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By email: [comments@pcaobus.org](mailto:comments@pcaobus.org)

Dear Sirs

**PCAOB CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION:  
RULEMAKING DOCKET MATTER NUMBER 37**

ICAEW is pleased to respond to your request for comments on *PCAOB's Concept Release 2011-006 on Auditor Independence and Audit Firm Rotation*.

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

### **PCAOB CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION**

**Memorandum of comment submitted in December 2011 by ICAEW, in response to PCAOB's Concept Release 2011-006 on Auditor Independence and Audit Firm Rotation published in August 2011**

<b>Contents</b>	<b>Paragraph</b>
Introduction	1
Who we are	2
Major points	4
Responses to general questions	7
Responses to specific questions	28

## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the *Concept Release 2011-006 on Auditor Independence and Audit Firm Rotation* published by PCAOB in August 2011, a copy of which is available from this [link](#).

## WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

## MAJOR POINTS

4. Professional scepticism is a fundamental element of audit quality and the topic merits serious consideration by an audit regulator. However, we do not believe that mandatory rotation of audit firms will address the concerns the PCAOB has. In fact, auditors are only in a position to apply scepticism fully when they have developed sufficient knowledge of the client and industry, which the PCAOB's release could undermine. The release itself summarises many of the arguments for and against rotation and on balance we believe the potential downside effect on quality (broadly supported by academic research) and on choice more than outweigh any supposed benefit. There should be further research before any implementation, including exploring some of the alternatives.
5. We note below a number of suggestions, including enhancing auditor documentation of the approach to scepticism, and increased audit committee involvement, including establishing a comply or explain approach to tendering.
6. In the detailed responses below, we have in a number of instances grouped questions together where the responses would overlap significantly.

## RESPONSES TO GENERAL QUESTIONS

**GQ1 - Should the Board focus on enhancing auditor independence, objectivity and professional skepticism? How significant are the problems in those areas relative to problems in other areas on which the Board might focus? Should the Board simply defer consideration of any proposals to enhance auditor independence, objectivity and professional skepticism?**

7. We agree that professional scepticism is a fundamental element of audit quality and is an issue meriting serious consideration by an audit regulator.
8. It does not mean that there is systemic lack of scepticism in auditing at present. Clearly the release reflects information obtained from inspection visits where serious regulatory and conduct issues had been discovered. However, the extent of the problem is unclear.

9. We also note that that it is unlikely that the audits inspected will have fully reflected the effects of some of the recent changes introduced to enhance audit quality, in particular PCAOB Auditing Standard 7.
10. We note that the discussion in the release tends to refer to objectivity, independence and scepticism. These are distinct terms. Scepticism certainly requires objectivity, but also knowledge and other skills. Objectivity, which is a state of mind, is distinct from independence, which is absence of interests and relationships which might compromise and/or be seen to compromise objectivity. Regulations tend to concentrate on independence and it is important, particularly in audit, but ultimately it is one of a number of necessary ingredients in achieving high quality audits, including a thorough understanding of the company and industry expertise.

**GQ2 - Would audit firm rotation enhance auditor independence, objectivity and professional skepticism?**

**GQ3 - What are the advantages and disadvantages of mandatory audit firm rotation? If there are potential disadvantages or unintended consequences, are there ways a rotation requirement could be structured to avoid or minimize them?**

11. Mandatory audit firm rotation would move work move around between professional audit firms, so we have no commercial imperative to oppose the proposal. However, while we understand the arguments for the potential benefits of rotation, the weight of academic evidence that we have seen (referred to in paragraph 12 below) indicates that there would not be an improvement in audit quality. In fact these studies have tended to conclude that discarding the audit firm's cumulative understanding every few years will inevitably lead to a higher risk of audit failure in the early stages of a new appointment.
12. Furthermore we believe:
  - that there would, in some parts of the market, be a negative effect on choice of auditor (paragraphs 36 to 38 below);
  - that there would undoubtedly be costs to entities audited, probably in terms of audit fees and definitely in terms of management time every time there is a change of audit firm (paragraphs 18 to 20 below);
  - that there is a significant potential effect on multinational audits (paragraphs 37 and 38 below); and
  - mandatory audit firm rotation removes authority from the audit committee which is not good for corporate governance generally (paragraph 23 below).
13. On balance therefore we must conclude that mandatory audit firm rotation would be a counterproductive step.
14. Examples of the academic evidence we refer to include:
  - 'Mandatory Rotation of Audit Firms' - FEE, 2004 (which summarises research to that point).
  - 'Mandatory Audit Firm Rotation and Audit Quality' – Jackson et al, Managerial Auditing Journal, 2008.
  - 'Does Mandatory Audit Rotation Enhance Auditor Independence? Evidence from Spain' – Barbadillo et al, Auditing: a journal of practice and theory, May 2009.
  - 'Mandatory Audit Firm Rotation and Audit Quality: Empirical Evidence from the Korean Audit Market' – Lim, 2010.
15. It is unusual in behavioural areas for academic research to point so strongly in one direction, so we believe that this research merits careful consideration.

16. Even without audit firm rotation, there are changes in key personnel involved so long audit firm tenure does not necessarily mean a long term relationship between key personnel involved in the audit process. The SEC independence rules require the lead and other significant audit partners rotate after five or seven years. In addition, there is significant management change within the entity being audited. For example we have seen research suggesting that on average U.S. CEOs change every 6 years<sup>1</sup>.

**GQ4 - Because there appears to be little or no relevant empirical data directly on mandatory rotation available, should the Board conduct a pilot program so that mandatory rotation of registered public accounting firms could be further studied before the Board determines whether to consider developing a more permanent requirement? How could such a program be structured?**

17. As noted above, we believe that the academic research, which is to a large extent based on experience around the world where mandatory firm rotation has been implemented but in some case withdrawn, suggests that mandatory rotation would be counterproductive.
18. A pilot programme would risk being unrepresentative, and, particularly with large issuers, would also risk significant and high visibility consequences should it be unsuccessful. We believe a better approach would be to conduct research with issuers who have undertaken audit tendering, enquiring why this did or did not result in a change of auditors, what the management experience was in terms of additional management time taken (including, where there was a change in auditor, time is getting the new auditors up to speed), and whether they felt that the change of auditors usefully produced a fresh look, compared to the current engagement partner rotation requirements. This would add usefully to the body of research to be considered before widespread imposition is agreed.

**GQ5 - According to the 2003 GAO Report, large firms estimated that a rotation requirement would increase initial year audit costs by more than 20 percent. What effect would a rotation requirement have on audit costs? Are there other costs the Board should consider, such as the potential time and disruption impact on company financial reporting staff as a result of a change in auditors? Are there implementation steps that could be taken to mitigate costs? The Board is particularly interested in any relevant empirical data commenters can provide in this area.**

19. Ultimately the cost of an efficient high quality audit must be borne by shareholders in a listed entity as part of the price of access to public funds. However the additional costs of mandatory rotation should not be underestimated.
20. We have no evidence to disagree with the GAO findings. However, it needs to be borne in mind that there will be increased costs of management time at the company bringing in the new auditors and getting them up to speed, and representing a significant distraction for management from growing the business.

**GQ6 - A 2003 report by the Conference Board Commission on Public Trust and Private Enterprise recommended that audit committees consider rotation when, among other factors, "the audit firm has been employed by the company for a substantial period of time — e.g., over 10 years." To what extent have audit committees considered implementing a policy of audit firm rotation? If audit committees have not considered implementing such a policy, why not? What have been the experiences of any audit committees that have implemented a policy of rotation?**

21. The low turnover rates of auditors in practice suggest that audit committees are not implementing a policy of audit firm rotation. Recent research for ICAEW, which involved extended interviews with the audit committee chairs of a number of FTSE100 companies in the

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<sup>1</sup> How Has CEO Turnover Changed? Kaplan and Minton, August 2008

UK, suggested that the majority see no need to make a change, which would be costly, time-consuming and result in loss of institutional knowledge<sup>2</sup>.

**GQ7 - Are there alternatives to mandatory rotation that the Board should consider that would meaningfully enhance auditor independence, objectivity and professional skepticism? For example, should broader alternatives be considered that relate to a company's requirement to obtain an audit, such as joint audits or a requirement for the audit committee to solicit bids on the audit after a certain number of years with the same auditor? Could audit committee oversight of the engagement be otherwise enhanced in a way that meaningfully improves auditor independence?**

22. We have never dismissed joint audit on principle, but we note that while joint audit is permissible in the UK it has not proven to be at all popular or, when used, very practical. We believe that it has been seen by companies as more costly and while there is an argument that it would cause auditors to be more diligent, it could also cause co-ordination problems and harm audit quality. There is also a possibility that some clients would seek to play the joint auditors off against each other in order to push through inappropriate accounting treatments.
23. Audit committee oversight of the external auditors, including appointment, is critical to shareholder control over the audit process. A full explanation in the annual report of the process adopted could be helpful in clarifying the audit committee's thought processes and assisting shareholders in making their own assessment of the process: perception is as important as reality in matters relating to public confidence. For example, the audit committee could describe how they have evaluated audit quality, the tenure of the current audit firm and why they are content not to tender/rotate, if that is the case.
24. If there is a concern that auditors are not displaying sufficient scepticism, a more direct approach might be to apply greater requirements on auditors for documentation of their approach to scepticism in relation to, for example, management representations.
25. The UK Financial Reporting Council is proposing that for listed companies, their audits should be subject to tendering after 10 years, although there would be an option to explain in the annual report that this was not being done, and why. This seems to be a sensible proposal that would merit consideration outside the UK. It encourages boards to think about the issue seriously, without imposing mandatory tendering. The latter could result in 'going through the motions' with consequent costs to all but to no benefit when the company is satisfied with its current audit quality.

**GQ8 - Should the Board continue to seek to address its concerns about independence, objectivity and professional skepticism through its current inspection program? Is there some enhanced or improved form of inspection that could better address the Board's concerns? If mandatory rotation were in place, could an enhanced inspection, perhaps focused particularly on professional skepticism, serve as a substitute in cases in which it would be unusually costly, disruptive or otherwise impracticable to rotate auditors?**

26. The current audit inspection regime in the US, as in the UK, was set up to address concerns about audit quality. If there are continuing concerns about audit scepticism and quality, the inspection regime is an appropriate regime for addressing them, though the regime itself should be reviewed to see if there are enhancements that could be made.
27. Should mandatory rotation be applied, additional regulatory inspection could be applied as a substitute in particularly impracticable cases, for example where capability to service the audit is limited by sector specialism or geography. This would of course lead to potential issues with

<sup>2</sup> [www.icaew.com/en/about-icaew/newsroom/press-releases/2011-press-releases/ftse-100-audit-committee-chairs-question-rationale-eu-reforms](http://www.icaew.com/en/about-icaew/newsroom/press-releases/2011-press-releases/ftse-100-audit-committee-chairs-question-rationale-eu-reforms)

how to determine whether a particular rotation would be unusually costly, disruptive or otherwise impracticable.

## RESPONSES TO SPECIFIC QUESTIONS

### Term of engagement

**Q1. If the Board determined to move forward with development of a rotation proposal, what would be an appropriate term length?**

**Q2. Should different term lengths for different kinds of engagements be considered? If so, what characteristics, such as client size or industry, should this differentiation be based on?**

- 28.** If implemented, the regime would need to take account of concern over early years audit quality (see paragraphs 11 to 15 above). It should also be consistent with any retained requirements for audit partner rotation.
- 29.** We understand that even the current requirements in the US and UK to rotate the engagement partner after five years, have caused logistical problems for some audit firms<sup>3</sup>. It follows that a mandatory firm rotation period of five years would cause even further disruption.
- 30.** Setting an appropriate term for very different sizes of company in different circumstances will inevitably mean that the cost/benefit equation does not work for all (or indeed even most). For example a small listed mutual fund changing its auditors is a much less daunting proposition than it would be for a major international bank. Nevertheless in our view the length of term should be the same for all of those types of entity to which it is thought necessary to apply mandatory audit firm rotation. Partner rotation requirements do not vary by types of listed entity and different periods depending upon the kind of engagement would unnecessarily complicate any resulting standard.

**Q3. Does audit effectiveness vary over an auditor's tenure on a particular engagement? For example, are auditors either more or less effective at the beginning of a new client relationship? If there is a "learning curve" before auditors can become effective, generally how long is it, and does it vary significantly by client type?**

**Q4. Some have also suggested that, in addition to being less effective at the beginning of an engagement, an auditor may be less diligent toward the end of the allowable term. On the other hand, others have suggested that auditors would be more diligent towards the end of the allowable term out of concern about what the replacement auditor might find. Would auditors become more or less diligent towards the end of their term? Does the answer depend on the length of the term?**

**Q5. How much time should be required before a rotated firm could return to an engagement?**

- 31.** As noted in paragraphs 11 to 15, there is academic evidence that suggests audit quality is lower in the earlier years of the term. Auditor effectiveness is particularly likely to be less in year one because of the learning curve effect and concentration on audit process although each audit should be looked at on its specific facts. Certainly an audit will be less efficient in year one because more time will be likely to be incurred by a new auditor to achieve the same outcome as an auditor who has been in place for several years.

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<sup>3</sup> This is recognised by the UK's auditor independence standards from the Auditing Practices Board, which allow an additional two years involvement, on audit quality grounds, provided (a) the audit committee requests it (rather than client management or the audit firm), and (b) there is shareholder disclosure with the shareholders able to exercise their ability to remove the auditor in general meeting if they are unhappy with the extension. Whilst governance measures differ between countries, where shareholders have this right we believe that this is a more appropriate method than a regulatory prohibition.

- 32.** As regards the end of the term, the logical conclusion would be that auditors would be more diligent at the end of an assignment because of the increased risk of inspection, if an inspection had not already taken place, and also because of the risk of litigation if their work was less than adequate when the next firm was appointed auditor. However, set against that there has to be a concern that audit firms expecting to lose audits may be less willing to invest time in ensuring they are keeping up with the client, or in some cases relevant requirements for public interest entity audits altogether.
- 33.** There can be no logic in having a cooling off longer than the rotation period. Indeed, should the period required before a firm could return to an engagement be longer than the maximum period before mandatory rotation is required, the potential negative effect on choice, about which we express concerns in paragraphs 36 to 38, would be heightened, as at least three firms would need to be involved, regardless of the circumstances.

### **Scope of potential requirement**

**Q6. Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers? Should the Board consider applying a rotation rule to some other subset of issuer audits? For example, are there reasons for applying a rotation requirement only to audits of companies in certain industries?**

- 34.** The real issue is whether mandatory firm rotation would diminish or enhance audit quality and if the latter, whether the benefit would outweigh the cost. Different rotation periods for different types/sizes of entity would unnecessarily complicate matters further.
- 35.** If the PCAOB's concerns about audit scepticism are more prevalent in particular types of business, say financial services, any audit firm rotation requirement could be restricted only to those types of business, although complex industries such as these are precisely when continuity and corporate knowledge are important. In addition, such an approach can lead to definitional issues as to which entities are in, say, financial services.

### **Transition and Implementation Considerations**

**Q7. To what extent would a rotation requirement limit a company's choice of an auditor? Are there specific industries or regions in which a rotation requirement would present particular difficulties in identifying an auditor with the necessary skills and expertise? Is it likely that some smaller audit firms might decide to leave the public company audit market due to the level of uncertainty regarding their ongoing client portfolios?**

**Q8. If rotation would limit the choice of auditors, are there steps that could be taken to allow a company sufficient time to transition out of non-audit service arrangements with firms that could be engaged to perform the audit? Are there other steps that could be taken to address any limitation on auditor choice?**

**Q9. If rotation were required, would audit firms have the capacity to assign appropriately qualified personnel to new engagements? If they do not currently have that capacity, could firms develop it in order to be able to compete for new clients, and would they do so?**

- 36.** We have significant concerns about the impact of mandatory rotation on choice of auditor, at both ends of the market for listed company audits. Mandatory rotation could force an audit committee to appoint a firm that it knows is not as experienced or expert in, for example, its industry.
- 37.** Some large specialist businesses (for example in financial services) have little choice already in their auditors, given non-audit service restrictions. Whilst in some cases these concerns could be dealt with by, for example, changing the provider of non-audit services at the same time, the SEC rules on cooling-off for non-audit services, together with the applicability of such restrictions to joint ventures where the choice of auditor and advisor may not be within the gift



of the audited entity, make sudden change often impractical. Some audit firms may not be willing to seek appointment as: a) they may be unable (or unwilling) to terminate some non-audit services that run for an extended period, for example, outsourcing services; b) given (certainly in the UK) the relatively small choice of retail banks, there would be a significant upheaval for the incoming auditor partner and staff in getting rid of the various banking products that have now become restricted. Large specialist businesses are likely to have little if any choice at all in who might be appointed on a rotation.

38. We also have concerns about those at the smaller end of the market – or larger companies in more remote areas. An example would be a firm having a substantially bigger practice than its competitors, which has grown up outside of a major city to service a large company headquartered in the local area. Regular rotation of auditors of such companies may be very disruptive to the office concerned or lead to large scale movements of engagement teams to the new audit firm (potentially leading to the same staff being involved, despite the change of audit firm). Given the extra regulatory burden for listed audits and the logistical problems with maintaining a relatively small number of partners and staff with the relevant expertise, some smaller firms or smaller offices of larger firms would be likely to opt out of listed audits altogether, reducing choice.

**Q10. Would rotation create unique challenges for audits of multinational companies? For voluntary rotations that have taken place, what have been the implementation and cost issues and how have they been managed?**

39. Rotation on multi-national audits would undoubtedly make the position more complicated. Often statutory audits of components of multinational companies are completed after the consolidated financial statements have been issued. Furthermore, there are often specific protocols that must be observed in changing statutory auditors. Indeed there are some countries where appointments are for a fixed term (for example, in some European countries, the fixed term runs for between 1 and 9 years). Problems already arise when, for example, French law means it is not possible to switch auditors of a subsidiary when the UK parent changes auditor.
40. As a result changing the group auditor may result in duplication of effort for companies if they are not able to change the statutory auditor at the same time throughout the group. At the very least there would need to be some allowance by way of, for example, transitional periods.
41. Sometimes, through lack of network reach or deliberate choice, auditors of components are not part of the network that the group auditor belongs to. For example, a particular challenge may apply to the auditor of a joint venture between an issuer and another investor. In such cases the issuer is unlikely to have sufficient control to force a change of auditor for the joint venture. The position in respect to these firms would need to be clarified.

**Q11. Would increased frequency of auditor changes disrupt audit firms' operations or interfere with their ability to focus on performing high quality audits? How would any such disruption vary by firm size? For example, would a rotation requirement pose fewer or more implementation issues for small firms than for large ones?**

42. We have already explained some of our concerns about the effect on smaller firms and regional offices of larger firms – see response to question 9 above. These could result in a cost increase where smaller firms need to factor in severance costs for staff as part of audit fees – and reduce choice where this might drive people instead towards a larger firm with more opportunity to redeploy staff. Even in these latter firms, there could be a need to move staff to different geographical locations for a few years, causing problems for other audits, for example where those staff have specialisms that are still needed in the original office.

**Q12. Would audit firms respond to a rotation requirement by devoting fewer resources to improving the quality of their audits? Would firms focus more on non-audit services than on audit services?**

**Q13. Would rotation have any effect on the market for non-audit services? Would any such effect be harmful or beneficial to investors?**

**43.** We believe there might be a detrimental effect on the market because firms hoping to replace the incumbent auditor would need to ensure they were independent. This is not always possible when certain non-audit engagements run for a number of years or cannot be easily transferred to another party, for example, outsourcing arrangements where audit relationships cannot be changed throughout the group at the same time, particularly where there are different cooling-off requirements in different jurisdictions. See also paragraphs 32 and 33, and 36 to 38 above.

**Q14. Some have expressed concern that rotation would lead to "opinion shopping," or that in competing for new engagements firms would offer favorable treatment. Others have suggested that rotation could be an antidote to opinion shopping because companies would know that they could not stick with a firm promising favourable treatment forever. Would opinion shopping be more or less likely if rotation were required? If rotation limits auditor choice, could it at the same time increase opinion shopping?**

**44.** This is a difficult question to address because it will depend on the individual facts and circumstances. As noted in the release, it could make auditors less likely to permit favourable treatments but there is also the potential to disguise opinion shopping – i.e. disguising a voluntary change of auditor as mandatory.

**45.** We understand that in any event the US position on providing accounting opinions to non-audit clients is fairly strict and note that ethics codes typically restrict opinion shopping to a certain extent (certainly those of the International Ethics Standards Board for Accountants and ICAEW).

**Q15. What effect would a rotation requirement have on competition for audit engagements? If competition would be increased, how might that affect audit quality?**

**46.** See paragraphs 36 to 38 above.

**Q16. Are there any requirements the Board should consider to mitigate any risks posed by rotation? For example, are there enhancements to firms' quality control systems that might address such risks?**

**Q17. If the early years of an auditor-client relationship pose higher audit risks than later years, should the Board require firms to provide additional audit supervision and oversight in the first year or two of a new engagement? Should the Board impose such a requirement for auditor changes even if it does not further consider requiring audit firm rotation? If firms are accepting new clients but are unable to perform quality audits for them until several years have passed, should the Board require enhanced client acceptance procedures? What impact would additional requirements of this type have on audit costs?**

**47.** Existing quality control arrangements ought already to be addressing risk at the appropriate level needed to support the audit opinion anyway.

**Q18. If mandatory rotation were required, are existing standards relating to communications between predecessor and successor auditors sufficient? Should additional communications be required? For example, should the outgoing auditor provide the incoming auditor with a written report outlining audit risks and other important information about the company?**

**Q19. Are there other audit procedures that should be required to mitigate any risks posed by rotation?**

48. We note that in the USA there is generally a more open approach to access to audit working papers than in some other jurisdictions where there may be confidentiality concerns. Restricted or limited access to predecessor auditor working papers would make rotation more expensive and is a factor that should be considered with regard to auditor effectiveness in the early years of an audit assignment.
49. Generally, more open access to previous audit files could be encouraged (regardless of whether mandatory rotation is implemented) to assist choice, though this is not without cost, and liability issues would need to be resolved.
50. We have no particular additional suggestions in this area, though would note in respect of the proposal of a written report to the incoming auditor, that this might be an unnecessary cost burden if there is appropriate access to predecessors' files.

**Q20. If the Board moved forward with development of a rotation proposal, should consideration be given to the recommendation for a cause restriction on the company's ability to remove an auditor before the end of a fixed term? Would such a provision be useful? Would there be unintended consequences of such a requirement? Should the Board work with the SEC on implementation of this recommendation? Are there other matters on which the Board should coordinate with the SEC?**

51. A fixed term would strengthen the auditors hand in a debate, but it removes their accountability for efficiency. In addition:
- forcing an auditor to remain in situ where the relationship with their client has broken down is likely to be counterproductive to a high quality audit – indeed threatening to resign can be a powerful weapon in persuading a client to adopt a better accounting treatment; and
  - It could cause restrictions on the ability to change auditor and/or upset arrangements for other advice if, for example, one registrant bought a significant stake in another.

**Q21. What other transition issues might arise in the first year of a rotation requirement? How should the Board address these issues?**

52. See paragraph 40 above re general transitional requirements. We do not believe that specific first year transitional arrangements will mitigate the concerns expressed above.

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