



Professional Ethics for Auditors

Professional ethics – two words which are central to our profession. How many times do you see auditors in the firing line because of claims that professional ethics have been breached? Disciplinary pages of various professional bodies are regularly littered with proceedings taken against practitioners because they have failed to comply with professional ethics, such as levels of fees or honesty and integrity.

In the world of auditing there are five ethical standards which auditors must adhere to and this article will recap on the fundamental aspects of these five standards which are:

- ES 1 Integrity, objectivity and independence
- ES 2 Financial, business, employment and personal relationships
- ES 3 Long Association with the Audit Engagement
- ES 4 Fees, remuneration and evaluation policies, litigation, gifts and hospitality
- ES 5 Non-audit services provided to audit clients

It is worth pointing out that this article considers the above ethical standards which are revised and are effective from 30 April 2011. Clearly an article cannot go into every single detail and auditors are advised to make sure they are familiar with the ethical standards, but here's a recap of the significant areas in each standard:

ES 1 Integrity, objectivity and independence

To all intents and purposes, this standard tells us what we already know; we have to act with integrity which the standard itself recognises as not just including honesty, but other qualities. The standard refers to characteristics such as fairness, candour, courage, intellectual honesty and confidentiality.

Auditors have been slammed recently for the way in which they have allegedly approached and undertaken their audit work. They have been accused of being anything but objective and independent! Unfortunately the audit profession always appears in the firing line when scandals hit the media and it's always the same "auditors need to be more independent" "auditors need to show more scepticism" "the audit model needs to evolve". It is (as I have frequently cited in lectures) like a broken record! Auditors do, however, need to be objective and independent. ES 1 considers objectivity to be a state of mind which excludes bias, prejudice and compromise. It goes on that being objective will enable the auditor to give fair and impartial consideration to all matters which are relevant. It also recognises that, essentially, objectivity goes 'hand in hand' with integrity.

Objectivity is a personal behavioural characteristic which concerns the auditor's state of mind. Independence according to ES 1 is freedom from situations and relationships which would otherwise make others think that objectivity is (or could be) impaired.

The main thrust of ES 1 is that integrity, objectivity and independence must be maintained at all times during the course of the audit. Where threats to any of these characteristics present themselves, they must either be reduced to an acceptable level or the audit firm must consider resignation. The standard itself recognising the following threats to an auditor's objectivity and independence:

Self-interest threat

This can occur when the auditor has a financial interest in the audit client.

Self-review threat

Self-review threats occur when the audit firm also performs non-audit services, such as preparing the management or year-end accounts and then also acts in the capacity of auditor.

Management threat

A management threat occurs when the audit firm performs non-audit services and management make judgements and take decisions based on that work. The standard itself cites the design, selection and implementation of an accounting IT system.

Advocacy threat

This can arise when the audit firm acts as a legal advocate for the audit client because here the audit firm will have to adopt a position which is very similar to that of a management role.

Familiarity threat

Familiarity threats are very popular – they arise when the auditor develops close relationships with the audit client, usually because of long association. Regular partner rotation is encouraged when this threat becomes an issue.

Intimidation threat

This can arise when the client is aggressive or the auditor feels intimidated by the client.

The above threats are not exhaustive and other threats may present themselves which might also need to be considered by the audit firm in the context of ES 1.

ES 2 Financial, business, employment and personal relationships

Auditors cannot have any financial interest in their audit client. To do so would give rise to a self-interest threat as described above and ES 2 acknowledges that there are no safeguards which can be implemented to reduce this risk to an acceptable level. However, situations can arise when the family of the audit partner may have a financial interest in the audit client. ES 2 makes allowances for these situations, but only in situations when an immediate family member of an audit partner is not in a position to influence the conduct and outcome of the audit. Generally speaking, where such financial interests are material and the audit partner has close contact with the audit engagement team, the ethics partner would consider the need to put safeguards in place and this may involve substituting the audit partner.

Business relationships can occur when the audit firm and the client have a common commercial interest and the standard itself recognises that this can create a self-interest, advocacy or intimidation threat. It gives various descriptions in ES 2 at paragraph 27 as to what might constitute a business relationship and is quite specific on what the audit firm should do under these circumstances. Basically, the audit firm must not enter into a business relationship with an audit client, its management or its affiliates. The standard does, however, give two exceptions to this rule and does allow the audit firm to enter into a business relationship where they:

- involve the purchase of goods and services from the audit firm or the audited entity in the ordinary course of business and on an arm's length basis and which are not material to either party; or
- are clearly inconsequential to either party.

[ES 2 paragraph 28]

Employment relationships occur when an audit firm employs someone from the audit client, or admits (say) the financial director to the audit firm's partnership. The standard also recognises instances when the audit firm might enter into an agreement with the audit client to supply staff (secondments). Such agreements are not permitted unless the agreement is for a short period of time and would not involve the staff (or the partners) providing services to the client which would not be allowed under ES 5. In addition, the audit firm must also ensure that the client agrees that the staff member(s) concerned will not hold a management position, make

management decisions or exercise discretionary authority to commit the audit client to a certain position or accounting treatment.

The standard is also quite strict on the what happens when a staff loan assignment has been undertaken which is permissible under ES 2. Where an audit partner or member of staff of the audit firm returns after completion of the loan assignment, they must not be involved in any area of the audit which might involve a function or activity which the employee or audit partner performed or supervised during their engagement.

In situations where a former audit partner takes up employment with the audit client, the firm must ensure that it takes all relevant action to ensure that no significant connections remain between the firm and the individual who has joined the client. Also where an audit partner who has been the partner in charge of the audit client leaves to take up employment with that same audit client in a key management position or appointed as a director of the audit client the audit firm must resign and not be re-appointed until a two-year period has elapsed. The two-year clock starts to tick when the former partner ceased to be able to influence the conduct and outcome of the audit, or when the former partner ceases to be employed by the audit client, whichever is the sooner.

Personal relationships

It is quite clear what constitutes a personal relationship. Personal relationships can hinder objectivity and independence when a family member has a financial, business or employment relationship with the audited entity. ES 2 acknowledges that this can result in a self-interest, familiarity or intimidation threat arising.

The audit firm must have procedures in place whereby partners and audit staff must report any family, close family and other personal relationships which involve the audit client and which might give rise to a threat to the auditor's objectivity or perceived loss of independence. The audit engagement partner will then assess these threats and apply appropriate safeguards which will normally involve removing the relevant individuals from the audit assignment.

ES 3 Long association with the audit client

This is a fairly common incidence and one which has been frequently criticised by the various professional bodies. Essentially the audit firm must have procedures and policies in place which monitor the length of time that audit engagement partners and other key staff (including key partners) are involved in the audit. Where such individuals have had a long association with the audit client, the firm must assess the threats to the auditor's objectivity and independence and put safeguards in place to reduce any threats to an acceptable level. This can usually involve partner rotation. In cases where the audit firm is small and partner rotation might not be available, and there are no other safeguards which can be put in place, the audit firm must resign.

ES 4 Fees, remuneration and evaluation policies, litigation, gifts and hospitality

Fees

In terms of fees, the audit partner must ensure that audit fees are not influenced or determined by any non-audit services which the firm might provide to the client. The audit fee must be for the audit and not manipulated in order to secure other work. Fees must also never be undertaken on a contingent basis; fees must always be calculated in accordance with the time spent on the audit and the level of skills and experience of the staff required to perform the audit work effectively.

Another thing to watch out for is the level of fees from an audit client. Fees for both audit and non-audit work from unquoted companies (and subsidiary companies) which regularly exceed 15% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm where the audit engagement partner's profit share is calculated, then the audit firm must either resign or not stand for re-appointment whichever is appropriate. The 15% figure is reduced to 10% for those companies which are listed.

In terms of fees, where it is expected that fees for both audit and non-audit work from an unquoted company and its subsidiaries will regularly exceed 10% of the annual fee income of the firm, but will not regularly exceed 15% the audit engagement partner must disclose this fact to the ethics partner as well as to those charged with governance. The audit firm must then arrange for an external independent quality control review prior to the auditor's report being signed (i.e. a hot review).

In terms of listed entities, where it is expected that fees for both audit and non-audit work will regularly exceed 5% of the annual fee income of the firm (or part of the firm from which the partner's profit is calculated), but will not regularly exceed 10% then the audit engagement partner will disclose that expectation to the ethics partner and to those charged with governance of the audit client and consider the need of appropriate safeguards to eliminate or reduce the threat to the auditor's objectivity and independence to an acceptable level.

Safeguards in respect of the fees above can usually include reducing the non-audit work to be undertaken (not the audit fee, however, as this would mean fees from non-audit work has influenced the audit fee in contravention of ES 4 paragraph 7) or applying independent file reviews.

Remuneration and evaluation policies

Remuneration and evaluation policies are where the audit firm sell non-audit services to an audit client and where the audit team is judged on the amount of non-audit services it sells to clients. Paragraph 38 of ES 4 requires an audit firm to establish policies and procedures which ensure that the objectives of the team do not include selling non-audit services to the audit client. In addition, any appraisals of the audit team for purposes of promotion or deciding on levels of pay must not include success in selling non-audit services to the client. The remuneration level of a member of the audit team also cannot be based on their success in selling non-audit services to the client.

Litigation

Unfortunately sometimes clients might not pay the auditor for work performed and the auditor may decide to instigate legal proceedings to recover monies due from the audit client. This can give rise to a self-interest, advocacy and intimidation threat and where litigation is significant and in progress, or where the audit engagement partners considers such legal action to be probable, the audit firm must either not continue with, or not accept, the audit engagement.

Gifts and hospitality

On the flip side of suing clients, the relationship between the audit firm and the client might be very good and they all get on very well. Sometimes the audit client might want to offer gifts or other hospitality to the audit team. The rules are clear – those in a position to influence the conduct and outcome of an audit (including immediate family members of such people) cannot accept hospitality from the audit client, unless it is reasonable in terms of its frequency nature and cost. So a two week cruise around the Mediterranean, free of charge, would not be considered 'reasonable', but accepting a cheese salad sandwich from the finance director would not really threaten objectivity and independence.

ES 5 – Non-audit services provided to audited entities

The debate about non-audit services has raged on and on for years. It's a fact of life that many auditors (particularly smaller firms of auditors) do provide additional services beyond the scope of audit work to their client. For example, payroll and corporate tax work. Essentially in such situations the audit engagement must ensure there are sufficient safeguards in place to eliminate any threats to independence or objectivity and ensure these threats are reduced to an acceptable level. A typical safeguard could be to have the file independently reviewed before you sign the audit report (a hot review). If your firm has the staff resources available you might also have an accounts preparation team doing the routine accounting work and a separate audit team doing the audit.

In situations when the audit engagement partner concludes that there are no appropriate safeguards available to eliminate or reduce any threats to independence and objectivity to an acceptable level, the firm must either refuse the non-audit work or not accept or withdraw from the audit engagement.

Where the firm accepts both audit and non-audit work, the audit engagement partner must ensure that they document the reasons for undertaking non-audit work to an audit client as well as the safeguards they have adopted.

ES 5 provides a number of general principles which are specific to non-audit services that should be applied. These are covered in paragraphs 40 to 135 and include requirements for both listed and unlisted entities.

Conclusion

To some extent it's fairly obvious when there is a threat to independence and objectivity and it is crystal clear to all accountants that they have to act with honesty and integrity – not just in audit but throughout their careers (though clearly there are those that do not). Knowing when a threat to independence and objectivity exists and what to do about the situation(s) is vital but deliberately ignoring the ethical standards is lethal.

About the Author



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