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INDEPENDENT
AUDIT LIMITED

Auditor Independence Policy

Why Auditor Independence Matters

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Introduction

The purpose of an external audit is to enhance the confidence of users of accounts in their accuracy, the presentation of results and the financial standing of the company. The need for an audit is created, most obviously in listed and private equity-owned companies, by the separation of the management from the ownership of a company and the requirement that management have to account for their stewardship.

Auditors in the UK and most developed economies are appointed by shareholders to provide an objective independent assessment of whether financial statements are prepared in accordance with the financial reporting framework, are presented fairly or give a true and fair view of the results. However, the results of an audit are relied upon not just by shareholders, but many other stakeholders including lenders, customers, suppliers, employers and regulators.

A distinguishing mark of an auditor is their acceptance of the responsibility to act in the public interest. An auditor's responsibility is not primarily to satisfy the needs of an individual client or employer. The auditing profession worldwide has agreed that it is of paramount importance to be seen to be independent and not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

The International Dimension

Auditors have to be members of a professional accountancy body and the auditor is subject to strict ethical requirements which have now been codifed on an international basis by the International Ethics Standards Board of Accountants ("IESBA"). In the UK, the Auditing Practices Board ("APB") regulates auditors to no less a standard than required by IESBA.

The Drivers of the "Independence Problem"

The accountancy profession worldwide has been through a period of dramatic change and intense market consolidation with the Big 4 international firms dominating large audits. All the sizeable audit firms are global with large numbers of employees and offering a wide range of multi-disciplinary services.

These drivers are arguably accelerating:

- → the number of audit firms in the UK in 2010 is nearly 22% lower than in 2005
- → in the UK just six firms audit all the FTSE 350 with BDO and Grant Thornton having just 11 audits, with only one company in the FTSE 100 using them
- → the percentage of fee income earned from audits by the Big 4 audit firms has been reducing consistently over the past 5 years and is now only around 25% of their income as they have developed their non-audit services.

The independence problems, which are exacerbated by these trends, include increases in:

- the provision by audit firms of additional professional or outsourcing services to clients, some of which are long term consultancy contracts which can lock clients in to relationships
- employees or partners of the auditor who may have family relationships with employees of the client
- employees or partners of the who may have financial interests (such as shares) in a client
- the likelihood of clients employing partners of the auditor or vice versa.

Meanwhile, consolidation seems irreversible and has resulted in a drastic reduction in choice.

Best Practice Governance for Companies

Companies with a Premium (formerly called a primary) Listing on the London Stock Exchange are bound to comply with the UK Governance Code, (the "Code") published by the Financial Reporting Council ("FRC"). It does not apply to those whose main listing is on another Stock Exchange or to AIM-listed companies. However, the Code was always designed to be a best practice guide and Aim-listed or large private companies as well as other non-business organisations regularly look to the Code for guidance on best practice.

The Code requires companies to set up an audit committee. This is supplemented by Guidance on Audit Committees issued by the FRC in December 2010 (the "Guidance"). The introduction to the Guidance states that whilst it is not compulsory, it is intended to assist Boards when implementing the relevant Code provisions. In relation to independence, the Guidance suggests that audit committees should:

- assess the independence and objectivity of the external auditor annually
- seek reassurance that the audit firm and its staff have no financial, business, employment or family and other personal relationship with the company which could adversely affect the auditor's independence and objectivity
- develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor, and keep the policy under review.

Annual assessment of auditor independence and objectivity

This assessment should take into consideration "relevant UK law, regulation and professional requirements" and should "involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services) and any safeguards established by the external auditor." Audit committees are advised to consider whether, "taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit" any of those relationships appear to impair the auditor's independence and objectivity.

Relationships affecting auditor independence and objectivity

The Guidance suggests taking account of relevant Ethical Standards which we cover below. The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff. Most audit firms of any size publish their independence policies, often on their web-sites.

Policy on non-audit services

The audit committee's objective is to ensure that the provision of non-audit services does not impair the auditor's independence or objectivity. In this context, the audit committee should consider:

- whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service
- whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the auditor
- the nature of the non-audit services
- the fees incurred, or to be incurred, for non-audit services both for individual services and in aggregate, relative to the audit fee
- the criteria which govern the compensation of the individuals performing the audit.

It is now standard practice for a written policy on the provision of non-audit services to be put in place. A suggested model independence policy for a typical listed company is set out in the Appendix. This is referenced in to the requirements for both companies and auditors and explains the options where provisions are subjective.

Accountancy Bodies' Requirements for Auditors

The APB, has published ethical standards which require auditors to "conduct the audit of financial statements … with integrity, objectivity and independence ". Audit firms are required to establish policies and procedures designed to ensure that the firm and "all those who are in a position to influence the conduct and outcome of the audit" act in accordance with these principles.

The APB is clear that the procedures do not just apply to the audit team, and personnel from other disciplines who are involved in the audit, but also:

- any person who forms part of the chain of command for the audit within the audit firm
- any person within the firm who may be able to exercise influence.

Therefore the procedures must include requirements for worldwide partners and staff to report family and personal relationships and financial interests in an audit client and any decisions to join an audit client. The procedures must be backed up by regular monitoring and communication to audit engagement partners who must then evaluate the implications. Audit firms must appoint an Ethics Partner to oversee these procedures.

Audit engagement partners are required to identify and assess any circumstances which could adversely affect the auditor's objectivity , including any perceived loss of independence, and to apply procedures to eliminate or reduce that threat to an acceptable level.

The principle types of threat to an auditor's objectivity and independence are:

- self-interest: where financial or other interests make an auditor reluctant to take action
- self-review: where the auditor is auditing work done by others within their firm
- management: where management of clients take decisions based on the work done by the audit firm
- advocacy: where the audit firm supports, in an adversarial context such as litigation, a decision taken by management
- familiarity: where the auditor is predisposed to accept the client's position
- intimidation: where the auditor's conduct is influenced by threats.

The APB suggests a number of safeguards which can address these threats, including:

- partner rotation
- involvement of an additional partner
- applying independent internal quality reviews to the audit in question.

Firms which are not one global firm, but which are members of a global network, are expected to impose APB Standards where member firms are involved in an audit and equivalent standards to network firms not involved in the audit.

Additional provisions for listed companies

For listed companies, the engagement partner must provide the audit committee of the client with:

- written disclosure of relationships that bear on the auditor's objectivity and independence
- details of non-audit services and the fees charged
- written confirmation that the auditor is independent
- details of any inconsistencies between the APB Ethical Standards on non-audit services and the client's policy for the supply of non-audit services
- an opportunity to discuss auditor independence issues.

Whilst these apply to listed companies, they also represent best practice for any other company with an audit committee.

Non-audit services

The APB has published a detailed ethical standard for auditors on the provision of non-audit services which includes considerations for the multitude of services which the large accountancy firms now provide (see Further Reading). The standard provides a fairly narrow definition of audit work. The audit does not include work where the objective is not to gather evidence to support the auditor's opinion on the financial statements, or where the nature and extent of testing is not determined by the auditor in the context of expressing an opinion on the financial statements or work undertaken on different terms and conditions from that of the audit.

The engagement partner on the audit should always be consulted by other parts of their firm before they agree to an engagement for non-audit services. The engagement partner is charged with considering whether the objectives of the engagement are inconsistent with the objectives of the audit and identifying and assessing any related threats to the auditor's objectivity and the effectiveness of the available safeguards. The APB specifically guides the engagement partner to consider factors such as the size of the engagement and associated fee, the staff carrying out the service for the firms and the staff involved from the client. Where the engagement partner believes the engagement is inconsistent with the audit objectives, the firm should either not undertake the non-audit service or withdraw from the audit.

Audit firms must have in place procedures to ensure that partners or employees do not take decisions which are the responsibility of management. In practice, this makes it very difficult for employees of audit firms to be seconded to act in senior management positions at a client.

Partner rotation

The audit committee should monitor the external audit firm's compliance with APB Ethical Standards for auditors relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, or relevant part of it, and other related regulatory requirements. The overall fee income of all sizeable audit firms is published in annual surveys by a number of accountancy magazines as well as in an annual study of "Key Facts and Trends in the Accountancy Profession" by the Professional Oversight Board, part of the FRC.

APB Ethical Standard 3 sets out requirements for auditors on "Long Association with Audit Engagement" and requires auditing firms to establish policies and procedures to monitor the length of time that audit partners and staff serve as members of an audit engagement team. It broadly requires audit engagement partners of listed and other Public Interest Entities (such as sizeable banks and insurance companies) not to hold their role for a continuous period of more than 5 years, or 10 years for other companies.

A degree of flexibility over the timing of rotation of the engagement partner is possible where the audit committee decides that it is necessary to safeguard the quality of the audit. In such circumstances, the engagement partner may continue in this position for an additional period of up to two years, so that no longer than seven years in total is spent in this position. The audit committee should disclose this fact and the reasons for it to the shareholders as early as practicable.

Conclusion

Demonstrating that an auditor is independent of the company it audits is a core plank of corporate governance and is vital in achieving objectivity. It provides stakeholders with confidence in the company's financial reporting. Developing and adhering to a strong policy on auditor independence is essential.

Appendix - Specimen Policy on Auditor Independence

Notes

This policy assumes that the audit committee has terms of reference substantially similar to the model Terms of Reference published by ICSA

Introduction

In order to fulfil the Audit Committee's obligations under [insert cross-reference] its Terms of Reference, the requirements of the UK Corporate Governance Code published in May 2010 and the associated Guidance on Audit Committees published in December 2010, the Audit Committee have formally adopted a policy which addresses the independence of the external auditors ("the auditors") in the provision of both audit and non-audit services. This policy also conforms with the APB Ethical Standards for Auditors (concerning the provision of non-audit services).

This policy will be reviewed on an annual basis by the Committee

Guidance 4.29

Policy objectives

The primary objective of this policy is to ensure that the auditors are, and are seen to be, objective and independent as defined by the Auditing Practices Board ("APB") and outlines the control processes that will be put in place to ensure compliance with this policy.

Guidance 4.20
Guidance 4.27
It is helpful to agree service levels with the auditors in line with the Guidance.

Code C.3.2.

Appointment of the auditors

The Audit Committee will assess the qualification, expertise and resources of the auditors annually [based on service level criteria determined in conjunction with the auditors in advance]. Subject to satisfactory performance and the recommendation of the Audit Committee, the Board will recommend the re-appointment of the auditors to shareholders at the Annual General Meeting. If the Audit Committee does not recommend the incumbent audit firm, a tender process will be carried out by the Audit Committee and executive management to select a new firm.

Guidance 4.29

Responsibilities of the Audit Committee

The Audit Committee is responsible for the Group's policy on external audit and for monitoring auditor independence. Day-to-day responsibility for external audit is delegated to the [Group Finance Director]. The Audit Committee will assess annually, and report accordingly to the Board, whether it is satisfied that the independence of the auditors has been maintained, taking into account the auditors' statements on independence and the Committee's own enquiries.

APB ES.5 para 63

Responsibilities of the auditors

The auditors will maintain a monitoring system that provides reasonable assurance that their independence will not be impaired. The auditors will report annually to the Audit Committee on all aspects concerning independence, including possible conflicts with this policy. The audit engagement partner will ensure that the Audit Committee is appropriately informed on a timely basis of all significant facts and matters that bear upon the auditor's objectivity and independence. The auditors are jointly responsible to the Board and the Audit Committee, with the Audit Committee being the primary contact.

Definition derived from APB ES 5 para. 55.

Delete as appropriate for companies which are not regulated.

Provision of services

Services available from the auditors are classified into

- → audit services
- → audit-related services
- → tax services
- → other non-audit services and
- → prohibited services.

Audit services

This comprises all services, including tax services and accounting consultation necessary to perform an audit of the consolidated financial statements of [Company name].

In order to ensure an appropriate scope of work, the auditors will present an audit plan annually to the Audit Committee, setting out the proposed audit activity considered necessary to deliver these opinions. The fees relating to this work will also be presented and agreed by the Audit Committee at the same time. Fees will be assessed on the basis of providing fair value for the services undertaken.

The auditors will be expected to undertake their work effectively and efficiently, using an appropriate balance of junior and senior staff.

Audit-related services

This represents work, generally of an assurance nature, provided by the auditors as a result of their expert knowledge and experience of the Group. It includes:

If applicable

- → reports required by regulatory bodies required to be provided by the auditors
- → [reporting on regulatory returns]
- → [reporting to a regulator on client assets]
- → reporting on Government Grants
- → reporting on internal financial controls when required by law or regulation
- → reviews of interim financial information
- → the audit of pension and share schemes

In respect of these services, executive management has discretion to use the auditors without prior consultation with the Audit Committee. However, the nature of and fees associated with that work must be regularly reported to the Committee and, if there is any concern on the part of executive management as to a potential threat to the auditors' independence, the Chairman of the Audit Committee must be consulted at an early stage.

Tax compliance can be considered separately from tax planning or consultancy, though in practice it may be difficult to separate them. Some companies prefer to treat this as a non-audit service.

Tax services

The Auditor shall be considered the preferred service provider of Tax Compliance Services so long as:

a) services are an extension of the work performed as part of the Audit, or rely on work performed as part of the Audit such that the quality and timeliness of the services can most effectively be provided by the Auditor.

b) services are not inconsistent with the approved role of the Auditor.

Insert a reasonable level of fees.

c) any one engagement does not exceed £[x0,000] (or where the value exceeds £[0,000] prior-written approval is sought from and obtained by the Audit Committee)

APB ES.5 para 95

d) the fees are not contingent on the proposed application of tax law which is uncertain.

Taxes for the purpose of this policy comprise taxes based on income, capital gains, stamp duties or on any other basis including revenue, assets, or payroll.

Tax Compliance Services are services that are intended to ensure [Company name] complies with the existing tax regulations of a taxing jurisdiction.

Examples of Tax Compliance Services that the Auditor may provide include:

- → Domestic and international tax return assistance.
- → Due diligence tax advice related to prospective acquisitions.
- → Requests for rulings or technical advice from taxing authorities.
- → Requests for interpretation or assistance in complying with proposed or existing tax regulations.

Where a company is particularly reliant on one type of non-audit service, it may be appropriate to have different policies for:
- Litigation support
- Legal services
- Recruitment and remuneration consultancy
- Corporate finance services
- Transaction services
- Restructuring services

Financial Services companies may wish to have separate provisions on Actuarial Valuation Services referring to APB ES.5 paras 84ff

Due diligence can be considered separately from other corporate finance services such as valuation which is usually covered under non-audit services

Other non-audit services

Other non-audit services include:

- tax advice or planning
- valuations
- corporate governance reviews
- due diligence related to mergers and acquisitions;
- accounting consultations and audits in connection with acquisitions
- internal control reviews;
- consultation concerning financial accounting and reporting standards; and
- other consultancy and corporate finance services, over and above those provided in conjunction with audit and audit-related services.

The auditors must conscientiously consider, before taking on non-audit work, whether the work involves any threats to auditor independence and the appropriate safeguards to eliminate them or reduce them to clearly insignificant levels.

The fees levels payable for non-audit services, individually and in the aggregate, relative to the audit fee and whether they are contingent on any particular outcome will be a material consideration in assessing any threat to the auditors' actual and perceived independence.

Executive management are required to select the most appropriate supplier of such services, having regard to the skills and experience offered and fees charged by alternative suppliers.

Guidance 4.32

Authorization Of Audit Related, Tax And Other Non-Audit Services

The Audit Committee is responsible for approving all Audit, Audit Related, Tax Services and Other Non-Audit Services.

Required for listed companies, good practice for other companies.

Each quarter, the Company or the Lead Audit Partner will provide the Audit Committee a report of actual Audit, Audit-Related, Tax and Other Non-Audit Services provided and expected to be provided. Any changes to the estimate of services reviewed as part of the Annual Audit Plan will be discussed with the Audit Committee at that time. The size of the fee and the scope of these services will be carefully considered so as to avoid any real or perceived question as to the Auditor's independence.

Guidance 4.31
This is practical for an audit committee which meets quarterly

The Board of Directors has authorized the Audit Committee Chair to pre-approve any Audit Related, Tax Services or Other Non-Audit Services between Audit Committee meetings. Such interim preapprovals shall be reviewed with the full Audit Committee at its next meeting for its ratification.

Insert an appropriate level of fees

All assignments for Non-Audit Services involving a fee exceeding £[x0,000] must be tendered and the best supplier chosen as appropriate on each occasion. In addition, any contract for the provision of non-audit services involving a fee exceeding £[x00,000] shall be referred to the Audit Committee for prior approval.

Guidance 4.30
As an alternative to prohibiting these services, the following could be adopted: "A very strong rationale must be presented to support the selection of the Auditor, and alternative service providers should be considered."

Prohibited services

The Company will not engage the auditors for services where there is an evident threat or perceived question as to the auditor's independence or where the work is deemed to or should be carried out by other providers.

In particular, the following are specifically prohibited:

- Preparation of accounting records and financial statements that will ultimately be subject to external audit except where this falls within the normal statutory audit mandate;
- Management of, or significant involvement in, internal audit services;
- Designing internal controls
- Providing IT design, provision or implementation services
- Valuation work where the valuation would have a material effect on the Company's financial statements
- Secondment to management positions that involve any decision-making; and
- Any work where a mutuality of interest is created that could compromise the independence of the external auditor.
- Any other work which is prohibited by UK ethical guidance.

Whilst provision of internal audit services is permitted by the APB Standard where the resulting work is not relied on for the audit, it is usual to prohibit it.
APB ES.5 para 73
APB ES.5 para 77

Rotation of audit partners

The auditors are required to adhere to a partner rotation policy in accordance with the requirements of the Institute of Chartered Accountants in England and Wales and which provides an appropriate balance between consistency and independence.

Hiring policy

[Company name] will agree on an ongoing basis with the auditors which members of the audit team are categorised as the “key audit partners” and “other key team members”. Key audit partners will not be offered employment by the Company or any of its subsidiary undertakings within two years of undertaking any role on the audit. Other key team members will not be offered employment by any Group company within 6 months of undertaking any role on the audit. Other audit team members who accept employment by any Group company must cease activity on the audit immediately they tender their resignation to the audit firm.

Any offer of employment to a former employee of the audit firm, within two years of the employee leaving the audit firm, must be pre-approved by the Committee where the offer is made in respect of a senior executive position. The Committee gives its Chairman delegated authority to deal with such appointments at his discretion, between meetings. Any such interim approval should be ratified at the next meeting of the Committee.

Further Reading

Guidance on Audit Committees *The Financial Reporting Council December 2010*

http://www.frc.org.uk/images/uploaded/documents/Guidance%20on%20Audit%20Committees%202010%20final1.pdf

Reviewing Auditor Independence *The Institute of Chartered Accountants of England & Wales November 2003*

http://www.icaew.com/~/media/Files/technical/Audit-and-assurance/audit/guidance-for-audit-committees/evaluating-your-auditors/reviewing-auditor-independence.ashx

The Auditing Practices Board Ethical Standards:

ES.1 Integrity, objectivity and independence December 2011

http://www.frc.org.uk/apb/publications/pub2675.html

ES.3 Long Association with the Audit Engagement October 2009

http://www.frc.org.uk/apb/publications/pub2121.html

ES.5 Non-audit services provided to audited entities December 2011

http://www.frc.org.uk/apb/publications/pub2676.html auditreview

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