

Integrity, Objectivity and Independence

(Effective: 1 September 1997 – this should be read together with ‘Additional Guidance on Independence for Auditors’ with effect from 1 November 1992)

The Preface and Introduction to this Statement apply to all members, together with Section D, Definitions. Sections A, B and C apply only to practising members, affiliates and, where appropriate, employees of practising firms.

This statement is currently being revised. Once approval has been given, an updated version will be available from the website at www.icaew.co.uk/membershandbook.

Preface

Integrity

1 The Fundamental Principles require that a member should behave with integrity in all professional, business and financial relationships. Integrity implies not merely honesty but fair dealing and truthfulness.

Objectivity

2 Objectivity is essential for any professional person exercising professional judgement. It is as essential for members in business as for practising members. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other. It is sometimes described as ‘independence of mind’.

The need for objectivity is particularly evident in the case of a practising accountant carrying out an audit or some other reporting role where his professional opinion is likely to affect rights between parties and the decisions they take.

Framework

3 This Statement provides a Framework within which members can identify actual or potential threats to objectivity and assess the safeguards which may be available to offset such threats. As well as including illustrative guidance, it includes examples of specific threats to objectivity.

Objectivity and independence regarding an auditor

4 Section A of this Statement which follows deals with the objectivity and independence required of an auditor. It starts with an analysis of potential threats to an auditor’s objectivity and of the safeguards available and continues with detailed guidance relating to specific areas of threat.

Objectivity and independence in other financial reporting roles

5 Section B calls for a similar degree of objectivity and independence to

be exercised by a member in financial reporting and similar roles outside the audit.

Objectivity in other situations

6 Section C deals with situations outside the areas dealt with in Sections A and B where a member must remain conscious of the need to preserve his objectivity and to observe appropriate safeguards so that his judgement is not swayed by considerations of self interest or other improper factors.

Members in business

7 Objectivity in relation to members in business is dealt with in Statement 1.220, *Guidance on Ethical Matters for Members in Business*, at the end of this Guide.

Conflicts of interest

8 Conflicts of interest have an important bearing on objectivity and independence. Attention is drawn to the guidance in Statement 1.205, *Conflicts of Interest and Confidential Information*.

Members in practice overseas

9 The attention of members in practice overseas is drawn to paragraph 1.8 of the Introduction (1.200) to this Guide.

Introduction

1.0 Safeguarding objectivity

1.1 In order to safeguard their objectivity, members should consider certain matters before deciding whether to accept any appointment. The matters to be considered include those under the following headings:

- *the expectations of those directly affected* (and entitled to be affected) by the work;
- *the public interest* and its bearing on the work;
- *the threats to objectivity* which may arise actually or potentially;
- *the safeguards* which are or can be put in place, overt or otherwise, to offset the threats.

These headings are discussed in more detail in the following paragraphs.

1.2 The responsibility for seeing that the above matters are properly considered resides ultimately, in the case of members in practice, with the engagement partner who takes the responsibility for signing the report for the client concerned. Firms should establish reliable procedures to ensure that these matters are properly addressed.

The expectations of those directly affected

1.3 Those directly affected are likely to be concerned about the existence of any relationship or situation affecting a member or firm, or any business or other interest held by the member or firm, which may threaten or appear

to threaten objectivity. Accordingly the member concerned should consider a possible need to disclose the relationship, situation or interest to the affected parties.

The public interest and any bearing it has on the work

1.4 The public interest should be a factor which all members should bear in mind when accepting any assignment or appointment.

Threats to objectivity

1.5 Threats to objectivity can arise in a number of ways, some general in nature and some related to the specific circumstances of an assignment or role. Members should identify the threats and consider them in the light of the environment in which they are working; they should also take into account the safeguards which assist them to withstand threats and risks to their objectivity.

Categories of threats

1.6 Threats to objectivity are discussed in more detail below, but in paragraph 2.1 there are set out some general categories under which threats may be considered. It may prove helpful to members to categorise the threats because the more clearly the nature of the threat is identified, the clearer it becomes:

- whether the member's own integrity and working environment may be sufficient to offset/mitigate the threat;
- whether specific safeguards should be added;
- if safeguards should be added, which of those would most appropriately address the risk;
- in what circumstances the appearance of risk or conflict becomes so great that there ought to be a refusal to act.

The easiest way of avoiding such threats would be for members to decline to act in any circumstances where the slightest threat to objectivity might exist. This could however deny to clients and employers proper access to a member's breadth of professional expertise and knowledge of the client's or employer's business, and, in deciding whether to include such a prohibition in its guidance, the Institute always bears in mind the need to maintain a balance that respects the interests of clients and employers and the possible wider public interest.

2.0 Section A – Objectivity, independence and the audit

Threats to objectivity

2.1 Threats to objectivity might include the following:

The self-interest threat

2.2 A threat to the auditor's objectivity stemming from a financial or other self-interest conflict. This could arise, for example, from a direct or indirect interest in a client or from a fear of losing a client.

The self-review threat

2.3 The apparent difficulty of maintaining objectivity and conducting what is effectively a self-review, if any product or judgement of a previous audit assignment or a non-audit assignment needs to be challenged or re-evaluated in reaching audit conclusions.

The advocacy threat

2.4 There is an apparent threat to the auditor's objectivity, if he becomes an advocate for (or against) his client's position in any adversarial proceedings or situations. Whenever the auditor takes a strongly proactive stance on the client's behalf, this may appear to be incompatible with the special objectivity that audit requires. (And see paragraphs 4.67 *et seq.* (below).)

The familiarity or trust threat

2.5 A threat that the auditor may become over-influenced by the personality and qualities of the directors and management, and consequently too sympathetic to their interest. Alternatively the auditor may become too trusting of management representations so as to be inadequately rigorous in his testing of them – because he knows the client too well or the issue too well or for some similar reason.

The intimidation threat

2.6 The possibility that the auditor may become intimidated by threat, by dominating personality, or by other pressures, actual or feared, by a director or manager of the client or by some other party.

Each of the above threats may arise either in relation to the auditor's own person or in relation to a connected person such as a member of his family or a partner or a person who is close to him for some other reason, such as past or present association or obligation or indebtedness. These aspects of the potential threats are explored in the detailed guidance of paragraphs 4.50 to 4.52.

3.0 The safeguards which are available to offset the threats

3.1 Auditors should always consider the use of safeguards and procedures which may negate or reduce threats. They should be prepared to demonstrate that in relation to each identified threat, they have considered the availability and effectiveness of the safeguards and procedures and are satisfied that their objectivity in carrying out the assignment will be properly preserved.

3.2 Safeguards and Procedures

The safeguards and procedures might include:

3.3 Factors in the environment of the practice which will operate so as to offset any threat to objectivity

An exhaustive list of these countervailing factors is not possible, but

auditors should expect where possible to have developed the following characteristics in their firms. Where they have been developed they will provide safeguards.

- (i) Chartered accountants are taught from the outset of their training contracts to behave with integrity in all their professional and business relationships and to strive for objectivity in all professional and business judgements. These factors rank highly in the qualities that chartered accountants have to demonstrate prior to admission. They should therefore be well used to setting personal views and inclinations aside.
- (ii) Engagement partners should have sufficient regard for their own careers and reputations to be encouraged towards objectivity and to effective use of safeguards.
- (iii) Within every firm there should be strong peer pressure towards integrity. Reliance on one another's integrity should be the essential force which permits partners to entrust their public reputation and personal liability to each other.
- (iv) Firms should set great store on their reputation for impartiality and objectivity. It is the foundation for their ability to practise and to gain work over the medium and long term, and they should not permit a member of the firm to risk it for short term benefit or gain.
- (v) Firms of all sizes should have established strong internal procedures and controls over the work of individual principals, so that difficult and sensitive judgements are reinforced by the collective views of other principals, thereby also reducing the possibility of litigation.

3.4 Safeguards and sanctions built into the structure of the profession itself

These might include:

- (i) The long-standing ethical code of the profession, of which this guidance forms part. Where appropriate, this code imposes specific prohibitions where the threat to the auditor's objectivity is so significant, or is generally perceived to be so, that no other appropriate safeguards would be effective.
- (ii) The ethical support provided by the Institute, including the Ethics Advisory Services helpline, published advice on ethics such as Help Sheets and the Support Member Scheme involving District Societies.
- (iii) The reinforcement given to the above safeguards by a policing system which reacts to complaints, whether by members of the public or members of the profession, investigates the background to the complaints, and where necessary commences disciplinary proceedings against an offending member. Together with monitoring (below), the system ensures that a firm's past conduct and current procedures are likely to come under close independent professional scrutiny if the conduct of practising members gives rise to challenge over their exercise of these guidelines.

- (iv) The active monitoring procedures conducted by the profession for reserved activities such as auditing. On behalf of the Institute Committees concerned, the Quality Assurance Directorate visits firms which are registered to conduct audits. It examines firms' compliance with the Audit Regulations and reports to those Committees. The Regulations embrace in their requirements the whole of this guidance.

3.5 Steps taken by firms to ensure that threats to objectivity are recognised, documented and mitigated

These might not be disclosed to outsiders unless disciplinary or regulatory follow-up requires it. Examples of internal procedures within firms which may contribute to reassurance that the required audit objectivity has been preserved include:

- (i) Arrangements to ensure that staff are adequately trained and empowered to communicate any issue of objectivity that concerns them to a separate principal.
- (ii) The involvement of an additional principal (in the case of a sole-practitioner, a qualified colleague) to carry out a review or otherwise advise. (See 3.6 below.)
- (iii) Rotation of engagement partners and staff.
- (iv) The evaluation of a potential client when a firm is approached to act, to assess such facts as the integrity of the client's management, company profile, accountancy competence, etc.
- (v) Formal consideration and review of the continuance of all engagements before the firm's name is allowed to go forward for reappointment as auditor.
- (vi) An overall control environment, starting with a professional approach towards matters of quality and ethics, and taking in staff training, development and performance appraisal, and the assurance provided by a regularly monitored and evidenced control system.

3.6 Review Procedures

- (i) Wherever the review procedures indicate that an audit assignment should be accepted or continued only with additional safeguards against loss of objectivity, the engagement partner's decision and the range of safeguards appropriate to the assignment should be subject to independent review by a partner unconnected with the engagement.
- (ii) The safeguards to be applied should include, as appropriate, rotation of the audit engagement partner and of senior audit staff. In particular the firm should review annually the possible need for rotation of an audit engagement partner.
- (iii) It is a useful practice to keep records of all reviews carried out.

3.7 Sole Practitioners and small firms

- (i) Not all the safeguards suggested in the course of the preceding guidance will be available to the sole practitioner within his or her firm. The practitioner should therefore set up alternative standing arrangements to consult externally with another member or with the Institute's

Advisory Practice Services (phone: 01908 248032 or e-mail: practice.services@icaew.co.uk). Where the arrangements are with another practitioner they could include provisions as to the maintenance by the latter of client confidentiality and an undertaking not to accept instructions from any client whose work is the subject of review for a period of two years thereafter.

- (ii) To the extent that a small firm may find difficulty in implementing the safeguards, principals should set up external consultation arrangements appropriate to their particular circumstances.
- (iii) Where the practitioner's own review indicates that an audit engagement should only be accepted or continued with additional safeguards to protect the practitioner's independence, he or she should undertake such consultation before proceeding further. The extent of the consultation will vary according to the nature of the problem; in some cases it may be confined to a discussion of principles; in others it may involve an examination of the file or a discussion of personal relationships.
- (iv) A sole practitioner should not accept or continue appointment as auditor of a company at a time when he is trustee of a trust holding shares in that company, unless he has made arrangements for such consultation. (See paragraph 4.46 below.)

3.8 The involvement of a third party such as a client audit committee, or a regulatory body or another firm

3.9 Refusal to act where no other course can abate the perceived problem

Some exclusions and prohibitions are the subject of statute or regulation outside the control of the profession. In addition, there are some situations in which the threat to an auditor's objectivity is so significant, or generally perceived to be so, that an auditor should, having regard to preservation of the public image of his profession, decline to accept appointment, even if he believes that the circumstances are such that available safeguards and procedures could, in his particular case, enable him to maintain proper objectivity. In this eventuality, he should decline or resign appointment.

3.10 It follows from the preceding paragraphs that the perception of the public (or any section of it) that an auditor's objectivity may be threatened is not, of itself, a reason why an appointment should be refused. The countervailing pressures and safeguards described above may often override a threat. Members and firms are encouraged to make clients and others outside the profession aware of the extensive and sophisticated compliance procedures that they employ.

4.0 Guidance on specific areas of threat

Area of risk – undue dependence on an audit client

4.1 If the recurring fees from a client company or group of companies constitute a substantial proportion of the fee income of an audit firm, a self-interest threat is likely to arise, so as to imperil objectivity.

4.2 Accordingly a member should not accept an audit appointment or similar financial reporting assignment from an entity which regularly provides him, his firm or an office within the firm with an unduly large proportion of his or its gross practice income. An unduly large proportion would normally be 15 per cent, or, in the case of listed or other public interest companies defined in paragraphs 7.6 and 7.7, the appropriate figure would be 10 per cent.

4.3 In the case of a member practising part-time, the relevant proportions are 15 per cent and 10 per cent of the member's gross *earned* income.

4.4 A new firm seeking to establish itself, or an established firm reducing its activities may not be able to comply with the above criteria, at any event in the short term. Such firms should take particular care to implement the safeguards referred to below.

4.5 The fees from a number of one-off assignments could contribute to a problem of undue dependence. One-off assignments which by their special and repetitive nature become regular assignments should be regarded on the same basis as recurring fees.

4.6 Where a member is dependent for his income on the profits of any one office within a firm and the gross income of that office is regularly dependent on one client or a group of connected clients for more than 15 per cent (in the case of listed or other public interest companies 10 per cent) of its gross fees, a partner from another office should take final responsibility for any report.

4.7 While the overall criteria set out in paragraph 4.2 do not indicate the presence of a serious threat, individual engagement partners may be faced with a personal threat because their personal portfolio is dominated by a single client, on whom they might become so dependent as to lose objectivity.

Safeguards in relation to undue dependence on an audit client

4.8 It is the responsibility of both the audit engagement partner and the management of the firm to ensure that in such situations additional safeguards are introduced by way of review and second partner support to ensure that objectivity of judgement is retained by the partner responsible for engagement decisions and audit judgements.

4.9 The figures in paragraph 4.2 above indicate only the extremes beyond which the public perception of a member's objectivity is likely to be at risk. It is the duty of the firm regularly to satisfy itself that it is not open to criticism in respect of any audit engagement, having regard to all the circumstances of the case. For this purpose a firm should, before accepting an audit appointment and as part of its annual review (see paragraphs 3.2 to 3.7 above), carefully consider against the criteria set out in this Statement the propriety of accepting or retaining each audit client or group of connected clients the fees from which for audit and other recurring work, excluding

one-off assignments, represent 10 per cent or more of the gross practice income or of the gross earned income of a member practising part-time. In the case of a listed company or other public interest company – see paragraphs 7.6 and 7.7 (Definitions) – a figure of not more than five per cent is the appropriate point to initiate review.

Area of risk – loans to or from a client; guarantees; overdue fees

4.10 A self-interest threat will arise if an audit firm or any principal of the firm should directly or indirectly make any loan to, or receive a loan from a client, or give or accept any guarantee in relation to a debt of the client, firm or principal.

4.11 An audit firm or a principal of the firm should not receive any loan from a client. This is because the size of the perceived self-interest threat arising in such circumstances is generally seen as being too great to be offset by any available safeguards. Nor should a firm or principal make any loan to a client, although this restriction does not normally apply to any account in credit with a client clearing bank or similar financial institution.

4.12 Paragraph 4.11 above is not intended to preclude a loan, overdraft or home mortgage being accepted from an audit-client financial institution in the normal course of business and on normal commercial terms by a principal or employee, unless:

- (a) the loan is applied so as to subscribe to partnership capital; or
- (b) the principal is an engagement partner in relation to the client.

Overdue fees

4.13 Similar considerations apply where there are significant overdue fees from a client or group of connected clients.

Safeguards in relation to overdue fees

4.14 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.

Area of risk – hospitality or other benefits

4.15 A self-interest threat arises where anyone in the firm receives a benefit by way of goods or services, or hospitality from a client. These should not, therefore, be accepted by a firm or by anyone closely connected with it unless the value of any benefit is modest.

Area of risk – actual or threatened litigation

4.16 Where litigation takes place, or appears likely to take place, between an audit firm and a client, both a self-interest threat and an advocacy threat may arise.

4.17 These threats are likely to call into question the objectivity of the 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 auditor.

4.18 The issue by the audit client of a writ for negligence against the 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 auditor may also impair objectivity. Such impairment may not necessarily result when the litigation arises solely out of a fee dispute.

4.19 It is not possible to specify precisely the point at which it would become improper for a firm to continue as auditors. However a firm should have regard to circumstances where litigation might reasonably be perceived by the public as in contemplation, e.g., where publicity is given to matters adversely affecting a listed or other public interest company and reference is made to the company's reliance on accounts or other financial statements prepared by the firm.

Area of risk – Participation in the affairs of a client

4.20 Participation in the affairs of a client is likely to lead to self-interest threats which are either in practice too great to be over-ridden by available safeguards, or are likely to appear so to interested parties.

4.21 There may be statutory prohibitions on a firm acting as auditor. For instance the Companies Act 1989, section 27, prohibits an officer or employee of a company, or a partner or employee of such a person from accepting appointment as auditor of that company.

4.22 In general, no principal or employee of an audit firm may be an officer or employee of a client, and should not have held such a position in a period so closely preceding the firm's appointment as to constitute a significant threat of self-interest or of self-review.

4.23 Self-interest threats can also arise if an officer or senior employee of an audit client is a close connection of a principal of the audit firm. For the purposes of this paragraph only, the definition of 'closely connected' (see paragraphs 7.2 to 7.5 (below)) includes additionally adult children and their spouses, brothers and sisters and their spouses, and any relative to whom regular financial assistance is given or who is otherwise indebted financially to the principal.

4.24 A member should not personally take part in the conduct of the audit of a company if he or she 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 (other than auditor) or employee of that company.

4.25 A firm should not report on a company if a company associated with the firm fills the appointment of secretary to the company. There is no objection to the firm providing assistance to the company secretary.

Area of risk – principal or senior employee joining client

4.26 The objectivity of a firm reporting on a company (or other entity) may be threatened, or appear to be threatened, if an officer of the audit client has been a principal or senior employee of the firm.

4.27 Threats to the firm's objectivity of a self-interest nature may arise where there remain significant connections between the officer and his former firm, and appropriate action should be taken to ensure that objectivity is not impaired. For example:

- (a) the officer should not derive 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; and
- (b) the officer should not participate or appear to participate in the firm's business or professional activities. Inclusion on the notepaper of the firm is an indication of such participation and the provision of office accommodation or secretarial or information technology support by the firm may indicate such participation.

4.28 Additionally, the firm's objectivity may be threatened because of participation in the conduct of an audit by a principal or senior employee in the knowledge that he is to join the client.

Safeguards in relation to principal or senior employee joining audit client

4.29 The firm should therefore make appropriate provision in its procedures for further safeguards to include the following:

- (a) a requirement for immediate notification to the firm by a principal or senior employee involved in a client's audit of the intention or any discussions concerning the possibility of joining the client;
- (b) 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.

Area of risk – mutual business interest

4.30 A mutual business interest with a client company or with an officer or employee of the company will create a self-interest threat. Where such an interest is an element of an engagement, the engagement should not be accepted or continued unless appropriate safeguards can be set up within the firm (see paragraphs 3.2 to 3.8 above).

Area of risk – beneficial interests in shares and other investments

4.31 Any beneficial interest on the part of a principal or anyone closely connected with a principal of the audit firm in a client company will constitute an insurmountable self-interest threat.

4.32 Where an employee, or a person closely connected with an employee, has such a beneficial interest, the employee should not take part in the audit of the client company.

4.33 A beneficial interest is a beneficial shareholding or other direct investment in the company (and see paragraph 7.9).

4.34 Paragraph 4.31 above is not intended to preclude a principal or a person closely connected with a principal from holding or continuing to hold, in the normal course of business and on normal commercial terms, an insurance or pension policy with a client insurance company or society, though an engagement partner should not take out a new policy with such a client.

4.35 Nor is a beneficial holding in an authorised unit or investment trust, or Lloyd's syndicate which holds shares in a client company so precluded.

4.36 A principal in an audit firm should not have a Personal Equity Plan (or equivalent) which has among its investments any audit client. However he may have a Personal Equity Plan (or equivalent) which invests solely in unit trusts or in an investment trust, provided that the firm does not report upon the trust.

4.37 Where a principal inherits shares or marries a shareholder, or a relevant investment occurs as a result of a takeover, the investment should be disposed of at the earliest practicable date, being a date at which the transaction would not amount to insider dealing. Similar action should be taken where a beneficial investment is held in a company becoming an audit client. Where the necessary disposal cannot be achieved within the timescale envisaged the firm should not continue as auditor.

4.38 Where a provision in the Articles of Association of a company or an Act of Parliament requires the auditor to be a shareholder the auditor should hold no more than the minimum number of shares necessary to comply with that provision in the Articles or with the Act, and the shareholding should be disclosed in the accounts, in the Directors' Report or in the Audit Report.

Area of risk – beneficial interests in trusts

4.39 A beneficial interest in a trust having a shareholding in an audit-client company should be regarded as a beneficial interest in that company and be subject to similar considerations as in 4.31 above.

4.40 Where a principal or a person closely connected with a principal holds a beneficial interest and the principal is and wishes to remain a trustee, the shareholding should be regarded as equivalent to a beneficial shareholding, and the practice should cease to report.

4.41 Where the principal or a person closely connected with him holds the beneficial interest in a trust, and where the principal is not a trustee, he should cease personally to take part in the audit of the company as soon as he becomes aware of the shareholding.

Area of risk – trusteeships

4.42 If a principal or employee of the firm or a person closely connected with either acts as a trustee of a trust which holds shares in a client company, a self interest and/or familiarity threat will arise. The threat to objectivity is patent where the shareholding is in excess of 10 per cent of the issued share capital of the company or of the total assets of the trust.

4.43 Where the trust holds shares in a listed company or other public interest company (see paragraphs 7.6 and 7.7 Definitions) and the holding is in excess of 10 per cent of the issued share capital of the company, or the trust's aggregate investment in the company exceeds 10 per cent of the total assets comprised in the trust, the firm should not accept or continue appointment as auditors. The shareholdings (in relation to the issued share capital of the company) of trusts of which principals or members of staff of the firm are trustees should be regarded as aggregated for the purposes of this paragraph.

4.44 The restrictions and aggregations contained in paragraph 4.43 above do not necessarily apply in the case of staff member trustees, where the trust is of a personal or family nature and is not client-related.

4.45 In the case of companies other than listed companies and public interest companies the 10 per cent limits do not apply, but appointment should not be accepted unless appropriate safeguards are implemented.

Safeguards in relation to trustee holdings

4.46 These include the following:

- (a) A trustee, or someone with whom a trustee is closely connected (see paragraph 7.2 *et seq.*) should not act as the principal or person responsible for the audit of the company in which the trust is a shareholder.
- (b) A sole practitioner should not accept or continue appointment as auditor unless he is able to arrange for the consultation referred to in paragraph 3.7 (above), and that consultation confirms the propriety of accepting or continuing appointment.
- (c) The disclosure of the trust investment in the accounts, in the Directors' Report or in the Audit Report, save in the case of trustee shareholdings where the aggregate of all relevant shareholdings is less than one per cent of the issued capital of the company.
- (d) Where a close personal relationship develops in the course of a trustee shareholding, a member should have regard to the review procedures recommended in paragraphs 3.2 to 3.7 (above).

4.47 Similar considerations apply when a person closely connected with the firm is a director or employee of a trust company which acts as trustee of a trust holding investments in a company on the accounts of which the firm reports.

Area of risk – nominee shareholdings; ‘bare trustee’ shareholdings

4.48 Similar considerations to those applying to trustee shareholdings (see paragraph 4.42 *et seq.*) apply also in the case of nominee shareholdings and ‘bare trustee’ shareholdings.

Area of risk – voting on audit appointments

4.49 Where a principal or employee of the audit firm holds shares in any capacity in an audit client company, those shares should not be voted at any general meeting of the company in relation to the appointment, removal or remuneration of auditors, because to do so would give rise to a patent conflict of interest.

Area of risk – connections; associated firms; influences outside the practice; employees

4.50 It should be recognised that each of the threats dealt with in paragraphs 2.1 to 4.49 may arise either in relation to a principal of the firm, or in relation to a close connection such as a member of his immediate family (see paragraphs 7.2 to 7.4 below). Threats can also arise because of pressures exerted upon a firm by an associated firm or an outside source introducing business, such as bankers, solicitors, or government.

4.51 The threat to objectivity will depend upon the closeness of relationships and associations, the strength of an associate’s interest in the firm’s retaining a client, and the extent to which the introduction of business by an outside source is able to affect the firm’s fee income.

4.52 The audit firm should not employ any person on the audit who would by any of the foregoing principles be personally excluded from the role of auditor.

Safeguards in relation to connections, etc.

4.53 The possibility of a threat to objectivity arising in such circumstances should be borne in mind and provided for in the firm’s review machinery. All the safeguards listed in paragraphs 3.2 to 3.9 (above) are of potential relevance.

4.54 It should be borne in mind that the threat to objectivity will be less where any connection is with a junior member of staff or with a member of the firm who is not personally engaged on the audit in question, and where his or her office is distant from the office conducting the audit.

Area of risk – provision of other services to audit clients

4.55 There are occasions where objectivity may be threatened or appear to be threatened by the provision to an audit client of services other than the audit. All the safeguards described in paragraphs 3.2 to 3.9 may have an application to the provision of other services.

4.56 There is no objection to a firm providing advisory services to a company which are additional to the audit. Care must be taken to ensure not to perform management functions or to make management decisions. It is economic in terms of skill and effort for professional accountants in public practice to be able to provide other services to their clients since they already have a good knowledge of their business. Many companies (particularly smaller ones) would be adversely affected if they were denied the right to obtain other services from their auditors.

4.57 The threats that may arise in the course of providing other services are discussed in the remainder of this section. The threats may be analysed under the headings set out in paragraph 2.0 above.

The self-interest threat

4.58 All work that creates a financial relationship between the auditor and the audit client may appear to create a self-interest threat – as does payment for the audit itself. The nature of the threat sometimes perceived is that the 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. But the most 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 threat is addressed by the guidance as to undue dependence in paragraphs 4.1 to 4.9 (above).

The self-review threat

4.59 Audit work itself gives rise to self-review. The auditor reviews matters that he has previously judged in prior-year audits, matters that were judged at planning stage, his recommendations (or lack of them) to management at previous audits, etc. In auditing, perhaps more than in any other activity, there is a need for a readiness to recognise and avoid past mistakes. The auditor must adopt the objectivity and independence of mind to be able to acknowledge past errors or mistakes of judgement and report fairly and afresh.

4.60 The provision of other services may give rise to further needs for self-review. If, for example, the firm has designed or recommended any part of the systems or controls on which the audit relies, the audit team will need to take particular care to ensure that the audit judgements are objective, perhaps in the case of larger firms by arranging that there is little or no common membership between the systems work and the audit team.

4.61 If, as is common for smaller companies, the auditor has prepared any of the data contained in the financial statements or drafted material for the notes, or assisted in the preparation of the accounting records, a degree of self-review arises.

4.62 There is a spectrum of involvement by the auditor in the preparation of accounting records. It ranges from the situation prevailing in small companies where the auditor may prepare much of the accounting records and the financial statements as well as auditing them, to the other end of the spectrum where in the case of a major listed company the auditor does not participate in any part of the preparation process. Even in the latter case, the auditor who detects omissions in the company's proposed disclosures will normally suggest and draft the amendments required, so that in the end it is uncommon for a set of financial statements to appear where the auditor has had no hand whatsoever in the presentation or drafting.

4.63 These processes of assistance, entailing self-review as they do, are not intrinsically damaging to audit objectivity, but pose a threat to it. Safeguards are necessary.

4.64 At the smaller company end of the spectrum the safeguards reside in a considered analysis by the 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. At the other end of the spectrum, in the case of a listed company or other public interest company audit client (see paragraphs 7.6 and 7.7 Definitions), an audit practice 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. The scale and nature of such work should be regularly reviewed.

Expert services as an example of the self-review threat

4.65 The provision for an audit client of expert services (as defined in paragraph 7.10), by an audit firm or an associated firm or organisation in the same country or overseas, 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 by an expert.

4.66 In these circumstances, the auditor should carefully consider whether the threat is so great that the firm should either not audit the financial statement concerned or advise the client to seek an alternative source for the particular expert services; in cases where the firm decides to accept such an engagement, the auditor 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 firms should record the basis of their decisions and document the safeguards.

A major issue affecting the self-review threat, which should be carefully considered by the 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 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.

Safeguards

4.66A Where a firm has identified a threat it should consider the matters set out in paragraph 4.60 (above) in relation to the audit team and take any necessary steps to safeguard its objectivity. Such steps will often 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. Firms should ensure that their work complies with the Statement of Auditing Standards 'Using the Work of an Expert' (SAS 520), particularly the elements identified in the section: 'Assessing the Work of an Expert'.

The advocacy threat

4.67 Advocacy arises where a practitioner becomes an advocate for a client's position in any adversarial proceeding or situation. There is nothing improper about a position of advocacy and many types of professional services and support to a client may require it.

4.68 Advocacy in a simple sense is always present where a firm supports its clients' interests. At the same time a professional person is always required to strive for objectivity in all professional work (see Fundamental Principle 2 in Statement 1.200 *Introduction and Fundamental Principles*).

4.69 But advocacy can take a *sharpened* form, a more committed and protagonist form, where the firm supports its client in an adversarial situation.

4.70 An auditor's client is in principle the company and its shareholders. But his duty to that particular client must be set in the context of the wider public interest which requires him (through Companies Acts requirements and the

Auditing Practices Board pronouncements) to provide an opinion as to whether a set of financial statements gives a true and fair view. That true and fair view must be an objective one, not tailored to or influenced by the needs of the client.

4.71 Hence advocacy in any sharpened form is likely to appear to the beholder to be incompatible with the particular objectivity required by the audit reporting role. And in fact, particular advocate roles, though adopted with objective judgement, may tend subsequently to form a degree of commitment in the professional's mind which may make it difficult to return to the objectivity required for reporting.

4.72 The following examples are provided to illustrate the classes of professional services or other activity which may give rise to these sharper forms of advocacy:

- (a) **The recommendation, or promotion, of shares** requires the adoption of a posture of advocacy in relation to the company concerned which cannot be compatible with objectivity in reporting. To recommend or promote shares usually requires a mental commitment to views or assertions about the strengths and qualities of the company. These views or assertions may have been reached by objective consideration, but once adopted the mental commitment does not readily permit a return to either the appearance or the reality of dispassionate and objective judgement.
- (b) **By extension, leading a corporate finance team which takes the responsibility for recommending or promoting shares** will be incompatible with objectivity in reporting. For this reason Statement 1.203, *Corporate Finance Advice* contains what amounts to a prohibition on the provision of such services to a company on which the firm reports.
- (c) **The adoption of an extreme position on any issue of accounting principles, taxation or other matter of professional judgement** will always raise the risk of putting the practitioner into a position of sharpened advocacy. This will be heightened if it becomes necessary for the firm to support the extreme position in adversarial proceedings such as litigation, Takeover Panel proceedings, or negotiations with government revenue departments. Such a position may both raise doubts in the minds of observers and make it genuinely difficult for a firm to preserve its own audit objectivity on the topics at issue.

4.73 The central issue for auditors in illustration (c) is the identification of what is or may become an extreme position.

Members should endeavour to foresee such difficulties arising, and either avoid the extreme position or suggest to the company that it may seek alternate advisers to perform any roles requiring adversarial advocacy. It should be re-emphasised that there is nothing inherently unethical in advocating an extreme position on a client's behalf, if it can be supported by objective evidence. But it may be improper to perform such advocacy while at the same time asserting that the objectivity of the audit role has been maintained. In some situations separation of roles between different partners

may provide a degree of internal safeguards, but practitioners should recognise the risk of bringing themselves and the profession into disrepute by entering into a situation where a position of advocacy appears to indicate a position of commitment or a bias in state of mind which is not consistent with the objective state of mind required for a reporting role.

The threat of over-familiarity

4.74 Members are warned in particular of the dangers of being inadvertently drawn into the provision of management functions where a range of services has been provided to an audit client over a period of years. A member should be careful not to go beyond the advisory role and drift into the management sphere.

Involvement in management

4.75 The objections to an auditor becoming involved in a management role should be apparent. *All* of the threats to objectivity discussed above would affect the auditor who took management decisions, and their combined weight would make it virtually impossible for a member to claim to have retained objectivity in audit reporting.

4.75A An auditor should also guard against the acceptance of an appointment or quasi appointment with a client by his firm or a member of his firm, which trespasses on the role of management. For example, the nature of the day-to-day responsibilities of an appointed actuary to an insurance company are generally such that the role would be incompatible with that of auditor.

4.76 A situation may arise where advice is tendered by the practitioner over a long period and the management of the company so frequently accepts and acts on the advice that it becomes difficult to separate the role of management from that of adviser. Members should ensure in every case that management accepts the judgements involved as its own after adequate consideration.

4.77 A practitioner would need to consider the position carefully if the firm were invited to design systems affecting operations on which the commercial success of the company depended. It might even be desirable for management to consider taking an expert second opinion if the advice from the auditor and the ensuing management judgements were crucial to the company's financial and operational success. Many practitioners would judge that objectivity could be preserved in the audit only if management was well qualified with its own expertise to make all the operating judgements involved in the adoption and implementation of the system and if there were, among other internal safeguards, a considerable degree of separation of the system designers from the audit team.

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

Area of risk – acting for a prolonged period of time

4.79 Where the same engagement partner acts for an audit-client company for a prolonged period of time, a familiarity threat will arise.

Safeguards in relation to acting for prolonged period of time

4.80 Firms should, in relation to the audit of ‘listed companies’ as defined in paragraph 7.6, ensure that no audit engagement partner remains in charge of such an audit for a period exceeding seven consecutive years. An audit engagement partner (see paragraph 7.1) who has ceased under the above provision to act as such should not return to that role in relation to that audit until a minimum of five years has passed but is not precluded from other involvement with the client.

4.81 A limited degree of flexibility over timing may be acceptable in circumstances where audit engagement partner continuity is especially important. Examples could include major changes to a company’s structure or management, or its involvement in a takeover, which would otherwise coincide with the partner change.

4.82 Because rotation of the audit engagement partner cannot be implemented by a sole-practitioner auditor, or by small firms where there is only one ‘responsible individual’, these should, in relation to the audit of listed companies, be prepared to demonstrate that the following procedures have been carried out:

- (a) internal review, at least annually coupled with
- (b) external consultation (see paragraph 3.7).

Companies and clients other than those specified in 4.80 (above)

4.83 The threat to a firm’s objectivity arising from audit engagement partners continuing in such roles for a prolonged period remains in relation to all clients and not merely those specified in paragraph 4.80; the same considerations apply in respect of senior audit staff. Members should, therefore, establish adequate review machinery along the lines indicated in paragraphs 3.2 to 3.7 above, including an annual review, in order to satisfy themselves that each engagement may properly be accepted or continued.

5.0 Section B – Objectivity and independence in financial reporting and similar non-audit roles

5.1 There are roles other than the audit, in which a member is required to report with similar authority on financial matters, and to which therefore the considerations referred to in Section A (above) apply, as follows:

Financial reporting

5.2 The considerations which make it essential for a member’s objectivity to be safeguarded when he or she carries out an audit are also relevant to other

financial reporting assignments requiring a professional opinion, including reporting assignments where a document has been prepared in contemplation that a third party may rely on it.

5.3 For reports commissioned by management for management's internal use only see paragraphs 6.1 to 6.3 below.

Litigation support

5.4 A member called upon to report or undertake work in connection with civil proceedings or with criminal prosecution should appreciate that such work may be tendered as evidence in a court of law and/or involve the member in giving evidence upon oath. The objectivity of such a member should, therefore, be safeguarded when he or she accepts and carries on such an assignment.

Specialist valuation

5.5 The objectivity of a member who carries out a specialist valuation, the results of which may be included in financial accounts or public documents, needs to be safeguarded, and similar considerations apply to those set out in Section A in relation to the carrying out of an audit.

Arbitration

5.6 It is a requirement of law that an arbitrator must act independently of the parties and of the issues involved in an arbitration.

Due diligence

5.7 Guidance on the considerations involved in the provision of due diligence work is dealt with in Statement 1.203, *Corporate Finance Advice*.

6.0 Section C – Objectivity and independence in professional roles other than those covered in sections A and B

6.1 This Section deals with work other than the work covered by Sections A and B of this Statement including:

- taxation services;
- preparation of accounts;
- corporate advisory services other than the preparation of documents for public use;
- management consultancy services; and
- reporting to management/secondment to management.

6.2 Independence in the sense in which it is sometimes applied to audit assignments (Section A above) is not essential to the work referred to in the previous paragraph, provided that the practice is not also auditor to the client and objectivity is not impaired. Guidance on the considerations relating to possible conflicts of interest is given in Statement 1.205, *Conflicts of Interest and Confidential Information*.

6.3 There are nevertheless certain factors which by their nature are a threat to objectivity in any professional role. Accordingly the following considerations referred to in Section A (above) apply to the professional assignments referred to in paragraph 6.1 above:

Area of risk – family and other personal relationships

6.4 An objective approach to any assignment may be subject to self-interest or familiarity threats as a consequence of a family or other close personal or business relationship.

6.5 Objectivity in relation to any assignment may be subject to a self-interest threat where a mutual business interest exists with a client company or with an officer or employee of the company. The safeguards indicated in paragraphs 3.2 to 3.7 should be implemented as appropriate. In addition adequate disclosure of any conflict of interest arising should be made to all relevant parties.

Area of risk – loans

6.6 An objective approach to any assignment may be subject to a self-interest threat if a firm, or any principal of the firm should directly or indirectly make any loan to, or receive a loan from a client, or give or accept any guarantee in relation to a debt of the client, firm or principal.

6.7 A firm or a principal of the firm should not receive any loan from a client. This is because the size of the perceived self-interest threat arising in such circumstances is generally seen as being too great to be offset by any available safeguards. Nor should a firm or principal make any loan to a client, although this restriction does not normally apply to any account in credit with a client clearing bank or similar financial institution.

6.8 The above advice is not intended to preclude a loan, overdraft or home mortgage being accepted from a client financial institution in the normal course of business and on normal commercial terms provided that, where the loan is applied so as to subscribe to partnership capital or where the loan is made to an engagement partner, the significance of the loan is not such as to cast doubt on the objectivity of the practice in performing the role or roles which it is contracted to discharge.

6.9 Similar considerations apply where there are significant overdue fees from a client or group of connected clients.

Area of risk – goods and services: hospitality or other benefits

6.10 A self-interest threat arises where anyone in the firm receives goods or services, or hospitality from a client. These should not, therefore be accepted by a firm or by anyone closely connected with it unless the value of any benefit is modest.

Beneficial interests in shares and other investments

6.11 A self-interest threat to the objectivity of a member or firm will arise in relation to any investment in a company or undertaking with which the firm has a professional relationship, and the safeguards set out in paragraphs 3.2 to 3.7 above should be implemented as appropriate. Where the value of the investment is material to the financial circumstances of the investing member or firm, they should cease to advise professionally (see paragraph 3.9).

Business advisers

6.12 Where a member or a practice acts as business adviser to a client, he, she, or it may invest in that client, and if the client is a company, act as sponsor or promoter of its shares, provided that the relationship is clearly declared to relevant parties.

Discussion

6.13 Members who hold office in a client company, or have a comparable business relationship with a client, should be aware of the dangers inherent in seeking to combine such a role with that of adviser, having regard to the self-interest threat to their objectivity. In such circumstances, members should be aware of the distinctive nature of each of the roles in which they are professionally engaged, and employ safeguards including disclosure where appropriate (see paragraphs 3.2 to 3.7, and also Statement 1.205, '*Conflicts of Interest and Confidential Information*').

7.0 Section D – Definitions

Audit engagement partner

7.1 An audit engagement partner is one who has the responsibility for the conduct of the audit and for the issue of an opinion on the financial statements. A member who has an equivalent responsibility in a corporate practice should be regarded on the same basis.

Closely connected

7.2 Paragraphs 4.23 and 4.50 (above) refer to a 'close connection' of a principal of a firm. This phrase has been chosen because it is not practicable in an advisory document such as this to stipulate precisely the relationships beyond which the independence of a practitioner may be put in jeopardy. Persons not related in any way by blood or marriage, for example, may nevertheless enjoy a friendship closer than many blood relationships. Conversely, two spouses may have lived apart from each other for many years without any financial dependency upon or contact with each other.

7.3 Bearing in mind however the need to maintain not merely independence but also the manifest appearance of independence, the following persons will normally be regarded as closely connected with a person, namely:

- (a) his or her spouse (other than a spouse from whom he is separated) or cohabitee or, in the case of a shareholding, other than a spouse or cohabitee of whose financial affairs he has been denied knowledge;
- (b) his minor children, including stepchildren;
- (c) a company in which he has a 20 per cent or more interest.

7.4 In the event of a complaint a member will be presumed to have knowledge of the financial affairs of his spouse or cohabitee unless he demonstrates the contrary.

7.5 The following persons will normally be regarded as being closely connected with a firm:

- (a) a partner or, in the case of a corporate practice, a director or shareholder;
- (b) a person closely connected with (a) above;
- (c) an employee of the firm.

For the reasons mentioned earlier these categories are not exhaustive of the relationships which might threaten independence.

Listed companies

7.6 For the purposes of this Statement, reference to listed companies should be taken to include the following:

- (a) companies whose shares or securities have been admitted to listing by a recognised stock exchange;
- (b) companies whose equity share capital is marketed under the regulations of a recognised stock exchange, e.g. companies whose shares are dealt with on the Alternative Investment Market.

Other public interest companies

7.7 Various paragraphs of this Statement refer to 'other public interest companies.' Where this occurs the phrase is intended to include those unlisted companies and organisations, in both the private and public sectors, which are 'in the public eye' because of their size or product or service they provide. Examples of such companies and organisations would be large charitable organisations and trusts, major monopolies, duopolies, building societies, industrial and provident societies or credit unions, deposit-taking organisations, and those holding investment business client money.

Principal

7.8 References to a principal of a firm include the following:

- (a) a partner;
- (b) a sole-practitioner;
- (c) a director of a corporate practice, who deals directly or indirectly with accountancy clients or potential accountancy clients of the firm;
- (d) an employee of a corporate firm who is:
a responsible individual within the meaning of the Audit Regulations;

- a licensed insolvency practitioner;
- defined as such in circumstances determined by Council.

Shares and shareholdings

7.9 Reference to shares and shareholdings should be taken to include debenture and other loan stock and the equivalent, and rights to acquire shares, debenture or other loan stock. Shareholdings also include options to purchase or sell such securities. A person's holdings include holdings by a nominee on behalf of that person or by a trust created by that person for his or her personal benefit. Shareholdings in parent, subsidiary or associated companies of a client company should normally be regarded on the same basis as shareholdings in the client company itself. However, if the firm is auditor only of a company or companies which taken together constitute an insignificant part of a group, independence of the parent company, etc. is not required.

Expert services

7.10 For the purposes of this Statement 'expert services' comprise reports, opinions, valuations or statements which directly affect amounts and disclosures in the financial statements. 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.

The following are also excluded from 'expert services':

- (i) valuations under Section 108, Companies Act 1985, of the consideration to be received for the allotment by a public company of shares otherwise than in cash;
- (ii) valuations under Section 109, Companies Act 1985, of the consideration to be received by a public company or any consideration other than cash to be given by the company, for the transfer during the initial period of a non-cash asset to the company or another.

