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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

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***It should be noted that the members of the Working Group were acting in their personal capacity and were not representing the organisations for which they work.***

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## 1.0 Executive Summary

### 1.1 Summary of Work Undertaken

- The Working Group (WG) was set up following the publication of the APB Consultation Paper “Consultation on audit firms providing non-audit services to listed companies that they audit” on 6 October 2009.
- The WG was composed of representatives from investors, listed companies, audit firms and academia.
- The WG reviewed the disclosures made by audit committees in relation to their policy on procuring non-audit services; the processes they apply in relation to awarding non-audit services and in assessing the independence of the auditor and the related disclosures in the company’s annual report. This is covered in section 4 of this report.
- The WG also reviewed the disclosures made by companies in the notes to their financial statements in relation to the total remuneration paid to the auditor. This is covered in section 5 of this report.
- The WG undertook a survey of audit committee chairs and finance directors of FTSE 350 companies and the results are contained in section 6 of this report.
- The WG sought the views of key investor representatives and these are contained in section 7 of this report.
- The WG responded to the specific questions raised by the APB in its consultation paper. The responses are contained in section 8 of this report.

### 1.2 Conclusions

- The WG concluded following detailed debate, research and communication that there is no benefit to be gained from a complete prohibition on auditors providing non-audit services to their listed clients. An overview of the debate, research and communication findings is included within this paper.
- The WG concluded that there are areas for improved disclosure, transparency and governance around the subject of non-audit fees and in particular policy, procedures and disclosure.
- The views of the WG are supported in general by evidence obtained from a survey it conducted amongst audit committee chairs and finance directors and conversations with institutional investors as detailed below.
- There is no appetite amongst investors and corporate entities for introducing a complete prohibition on auditors providing non-audit services to their listed audit clients. No respondent to the survey of audit committee chairs and finance directors supported such a move. Likewise, none of the investors consulted supported such a move.
- In general, most corporates and investors believe that the APB’s Ethical Standards for Auditors remain fit for purpose. The WG recognises that some investors believe that further restrictions might be introduced in specific areas, although it has not yet detected a consensus about such areas.

- Whilst the WG believes that the FRC ‘Guidance on Audit Committees’ is still fit for purpose, there is scope for improvement in listed companies with regards to the transparency of corporate governance procedures which oversee the procuring of non-audit services and in relation to the associated disclosures in the audit committee report. Whilst those from corporate entities believe that the current audit committee disclosures in relation to the audit committee policy and process and in the notes to the financial statements are appropriate, neither investors nor the WG concur with this view.

### 1.3 **Recommendations**

#### Principal Recommendation

- Based on its discussions and the evidence gathered from company directors and investors, the WG recommends that the APB should not introduce a complete prohibition on audit firms providing non-audit services to their listed audit clients. The WG does however, believe that there are certain actions which could be taken to address any perceived issues that remain, and these are listed below.

#### Other Recommendations

- An audit committee should be required to publish its policy in relation to determining whether a non-audit service can be provided by the company’s external auditor. The policy can either be published on a company’s website or included in its annual report. The level of detail provided should be left to the judgement of the audit committee but the disclosures should be sufficient to allow stakeholders to understand the substance of the policy applied by the company and, where applicable, clearly state what non-audit services cannot be provided by the company’s auditors.
- The company’s policy should take account of emergency situations that may occur, for example, a company in a distressed situation and needing urgent advice. In such circumstances it is envisaged that the approval of the audit committee chair would be sought and that he would then be tasked with reporting back to the audit committee at its next meeting.
- The audit committee should clearly set out its policy on how any perceived conflicts of interest will be addressed in relation to the audit firm and also to members of the board of directors or other related parties.
- A requirement for an audit committee to pre-approve all non-audit services above a set fee level should be introduced. This fee level would be established by the audit committee. Additionally, all non-audit services of an internal audit nature or which are procured on a contingency fee basis should also be subject to pre-approval by the audit committee.
- The WG believes that the current auditor remuneration disclosure rules need to be revised as they do not result in the provision of useful information to stakeholders. The WG puts forward its suggested improvements in section 5. However, the WG acknowledges that, ultimately, a change in the auditor remuneration disclosure regulations is required.

#### In Summation

- The WG believes that greater transparency in regard to the procurement of non-audit services together with improved disclosure, will assist stakeholders’ understanding and should remove some of the negative perceptions that currently exist.

## 2.0 Background

### 2.1 Treasury Select Committee Report

On 15 May 2009, the House of Commons Treasury Select Committee (TSC) published its ninth report of session 2008-09 entitled “Banking Crisis: reforming corporate governance and pay in the city”<sup>1</sup>. Chapter 6 of the report reviewed the performance of auditors during the crisis. The TSC concluded at paragraph 221 that there was little evidence to suggest that the auditors of the banks had not fulfilled their current responsibilities:

*“We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient.”*

However, despite the above, the TSC recommended the following at paragraph 237 of the report:

*“We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. Representatives of the investor community told us of their scepticism that audit independence could be maintained under such circumstances. This problem is exacerbated by the concentration of audit work in so few major firms. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.”*

### 2.2 Auditing Practices Board (APB) Consultation Paper

In response to the TSC’s recommendation, the APB, a subsidiary board of the Financial Reporting Council (FRC) published its consultation paper “Consultation on audit firms providing non-audit services to listed companies that they audit”<sup>2</sup>, on 6 October 2009 with a consultation deadline of 29 January 2010. The APB paper covered the following areas:

- Introduction;
- Different services that audit firms have the capability to provide;
- Issues related to the provision of non-audit services to audited entities;
- The approach taken in the UK to the provision of non-audit services since 2000;
- Developments since 2004;
- The international environment; and
- Issues on which the APB seeks views.

In the last of these sections, the APB set out the specific questions on which it sought views. The Working Group’s (WG) responses to those specific questions are contained in section 8 of this report.

### **2.3 Establishment of the Working Group**

The WG was set up by the Institute of Chartered Accountants of Scotland (ICAS) in October 2009 and held meetings in November 2009, December 2009 and January 2010. The WG comprised representatives from industry, the investor community, larger audit firms and academia. An observer from the APB staff was also present at all meetings of the WG. A full list of the members of the Working Group is contained at the front of this report.

### **2.4 Terms of Reference**

A copy of the WG's terms of reference is included at Appendix A. It should be noted that the WG was not specifically set up to respond to the APB Consultation Paper but rather:

- (i) To review the current provision by auditors of non-audit services to their listed company audit clients in the light of the TSC Report and APB Consultation Paper and provide comment thereon;
- (ii) To engage with the investor and business communities:
  - (a) to assess the degree to which investors and others believe that the provision of those non-audit services which are permitted under the APB's Ethical Standards may represent a threat to auditor independence and/or audit quality, which is not capable of being reduced to an acceptable level through appropriate safeguards; and
  - (b) to seek to better inform them of the nature and types of services provided and the safeguards that exist and are currently implemented to mitigate any threats that may exist; and.
- (iii) To make suitable recommendations to seek to address any issues and concerns identified. This will include seeking to improve the transparency of the policies, process, and safeguards that surround the provision of non-audit services by auditors to their listed company audit clients and by increasing and improving, the level of disclosure of the nature of such services in a company's annual statutory financial statements.

To this effect a survey of the audit committee chairs and finance directors of the FTSE 350 companies was undertaken. A copy of the survey and supporting documentation is contained at Appendix B. The findings from the survey are contained in section 6 of this report. The survey results were also provided to the FRC to aid its preparation for a discussion forum it held with audit committee chairs on 25 January 2010.

The WG also sought the views of various investors to ensure that it had benchmarked its discussions and views and had captured the opinions from as wide a range of stakeholders as was possible within the limited timeframe.

## 2.5 Changes in the Regulatory Framework Since 2002

Since the accounting scandals which occurred in the USA in the early part of this century, major changes have taken place in the UK to the framework which governs the provision by auditors of non-audit services to their audit clients. Many of the changes originated from the work of the Co-ordinating Group on Audit and Accounting issues (CGAA)<sup>3</sup> which was set up by the UK Government in 2002 to oversee and co-ordinate the UK response to these US scandals. Although the CGAA concluded that there was little clear support for the view that the provision by auditors of non-audit services to their listed audit clients had actually compromised auditor independence, it recommended at page 29 of its report that there was a need for:

*'tougher and clearer safeguards to ensure that joint provision of audit and non-audit services does not undermine auditor independence in fact or appearance'.*

As a result, ethical standards for auditors were no longer to be set by the professional accountancy bodies but by a new independent body charged with that role. This was despite the fact that the UK accountancy bodies had already reacted by introducing more stringent ethical requirements in the area of non-audit services. Additionally, there was to be an increased role for audit committees in relation to overseeing auditor independence and the provision of non-audit services. The above changes resulted in the following:

- (i) the introduction of guidance for audit committees;

The Combined Code was subject to a major revision in 2003 and, with the associated Smith guidance (now known as the FRC 'Guidance on Audit Committees'), introduced a robust framework for the approval of non-audit services. The Smith Guidance provided that:

*"The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity."*

This Guidance also encouraged the audit committee to set and apply a specific policy detailing which non-audit services the auditor was prohibited from providing; those which had to be approved on a case by case basis; and those for which referral to the audit committee was not required.

The audit committee is also expected to take account of relevant ethical guidance applicable to auditors and satisfy itself that, where necessary, in relation to the provision of a non-audit service, the auditor adopted appropriate safeguards to mitigate any threats to independence. A 'comply or explain' provision effectively requires the audit committee to disclose in the annual report how its policy on non-audit services provides adequate protection of auditor independence.

- (ii) the introduction of the independent ethical standards for auditors;

The CGAA had advised that an independent body should issue ethical standards for auditors. The APB was tasked with this initiative and introduced its Ethical Standards for auditors in 2004. APB reviewed the Ethical Standards in 2007 and found that they were working in practice and meeting the needs of stakeholders. Subsequent to this, minor revisions were made to these standards in 2008 and in 2009.

APB Ethical Standard 5<sup>4</sup> is the standard which deals specifically with non-audit services. It adopts a ‘threats and safeguards’ approach and in instances where the APB does not believe that there are any appropriate safeguards which can be implemented then provision of the specific service is prohibited.

#### Other Developments

As well as these changes which came out of the work of the CGAA, the following other developments have taken place.

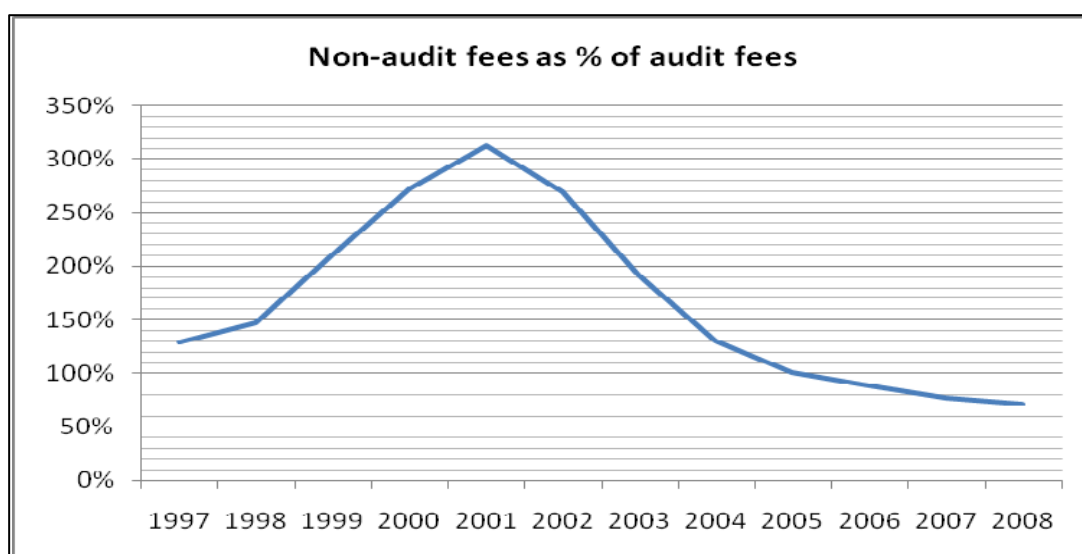
- (i) the introduction of ‘The Companies (Disclosure of Auditor Remuneration) Regulations 2005’<sup>5</sup> which have now been superseded by ‘The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008’<sup>6</sup>.

These regulations were intended to improve transparency in relation to the nature and quantity of non-audit services provided by auditors to their clients. The 2008 regulations did not make any substantive changes to the disclosure requirements.

- (ii) the introduction (for financial years commencing on or after 1 June 2010) of ‘The Audit Firm Governance Code’<sup>7</sup>.

This Code “is intended to assist in promoting continuing confidence and choice in the market for the audit of listed companies and should be relevant to everyone who sees audit as playing a vital role in a market economy”. The involvement of independent non-executives is intended to have an impact on firms’ independence on auditors which will be reinforced by dialogue with listed company stakeholders and enhanced transparency.

## 2.6 Level of Non-audit Fees



1997-2007: *Financial Director survey of audit fees. 2008 survey not yet available.*

2008: *Extracted from company-by-company data for 98 companies in FTSE 100. For the other two (F&C Investment Trust PLC and Carnival PLC), taken directly from annual report*

The above table illustrates the impact that the changes in the regulatory framework have had on the level of non-audit services provided by audit firms to their listed audit clients. The ratio of non-audit to audit services peaked in 2001 at a level of around 3.1. By 2008, the ratio had fallen significantly to 0.7.

## 2.7 International Comparison

In the European Union (EU), the EU Statutory Audit Directive<sup>8</sup> contains certain high level material on auditor independence. Additionally, there is a European Commission (EC) Recommendation on Auditor Independence<sup>9</sup> which was issued in 2002. It is the view of the APB that its Ethical Standards for Auditors are consistent with both the Statutory Audit Directive and the EC Recommendation. As also noted by the APB, most other EU countries adopt a similar threats and safeguards approach as that used by the APB and the International Federation of Accountants (IFAC), with the exception of France which follows a more prohibitive approach. Whilst, in form, France appears to adopt a far more prohibitive approach to non-audit services, the reality is that in substance many non-audit engagements are deemed allowable as they are encapsulated in the definition of 'audit', provided the service is of a type which is directly related to the audit and for which a standard has been issued by the French professional accountancy body.

In the United States (US), the Securities Exchange Commission (SEC) requires a company's audit committee to adopt a pre-approval approach to non-audit services provided by audit firms to their listed clients. Furthermore, there is a list of specific services which cannot be provided by a company's auditor which includes bookkeeping, actuarial services and internal audit outsourcing functions.

In 2009, the International Ethics Standards Board for Accountants (IESBA) finalised its revisions to the IFAC Code of Ethics. The revisions largely related to the "independence" sections of the IFAC Code and, in many areas, bring the IFAC Code into line with the content of the APB's Ethical Standards for Auditors.

### **3.0 Work Undertaken**

#### **3.1 Introduction**

The rationale for undertaking work on which to base the WG's conclusions is included in the background section of this report along with other relevant information. The Terms of Reference are contained in Appendix A.

The following provides a summary of the work undertaken by the WG and a brief summary of some of the discussions at its meetings. It also details how the views of the main stakeholders, company directors and investors were sought.

The membership of the WG is stated at the front of the report. The members were specifically chosen to ensure that each of the main stakeholder groups - namely investors, company directors, audit firms and academia - were represented.

#### **3.2 Discussion of Generic Points**

The WG believes that it is necessary to consider some of the more generic points that it discussed, which will provide some insight into the wide ranging debate that was had, and also to evidence that the WG sought to discuss and address all the relevant issues.

In discussing the issue of non-audit fees the WG was clear that, depending on stakeholder perspective, there were degrees of perception that covered a very wide spectrum. Hence the WG needed to establish the reality and seek over time to align perception with it. The issue of perception versus reality and what needs to be done to reconcile them is revisited later in the report.

#### **3.3 Discussion of Potential Prohibition of Non-audit Services**

The WG sought to establish whether an outright ban on the provision of non-audit services is the right way to proceed. Whilst the report addresses disclosure, governance and end user views in separate sections, the WG, after detailed discussion, unanimously agreed that to ban the provision of non-audit services would be wrong from the user perspective and could do more harm than good – many listed companies rely on the other services provided by the audit firm they instruct and their legitimate commercial interests would be prejudiced by any further limitation on their access to services from auditors.

Indeed, the WG did not identify any benefits from prohibiting the provision of non-audit services, provided any conflicts were identified and controlled via the implementation of appropriate safeguards. The respondents to the survey (section 6) fully supported this stance. In this respect, the WG believes that the APB's Ethical Standards for Auditors are still fit for purpose, which was again a view fully supported by respondents to the survey. The WG was also aware that the APB had undertaken a review of its ethical standards in 2007 and concluded after appropriate due process that no significant changes were required. The WG was also aware that audit quality, as reported by the Audit Inspection Unit, was considered fundamentally sound.

### **3.4 Consideration of Alternative International Regimes**

The WG looked at various international approaches (the USA and France in particular) but did not believe that they offer a better solution than that which currently exists in the United Kingdom.

During its deliberations, the WG held a detailed debate on whether it would wish to see a move towards the French regime. There was no appetite for this amongst any of the members of the WG. It was also noted that France is currently the subject of a review by the European Commission as to whether France has violated the principle of proportionality embedded in the EU Statutory Audit Directive and unduly restricts the freedom to provide services by overseas network firms of French firms. Additionally, as noted earlier, the degree of prohibition in France is not as extensive in substance as it would appear in form. The APB would therefore need to consider whether there would be any potential consequences for the UK if it was to decide to introduce a complete prohibition on audit firms providing non-audit services to their audit clients. The WG also did not support the US approach which adopts a rules based approach to the provision of non-audit services. Whilst this may in certain areas be more restrictive than the APB's principles based approach, the WG believes that it does not try to equate the threat to the auditor's independence that actually exists.

In 2009, IESBA finalised its revisions to the IFAC Code of Ethics. The revisions largely related to the "independence" sections of the IFAC Code and in many areas bring the IFAC Code into line with the content of the APB's Ethical Standards for Auditors. Whilst the APB would accept that the substance of the IFAC Code and its ethical standards are now broadly similar, the APB retains concerns that the form of the Code is not suitable for use in the UK. It believes that there is a need to clarify the requirements and prohibitions that exist and for IFAC to incorporate in standards, as opposed to a Code, the specific content which relates to auditor independence. The WG does not have a remit on this specific point but believes that the need for a global road map to convergence should be the subject of further discussion between the profession and standard setters. Ultimately, many listed audit engagements have an international dimension and do not need the red tape associated with complying with different sets of national standards which is a cost on business and can create a lack of clarity for stakeholders.

### **3.5 Current Economic Conditions**

In conducting its debate the WG was also very focused on the current state of the economy and in particular the need to ensure that its proposals do nothing to damage the fragile recovery. Indeed, the current environment was one where many companies would be seeking external assurance and attestation and in many situations the auditors would be well placed to provide such services. The WG specifically debated the provision by auditors of restructuring services to their audit clients and believe that the current requirements are appropriate (this includes the guidance in APB Bulletin 2008/10)<sup>10</sup>. The WG recognizes that in such circumstances, time is very much of the essence and quick action must be in the best interests of the shareholders and other stakeholders. Otherwise there is a serious risk of distressed companies not being able to seek immediate professional advice from someone who fully understands their business. Any delay could result in a failure of the business and the loss of jobs and cumulative knowledge at a time when this can least be afforded by the business and the nation.

### **3.6 Specific Non-audit Services provided by Auditors to their Audit Clients**

The WG debated the types of services that auditors provide and, in particular, the topical issues of internal audit services, contingent fees, restructuring services (see para 3.5 above) and whether all non-audit services should be pre-approved by the audit committee and if so, whether this would place a further burden on businesses and the audit committee.

The Working Group considered the issue where a conflict of interest might exist between management and the shareholders or some other stakeholder and felt this was an issue for the independent directors and the audit committee and not one upon which the auditors should opine or indeed why appointing a party other than the auditors would necessarily remove this potential conflict.

As always, clear and transparent disclosure, together with good governance is essential where the potential exists for advising on issues where there is a possible conflict of interest between the shareholders and management.

The WG reviewed the content of the APB's Ethical Standards and guidance in the above areas and believed these still to be fit for purpose. In the view of the WG, the Standards are quite clear: if a non-audit service is not specifically prohibited then the auditor must implement appropriate safeguards to manage any threats to independence that may exist or decline the work. Additionally, the Standards prohibit the auditor from undertaking a management role for a client and from acting as an advocate for that client. There was also acknowledgment that in certain instances the information presented in the media was at best misleading.

### **3.7 Consultation**

The WG felt it important to consult with the main stakeholders, namely company directors and investors, to ascertain their views. A survey was conducted of audit committee chairs and finance directors and the results are discussed in section 6 of this report. In relation to investors, a series of telephone discussions took place to ascertain whether investors would support a complete prohibition and whether there were any specific non-audit services provided by auditors to their clients about which they had concerns. A summary of the views expressed is included in section 7 of this report.

### **3.8 Conclusion**

The WG concluded that the Ethical Standards adopted in the UK, which have evolved over the last decade, provide sufficient safeguards and as such no radical or knee-jerk changes are required.

However, the WG kept returning throughout its discussions to the issue of perception and reality. The WG also discussed how it could move matters forward in regard to bringing perception and reality into line.

The WG's discussions focused on 4 main areas:

- (1) Greater involvement of the audit committee in the instruction of non-audit services and in particular, clear articulation of its policy (either on a corporate website or in the annual report) regarding the award of non-audit services. This would, along with improved disclosure, help greater understanding and exhibit clear ownership of the decision-making process. This is covered in section 4 of this report.
- (2) More detailed and informative disclosure of fees paid to auditors in the annual report and accounts. This is covered in section 5 of this report.
- (3) Pre-approval of non-audit services. While the WG debated pre-approval it believes that a clear policy could prevent over-burdening the audit committee and delaying due process and concluded that pre-approval should be restricted to non-audit services over an agreed fee level (see section 4) and a process that would also be appropriate for all internal audit services and any work undertaken on a contingency fee basis.
- (4) The clarity of approval processes. Clear internal procedures regarding the process that should be followed regarding audit and non-audit services that are:
  - (a) approved by the audit committee; and
  - (b) adopted by both the company and the audit firm.

Indeed these procedures should be expressed in a memorandum of understanding and operation which would likely have the policy referred to above appended. It was noted that some companies may wish to combine the process and the policy. Ultimately, disclosure via a corporate website or in the annual report can only help improve transparency and understanding.

While not within the remit of the WG it believes that consideration should be given to the issue of perception and reality when a review is undertaken of corporate governance. This review should start from the premise of what has worked well and is not fundamentally broken – but should also recognise that best practice requires to continually evolve and develop.

While much of good governance is really about good sustainable business practices and their moral and ethical implementation it should also be recognised that responsibility and accountability are strong motivators in regard to adoption and compliance. While not advocating a shareholder vote on the report of the audit committee, the Working Group believes that as part of a wider review of corporate governance, consideration should be given as to how greater involvement and communication can be built between audit committee, boards and shareholders with the objective of helping to align perception and reality for all stakeholders.

While the WG is keen to improve understanding and transparency, it also believes that annual reports are becoming unwieldy and contain too much boilerplate text that adds nothing to either.

In conclusion, the WG believes, for a number of reasons, that the provision of non-audit services by audit firms is a positive outcome provided the correct safeguards exist, the right governance environment exists, that suppliers and users are clearly accountable for their decisions and that all of this is clearly communicated to the relevant stakeholders.

The WG's recommendations therefore focus on what needs to be done and how best practice can evolve and move forward with the objective of starting to align perception and reality.

## **4.0 Audit Committee Transparency Reporting**

### **4.1 Objective**

The aim of this section is to review current practice and disclosures made by audit committees in relation to their policies and processes adopted to review the independence of the company's external auditors and the awarding of non-audit services, and where appropriate to propose recommendations for improvement.

### **4.2 FRC 'Guidance on Audit Committees'**

The Smith Guidance, now known as the FRC 'Guidance on Audit Committees' was issued in 2003, revised in 2005 and then subsequently further revised in 2008. The objective of the guidance is to:

- (i) assist company boards when implementing the sections of the Combined Code on Corporate Governance dealing with audit committees; and
- (ii) assist directors serving on audit committees in carrying out their role.

The Guidance specifically addresses the issue of the need for the audit committee to consider the independence of the external auditor in paragraphs 4.26 to 4.34 of the 2008 version of the Guidance.

Audit committees can also refer to the ICAS Guidance “Appraising Your Auditors”<sup>11</sup> when assessing the performance and independence of the auditors.”

#### Summary of FRC Guidance

The principal objective of paragraphs 4.26 to 4.34 of the Guidance is to ensure that if a company engages its external auditors to perform other non-audit services, there are sufficient safeguards in place to protect the external auditor’s independence and objectivity. Shareholders and the market in general must have confidence that any non-audit services provided by the external auditor are necessary and appropriate in the given circumstances, provide value for money and have been subject to the due process the company has in place to oversee them. Part of this involves the audit committee developing the company’s policy for the provision of non-audit services by the auditor and its recommendation to the board.

The FRC Guidance states:

*“The development of the company’s policy for the provision of non-audit services by the external auditor should be clearly set out, applied consistently and have regard to the types of non-audit work –*

- *that is specifically excluded from being supplied by the external auditor*
- *that does not need audit committee referral and so can be supplied by the external auditor*
- *that will need to be decided on in advance and on an individual case by case basis*

*The policy on the provision of non-audit services on an individual case by case basis is one that can naturally be problematic and can give rise to practical difficulties. These can be overcome by the audit committee providing a general pre-approval for certain classes of work (subject to an agreed fee limit) and ensuring these are sanctioned at the next meeting of the audit committee.*

*In developing the policy on the provision of non-audit services, the audit committee should have regard to the relevant Ethical Standards on the provision of these services by the external auditor and should not give consent to the external auditor providing such services if it would result in –*

- *the external auditor auditing its own work*
- *the external auditor making management decisions on behalf of the company*
- *the external auditor developing close personal relationships with the company’s personnel*
- *the external auditor is put in the role of advocate for the company*
- *a mutuality of interest is created.”*

The guidance provides that the above should all be clearly and adequately explained by the company in its annual report.

#### View of WG

The WG believes that the spirit and content of the above Guidance are still fit for purpose.

### 4.3 **Review of Current Disclosures**

The WG undertook a limited review of 30 FTSE 350 listed companies to assess their disclosures in this area.

This limited review revealed that there is currently considerable diversity in the marketplace, from very limited boilerplate disclosures to very detailed and transparent disclosure of the processes and policies adopted by the audit committee in relation to the awarding of non-audit services to a company's auditor. The WG therefore believes that there is scope for improvement in this area. Stakeholders need to be provided with sufficient information to allow them to form their own assessment of the company's policy in relation to the procuring of non-audit services.

### 4.4 **Recommendations for Improvement**

In light of the points made at 4.3 the WG seeks to promote the use of certain key principles to improve the general level of disclosure in this area whilst accepting that audit committees will need to exercise judgement as to the level of disclosure that is appropriate for their particular entity.

#### Policy adopted by audit committee

The WG recommends that each audit committee should ensure that its policy in relation to determining whether a non-audit service can be provided by the external auditor is publicly available and notes that some companies already do this. The WG anticipates that most companies would choose to put this on the company's website and cross refer from the audit committee report in the annual report. However, other companies may prefer to include their policy in the governance section of the annual report. The WG believes that either approach is appropriate. The level of detail provided should be left to the judgement of the audit committee but the disclosures made should be sufficient to allow stakeholders to understand the substance of the policy applied by the company and, where applicable, clearly state what non-audit services cannot be provided by the company's auditors.

The company's policy should take account of emergency situations that may occur - for example a company in a distressed situation and needing urgent advice. In such circumstances it is envisaged that the approval of the audit committee chair would be sought and he would then be tasked with reporting back to the audit committee at its next meeting.

The audit committee should clearly set out in its policy how any potential conflicts of interest would be addressed in relation to the audit firm and also to members of the board of directors or other related parties.

### Audit committee assessment of auditor independence

Additionally, for many companies, the WG believes that greater detail is required as to how the audit committee forms its assessment of the independence or otherwise of the company's auditor. Currently, disclosure in this area is generally of a boilerplate nature and not helpful to users of this information. There is a need for much more substantive disclosures in this respect. These disclosures should evidence the processes adopted by the audit committee to satisfy itself as to the independence of the auditor. This will include providing greater detail as to why certain non-audit services were procured from the auditor. The WG believes that such information will be useful to stakeholders in the business.

### Exceptional circumstances

Explanations should be provided where the level of non-audit services in any one year is large in comparison with the audit fee or where it is not immediately apparent to the reader why the audit firm was considered to be the most suitable service provider for a particular non-audit service. Such disclosures could either be included in the audit committee report or in the notes to the financial statements with cross referencing as appropriate.

### Pre-approval of non-audit services

The FRC recently published its final report of the 2009 review of the Combined Code which it is proposed will be renamed the UK Corporate Governance Code.

In relation to the FRC's 'Guidance on Audit Committees' the WG notes that:

*"In addition it is possible that the FRC may wish to propose limited changes to its existing guidance to audit committees depending on the outcome of work being undertaken by the FRC's Auditing Practices Board on the provision of non-audit services and audit partner rotation."*

The WG notes this development and believes that one area that should be reviewed is in relation to the pre-approval of non-audit services.

The WG is aware that this is an area which attracts a significant amount of attention. At present there is no specific requirement for companies to have a "pre-approval" policy in place although some companies do adopt this approach. The WG was also aware that in the US the SEC does impose a pre-approval requirement on audit committees for the provision of non-audit services.

The WG debated whether it would be a good idea to introduce a requirement for all non-audit services to be required to be pre-approved by the audit committee. The WG concluded that if a clear policy for procuring non-audit services is in place (and in order to prevent over burdening the audit committee and delaying due process) pre-approval should be restricted to non-audit services over an agreed fee level and in cases of the provision of internal audit services and any work undertaken on a contingency fee basis. The fee level threshold would need to be set in advance by the audit committee but the WG believes its determination should be left to the company concerned. It believes that the imposition of some arbitrary figure or percentage via regulation would be inappropriate.

The WG believes the audit committee must be left with sufficient flexibility to tailor its policy as it sees fit within the constraints of the FRC ‘Guidance on Audit Committees’ and the APB’s Ethical Standards for Auditors. Over time, the WG believes that best practice in this area would develop and enable users to benchmark policies in this area.

#### Disclosure of auditor remuneration

In addition to the disclosures in relation to the audit committee policy and process it is essential that these are appropriately linked to the disclosure of the auditor’s remuneration in the notes to the financial statements containing information in relation to the quantum and nature of the non-audit services provided by the auditor to the company. This topic is examined in the next section of the report.

### **4.5 Example Disclosures**

The company’s website or its annual report should set out the company’s policy on the provision of non-audit services by the company’s auditor.

The corporate governance section of the company’s annual report should specify where the company’s policy on non-audit services can be viewed, either within the annual report or on the company’s website.

The corporate governance disclosures should also make clear the processes applied by the audit committee in relation to the procuring of non-audit services and also how it has satisfied itself in relation to the independence of the auditor. These disclosures would then be cross referenced to the disclosure of the quantity and nature of non-audit services set out in the notes to the financial statements.

Such disclosures are illustrated below. These are taken from Taylor Wimpey’s 2008 annual report<sup>12</sup>.

#### “Appointment of the auditors for non-audit services

The Audit Committee has approved a policy on employing the auditors to provide services other than audit services, which is to require a competitive tender except in narrowly defined circumstances where the Company considers that for confidentiality, past knowledge or other reasons, there is an advantage in using a single tender procurement procedure.

The Committee has determined that the following assignments should not be undertaken by the auditors:

- bookkeeping or other services related to the accounting records or financial statements;
- internal audit outsourcing services;
- the provision of advice on large Information Technology systems;
- services connected with valuation, litigation support, legal, recruitment or remuneration.

The Board is satisfied that this policy is conducive to the maintenance of auditor independence and objectivity. During the year a significant amount of non-audit related work was performed by the external auditors as a consequence of the challenges faced by the Group. A major component of this work related to the attempted equity raising which is work ordinarily performed by the auditors for companies involved in such projects. Having performed this work, they were requested to provide further advice and support in connection with the amendment of the Company's debt facilities which commenced in July 2008. In addition, following an initial competitive tender, they provided advisory services in connection with the successful sale of the Taylor Woodrow Construction business.

The Audit Committee is satisfied that the carrying out of this work would not impair the independence of the external auditors.”

#### **4.6 Conclusion**

Whilst the WG believes that the FRC ‘Guidance on Audit Committees’ is still fit for purpose there is scope for improvement in listed companies with regard to the corporate governance procedures which oversee the procuring of such services and in relation to the associated disclosures in the audit committee report.

#### **5.0 Disclosure in the Financial Statements of Non-audit Services provided by the Listed Company’s Auditors**

##### **5.1 Objective**

The previous section suggested improvements for the transparency of the policy and processes adopted by the audit committee in relation to determining whether a non-audit service can be provided by the company’s auditor. This section now looks at the disclosure in the financial statements of the auditor’s total remuneration.

As has been stated by various parties, the existing requirements for the disclosure of auditors’ remuneration for audit and other services have significant shortcomings. These shortcomings have hindered, rather than assisted users of financial statements to assess the nature and quantity of non-audit services that are being provided by audit firms to their audit clients. Indeed, on a number of occasions the disclosures that they generate are often misinterpreted. There is a pressing need for improvement in this area.

This section puts forward proposals designed to provide stakeholders with better information to assess the level and nature of non-audit services supplied by auditors to their listed audit clients. In the short-term this might be achieved through voluntary adoption of the WG’s proposals, but the ultimate objective is to seek changes to the disclosure regulations.

## 5.2 Background

### Companies Act Requirement

There is a long-standing requirement for company accounts to disclose the cost of auditing those accounts. A requirement for large companies to disclose the total remuneration of their auditors for non-audit services was introduced in 1991. This was restricted to services supplied by the auditors and their UK associates to the company and its UK subsidiaries and so was of limited value in the case of international groups. Much more extensive and detailed requirements were introduced in 2005 as part of the Government's response to US financial scandals, as recommended in the final report of the Coordinating Group on Audit and Accounting Issues. No significant changes to these requirements were made by the introduction of the Companies Act 2006.

### Guidance on Disclosure of Auditor Remuneration

With the aim of ensuring that directors and auditors understood the nature and purpose of the new requirements, the Institute of Chartered Accountants in England and Wales (ICAEW) published TECH 06/06 'Disclosure of Auditor Remuneration' in October 2006. TECH 06/06 provides guidance, in particular, on the basis for deciding into which categories a service provided by the auditors falls. TECH 06/06 is written in a Question and Answer format, containing 49 questions and answers and runs to 29 pages. It was updated in July 2007<sup>13</sup> in the light of practical experience of working with the new requirements. Most of the large accounting firms were involved in the development of TECH 06/06.

Currently, under the 2008 disclosure requirements, fees paid to auditors should be split into the following categories:

- (i) Fees payable to the company's auditor for the audit of the company's annual accounts;
- (ii) Fees payable to the company's auditor and its associates for other services separated into the following categories (where applicable):
  1. The auditing of accounts of associates of the company pursuant to legislation (including that of countries and territories outside the United Kingdom).
  2. Other services supplied pursuant to such legislation.
  3. Other services relating to taxation.
  4. Services relating to information technology.
  5. Internal audit services.
  6. Valuation and actuarial services.
  7. Services relating to litigation.
  8. Services relating to recruitment and remuneration.
  9. Services relating to corporate finance transactions entered into or proposed to be entered into on behalf of the company or any of its associates.
  10. All other services.

### EU Requirements

Article 49 of the EU Statutory Audit Directive requires member states to implement certain requirements for the disclosure of fees paid to auditors for audit and non-audit services. The EU requirements are relatively brief and require an analysis of fees paid to the statutory auditors for:

- the statutory audit;
- other assurance services;
- tax advice; and
- all other services.

Following a consultation in 2007, the Government decided that no changes to UK disclosure requirements should be made because they already went further than necessary to meet EU requirements. This was despite some respondents to the consultation suggesting that the opportunity should be taken to simplify the existing regime while aligning it with the EU requirements.

### **5.3 Recent Developments**

The remuneration of auditors for non-audit services has recently attracted negative comment, particularly in connection with the audit of banks. Much of this criticism fails to make the distinction between those ‘other services’ which represent a potential conflict to auditor independence and objectivity and those that do not. This misunderstanding is fuelled by the existing disclosure requirements which do not make the distinction clear. The disclosures made in accordance with the law may be difficult to interpret and therefore gives a false impression of threats to auditor independence. It is therefore important to achieve amendments to the law to ensure that disclosure requirements provide a meaningful analysis of fees which facilitates assessment of threats to the auditors’ independence and objectivity.

Acknowledging that it will be difficult to obtain a change in the applicable law in the short-term, the WG believes that it is necessary to promote what it would consider ‘best practice’ in this area to assist companies in providing more informed disclosures within the confines of the existing law. This might be done, for example, through greater analysis and transparency, additional sub-totals and the provision of additional narrative disclosures about the nature of the services provided.

### **5.4 Criticisms of the Current Requirements**

The following points provide examples of the difficulties with the current regime. They include some simplifications in the interests of brevity.

- The audit of subsidiaries pursuant to legislation is Category 1 of ‘other services’ and cannot be included in the total of auditors’ remuneration for audit services. Even if the audits of the subsidiaries go beyond the level of work required to audit the consolidated accounts, it is still difficult to see that anyone could regard it as a threat to the auditors’ independence. However, a group might, for example, disclose auditors’ remuneration for audit services of £1m and fees for the audit of subsidiaries of £9m. A simplistic and uninformed analysis of these figures in the accounts might lead to the conclusion that ‘non-audit services’ is nine times the audit fee.

- For consolidated accounts, auditors' remuneration for audit services can include only fees paid to the auditors of the parent company as a separate legal entity. They will therefore exclude fees for services supplied by other members of the auditors' network. Such fees are included in Category 1 of 'other services'. TECH 06/06 confirms that this includes work on consolidation returns as well as statutory accounts of the subsidiaries. As in the above example, fees which are an indispensable part of the audit of the consolidated accounts are excluded from the amounts disclosed as auditors' remuneration for audit services. This is illogical.
- Category 2 of 'Other services' comprises 'other services supplied pursuant to legislation'. This includes, for example, regulatory reporting where it is required by the Listing Rules or other FSA rules which have the force of law under the Financial Services and Markets Act. Most of this type of work raises no concerns about auditors' independence and is work that the auditors would be expected to undertake. However, for a service to be included in Category 2 it is not necessary for legislation to require the auditors to perform the service and so it can include services where the company was free to choose another firm even though this might be impracticable or involve substantial additional cost for little or no real benefit.
- TECH 06/06 suggests that for SEC registrants, work undertaken in relation to satisfying the requirements of section 404 of the Sarbanes Oxley Act 2002 on internal controls will be included within fees for audit services where an approach is taken whereby work performed on internal controls forms an integral part of the audit procedures for the UK statutory audit. However, it also envisages that if that work goes beyond that which would be required for the UK statutory audit, the fees for the additional work should be included in Category 2. It is possible that this part of TECH 06/06 is out of line with current practice as it is usual for the section 404 work to be an integral part of the audit. Nevertheless, fees for such work are sometimes included in Category 2 and therefore regarded as 'non-audit' by commentators.

Furthermore, there are a number of other areas where the current law is difficult to apply or produces unexpected results. A particular area of concern is the definition of the 'associates' of the auditors which picks up some entities which have only a remote connection with the audit firm.

## 5.5 **Recommendations for Improved Reporting**

### Key Principle

The key principle that should be followed is that the company should provide sufficient information to allow users of accounts to be able to properly assess the quantity and nature of non-audit services provided by their auditor. It is envisaged that this will normally be achieved by requiring disclosure of all such services within the three categories listed below. However, it is recognised that on occasion, companies will need to provide additional narrative to allow the user to form a proper assessment. The need for this additional narrative increases as the level of non-audit fees procured from the company's auditor increases.

Additionally, this disclosure needs to explain or be cross referenced to the explanation in the corporate governance section of the annual report as to why the audit committee believes that it is in the best interests of the company and shareholders for certain non-audit services to be provided by the auditors.

#### Disclosure Categories

The three main categories would be as follows:

- 1. Audit services provided to all group companies (including significant associates and joint ventures)**
- 2. Other assurance services to stakeholders**
- 3. All other services**

Examples of the types of services which would be included in these particular categories is set out in the “Classification of Services Disclosure Categories” set out below. These categories would of course be supplemented by further sub-categories as deemed necessary.

Category 3 would include everything not included in categories 1 or 2. This amount would be broken down into sub-headings providing at least the level of detail required at present. It is anticipated that where relevant these services would benefit from additional narrative.

This analysis could be viewed as generally being consistent with the EU requirements if “Other assurance services to stakeholders’ can be equated with ‘Assurance services’. In any event, the EU requirements could be met by additional analysis.

Although a change in legislation is ultimately required, in the short-term the WG would encourage companies to report voluntarily the three categories and related totals mentioned above. Some companies already provide information along these lines.

Another area for possible improvement relates to the provision of additional narrative disclosures about the nature of the services supplied by the auditors. There is no requirement to do this at present. However, particularly while the current legal requirements are retained, it would be helpful to describe the services included under those headings which are not clear from their caption. For example, it is useful to describe the nature of the services included in ‘Other services supplied pursuant to legislation’. This would allow a more meaningful assessment of the nature of the non-audit services provided by the auditor.

#### Proposed Disclosures

The following are the disclosures which the WG would encourage companies to provide in the notes to their financial statements. These illustrative disclosures will also need to be considered in conjunction with the company’s disclosure of its policy and process with respect to the review and approval of non-audit services (please refer to section 4 of this report). The WG does not believe that the disclosure of the analysis of non-audit fees in this manner would represent a significant additional burden on business. The WG is aware of some companies who already provide disclosures similar to those being promoted.

	2009	2008
	£m	£m
Audit services provided to all group companies (including significant associates and joint ventures)	xx	xx
Other assurance services to stakeholders (see notes 1 and 2)	xx	xx
All other services (see notes 1 and 2 below)	xx	xx
Total auditor's remuneration	<u>xx</u>	<u>xx</u>

Note 1: Narrative explanation of the nature of these services should be provided

Note 2: Explanation as to why the Audit Committee believes that it is in the best interests of the company and shareholders for certain non-audit services to be provided by the auditors or cross reference to corporate governance statement

Note 3: The existing statutory disclosures would also need to be shown.

Classification of services into Proposed Disclosure Categories:

	Nature of services	Examples of services
1	Audit services provided to all group companies	<ul style="list-style-type: none"> <li>• All audit services provided to group companies. This would include:</li> <li>• Audit of the group, holding company and all subsidiaries</li> <li>• Audit of affiliates (associates, JVs etc.) which are considered significant to the group accounts</li> <li>• Advice on compliance with accounting standards relevant to the audit</li> <li>• Particular assignments that audit committees ask auditors to undertake directly connected with an audit</li> <li>• SOx reporting (Section 404 work is included in this category in accordance with the requirements of PCAOB Auditing Standard 5)</li> </ul>
2	Other assurance services to stakeholders	<ul style="list-style-type: none"> <li>• Regulatory returns</li> <li>• Other returns (such as industry returns that are required to be reported on by the company's auditors for stakeholders).</li> <li>• Reporting in respect of capital market transactions (prospectuses, comfort letters, working capital reports etc.)</li> <li>• Other assurance services (detail required)</li> </ul>
3	All other services	<ul style="list-style-type: none"> <li>• Includes other services which do not fall into the above categories where explanation is given why it is in the best interests of the company and shareholders for the services to be provided by the company's auditors.</li> </ul>

### Joint Ventures/Associates

Under the existing disclosure regulations the biggest omission is non-statutory entities e.g. joint ventures are not specifically captured by the definition of what is currently required to be disclosed by the regulations in relation to the group audit fee although additional disclosure is deemed desirable. The result is that disclosure with regards to joint ventures is not consistent – some companies include disclosures in respect of them but others do not, although it does depend to some degree on materiality.

As a result where joint ventures are significant to the group, the WG proposes that 100% of the audit fees paid to the auditor should be included in category 1 and likewise in relation to other services provided to them that would fall into categories 2 and 3. The same proposal applies to associates.

### Joint Audits

In relation to joint audits, which are rare in the UK, the WG proposes that the fees of both auditors would require to be disclosed separately.

### Where the Group Auditor does not audit all group companies

Where more than one auditor is involved in auditing the component parts of a group the WG proposes that the total fees for all three categories should be included separately.

### Non-audit services provided to Directors or Entities in which they have a significant interest

Where non-audit services are provided to directors or to entities in which they have a significant interest, it is proposed that disclosure would be usefully enhanced beyond that required by statutory requirements to explain situations where auditors have earned significant fees for non-audit services for instance in relation to management buy outs. This could help ensure that there is greater accountability to shareholders. The determination of what is significant in such instances would be for the directors of the company to judge.

## **5.6 Disclosure of Auditor's Remuneration – Illustrative Example**

### Example:

Group XYZ plc procured the following services from its auditors in the year to 31 December 2009.

- Audit of parent company accounts and group accounts	£ 2m
- Assurance/attestation services pursuant to legislation	0.5m
- Audit of the subsidiaries	5m
- Other assurance services	1.5m
- Taxation services	1.5m
- Corporate finance services	1.5m

### Current Required Disclosure

Under the current disclosure requirements the group's auditor remuneration note would be as follows:

	2009
<b>Audit services</b>	£m
Fees payable to the company's auditors for the audit of the company's annual accounts and consolidated accounts	2.0
<b>Non-audit services</b>	
Fees payable to the Company's auditor and network firms for other services	
- the audit of the accounts of the Company's subsidiaries pursuant to legislation	5.0
- other services pursuant to such legislation	0.5
- other services relating to taxation	1.5
- other services relating to corporate finance transactions	1.5
- all other services	1.5
<b>Total auditor remuneration</b>	<b>12.0</b>

From this analysis, non-audit fees represent 500% of the audit fee. However, included in non-audit fees are the fees payable to the auditor in relation to the audit of the company's subsidiaries. The WG believes that this analysis is misleading and that such fees should be included in the audit fees category. Additionally, in this analysis the additional assurance type work performed by the auditor is partly included in "Other services pursuant to legislation" and "Other services". The WG believes that these amounts would be better disclosed in a separate category "Other assurance services to stakeholders".

### WG Proposed Disclosure

The revised analysis of the above per the WG's proposals would be as follows:

	£m
<b>Audit services provided to all group companies</b> – This includes the audit fees for all subsidiary companies and significant associates and joint ventures.	7.0
<b>Other assurance services to stakeholders</b>	2.0
<b>All other services</b>	
- tax services	1.5
- corporate finance transactions	1.5
<b>Total auditor remuneration</b>	<b>12.0</b>

The WG firmly believes that this analysis allows a more meaningful assessment of the level and nature of the non-audit services provided by the auditor. The fees for the audit of the subsidiaries are included in the first category "Audit services provided to all group companies". As a result, the ratio of non-audit services to audit services falls significantly to 71%. One could argue that the true comparison should be between the "all other services" category and audit, as these services will present more of a threat to the auditor's independence than those of an assurance/attestation nature.

However, pending a change in the law, additional disclosures will be necessary to ensure that the statutory totals described above under “Current Required Disclosures” can be ascertained. These totals must be in accordance with the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489).

Another more detailed example of the WG’s proposed disclosures is included at Appendix C.

#### Additional Narrative

In addition to the above, the WG believes that where non-audit services are high in relation to audit fees then sufficient disclosure should be made as is necessary to provide stakeholders with a more informed picture. This could in exceptional circumstances mean putting the fees paid to the auditor in perspective with certain other professional fees paid. In this area, best practice should be allowed to evolve and hard and fast rules could reduce the value of the disclosures.

Such additional narrative was provided by Taylor Wimpey in the notes to its 2008 financial statements<sup>14</sup>.

“Non-audit services in 2008 predominantly relate to work required as a result of Deloitte LLP’s role as auditors, or work resultant from knowledge and experience gained as part of the role. Corporate finance services include necessary work related to the Group’s proposed equity raising and subsequent advice and support with bank renegotiations. It also includes work performed in connection with the disposal of the construction business. Their work was either the subject of a competitive tender or was best performed by the Group’s auditors because of their knowledge of the Group. Tax services include tax compliance work for certain subsidiaries, as well as advice in connection with a restructuring of the Group. Other services include advice in respect of the Group’s forecasting and cash management procedures. See page 41 for details of the Group’s policies in respect of non-audit services and approval by the Audit Committee.”

The WG is fully supportive of this approach. Where an audit committee has decided to procure a large level of non-audit services from its audit firm it should be able to justify its reasoning in the annual report.

## **5.7 Conclusion**

The WG believes that the current auditor remuneration disclosure rules require to be revised as they do not result in the provision of useful information to stakeholders. The WG has put forward its proposals for improvement on a voluntary basis but ultimately it is acknowledged that a change in the auditor remuneration disclosure regulations is required.

It is suggested that corporate entities adopt this best practice and that such disclosures be allowed to evolve over the next 2 years before law and regulations are subject to revision.

## 6.0 Views of Directors

### 6.1 Objective

The objective of this section was to ascertain the views of the directors of the FTSE 350 listed companies which are subject to audit.

### 6.2 Views of the Directors of Companies Subject to Audit

For the purposes of seeking the views of the directors of these companies, it was decided to focus on the audit committee chair and finance director, the two individuals most normally associated with the decision making regarding the procurement of non-audit services.

#### Method

A letter was sent to the company secretaries of each of the FTSE 350 listed companies. The letter contained 2 copies of the survey and requested that these should be completed independently by the respective company's audit committee chair and finance director. Copies of the letters and survey are contained in Appendix B. The survey posed 13 questions and a summary of the results are shown below.

#### Response Rate

The population comprised 350 audit committee chairs and 350 finance directors of the FTSE 350 listed companies. A total of 52 completed replies (7%) were received, proportioned as follows:

- 28 audit committee chairs;
- 14 finance directors;
- 7 company secretariat; and
- 3 other.

### 6.3 Main Findings of the Survey

- There is no support for a complete prohibition on auditors being able to provide non-audit services to their listed audit clients.
- None of the respondents were of the view that a complete prohibition would result in improved audit quality with 52% of respondents believing that it would not change and 48% believing that it would result in a decrease in audit quality.
- The current extent of prohibitions contained in the APB Ethical Standards for Auditors is deemed sufficient.
- The FRC 'Guidance for Audit Committees' is deemed to be still fit for purpose.
- There is support for non-audit services to be subject to pre-approval above a de minimis level.
- There is widespread support for the "threats and safeguards" approach adopted by the APB.

- The current level of disclosures in relation to the audit committee and in the notes to the financial statements is appropriate. This is the only area where the WG disagrees with the respondents, as discussed in sections 4 and 5. The WG’s view is supported by investors who are keen for greater transparency and better quality information in these areas.
- The majority of respondents (71%) believe that there would be no change to audit market concentration if a ban was introduced. Interestingly, 17% thought that it would be increased and only 12% thought that it would result in a decrease.
- 96% of respondents believe that the UK would be imposing an additional financial or other unnecessary burden on UK plc if it decided to deviate from the international norm in this area and prohibit auditors from providing non-audit services to their listed audit clients.

## 6.4 Summary of Responses

The questions asked and a summary of the results are shown below. The percentage figures shown in each category relate to the particular category in question.

1. *Do you believe that the current guidance for audit committees in relation to the procuring of non-audit services from a company’s auditor is sufficient? (FRC ‘Guidance on Audit Committees’ (October 2008) – paragraphs 4.26-4.34.)*  
[http://www.frc.org.uk/documents/pagemanager/frc/Smith\\_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf](http://www.frc.org.uk/documents/pagemanager/frc/Smith_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf)

Audit Committee Chairs		Financial Directors		Company Secretariat		Other		Total	
Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
28	0	14	0	7	0	3	0	52	0
100%	0%	100%	0%	100%	0%	100%	0%	100%	0%

### **WG Comments:**

**The respondents unanimously support the view of the WG that the content of the FRC ‘Guidance on Audit Committees’ remains fit for purpose.**

2. *Do you believe that auditors should be prohibited from providing all non-audit services to their listed audit clients?*

*If yes, please provide details of your reasoning and describe what services you understand to be audit services and would include under this heading (e.g. reports on interims, prelims, working capital, covenants, confirmations of contract terms) and then go to question 6.*

Audit Committee Chairs		Financial Directors		Company Secretariat		Other		Total	
Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
0	28	0	14	0	7	0	3	0	52
0%	100%	0%	100%	0%	100%	0	100%	0%	100%

**WG Comments:**

No respondent expressed the view that auditors should be prohibited from providing non-audit services to their listed audit clients. This supports the view of the WG who do not believe that auditors should be prohibited from providing non-audit services to their listed audit clients.

3. *Do you believe that non-audit services procured from a company’s auditors should be subject to pre-approval by the Audit Committee?*

- A. *Yes – all non-audit services*
- B. *Yes – except for non-audit services the anticipated fee for which is below a de minimis level of £,\_\_\_\_\_*
- C. *Yes – but only for certain specified non-audit services*
- D. *No – no non-audit services require pre-approval*

*If option C, what are the specified non-audit services which you believe require pre-approval by the audit committee? Please write your response in the space below.*

	Audit Committee Chairs				Financial Directors				Group Secretariat				Other				Total			
	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D
No.	3	20	5	0	0	13	0	1	1	6	0	0	1	1	0	1	5	40	5	2
%	11	71	18	0	0	93	0	7	14	86	0	0	34	33	0	33	10	77	10	3

**WG Comments:**

Significantly, in each category, the vast majority of respondents believe that non-audit services procured from a company’s auditors should be subject to pre-approval by the audit committee except for such services below a set de minimis threshold. This echoes the views of the WG in section 4 of this report.

4. *With certain exceptions, the APB’s Ethical Standard 5 (revised April 2008) currently permits auditors of listed companies to provide those companies with non-audit services, provided that:*
- *the auditor is satisfied that any threats to independence can be safeguarded against;*
  - *the auditor discusses any potential threats and safeguards with the audit committee; and*
  - *the auditor discusses any inconsistencies between the APB Ethical Standards, and the policy on the provision of non-audit services, that the Combined Code requires audit committees to develop.*

*Some services are prohibited because they are deemed to pose such a significant threat to independence that no safeguard would be sufficient.*

*Do you support the threats and safeguards approach adopted by the Auditing Practices Board (APB) in relation to the provision by auditors of non-audit services to their listed audit clients?*

*If no, please provide details of the changes to the current approach that you would like to see.*

Audit Committee Chairs		Financial Directors		Company Secretariat		Other		Total	
Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
28	0	14	0	7	0	3	0	52	0
100%	0%	100%	0%	100%	0%	100%	0%	100%	0%

**WG Comments:**

**All respondents supported the threats and safeguards approach adopted by the APB.**

5. *Do you believe that the current level of prohibitions on the types of non-audit services that can be provided by auditors to their listed company clients is sufficient?*

A. *Yes* B. *No*

*If no, please state in what areas you believe further prohibitions are required.*

Audit Committee Chairs		Financial Directors		Company Secretariat		Other		Total	
Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
28	0	14	0	7	0	3	0	52	0
100%	0%	100%	0%	100%	0%	100%	0%	100%	0%

**WG Comments:**

**No respondent felt that any further prohibitions should be included in the APB's Ethical Standards for Auditors. The overall response to this question plus that to question 4, makes it clear that the respondents believe that the APB's Ethical Standards for Auditors are currently still fit for purpose.**

6. *Do you believe that the current disclosure of non-audit services in a company's annual financial statements is adequate and allows the user to develop an informed opinion as to the appropriateness of the services provided by audit firms to their listed clients?*

A. *It is adequate in both the audit committee report and fee disclosure note.*  
 B. *It is adequate in the audit committee report only.*  
 C. *It is adequate in the fee disclosure note only.*  
 D. *It is not adequate in either.*

*If your answer was B, C or D, please give the reasons for your response and what changes you would propose to the current disclosures made.*

	Audit Committee Chairs				Financial Directors				Group Secretariat				Other				Total			
	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D
No.	22	1	1	4	13	1	0	0	5	0	1	1	2	1	0	0	42	3	2	5
%	78	4	4	14	93	7	0	0	72	0	14	14	67	33	0	0	80	6	4	10

**WG Comments:**

The vast majority of respondents believe that the current disclosure regime is appropriate. This does not coincide with the views of the WG which believes that improved and more transparent disclosure is required in relation to the audit committee report and fee disclosure note. The WG is satisfied that its proposals would not result in an additional burden on business and will instead help to promulgate the best practice of companies already providing such disclosures. The WG is also aware that investors are keen for increased transparency and better quality disclosures in these areas.

7. *Would you support a requirement for a disclosure that separately identified audit and audit related services, such that the fees earned for services provided by the auditors relating to all reports to shareholders (interims, prelims, prospectuses) and the fees earned by auditors because of their role as auditors (e.g. bank covenant or contracts requiring reports from auditors) were separately shown?*

A. Yes

B. No

Audit Committee Chairs		Financial Directors		Company Secretariat		Other		Total	
Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
14	13	11	2	5	2	2	1	32	18
52%	48%	85%	15%	72%	28%	67%	33%	64%	36%

2 respondents did not answer this question.

**WG Comments:**

There was a clear majority of finance directors and company secretaries who supported clearer disclosure.

8. *Do you believe that the UK would be imposing an additional financial or other unnecessary burden on UK plc if it decided to deviate from the international norm in this area and prohibit auditors from providing non-audit services to their listed audit clients?*

A. Yes

B. No

Audit Committee Chairs		Financial Directors		Company Secretariat		Other		Total	
Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
27	1	13	1	7	0	3	0	50	2
96	4%	93%	7%	100%	0%	100%	0%	96%	4%

**WG Comments:**

Virtually all respondents believe that prohibiting auditors from providing non-audit services to their listed audit clients would impose an additional burden on UK plc. Such a burden would be particularly unwelcome in the current economic climate with the UK just beginning to emerge from recession. A common criticism from businesses is that the UK has a habit of “gold-plating” legislation which emanates from Brussels. There is little doubt that if a decision to introduce a complete prohibition was made, it would exceed the agreed EU position as contained in the EC Recommendation on Auditor Independence.

9. *What negatives would there be if auditors were not allowed to provide non-audit services to their audit clients?*

*Please write your answer in the space below.*

**WG Comments:**

There was a limited number of reasons given here which mainly focused on there being increased costs, a lack of understanding of the business and a risk of delays in using a different firm for users’ non-audit services. A number of respondents also cited a risk of a lower quality of service. Such a risk may be more prevalent in certain companies in particular sectors but should not be understated.

10. *What do you believe would be the impact on audit quality if audit firms were prohibited from providing non-audit services to their listed audit clients?*

- A. *Increased*
- B. *Decreased*
- C. *No change*

*Please give the reason for your answer in the space below.*

Audit Committee Chairs			Financial Directors			Company Secretariat			Other			Total		
A	B	C	A	B	C	A	B	C	A	B	C	A	B	C
0	15	13	0	6	8	0	2	5	0	2	1	0	25	27
0%	54%	46%	0%	43%	57%	0%	28%	72%	0%	67%	33%	0%	48%	52%

**WG Comments:**

Whilst a slight majority of respondents felt that there would be no impact on audit quality, rather worryingly 48% of respondents felt that there would be a decrease in audit quality.

11. *What do you believe would be the impact on the level of concentration in the listed FTSE 350 audit market if auditors were prohibited from providing non-audit services to their audit clients?*

- A. *Increased*
- B. *Decreased*
- C. *No change*

*Please give the reason for your answer in the space below.*

Audit Committee Chairs			Financial Directors			Company Secretariat			Other			Total		
A	B	C	A	B	C	A	B	C	A	B	C	A	B	C
2	3	23	5	1	8	1	2	4	1	0	2	9	6	37
7%	11%	82%	36%	7%	57%	14%	28%	58%	33%	0%	67%	17%	12%	71%

**WG Comments:**

A substantial majority of respondents believed that such a change would not impact on the level of concentration in the FTSE 350 audit market. Only 12% felt that such a move would help to decrease the current level of concentration.

12. *Which types of non-audit services have you purchased from your auditors in the last year and what types of non-audit services would you envisage purchasing from them in the future?*

*Please write your response in the space below?*

**WG Comments:**

A wide range of non-audit services was given here and most respondents commented that these would probably continue from year to year.

The most common non-audit service cited was in the area of tax – both in terms of compliance and other specialist advice, with due diligence work being the second most common.

Debt restructuring and remuneration advice were also commonly cited along with work on internal or “enhanced” controls.

Several respondents gave unspecific answers such as “ad-hoc” and “confidential” services.

13. *Have you procured a non-audit service from a provider other than your auditor, even though you believed that the service could be provided in a more efficient or effective way by the auditor, because of the need to disclose the level of non-audit services?*

- A. *Yes*
- B. *No*
- C. *Not applicable*

Audit Committee Chairs			Financial Directors			Company Secretariat			Other			Total		
A	B	C	A	B	C	A	B	C	A	B	C	A	B	C
5	20	3	2	12	0	1	6	0	0	3	0	8	41	3
18%	71%	11%	14%	86%	0%	14%	86%	0%	0%	100%	0%	15%	79%	6%

**WG Comments:**

The vast majority of directors had not procured a non-audit service from a provider other than the company's auditor in circumstances where it was felt that the service could have been provided in a more efficient or effective way by the auditor. However, 15% advised that this had indeed been the case.

**6.5 Conclusion**

Whilst the response rate is low it is not untypical of surveys of this nature. Moreover, in general, the results supported the discussions and deliberations of the WG and other conversations that took place.

**7.0 Views of Investors**

**7.1 Objective**

The objective of this section was to ascertain the views of investors.

**7.2 Main Findings**

- There is no support for a complete prohibition on auditors being able to provide non-audit services to their listed audit clients.
- Generally, the current level of prohibitions contained in the APB Ethical Standards for Auditors is deemed sufficient. Certain commentators believed that further revisions to the APB's ethical standards might be required in certain areas, although it was not clear as to whether these views were based on perception or on real life examples.
- There is support for improving the current level of disclosures in relation to the policy and processes adopted by the audit committee.

**7.3 Method**

It was decided to speak directly via telephone to key personnel within the investor community. The organisations which provided comment were as follows:

Association of British Insurers  
Investment Management Association  
F & C Asset Management plc  
Standard Life Investments Limited

## 7.4 Summary of Discussions

As with the results of the survey of audit committee chairs and finance directors, none of the above organisations believed that there should be a complete prohibition on the auditors of listed entities providing non-audit services to those entities. Generally, the investors appeared satisfied with the current threats and safeguards approach used in the UK. Some believed that further changes might be required in certain areas although there appeared no great consensus over what aspects of the APB's ethical standards required revision. It was also not clear whether comments in this specific area were based on perception or real life examples.

The investors did support increased transparency over the audit committee policy and process in relation to the procuring of non-audit services as proposed by the WG in section 4 of this report.

## 8.0 **APB Consultation Paper**

### 8.1 Objective

The objective of this section is to respond to the specific questions posed by the Auditing Practices Board (APB) in its consultation paper issued in October 2009.

Whilst this was not the primary objective of the WG, it was still felt that it was important to consider and respond to the specific questions raised by the APB and to assist it in its deliberations.

### 8.2 Responses to the APB Questions

The WG's responses to specific questions posed in the APB Consultation Paper were as follows:

*In respect of listed companies:*

1. (a) *Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?*

The WG is aware that there is a perception in certain quarters that the provision of certain types of non-audit by auditors to their audit clients does impact on confidence in the independence of auditors. However, the WG believes this to be a perception issue and not reflective of the actual position. The WG's survey of audit committee chairs and finance directors revealed that no respondent believed that the provision of non-audit services by auditors to their listed audit clients should be completely prohibited. The current disclosure requirements in relation to non-audit services are positively unhelpful in this regard. This is why in section 5 of this report the WG has sought to propose changes to the current disclosure requirements in this area.

The WG believes that more transparent reporting is required not just in relation to the disclosure of the types of non-audit services provided in the notes to the company's financial statements but also the reporting of the policies and processes adopted by the audit committee in relation to such matters (as per section 4 of this report).

*(b) Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality?*

Post 2004 (following the introduction of the APB's Ethical Standards for Auditors), in a UK context, the WG is not aware of any evidence which exists which would indicate that the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality.

*Please give the reasons for your views.*

*2. If you do consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors please identify which non-audit services are of concern. Please give the reasons for your view.*

In light of the WG's response to question 2, this question is redundant.

*3. In the light of your answers to questions 1 and 2, do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit? Please give reasons for your view.*

The WG does not believe that there needs to be a change in the approach taken by the APB in this regard. The respondents to the survey of audit committee chairs and finance directors fully support this view. Since the APB's Ethical Standards for Auditors were introduced in late 2004, there has been a significant reduction in the level of non-audit services undertaken by auditors for their audit clients. The standards have therefore had an impact and at the same time there is no evidence to suggest that audit quality has suffered as a result of an auditor providing non-audit services to their respective clients. There is also a need to ensure that the UK remains at the forefront of global best practice and in line with the EU Recommendation on Auditor Independence. Otherwise there is a risk of the UK imposing an unnecessary burden on business.

*4. If you think that there should be a change in the current arrangements, would you advocate:*

- *Complete or more extensive prohibitions on the provision of non-audit services by accounting firms to their audit clients within the Ethical Standards for Auditors;*
- *The imposition of other requirements through the Ethical Standards for Auditors (and if so which);*
- *More active corporate governance – e.g. so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee;*
- *Better (and more extensive) disclosure in financial statements.*

*Please provide reasons for your views and any suggested solutions.*

The changes that the WG proposes fall into the last two bullet point categories above and are as follows:

- (i) more active corporate governance – this would entail audit committees making publicly available their policy for non-audit services which can be referred to, to determine whether an auditor should be providing a certain type of non-audit service (as per section 4 of this report).
- (ii) clear internal procedures (regarding the process that should be followed regarding audit and non-audit services) that are approved by the audit committee and are adopted by both the company and the audit firm. Indeed these procedures would be a memorandum of understanding and operation which would probably have the policy referred to above appended to them. Ultimately, disclosure via a corporate website or in the annual report can only help improve transparency and understanding (as per section 4 of this report).
- (iii) a threshold should be set above which all non-audit services should require the pre-approval of the audit committee. This threshold should be set by the audit committee. Additionally, pre-approval would also be appropriate for all internal audit type services and work undertaken on a contingency fee basis (as per section 4 of this report).
- (iv) better disclosure of the nature and types of services (audit, other assurance and other non-audit services) being provided in a company's financial statements (as per section 5 of this report).

*5. In setting the standards relating to auditor independence, do you believe regard should be had to the perceived benefits that are derived by companies from the provision of non-audit services by their auditors? If your answer is yes, please provide specific examples of these benefits and indicate the magnitude of any cost savings that arise.*

Yes, the WG believes that regard must be had to the benefits that are derived from companies from the provision of non-audit services by their auditors. Not all of these benefits can be easily quantified but account must also be taken of the significant qualitative benefits which are derived for shareholders. We are not in a position to be able to quantify any cost savings that arise but would re-iterate that we believe this to be more of a quality issue with knowledge of the business and speed of delivery being key benefits to the client and ultimately to the shareholders.

One audit committee chair responded to the survey as follows:

*“Company X would only engage its auditors where it is satisfied that there would be no impact whatsoever on independence and where it is satisfied their engagement would bring significant economic or effectiveness benefit. It follows that denying the group access to that reservoir of knowledge and experience would be (on occasion) detrimental to the group's interests – notably where significant transactions or projects were being undertaken against tight timescales.”*

*6. Are there any other views that you would like the APB to take into account?*

As already referred to, the WG has undertaken a survey of the audit committee chairs and FDs of the FTSE 350 companies and a summary of the results is included in section 6 of this report for the consideration of the FRC and APB. Discussions were also had with investors and a summary of these discussions is included in section 7 of this report.

## **Appendix A: Terms of Reference**

### **The Institute of Chartered Accountants of Scotland Non-audit Services Working Group (WG)**

#### ***Objectives***

- (i) To review the current provision by auditors of non-audit services to their listed company audit clients in the light of the Treasury Select Committee (TSC) Report and Auditing Practices Board (APB) Consultation Paper and provide comment thereon.
- (ii) To engage with the investor and business communities:
  - (a) to assess the degree to which investors and others believe that the provision of those non-audit services which are permitted under the APB's Ethical Standards may represent a threat to auditor independence and/or audit quality, which is not capable of being reduced to an acceptable level through appropriate safeguards; and
  - (b) to seek to better inform them of the nature and types of services provided and the safeguards that exist and are currently implemented to mitigate any threats that may exist; and
- (iii) To make suitable recommendations to seek to address any issues and concerns identified. This will include seeking to improve the transparency of the policies, process, and safeguards that surround the provision of non-audit services by auditors to their listed company audit clients and by increasing and improving, the level of disclosure of the nature of such services in a company's annual statutory financial statements.

#### ***Scope***

The scope of the WG's remit shall be restricted to listed companies.

#### ***Timescale***

The WG should be established with immediate effect.

- (a) The interim proposals for improving the disclosure of non-audit services provided by auditors to their listed audit clients in annual accounts should be produced in a timely manner.
- (b) Further longer-term solutions should then be developed no later than 22 January 2010 and the report finalised by 29 January 2010.

***Main Areas of Work:***

The Working Group should address the following:

- (i) Research and establish the extent and nature of non-audit services provided to listed companies by their auditors and establish the degree to which market forces and the APB Ethical Standards introduced post-Enron, have impacted on the level and nature of the services provided. (ICAEW Research, FRC Research.)
- (ii) Undertake research into the views of audit committee chairs.
- (iii) Consider whether academic research, both in the UK and abroad, has identified a correlation between non-audit services and audit quality. (Tony Hines, Stella Fernley and Vivien Beattie Research.)
- (iv) During the period of the APB Consultation (6 October 2009 to 29 January 2010) meet and enter into dialogue with representatives from the various stakeholder groups. A plan of action should be drawn up to ensure that representatives from relevant parties are provided an opportunity to express their views. The aim is to better inform such parties of the nature of the services provided and to allow them to express any concerns that they may have.
- (v) Make recommendations to establish best practice disclosures around non-audit services (including the possibility of better disclosures of audit committee policies in this area). In the first instance, any interim recommendations should be made to allow best practice to emerge in time for the December 2009 reporting season. This will involve:
  - (a) identifying current best practice disclosures; and
  - (b) using current best practice as a basis for promoting change.

Where recommendations for best practice could usefully be re-enforced by amendments to regulations or standards, these should be provided to BIS, the APB or other appropriate body, so that such amendments could be considered in time for the December 2010 reporting season (Deloitte paper provides a starting point).

## **Appendix B: Survey Documentation**

Company Secretary

20 November 2009

Dear

### **SURVEY OF THE VIEWS OF AUDIT COMMITTEE CHAIRS AND FINANCIAL DIRECTORS ON NON-AUDIT SERVICES**

The Institute of Chartered Accountants of Scotland has set up a Working Group:

- (i) To review the current provision by auditors of non-audit services to their listed company audit clients in the light of the Treasury Select Committee (TSC) Report and Auditing Practices Board (APB) Consultation Paper and provide comment thereon.
- (ii) To engage with the investor and business community:
  - (a) to assess the degree to which investors and others believe that the provision of those non-audit services which are permitted under the APB's Ethical Standards may represent a threat to auditor independence and/or audit quality, which is not capable of being reduced to an acceptable level through appropriate safeguards; and
  - (b) to seek to better inform them of the nature and types of services provided and the safeguards that exist and are currently implemented to mitigate any threats that may exist.
- (iii) To make suitable recommendations to seek to address any issues and concerns identified. This will include seeking to improve the transparency of the policies, process, and safeguards that surround the provision of non-audit services by auditors to their listed company audit clients and by increasing and improving, the level of disclosure of the nature of such services in a company's annual statutory financial statements.

As part of its evidence gathering process, I should be obliged if you would arrange for the Audit Committee Chair and Finance Director of your company to separately complete the attached identical surveys and return them in the reply paid envelopes. Due to the timing of the APB consultation, I should be very much obliged if you would arrange for the replies to be returned no later than Thursday 10 December 2009. A letter providing greater detail is enclosed for the Audit Committee Chair and Finance Director respectively.

Whilst replying to this ICAS Working Group survey is important to gather a body of evidence, it is not a substitute for Audit Committee Chairmen and Finance Directors responding directly to the APB on its consultation. The deadline for responses to the consultation is 29 January 2010, and individuals are strongly encouraged to make their views known to the APB, as it is particularly interested to hear the views of the business community on this topic. The project director dealing with responses at the APB is Hazel O'Sullivan, and her email address is [h.osullivan@frc-apb.org.uk](mailto:h.osullivan@frc-apb.org.uk).

Your assistance in this matter is greatly appreciated. If you have any questions in relation to this request please contact James E Barbour, Director of Technical Policy, The Institute of Chartered Accountants: Tel: 0131 347 0234 or email [jbarbour@icas.org.uk](mailto:jbarbour@icas.org.uk)

Yours sincerely  
IAN PATERSON BROWN  
Chair of ICAS Working Group

Audit Committee Chair

20 November 2009

Dear Sir or Madam

### **SURVEY ON NON-AUDIT SERVICES**

The Institute of Chartered Accountants of Scotland has set up a Working Group:

- (i) To review the current provision by auditors of non-audit services to their listed company audit clients in the light of the Treasury Select Committee (TSC) Report and Auditing Practices Board (APB) Consultation Paper and provide comment thereon.
- (ii) To engage with the investor and business community:
  - (a) to assess the degree to which investors and others believe that the provision of those non-audit services which are permitted under the APB's Ethical Standards may represent a threat to auditor independence and/or audit quality, which is not capable of being reduced to an acceptable level through appropriate safeguards; and
  - (b) to seek to better inform them of the nature and types of services provided and the safeguards that exist and are currently implemented to mitigate any threats that may exist.
- (iii) To make suitable recommendations to seek to address any issues and concerns identified. This will include seeking to improve the transparency of the policies, process, and safeguards that surround the provision of non-audit services by auditors to their listed company audit clients and by increasing and improving, the level of disclosure of the nature of such services in a company's annual statutory financial statements.

### **Background**

As you may be aware the extent to which an auditor could provide non-audit services to their audit clients was the subject of intense scrutiny in the early part of this decade by the Government's Co-ordinating Group on Audit and Accounting Issues as a result of the fallout from Enron *et al.* The recommendations from this review and subsequent developments have impacted on the types of non-audit services which can be supplied by an auditor to its listed company audit clients.

These developments include:

- (i) the introduction of the Financial Reporting Council (FRC) ‘Guidance on Audit Committees’ which provides guidance to audit committees on how to comply with the relevant provisions of the Combined Code on Corporate Governance, including guidance in relation to establishing a policy on the procuring of non-audit services from a company’s auditor.
- (ii) the introduction of regulations imposing the requirement for more detailed disclosure in the notes to the financial statements of the fees paid to the company’s auditors for the different types of non-audit services that have been supplied by them.
- (iii) the introduction in 2004 and subsequent revision in 2008 of the APB’s Ethical Standards for auditors. Ethical Standard 5 restricts the types of non-audit services which can be provided.

Furthermore, the findings of annual audit quality inspections on the audit firms are now published. The findings include an assessment of the audit firm’s compliance with the APB’s Ethical Standards.

Despite the above framework being in place, in its report “Banking Crisis: reforming corporate governance and pay in the City” published in May, the Treasury Select Committee stated:

“We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.”

In response to this, the FRC through its Auditing Practices Board issued its consultation paper on non-audit services in October. The deadline for responses to the consultation is 29 January 2010 and you are strongly encouraged to make your views known to the APB, as it is particularly interested to hear the views of the business community on this topic. The project director dealing with responses at the APB is Hazel O’Sullivan and her email address is [h.osullivan@frc-apb.org.uk](mailto:h.osullivan@frc-apb.org.uk).

### **Evidence Gathering**

In order to assist the Working Group in meeting its objectives I should be obliged if you would complete the attached survey and return it in the reply paid envelope provided, no later than Thursday 10 December 2009.

Your assistance in this matter is greatly appreciated. If you have any questions in relation to this request please contact James E Barbour, Director of Technical Policy, The Institute of Chartered Accountants: Tel: 0131 347 0234 or email [jbarbour@icas.org.uk](mailto:jbarbour@icas.org.uk) .

Yours faithfully  
IAN PATERSON BROWN  
Chair of ICAS Working Group

Finance Director

20 November 2009

Dear Sir or Madam

### **SURVEY ON NON-AUDIT SERVICES**

The Institute of Chartered Accountants of Scotland has set up a Working Group:

- (i) To review the current provision by auditors of non-audit services to their listed company audit clients in the light of the Treasury Select Committee (TSC) Report and Auditing Practices Board (APB) Consultation Paper and provide comment thereon.
- (ii) To engage with the investor and business community:
  - (a) to assess the degree to which investors and others believe that the provision of those non-audit services which are permitted under the APB's Ethical Standards may represent a threat to auditor independence and/or audit quality, which is not capable of being reduced to an acceptable level through appropriate safeguards; and
  - (b) to seek to better inform them of the nature and types of services provided and the safeguards that exist and are currently implemented to mitigate any threats that may exist.
- (iii) To make suitable recommendations to seek to address any issues and concerns identified. This will include seeking to improve the transparency of the policies, process, and safeguards that surround the provision of non-audit services by auditors to their listed company audit clients and by increasing and improving, the level of disclosure of the nature of such services in a company's annual statutory financial statements.

### **Background**

As you may be aware the extent to which an auditor could provide non-audit services to their audit clients was the subject of intense scrutiny in the early part of this decade by the Government's Co-ordinating Group on Audit and Accounting Issues as a result of the fallout from Enron *et al.* The recommendations from this review and subsequent developments have impacted on the types of non-audit services which can be supplied by an auditor to its listed company audit clients.

These developments include:

- (i) the introduction of the Financial Reporting Council (FRC) Guidance on ‘Audit Committees’ which provides guidance to audit committees on how to comply with the relevant provisions of the Combined Code on Corporate Governance, including guidance in relation to establishing a policy on the procuring of non-audit services from a company’s auditor.
- (ii) the introduction of regulations imposing the requirement for more detailed disclosure in the notes to the financial statements of the fees paid to the company’s auditors for the different types of non-audit services that have been supplied by them.
- (iii) the introduction in 2004 and subsequent revision in 2008 of the APB’s Ethical Standards for auditors. Ethical Standard 5 restricts the types of non-audit services which can be provided.

Furthermore, the findings of annual audit quality inspections on the audit firms are now published. The findings include an assessment of the audit firm’s compliance with the APB’s Ethical Standards.

Despite the above framework being in place, in its report “Banking Crisis: reforming corporate governance and pay in the City” published in May, the Treasury Select Committee stated:

“We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.”

In response to this, the FRC through its Auditing Practices Board issued its consultation paper on non-audit services in October. The deadline for responses to the consultation is 29 January 2010 and you are strongly encouraged to make your views known to the APB, as it is particularly interested to hear the views of the business community on this topic. The project director dealing with responses at the APB is Hazel O’Sullivan and her email address is [h.osullivan@frc-apb.org.uk](mailto:h.osullivan@frc-apb.org.uk).

### **Evidence Gathering**

In order to assist the Working Group in meeting its objectives I should be obliged if you would complete the attached survey and return it in the reply paid envelope provided, no later than Thursday 10 December 2009.

Your assistance in this matter is greatly appreciated. If you have any questions in relation to this request please contact James E Barbour, Director of Technical Policy, The Institute of Chartered Accountants: Tel: 0131 347 0234 or email [jbarbour@icas.org.uk](mailto:jbarbour@icas.org.uk) .

Yours faithfully  
IAN PATERSON BROWN  
Chair of ICAS Working Group

## SURVEY OF FTSE 350 AUDIT COMMITTEE CHAIRS AND FINANCE DIRECTORS

### Provision of Non-Audit Services by auditors to their listed audit clients

The following is a survey being undertaken by a Working Group (WG) set up by the Institute of Chartered Accountants of Scotland (ICAS). The WG has been formed with the principal objective of reviewing the current provision of non-audit services to audit clients in the light of the Treasury Select Committee (TSC) Report and Auditing Practices Board (APB) Consultation Paper with a view to proposing suitable recommendations to seek to address any issues and concerns identified. We are writing to you as any amendments arising from the Consultation could have a significant impact on audit committees and finance directors.

The WG would very much appreciate a few minutes of your time to assist us in meeting those objectives by answering the following short series of questions. All responses will be anonymised.

We thank you in advance for your assistance.

#### Details

Company: .....

Your Name:.....

Role: .....

#### Please circle the appropriate response.

1. Do you believe that the current guidance for audit committees in relation to the procuring of non-audit services from a company's auditor is sufficient? (FRC 'Guidance on Audit Committees' (October 2008) – paragraphs 4.26-4.34)  
([http://www.frc.org.uk/documents/pagemanager/frc/Smith\\_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf](http://www.frc.org.uk/documents/pagemanager/frc/Smith_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf))
2. Do you believe that auditors should be prohibited from providing all non-audit services to their listed audit clients?

If yes, please provide details of your reasoning and describe what services you understand to be audit services and would include under this heading (e.g. reports on interims, prelims, working capital, covenants, confirmations of contract terms) **and then go to question 6.**



6. Do you believe that the current disclosure of non-audit services in a company's annual financial statements is adequate and allows the user to develop an informed opinion as to the appropriateness of the services provided by audit firms to their listed clients?
- A. It is adequate in both the audit committee report and fee disclosure note.
  - B. It is adequate in the audit committee report only.
  - C. It is adequate in the fee disclosure note only.
  - D. It is not adequate in either.

If your answer was B, C or D, please give the reasons for your response and what changes you would propose to the current disclosures made.

7. Would you support a requirement for a disclosure that separately identified audit and audit related services, such that the fees earned for services provided by the auditors relating to all reports to shareholders (interims, prelims, prospectuses) and the fees earned by auditors because of their role as auditors (e.g. bank covenant or contracts requiring reports from auditors) were separately shown?
- A. Yes
  - B. No

8. Do you believe that the UK would be imposing an additional financial or other unnecessary burden on UK plc if it decided to deviate from the international norm in this area and prohibit auditors from providing non-audit services to their listed audit clients?
- A. Yes
  - B. No

9. What negatives would there be if auditors were not allowed to provide non-audit services to their audit clients?

Please write your answer in the space below.

10. What do you believe would be the impact on audit quality if audit firms were prohibited from providing non-audit services to their listed audit clients?
- A. Increased
  - B. Decreased
  - C. No change

Please give the reason for your answer in the space below.

11. What do you believe would be the impact on the level of concentration in the listed FTSE 350 audit market if auditors were prohibited from providing non-audit services to their audit clients?
- A. Increased
  - B. Decreased
  - C. No change

Please give the reason for your answer in the space below.

12. Which types of non-audit services have you purchased from your auditors in the last year and what types of non-audit services would you envisage purchasing from them in the future?

Please write your response in the space below?

13. Have you procured a non-audit service from a provider other than your auditor, even though you believed that the service could be provided in a more efficient or effective way by the auditor, because of the need to disclose the level of non-audit services?
- A. Yes
  - B. No
  - C. Not applicable

## Appendix C: Additional Disclosure Example of Auditor Remuneration

The following fees were paid to a number of different auditors in respect of various parts of the group:

	<b>2009</b>	<b>2008</b>	
<b>Group Auditors</b>			Note on legislation
Fees payable to the group's auditors for the audit of the company's annual accounts and consolidated financial statements	xx	xx	
Fees payable to the group's auditors and their related audit firms for the audit of subsidiaries pursuant to legislation	xx	xx	Represents category 1 of 'Other Services'
Fees payable to the group's auditors and their related audit firms for the audit of associates and joint ventures pursuant to legislation (see Note 1)	xx	xx	
<b>Audit services provided to all group companies</b>	<b>xx</b>	<b>xx</b>	
Fees payable to the group's auditors and their related audit firms for:			
- Other services pursuant to legislation (see Note 2)	xx	xx	Category 2
- Services relating to corporate finance transactions	xx	xx	Category 9
<b>Other assurance services to stakeholders</b>	<b>xx</b>	<b>xx</b>	
- Other services relating to taxation	xx	xx	Category 3
- Services relating to information technology	xx	xx	Category 4
- Valuation and actuarial services	xx	xx	Category 6
- Services relating to litigation	xx	xx	Category 7
- Services relating to recruitment and remuneration	xx	xx	Category 8
- Other services (see Note 3)	xx	xx	Category 10
<b>All other services</b>	<b>xx</b>	<b>xx</b>	
<b>Total group auditor's remuneration</b>	<b>zz</b>	<b>zz</b>	
<b>Other auditors (see Note 4)</b>			
Fees payable to other auditors for other services provided to group companies:			
- Auditing of subsidiaries pursuant to legislation	xx	xx	
- Auditing of associates and joint ventures pursuant to legislation	xx	xx	
<b>Audit services provided to all group companies</b>	<b>xx</b>	<b>xx</b>	

*(Continued on next page)*

	<b>2009</b>	<b>2008</b>	
- Other services relating to taxation	xx	xx	Category 3
- Internal audit services	xx	xx	Category 5
- Other services	xx	xx	Category 10
<b>All other services</b>	<b>xx</b>	<b>xx</b>	
<b>Total other auditors' remuneration</b>	<b>zz</b>	<b>zz</b>	

Narrative disclosure may include:

- (a) details of the type of work included in each of the non-audit service categories above;
- (b) reasons to support the fact that the auditors were best suited to perform this work; and
- (c) reference to the company's disclosure of its policy with respect to the review and approval of non audit services, potentially cross-referencing to the annual report.

**Note 1:** Note that work performed by the group auditor in support of the consolidated group accounts on these entities would be included in the group audit fee disclosure. Additional disclosure of associate and JV audit fees are not currently mandated by the UK legislative requirements, but Tech release 06/06 (revised) - 'Disclosure of auditor remuneration' para 13.1 notes that additional voluntary disclosure of the audit fee of an 'associate' or 'joint venture' may be desirable as good practice if such interests are particularly material. This is in line with the Working Group's comments on the inclusion of associate and JV fees.

**Note 2:** The working group noted that it would be desirable to include all section 404 work in the group audit fee disclosure on the basis that the work is an integral part of the overall audit procedures. Tech 06/06 notes that consideration should be given as to whether a portion of fees should be included in Category 2, to the extent that there is additional cost in preparing the section 404 report itself or if additional work is performed which would not be required for the UK statutory audit.

**Note 3:** It is a statutory requirement that the audit of a subsidiary other than for consolidation purposes that was not required by local legislative requirements be included in Category 10 - 'All other services'. The WG's proposal would seek to include these type of expenses in the first category 'Audit services provided to all group companies'. To do this would require breaking out the 'Other services' into two separate lines. It may be preferable to disclose what proportion of 'Other services' relates to audit work of this nature.

**Note 4:** As noted in Tech 06/06 (revised) para 24.1, fees paid by subsidiaries to unassociated auditors (sometimes referred to as 'secondary auditors') are not disclosable, although voluntary disclosure is not prohibited.

Please note categorisation of fees will always be dependent on the nature of the fees and whether the work is driven by legislation.

## References

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- <sup>4</sup> APB (2008), 'Non-audit services provided to audit clients', Ethical Standard 5 (Revised), Financial Reporting Council, <http://www.frc.org.uk/apb/publications/pub1569.html>
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