

Economic Dependence

Background

The Code (ED paragraphs 290. 213-214) provides that when the total fees from an assurance client represent a large proportion of the total fees of the firm, the dependence on that client or client group and concern about losing the client may create a self-interest threat. The Code also provides that a self-interest threat may be created when the fees generated from an assurance client represent a large proportion of the revenue from an individual partner's clients.

Comparative Positions

Appendix A to this agenda paper contains text of positions taken by others in this area.

The positions taken are consistent in that they recognize a threat is created when total fees from an audit client represent a substantial portion of the total fees of the firm. The positions differ in that some jurisdictions also recognize a threat may be created by the significance of the fees relative to the particular audit partner. Also some jurisdictions contain a specific threshold above which independence would be considered to be impaired.

The positions can be summarised as follows:

	Listed	Unlisted
SEC	Independence may be impaired if 15% of total firm revenues from one client or group of clients	n/a
AICPA	Threats and safeguards - firms should consider implementing policies and procedures to identify and monitor significant clients to help mitigate possible threats to a member's objectivity and independence	
EC Recommendation	Independence impaired if firm or network receives from one audit client and its affiliates an unduly high percentage of total revenues in each year over a five year period	
APB	<p>Independence impaired if >10% of total firm revenues from audit client and its subsidiaries audited by the firm</p> <p>Where profits not shared on a firm wide basis independence impaired if >10% of annual fee income of part of the firm by reference to which engagement partner's profit share is calculated</p> <p>If between 5% and 10% disclose to ethics partner and those charged with governance of the audit client and consider need for safeguards</p>	<p>Independence impaired if >15% of total firm revenues from audit client and its subsidiaries audited by the firm</p> <p>Where profits not shared on a firm wide basis independence impaired if >15% of annual fee income of part of the firm by reference to which engagement partner's profit share is calculated</p> <p>If between 10% and 15% disclose to ethics partner and those charged with governance and arrange for an external independent quality control review of the audit engagement to be undertaken before the audit report is finalized. (exemption for small entities)</p>
Germany	Independence impaired if >15% of total firm revenues from client and its affiliates (>20% of total shares)	Independence impaired if >30% of total firm revenues from client and its affiliates (>20% of total shares)

Discussion

The Task Force (TF) discussed the existing position to consider whether it was appropriate or should be strengthened.

The TF considered whether there is a specific threshold level of fees above which the threats would be so significant that safeguards could not reduce the threat to an acceptable level. The TF was mindful that Section 290 applies to all professional accountants performing audit and review engagements irrespective of the size of firm or the size of client. The TF was also mindful of situations where an individual might have a part-time practice with only one or two small audit clients – for example performing the audits of two charities on a part-time basis.

The TF was of the view that the existing guidance is appropriate for audit clients that are not entities of significant public interest. It requires the firm to evaluate the significance of the threat and, if the threat is not clearly insignificant, consider and apply safeguards as necessary to reduce the threat to an acceptable level.

With respect to audit clients that are entities of significant public interest, the TF is of the view that there should be a presumption that if the total fees from the client are over a set percentage of the total firm's fees independence would be deemed to be compromised. The TF considered the following matters:

- Fees received by whom? – The TF concluded that the relevant figure was the total fees received by the firm expressing the audit opinion. Before concluding this the TF considered the following alternative measures:
 - Total fees received by the network– this would result in too broad a measure – for example in the case of a Big 4 firm this would capture the fees of all of the network;
 - Total fees received by the firm and other network firms in the same country/jurisdiction as the firm – this would also, potentially, result in too broad a measure – for example, in the case of a network which operates only in one country and has few audit clients which are entities of significant public interest this would capture the fees of all of the network.
- Fees received from whom? – The TF concluded that the measure should include fees received from the audit client and its subsidiaries. The TF considered whether to include the fees from all related entities of the audit client but concluded that this would be inappropriate in that it would include fees from the parent and the fees from an entity which is under common control with the client provided the entity and the client are both material to the parent.
- Percentage threshold? – The majority of the TF concluded that a specific threshold was appropriate because the absence of a specific threshold might lead to inconsistent application. For example, if the Section stated that if the fees represented a “substantial portion”, or a similar type of description, this could lead in significant differences in interpretation. The threshold recommended by the TF is 15%. This threshold is consistent with those jurisdictions which have established a bright-line threshold.

- Prohibition or presumption of compromised independence? – The TF concluded that, because of the diverse circumstances that might be faced, it was inappropriate to establish an absolute bright-line test. Rather it was appropriate to establish a presumption independence would be impaired if the fees were over 15% unless specific safeguards were applied.
- Safeguards to be applied? – The TF concluded that two safeguards should be applied if the fees were over the 15% threshold: Firstly, an engagement quality control review should be performed by someone from outside of the firm. The engagement quality control review is completed before the audit opinion is issued and provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor’s report. Secondly, the firm should disclose to those charged with governance that the total fees from the client and its subsidiaries represented more than 15% of the total fees of the firm.
- Period of time over which fees are more than 15%? – The TF recognized that due to unusual circumstances the fees from an audit client in a particular year might be more than 15% of the total fees. The TF concluded that such a one-time situation would not result in dependence. The TF is of the view that the fees need to be over the threshold for a period of time to create the potential dependency. The TF considered whether the trigger point should be where the fees were “regularly” over 15% but were concerned that this may lead to inconsistent interpretation of “regularly”. The TF, therefore, was of the view that it was appropriate to establish a set period of time. The TF recognized that a firm may need a period of time to find a suitable individual from outside the firm to perform the engagement quality control review and that this review should occur before the audit opinion is issued. Therefore, the TF concluded that an engagement quality control review should be required if the fees exceed 15% for two consecutive years. In addition, the firm should disclose to those charged with governance that the total fees from the client and its subsidiaries represented more than 15% of the total fees of the firm.

Recommendation

The TF recommends that Section 290 should contain the following with respect to the relative size of fees:

1. Retention of the existing general guidance in ED 290.213 regarding the threat created when the total fees from an audit client represent a large proportion of the total fees of the firm expressing and audit opinion and in ED 290.214 regarding the threat created when the fees generated from an audit client represent a large proportion of the revenue from an individual partner’s clients.
2. New guidance stating that in the case of an audit client that is an entity of significant public interest when for more that two consecutive years the total fees from that client, and its subsidiaries, received by the firm expressing the audit opinion, amount to more than 15% of the total fees of the firm, the self-interest threat to independence would generally be so significant it could not be reduced to an acceptable level unless both of the following safeguards are applied:
 - An engagement quality control review performed by a professional accountant who was not a member of the firm expressing the audit opinion (the review

- would be performed before the issuance of the audit opinion in the third year);
and
- Disclosure to those charged with governance that the total fees from the client and its subsidiaries represented more than 15% of the total fees of the firm.
3. New guidance stating that if the audit client is an entity of significant public interest and it is a subsidiary of an entity that is not an entity of significant public interest, the firm should consider the significance of the self-interest threat created by total fees from the audit client, its subsidiaries and the parent. If the threat is other than clearly insignificant apply safeguards to eliminate the threat or reduce it to an acceptable level.

The TF recommends no change to the guidance in Section 291.

Action requested

Members are asked to consider the recommendations of the Task Force.

Appendix A

Comparative positions – for information

SEC/PCAOB

According to SEC guidance, in general, if a firm derives more than 15 percent of its total revenues from one client or group of related clients, independence may be impaired because this may cause the firm to be overly dependent on the client or group of related clients.

AICPA – US

The Conceptual Framework for AICPA Independence Standards states that a *financial self-interest threat* may exist due to “excessive reliance on revenue from a single attest client.” In addition, Rule 102, *Integrity and Objectivity*, and ET section 55, Article IV, *Objectivity and Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 55), discuss in broad terms that members should be alert for relationships that could diminish their objectivity and independence in performing attest services. The significance of a client to a member (or his or her firm)—measured in terms of fees, status, or other factors—may diminish a member’s ability to be objective and maintain independence when performing attest services.

EC Recommendation

1. The rendering of any (audit and non-audit) services by a Statutory Auditor, an Audit Firm or a Network to one Audit Client or its Affiliates should not be allowed to create a financial dependency on that Audit Client or client group, either in fact or in appearance.
2. A financial dependency is considered to exist when the total (audit and non-audit) fees that an Audit Firm, or a Network receives or will receive from one Audit Client and its Affiliates make up an unduly high percentage of the total revenues in each year over a five-year period.
3. The Statutory Auditor should also consider whether there are certain fee relationships with one Audit Client and its Affiliates which may appear to create a financial dependency in respect of a person who is in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2).
4. In any case, the Statutory Auditor, the Audit Firm or the Network should be able to demonstrate that no financial dependency exists in relation to a particular Audit Client or its Affiliates.

Excessive dependence on audit and non-audit fees from one Audit Client or one client group clearly gives rise to a self-interest threat to the Statutory Auditor’s independence. The Statutory Auditor or the Audit Firm has not only to avoid the existence of such a financial dependency, but also has to consider carefully whether

the appearance of such a dependency might create a significant threat to independence.

The Statutory Auditor, the Audit Firm or a Network might be perceived to be financially dependent on a single Audit Client or client group when the total audit and non-audit fee that it receives, or expects to receive, from that client or client group exceeds a critical percentage of its total income. The public perception of this critical percentage will depend upon different factors within the audit environment. For example, the level might be different depending on the size of the firm, whether it is well established or newly created, whether it operates locally, nationally or internationally, and on the general business situation in markets in which it is operating.

These circumstances have to be carefully considered by the Statutory Auditor when he assesses the significance of the self-interest threat to his appearance of independence. An analysis should be performed of all fees received for audit and non-audit services from a particular client or client group compared to the firm's or Network's total income, as well as of the relevant amounts that are expected to be received during the current firm's or Network's reporting period. If this analysis indicates a level of dependency and a need for safeguards, an Audit Partner who has not been engaged in any of the audit or non-audit work for the client should carry out a review of the significant audit and non-audit work done for the client and advise as necessary. The review should also take into consideration any audit and non-audit work that has been contracted or is the subject of an outstanding proposal. Where doubts remain, or where, because of the size of the firm, no such partner is available, the Statutory Auditor should seek the advice of his professional regulatory body or a review by another statutory auditor.

The Statutory Auditor should also consider whether there are, or appear to be, other types of fee relationships between a single Audit Client or client group and himself or the Audit Firm that may cause a self-interest threat. For example, an Audit Partner within an office or branch might be perceived to be dependent on fees from a certain Audit Client, if most of that office's services are provided to that Audit Client, or if the same individual is responsible for selling both audit and non-audit engagements to the Audit Client. To mitigate such self-interest threats, an Audit Firm may reconsider its organisational structures and the responsibilities of certain individuals, or, where applicable, discuss the way services are provided and charged with the Audit Client's Governance Body.

Independence may particularly be compromised when significant fees are generated from the provision of non-audit services to an Audit Client or its Affiliates. The Statutory Auditor should therefore assess this risk to his independence. In particular, he should consider the nature of the non-audit services provided, the different fees generated from the statutory audit engagement and the non-audit engagements, and their respective relationship to the total fees received by the Audit Firm or Network. If the analysis indicates the need for safeguards, particularly when the non-audit fees

exceed the audit fees, an Audit Partner who is not involved in any of the audit and non-audit engagements should carry out a review of the work done for the client and advise as necessary.

UK – APB

- 23 Where it is expected that the total fees for both audit and non-audit services receivable from a listed audit client and its subsidiaries audited by the audit firm¹ will regularly exceed 10% 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 by reference to which the audit engagement partner's profit share is calculated, the firm should not act as the auditors of that entity and should either resign as auditors or not stand for reappointment, as appropriate.²
- 24 Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audit client and its subsidiaries audited by the audit firm will regularly exceed 15% of the annual fee income of audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm should not act as the auditors of that entity and should either resign as auditors or not stand for reappointment, as appropriate.
- 25 Where it is expected that the total fees for both audit and non-audit services receivable from an audit client and its subsidiaries that are audited by the audit firm will regularly exceed 10% in the case of listed companies and 15% in the case of non-listed entities of the annual fee income of the part of the firm by reference to which the audit engagement partner's profit share is calculated, it may be possible to assign the audit client to another part of the firm.
- 26 Paragraph 23 and 24 are not intended to require the audit firm to resign as auditors or not stand for reappointment as a result of an individual event or engagement, the nature or size of which was unpredictable and where a reasonable and informed third party would regard ceasing to act as detrimental to the shareholders (or equivalent) of the audit client. However, in such circumstances, the audit firm discloses full details of the position to the ethics partner and to those charged with governance of the audit client and discusses with both what, if any, safeguards may be appropriate.
- 27 Where it is expected that the total fees for both audit and non-audit services receivable from a listed audit client and its subsidiaries audited by the audit firm will regularly exceed 5% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but

¹ Total fees will include those billed by others where the audit firm is entitled to the fees, but will not include fees billed by the firm where it is acting as agent for another party.

² Paragraphs 23 to 30 do not apply to the audits of those public sector bodies where the responsibility for the audit is assigned by legislation. In such cases, the auditors cannot resign from the audit engagement, irrespective of considerations of economic dependence.

will not regularly exceed 10%, the audit engagement partner should disclose that expectation to the ethics partner and to those charged with governance of the audit client and consider whether appropriate safeguards should be applied to eliminate or reduce to an acceptable level the threat to the auditors' objectivity and independence.

- 28 It is fundamental to the auditors' objectivity that they be willing and able, if necessary, to disagree with the directors and management, regardless of the consequences to their own position. Where the auditors are, to any significant extent, economically dependent on the audit client, this may inhibit their willingness or constrain their ability to express a qualified opinion on the financial statements, since this could be viewed as likely to lead to them losing the audit client.
- 29 An audit firm is deemed to be economically dependent on an audit client if the total fees for audit and all other services from that client and its subsidiaries which are audited by the audit firm represent 10% of the total fees of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated. Where such fees are between 5% and 10%, the audit engagement partner and the ethics partner consider the significance of the threat and the need for appropriate safeguards.
- 30 Such safeguards might include:
- taking steps to reduce the non-audit work to be undertaken and therefore the fees earned from the audit client;
 - applying independent internal quality control reviews.
- 31 Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audit client and its subsidiaries audited by the audit firm will regularly exceed 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 15%, the audit engagement partner should disclose that expectation to the ethics partner and to those charged with governance of the audit client and the firm should arrange an external independent quality control review of the audit engagement to be undertaken before the auditors' report is finalized.
- 32 A quality control review involves discussion with the audit engagement partner, a review of the financial statements and the auditors' report, and consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments the engagement team has made and the conclusions they have reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review includes considering the following:
- Significant risks identified during the audit and the responses to those risks;
 - Judgments made, particularly with respect to materiality and significant risks;
 - Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations;

- The significance and disposition of corrected and uncorrected misstatements identified during the audit;
- The appropriateness of the report to be issued.

Where the quality control reviewer makes recommendations that the audit engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the audit firm's procedures for dealing with differences of opinion.

33 A new audit firm seeking to establish itself may find the requirements relating to economic dependence difficult to comply with in the short term. In these circumstances, such firms would:

- (a) not undertake any audits of listed companies, where fees from such a client would represent 10% or more of the annual fee income of the firm; and
- (b) for a period not exceeding two years, require external independent quality control reviews of those audits of unlisted entities that represent more than 15% of the annual fee income before the audit opinion is issued.

The firm might also develop its practice by accepting work from non-audit clients so as to bring the fees payable by each audit client below 15%.

34 A self-interest threat may also be created where an audit partner in the engagement team:

- is employed exclusively or principally on that audit engagement;
- is remunerated on the basis of the performance of part of the firm which is substantially dependent on fees from that audit client.

35 Where the circumstances described in paragraph 34 arise, the audit firm assesses the significance of the threat and, if it is other than clearly insignificant, applies safeguards to reduce the threat to an acceptable level. Such safeguards might include:

- reducing the dependence of the office, partner or person in a position to influence the conduct and outcome of the audit by reallocating the work within the practice;
- a review by an audit partner who is not involved with the audit engagement to ensure that the auditors' objectivity and independence is not affected by the self-interest threat.

Application to small entities

5. When auditing the financial statements of a Small Entity and audit firm is not required to comply with the requirement in APB Ethical Standard 4, paragraph 31 that an external; independent quality control review is performed.

4. APB Ethical Standard 4, paragraph 31 provides that, where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audit client and its subsidiaries audited by the audit client will regularly exceed 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 15% the firm should arrange an external independent quality control review of the audit engagement to be undertaken before the auditors' report is finalised. Although an

external independent quality control review is not required, nevertheless the audit engagement partner discloses the expectation that the fees will be between 10% and 15% of the firm's annual fee income to the ethics partner and to those charged with governance of the audit client.

Germany

§ 319 (3) No. 5 HGB (German Commercial Code) for all audit clients:

"Specifically, German public auditors or German sworn auditors are excluded from auditing financial statements if they, or a person with whom they jointly practice their profession: have in each of the last five years generated more than thirty per cent of their total income from professional activities from the corporation to be audited and from companies in which the corporation holds more than twenty per cent of the shares, and where this is also expected in the current year; the Chamber of German Public Auditors may grant permission for temporary exceptions to avoid hardship."

§ 319a (1) No. 1 HGB for audits of listed companies:

"In addition to the grounds listed in section 319 (2) and (3), German public auditors may not audit the financial statements of a company that makes use of a regulated market with in the meaning of section 2 (5) of the German Securities Trading Act, if:

they have in each of the last five years generated more than fifteen per cent of their total income from professional activities from the corporation to be audited and from companies in which the corporation holds more than twenty per cent of the shares, and where this is also expected in the current year;"