocacy threats in the conduct of the audit.

#### **Requirements**

- a) Because the self-interest and advocacy threats which may appear are too high to be over-ridden by safeguards, the statutory auditor should never conclude any fee arrangement under which the amount of his fee is contingent upon the result of his work as statutory auditor.
- b) A basis for the calculation of audit fees must be agreed each year in advance with the authority of the entity being audited. The basis for the charge should include scope for variation so as to take account of unexpected factors in the work.

### **4.2 Relation between fees and the total revenues of the audit firm**

#### **Description - situations which give rise to threats**

Annual fees from an audit client comprise audit fees as well as fees charged for other services by the statutory auditor or any associated audit or consultancy firm.

Undue dependence on fees from one audit client clearly gives rise to a self-interest threat and might give rise to a real or perceived lack of objectivity.

#### **Requirements**

- a) Because of the real and apparent risks of losing its objectivity through self-interest in over-reliance on a single client, the statutory audit firm should not accept an audit appointment from an entity which provides it with an unduly large proportion of gross practice income. The size of the threat and the possible safeguards will vary but the statutory audit firm should recognise that the public perception of its objectivity is likely to be in jeopardy if revenues from a single client or group of connected clients (all entities that would fall within the consolidation scope) exceed a certain percentage of his average yearly total revenues of the last 5 years. That percentage should lie between 5% and 15%.
- b) The statutory audit firm should be able to demonstrate that temporary breaches of this percentage do not impair objectivity.

### **4.3 Fees outstanding beyond a normal credit period**

#### **Description - situations which give rise to threats**

Overdue fees may give rise to a perceived or real self-interest threat. They can be equated to a loan made to a client. Outstanding fees will be considered a real or perceived threat to objectivity only if they are significant with respect to both the total fees charged to the client or group of connected clients and the turnover of the statutory auditor.

#### **Requirements**

- a) Before work is commenced on an audit where there are overdue fees, a review of the situation should be undertaken by a principal not involved in the audit, to ascertain whether the overdue fees, taken together with the fees for the current assignment, could be regarded as a significant loan.
- b) Unless it can be demonstrated that the overdue fees do not impair objectivity, the statutory auditor should resign.

#### **4.4 Pricing**

##### **Description - situations which give rise to threats**

Statutory audit, as with any other audit, is subject to free competition. Free competition includes competition over the quality and scope of services provided but also over price. However, as explained in the introduction, statutory audit is a service of a specific nature. The public interest at stake led the legislature to make statutory audit compulsory for companies. While market pressure can lead to improvement of audit quality, the fact that the company must by law have its financial statements audited and the fact that it might not always be able to judge the quality of statutory audit services (or even desire high quality services) has led the profession to develop its auditing standards, ethical guidance and quality control procedures for the specific purpose of ensuring and controlling audit quality.

Because of this specific nature of statutory audit, pricing is a very sensitive issue related to independence. A statutory auditor must be aware that his independence in appearance may be threatened where he obtains statutory audit work at a fee level significantly lower than that charged by other statutory auditors. The main threat concerning pricing is a self-interest threat coupled with a risk of perceived lack of quality and/or objectivity in the audit work, especially in cases where other services are material in terms of fees from the same client. The statutory auditor must be aware that if he is perceived as being prepared to obtain an audit client through low pricing, he may also be perceived as being ready to impair his objectivity (if necessary) to retain that client.

##### **Requirements**

In particular where he obtains audit work at a fee level significantly lower than that charged by other statutory auditors, the statutory auditor must be able to demonstrate that appropriate time and qualified staff are assigned to the task and that all auditing standards, guidelines and quality control procedures are being complied with. He must be aware that the acceptance of statutory audit work at fee levels significantly lower than those charged by other statutory auditors may be perceived as a major threat factor by the external quality control function monitoring his activity and will require particularly detailed documentation and evidence to demonstrate that the low price did not lead to sub-standard work.

## **5 Acting for a client for a prolonged period of time**

### **Description - situations which give rise to threats**

Where the statutory auditor has been acting with the same engagement partner and team for an audit client for a prolonged period of time, a perception of an over-familiarity threat might arise. This threat is certainly more perceived than real. In any event rotation takes place automatically in practice because of changes in personnel in client company management and in the audit team, the frequency of changes in the latter being quite high. Company takeovers, too, often lead to changes of statutory auditors. On balance, the entailed benefits of having acted for a prolonged period of time for an audit client offset the entailed risks.

### **Requirements**

Replacing the audit team step by step within a reasonable time (5 to 7 years) is one possible safeguard against the perceived threat of over-familiarity. Other internal safeguards are possible, such as the involvement of an additional partner or procedures for independent internal quality reviews<sup>5</sup>.

## **6 Actual or threatened litigation between a statutory auditor and a client**

### **Description - situations which give rise to threats**

Where litigation takes place, or appears likely to take place, between a statutory auditor and a client, both a self-interest threat and an advocacy threat may arise. These threats are likely to call into question the objectivity of the statutory auditor and his ability to report fairly and impartially on the company's accounts. At the same time, the existence of such action or threat of action could affect the willingness of the management of the company to disclose necessary information to the statutory auditor.

The issue by the audit client of a writ for negligence against the statutory auditor would be considered to impair the latter's objectivity. The inclusion in any litigation of allegations against the client of fraud or deceit made by the statutory auditor may also impair objectivity. Such impairment may not necessarily result when the litigation arises solely out of a fee dispute.

### **Requirements**

It is not possible to specify precisely the point at which it would become improper for a statutory auditor to continue as statutory auditor. However a statutory auditor should cease to act as soon as the circumstances of the litigation might reasonably be perceived by the public as threatening his objectivity, e.g., where publicity is given to matters adversely affecting a company and reference is made to the company's reliance on accounts or other financial statements audited by the statutory auditor.

## **7 Seeking second opinions from other statutory auditors**

### **Description - situations which give rise to threats**

The opinion of a statutory auditor ("the professional") is sometimes sought on an accounting treatment or other matter by or on behalf of a company or entity which is not an existing client of the statutory auditor. Where the opinion of the professional is sought on the application of accounting standards or principles to specific circumstances or transactions, either completed or contemplated, of an entity with which the professional does not have an ongoing professional relationship to provide audit services, he should be alert to the possibility of his opinion creating undue pressure on the judgement and objectivity of the statutory auditor.

Not at issue are opinions provided pursuant to litigation, expert testimony and assistance provided to other firms and their clients jointly.

This situation gives rise to perceived or real self-interest threats and the advocacy threats which follow, where the professional consulted might be perceived, for example, to have constructed his opinion in line with what the company is seeking, in order to obtain the statutory audit appointment. There is also a danger that the opinion he expresses may not be based on the same set of facts as is available to the statutory auditor, or may be based on inadequate evidence, and that the opinion he expresses may be difficult to modify if further facts come to light.

### **Requirements**

The professional should seek to minimise the risk of giving inappropriate guidance to a non-audit client by ensuring that he has access to all relevant information. It is important, therefore, that the professional whose opinion is sought in such cases should ascertain the circumstances of his being consulted and all the other available facts relevant to formulating a judgement. For this purpose he should contact the statutory auditor to provide an opportunity for the latter to bring to his attention any relevant facts and should be prepared, given his client's permission, to provide a copy of his opinion to the statutory auditor. If the company or entity seeking the opinion will not permit the professional to communicate with the statutory auditor then he should decline to act. In all circumstances, he should ensure that the nature of his opinion is made clear.

## 8 Audit firms

### **Description - situations which give rise to threats**

A statutory auditor must make appropriate arrangements designed to ensure that individuals who are not statutory auditors are unable to exert any influence over the way an audit is conducted. To this end, a firm of statutory auditors must satisfy at least the conditions set out below.

### **Requirements**

The natural persons who carry out audits on behalf of firms of statutory auditors must satisfy at least the conditions imposed on statutory auditors.

- a) A majority of the voting rights must be held by natural persons or firms of statutory auditors who satisfy at least the conditions imposed on statutory auditors. However, those countries which do not impose such majority at the moment need not impose it provided that all the shares in a firm of statutory auditors are registered and can be transferred only with the agreement of the firm of statutory auditors and/or, where the country so provides, with the approval of the competent authority.
- b) A majority of the members of the administrative or management body of a firm of statutory auditors must be natural persons or firms of statutory auditors who satisfy at least the conditions imposed on statutory auditors. Where such body has no more than two members, one of those members must satisfy at least those conditions.

### **Note**

All these safeguards are enshrined in the Eighth Directive and therefore throughout the EU. The Eighth Directive requires that audits firms should be owned, controlled and managed by at least a simple majority of statutory auditors. However, when implementing the Eighth Directive, Member States were left free to impose more stringent rules concerning the ownership, management and control of the audit firms, and often require more than a simple majority of locally qualified statutory auditors in the capital, the management board and the supervisory board of the audit firms. As mentioned in the introduction, FEE is undertaking separate work on this specific issue of liberalisation.

1. Use of the word "independence" on its own has often created misunderstandings in discussing this topic because standing alone the word appears to denote an absolute standard which professionals must attain. It leads observers to suppose that a person exercising professional judgement ought to be free from all economic, financial and other relationships which appear to entail dependance of any kind. This is manifestly impossible, as every member of society has some dependency and relationship with every other.
2. In some countries there are minimal exceptions to these general rules (such as non-beneficial shareholdings by trustees in Ireland and in the UK). In such cases, statutory auditors must take steps to protect their objectivity.
3. It must be noted that a statutory auditor who joined an audit client would in most countries leave the profession and therefore would not be subject to the ethical rules of the profession.
4. The specific case of former internal auditors who join the audit firm as a result of the outsourcing of the internal audit department of the audit client is still under discussion due to the very specific nature of such an operation.
5. It has to be borne in mind, however, that a reasonable continuity in the composition of the audit team is usually beneficial to the quality of the audit. Some countries have laid down in their law a fixed duration for the audit mandate of a minimum number of years to help preserve the independence of the statutory auditor and the resulting quality of audit.
6. It has to be borne in mind, however, that a reasonable continuity in the composition of the audit team is usually beneficial to the quality of the audit. Some countries have laid down in their law a fixed duration for the audit mandate of a minimum number of years to help preserve the independence of the statutory auditor and the resulting quality of audit.