

FEE's POSITION ON AUDITOR'S INDEPENDENCE

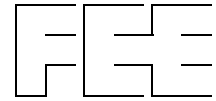
In May 2002 the European Commission published its Recommendation on Auditor Independence and in October 2002, IOSCO published a Statement of Principles on the topic. At the end of January 2003, the SEC published its final rule on Strengthening the Commission's Requirements Regarding Auditor Independence. In May 2003 the European Commission published a Communication on Reinforcing Statutory Audit in the EU which also refers to auditor independence. This note summarises FEE's position on auditor independence and relates to all companies.

FEE and Auditor Independence

FEE has for many years been active in the area of auditor independence. In 1998 FEE published a position paper "Statutory Audit Independence and Objectivity – Common Core of Principles", based on a principles-based conceptual framework, supplemented by guidance, restrictions and prohibitions flowing from the application of the principles to commonly encountered situations. In February 2001, an additional paper was published "The Conceptual Approach to Protecting Auditor Independence" in order to foster understanding of the conceptual approach to the setting and enforcement of ethical requirements for independence. The FEE work provided a contribution to the European Commission Recommendation of 16 May 2002 on "Statutory Auditors' Independence in the EU: A Set of Fundamental Principles". FEE strongly supports the Recommendation, which takes a similar approach to the professions global code, the IFAC Code of Ethics; Section 8 of this code, "Independence" was revised in November 2001. The IOSCO Statement on Principles of Auditor Independence and the Role of Corporate Governance in Monitoring of Auditor's Independence of October 2002 also supports a principles based approach.

FEE supports a principles-based approach to independence, supplemented by appropriate guidance, restrictions and prohibitions. The auditor must conscientiously consider whether a proposed engagement involves threats which would, or would appear to, threaten observance of the fundamental principles. Where such threats exist, the auditor should put safeguards in place that eliminate the threats or reduce them to clearly insignificant levels. Where it is not possible to reduce or mitigate the threats, the ultimate safeguard is not to carry out the work (abstention or resignation). For some situations where other safeguards are typically not available, the European Commission's Recommendation on Independence includes specific prohibitions, for example on bookkeeping services for listed companies and on certain IT and valuation services. This approach prohibits relationships and situations, including in certain circumstances the provision of some non-audit services, where they compromise auditors' objectivity or would appear to do so to a reasonable and informed observer.

By focusing on the underlying aim rather than detailed prohibitions, the principles-based approach combines flexibility with rigour in a way that is unattainable with a rule-based approach. In particular, it:



- allows for the almost infinite variations in circumstances that arise in practice;
- can cope with the rapid changes in the modern business environment;
- prevents the use of legalistic devices to avoid compliance;
- requires auditors to consider actively, and to be ready to demonstrate the efficacy of, arrangements for safeguarding independence, especially in relation to relationships or proposed services which are not specifically prohibited or restricted.

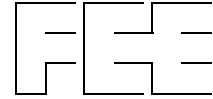
In the rapidly evolving modern global economy, it is impractical to list comprehensively all possible threats to independence. In fact, such an approach is open to the danger of ignoring threats not specifically mentioned or detailed in the rules. The accountancy profession's ethical guidance based on the conceptual framework approach includes examples of threats that might arise and appropriate safeguards to deal with them. But these are clearly stated to be illustrative and not exhaustive. If an auditor were to appear before a disciplinary tribunal charged with a breach of ethical requirements, it would not be a sufficient defence to demonstrate that particular examples of threats and safeguards in the ethical code had been addressed. He would need to be able to demonstrate that, in the particular circumstances under consideration, the fundamental principles had in fact been observed – a far more rigorous test of compliance.

This is the most robust and effective approach to securing auditor independence because it requires observance of the principles in all circumstances. This is why governments, regulators and the profession should, in FEE's view, implement a principles based approach to auditor independence. This does not exclude some specific rule-making in support of the principles, where considered appropriate. The European Commission's Recommendation is a good example of such an approach.

The framework approach is also the best way for an audit committee to exercise judgement in relation to non-audit services, as this approach allows it to consider the relevant threats and safeguards in the particular circumstances under consideration. FEE is developing a paper "A Conceptual Approach to Independence in the Financial Reporting Chain" explaining how the framework approach could be of benefit to other parts of the financial reporting chain, such as Management, Boards of Directors, Supervisory Boards, audit committees and also analysts, journalists, investors and other stakeholders.

In FEE's view a blanket prohibition of non-audit services is inappropriate and misguided in most cases. It is often stated, and quite widely accepted at face value, that there is a conflict between audit and non-audit services, mainly because of the perceived risk of the auditors "checking their own work". In fact, as the European Commission Recommendation recognises, the risks will vary across a spectrum from negligible to high, depending on the circumstances and the type of service.

In many cases auditors are the only or are the best persons to provide a particular service. Firstly, auditors often have other mandates given to them by law. Secondly, it is often necessary for an enterprise to request its auditors to provide assurance to third parties about its affairs; examples include IPOs, placing of new shares and other fundraising and information for regulators.



Thirdly, it is often entirely appropriate for an enterprise to look to its auditors for such other services as due diligence examination of an acquisition target or a detailed assessment of, say, computer controls. The results of taxation services provided by audit firms are subject to review by fiscal authorities, especially in more significant transactions; this external safeguard is one reason why a prohibition on tax services is not required.

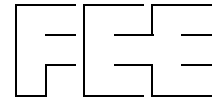
Finally, a complete prohibition on non-audit services could at the extreme have perverse consequences. If the auditors find a serious problem in internal controls over risk, say, they must be entitled both to advise the client of the finding and to make a recommendation on how it may be rectified. In many such cases, the auditors will be best placed to assist in implementing rapid improvements in control. The same applies if the client identifies a problem and asks the auditors for advice. In both cases, of course, any assignment must always be subject to proper consideration of whether the work might imperil the auditor's objectivity and independence and of available safeguards to be implemented.

Any set of rules which arbitrarily prohibit such services is unwise and unnecessarily restricts the operation of the market. This is in contrast to a principles based approach to regulation which identifies selectively circumstances where non-audit services would threaten the auditors' objectivity and independence and no adequate safeguards are available.

Further, the provision of non-audit services to an audit client can benefit both the client as well as users of the financial statements, as such services can increase the external auditor's understanding of the client's business and may result in a better audit. In addition, under certain circumstances additional services may be a direct consequence of the audit, for instance a recommendation relating to the correction of errors detected during the course of the audit. Statutory auditors should therefore be allowed to provide services beyond the performance of the audit, provided that the provision of such services does not impair their objectivity by, for example, placing them in a position where they play a managerial role. A general prohibition on the external auditor providing non-audit services or the development of lists of specific services to be banned, however, would not be appropriate. In the recent corporate governance discussion, there is a strong role for the audit committee (non-executive directors or supervisory body) in the assessment of the auditor's independence.

European Commission Recommendation and Implementation in the Member States

The most important feature of the Recommendation is that it is based on a clear set of principles, which must always be observed. As might be expected, this is supplemented by guidance, restrictions and prohibitions in relation to some non-audit services. In every case, these supplementary elements of the Recommendation derive directly from application of the principles to commonly encountered circumstances. The Recommendation is therefore internally consistent and logical, thus helping its consistent application in practice. The need to safeguard independence on a continuous basis is emphasised. In the case of enforcement, the existence of clear principles is a demanding test. The risk is avoided that an inappropriate service, which



imperils auditor independence, might be justified on the ground that it is not specifically prohibited.

Furthermore, as new economic circumstances and new business techniques and systems arise and new services are developed to address them, the Recommendation's principles are of enduring relevance. The principles provide a clear guide to addressing circumstances not specifically anticipated in the Recommendation.

It also provides for clear oversight by audit committees (or similar bodies) of the services provided by the auditors. This includes full, detailed transparency on fees. Fee disclosure, analysed by service, is also required in the annual financial statements.

The Recommendation therefore is a common framework for securing auditor independence, including on scope of services, across the EU. As it is based on principles, it also incorporates a degree of adaptability to the legal and regulatory variations in member states.

Nevertheless, it is of great concern that the implementation of the European Commission Recommendation appears to date to vary widely between the Member States, although the minimum requirements of the Recommendation are met. As yet not all countries have fully implemented the Recommendation. Moreover, many Member States appear to regard the Recommendation as an instrument with minimum requirements and introduce additional restrictions and prohibitions, perhaps in reaction to the current climate and environment. By doing so they risk moving away from a principles-based approach to a more rules-based approach thereby ignoring the real strength of the principle-based approach of the Recommendation. In addition some Member States have created extra-territorial implications, even within the EU, by requiring their rules also to be applied by auditors outside their country (for example application to foreign subsidiaries). This is widely seen as unwelcome because of the potential conflicts of law and the difficulty, or even impossibility, for auditors of groups to know the legislation in each country where the group has subsidiaries.

In Europe's single market there will soon be common accounting standards (IAS/IFRS) and common auditing standards (ISA); there is a corresponding need and logic for a common approach to auditor independence. For the single market to work effectively, the European Commission's Recommendation should be used as benchmark. In particular, countries should not be allowed to apply stricter rules to auditors outside their country than the Recommendation. A legal underpinning in the Eighth Directive would help to achieve this. Further guidance could then be provided in form of the European Commission Recommendation and the IFAC Ethics Code. Use of appropriate global professional ethical codes dealing with independence in a consistent way in the EU would also strengthen the EU's position in consistent regulation of global capital markets.

FEE supports the legal underpinning of the European Commission Recommendation by introducing the principles on independence into the Eighth Directive.