



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

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Dear Hazel

REVISED DRAFT ETHICAL STANDARDS FOR AUDITORS

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the *Revised Draft Ethical Standards for Auditors* published in March 2009.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW Representation

ICAEW REP 52/09

REVISED DRAFT ETHICAL STANDARDS FOR AUDITORS

Memorandum of comment submitted in June 2009 by the Institute of Chartered Accountants in England and Wales, in response to the Auditing Practices Board consultation paper: Revised Draft Ethical Standards for Auditors

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute' or the 'ICAEW') welcomes the opportunity to comment on the Auditing Practices Board (APB) consultation paper: *Revised Draft Ethical Standards for Auditors* published in March 2009.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

OVERALL COMMENTS

4. We welcome most of the proposals as a balanced reaction to comments received by the APB about the Ethical Standards at the time of the previous consultation and subsequently. However, we have significant concerns in respect of two of the proposals.
5. Our most serious concern relates to the proposal to retain the default rotation period for engagement partners on listed entity audits at a maximum of five years. We accept that opinion varies but believe that insufficient weight has been given to a number of factors that would point towards a maximum seven year rotation period, including the attitude of audit committees and businesses, the advantages of international alignment, and a number of changes since the current five year period was introduced post-Enron. We address this in more detail in our response to question 3.
6. We also believe that, while nearly aligning the definition of affiliate with that used by the International Federation of Accountants (IFAC) is a move in the right direction, there can be no advantage at all (and a number of cost disadvantages to firms) in the alignment process only being 'nearly' accomplished, through replacing the IFAC use of 'materiality' with 'clearly insignificant'. We address this in more detail in our response to question 14.
7. We are pleased to see the proposed retention of a broadly principles based approach to restructuring services, as the threats to independence can vary significantly in this area. The proposed clarification in the ES-PASE that an exemption is available for smaller entity audits is particularly welcome.

RESPONSES TO CONSULTATION PAPER QUESTIONS

Question 1: Do you believe that any of the proposed changes will add to audit costs? If so, which changes and why?

8. We refer to the changes in respect of work which legislation specifies may be performed by an auditor discussed in question 17 below. It is likely that having the incumbent auditor perform, for example, the report on non-cash consideration for share issues will be more cost effective than bringing in another firm with less knowledge of the business. There is therefore likely to be some additional cost to audited entities arising from this proposal. However, we doubt that it will be particularly significant.

Question 2: Are there any changes to the ESs proposed by the APB which will be difficult to implement for audits of financial statements for periods commencing on or after 15 December 2009?

9. As noted in our response to question 17 below, while we do not disagree with the changes in respect of work which legislation specifies may be performed by an auditor, we believe that there could be an impact here and we believe that an additional transition period of, say one year for simplicity, should be permitted. We also believe there need to be arrangements to deal with pre-existing valuations by the auditors in the financial statements, included under the current exception.
10. Similar considerations apply to the new requirements which widen the scope of audit firm staff who can be a director/officer of an audited entity and the additional clarification on the incentivisation of partners in the audit firm.

Question 3: The APB would appreciate commentators' views on whether it would be appropriate to provide greater flexibility to ES 3 (Revised) to permit in certain circumstances, and with the prior approval of the audit committee, the rotation period to be extended from five to seven years?

11. We believe there is a strong case for aligning with the IFAC requirements of a maximum rotation period of seven rather than five years. We accept that opinion varies, noting the comment in the consultation paper that a number of investor groups believe that the basic period should remain at five years, effectively because that is what we have at present. However, we do not believe that there is any evidence that suggests that independence will actually be enhanced by doing this. The five year rotation period was introduced as part of the initial regulatory reaction in the immediate post-Enron period. Since then there has been a whole series of other changes (for example personal sign offs, independent regulation and oversight, public reporting on quality assurance visits). We do not believe the APB has taken these into consideration in assessing whether there is a case for change.
12. Indeed we believe there could be a negative impact on audit quality of the shorter period. Independence is one of a number of means of achieving high audit quality: knowledge of the client is another. Frequent changes of audit partner can reduce knowledge, which is particularly valuable in the audit of complex specialised clients as it takes time to acquire. We believe this outweighs the potential benefits of having a fresh view more often (which are in any event achieved in large teams by changes in other personnel).

13. We also believe there are two competition considerations here. First, a rotation period of five years reduces the number of firms / offices able to provide audit services to listed entities (especially those in a specialised industry). Smaller firms in particular commented on the impact the rotation period has on their ability to service AIM clients. Second, by requiring that listed companies be large (as well as complex) for the relaxation to be available, this could lead to a polarisation where only larger firms (that tend to audit the largest listed companies) may avoid the costs and disruption of frequent rotation that smaller firms (which generally audit smaller listed clients) will not be relieved from applying.
14. The consultation paper suggests that audit committee chairs favour the introduction of more flexibility around the basic five year period. We believe that audit committee and other business representatives actually quite understood the significant downsides associated with maintaining the basic rotation period at five years and would have preferred alignment with the international position. This seems to have been ignored.
15. Clearly, enhanced flexibility is an improvement on the existing position, where the current flexibility paragraph is widely regarded as being unusable in practice. This would, in theory, mitigate some of the practical difficulties where a required rotation would coincide with a particularly sensitive period at an audited entity. However, any exception must be genuinely usable: concerns have been expressed to us that the exception is drafted in such a way that it will not be used, either through conformist pressure from organisations that advise investors on how to vote, or because the actual reasons would be commercially sensitive and the disclosure requirements could not be complied with.
16. We note that there is no comment about the duration of the period during which the engagement partner is required to remain uninvolved with the audit, after rotation off. The IFAC requirement of two years has a clear logic to ensure no involvement during a full audit cycle but there is no reason why a longer period is necessary. Again, we believe there are competition issues with this. We refer above to the impact of a five year 'on' period on smaller firms: a five year 'off' period has a similar impact.

Question 4: In addition to large listed companies which are also complex or diverse, are there any other circumstances where some flexibility as regards the rotation period for audit engagement partners on listed companies would be appropriate? If so, please explain the rationale for your views.

17. While large companies are more likely to be complex, we do not see that it can be said that smaller listed companies will never have issues of complexity such that they should not be able to avail themselves of this part of the flexibility paragraph. See also paragraph 13 above.

Question 5: Do you agree that if an audit committee is able to decide to extend the period of rotation, this fact and the reasons for it should be disclosed to shareholders?

18. We agree in principle, though as noted above, the exception is only of value if it can actually be used. It would be unfortunate if the proposed disclosure resulted in pressure not to use the flexibility regardless of the circumstances.
19. In addition, it should be recognised that there may be occasions where disclosure of the reasons for applying the flexibility paragraph may be commercially

sensitive. In these circumstances, it ought to be sufficient for the audit committee chairman to confirm that the committee was satisfied that the extension was justified.

Question 6: Do you agree that the APB should retain the existing requirement and provide additional guidance in respect of partners and staff in senior positions for a continuous period longer than seven years?

20. We agree. We are pleased to see a principles-based threats and safeguards approach retained in this area, where circumstances can vary significantly.

Question 7: Do you support the proposed extension of the rotation period for the EQCR on listed company audits to seven years?

21. We support the proposal. Regardless of the outcome of the debate on the rotation period for the engagement partner (see above) the degree of familiarity threat associated with the position of engagement quality review partner, by its very nature, must be far less than for the audit engagement partner.

Question 8: Do you support the proposed approach of the APB towards internal audit staff working directly for the audit team?

22. We support the proposal. Use of internal audit staff can be an invaluable means of maintaining audit efficiency. From an independence perspective it is clearly necessary to ensure that the work of internal audit staff is not relied on heavily for key audit judgments judgements and the proposal provides for this.

Question 9: Do you support the proposed approach of the APB towards the provision of restructuring services by the external auditor?

23. We support the proposal, which we see as formalising a thought process that we would already expect auditors to apply under the existing principles-based threats and safeguards framework.

24. We particularly welcome the proposed clarification in the ES-PASE that an exemption is available for smaller entity audits in this area. We would point out though, that this merely puts the provision of restructuring services onto the same basis as tax services, where we have previously expressed concern that, for example, representing clients in tax tribunals is of particular concern for small practices who audit and provide accounting services and tax compliance work to SMEs.

Question 10: Do respondents support the APB's analysis and conclusion in relation to securitisation services?

Question 11: ES 5 (Revised) paragraph 119 sets out the circumstances in which securitisation services would be prohibited. Are there other circumstances that should result in a prohibition?

25. We support the proposals. The auditors are often the most appropriate to perform such services in terms of speed and efficiency. Clearly threats to independence from the provision of such services need to be addressed but they can vary significantly depending on the circumstances and it is appropriate to retain a largely threats and safeguards based approach.

Question 12: Do you support the proposed relaxation of the ESs with respect to financial interests of new partners joining the firm?

26. We do not object to the proposals, subject to a couple of wording clarifications.
27. Firstly, it should be made clear whether 'joins the audit firm as a partner' covers not only persons coming in as a partner from outside the firm, but those promoted from within.
28. Secondly, as proposed paragraph ES2 [A] permits a variation to ES2 7, it should also address immediate family members.

Question 13: Do you support the proposed strengthening of the ESs with respect to governance roles with an audited entity?

29. We believe this is a reasonable change given that it aligns the Ethical Standards more closely with the IFAC Code of Ethics. In terms of independence issues it would often be possible for audit firm staff not involved in the audit to be a director or officer of the audited entity without creating an actual threat to independence. However, as with immaterial direct financial interests, there is a perception issue which we believe merits extension of the requirement in line with that proposed.
30. It would align further with the IFAC Code (and close a potential loophole) to refer to 'other officers', as well as directors

Question 14: Do you support the APB's proposed definition of an affiliate?

31. We entirely fail to see the point of changing a definition to align with the definition in the IFAC Code of Ethics, and then engage in a minor tinkering with words.
32. We agree that there are a number of contributing factors in determining whether an entity is important to another entity's financial statements but believe that retaining the IFAC wording allows for this consideration. 'Materiality' is not defined to refer exclusively to the size of the entity and as the requirement is within an overall threats and safeguards structure, we would expect all relevant factors to be considered.
33. In addition, there is a concern that the phrase 'clearly insignificant' imposes an impossible onus of demonstration: there will always be someone to whom something is not *clearly* insignificant. We understand that IFAC is minimising use of this phrase in its own code in its redrafting conventions project.
34. The IFAC definition should be adopted unchanged. This will improve audit efficiency on international engagements and avoid asynchronous application of independence requirements.

Question 15: Do you support the proposed change to the ESs with respect to extending the requirements relating to remuneration and evaluation policies to key partners involved in the audit?

35. We believe this is a useful clarification.

Question 16: Do you believe that the requirement for remuneration and evaluation policies should be applied to other partners and staff from non-audit disciplines?

36. We do not believe that there needs to be an additional prohibition on such staff. In principle the threat could arise where a member of staff, from whatever discipline, makes key audit judgments and it may be useful to clarify this in the discussion following ES4 38. However, it would be rare for such staff to be in that position so general threats and safeguards requirements are appropriate in these circumstances.

Question 17: Do you support the proposed strengthening of the ESs with respect to valuations and other non-audit services where legislation provides that the auditor is eligible to carry out a non-audit service, but does not require the auditor to undertake such work?

37. On balance, we support the proposal. As a pragmatic measure, where legislation requires the auditors to perform a task, independence requirements cannot prohibit that outright.
38. However, merely because legislation states that something may or even must be performed by the auditor does not remove the possibility of a threat to audit independence: carve outs from a principles-based standard should therefore be kept to a minimum.
39. UK legislation generally specifies that a task (for example the report on non-cash consideration for share issues) should be performed by someone who is 'eligible for appointment as a statutory auditor'¹. Accordingly this change could have a significant impact. We refer to this further in our response to questions 1 and 2 above.

COMMENTS ON OTHER ASPECTS OF THE REVISED DRAFT STANDARDS.

References below are to paragraph numbers in the revised draft standards

40. ES5 [G], and for that matter a number of other paragraphs, discuss advocating matters material to the financial statements. This should relate only to financial statements to be audited rather than ones which have been audited and signed off in the past. We are not sure that it is clear from the generality of the ESs that this is so.
41. ES5 [H] is written slightly oddly. It could be interpreted as stating that auditors carrying out a going concern assessment as part of restructuring services always cause a self-review threat: we do not believe that to be the case.

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¹ Companies Act 2006 section 1150

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