STAFF PUBLICATION

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[DRAFT]

ETHICAL CONSIDERATIONS RELATING TO AUDIT FEE SETTING IN THE CONTEXT OF DOWNWARD FEE PRESSURE

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Purpose of this Publication

1. The purpose of this IESBA Staff publication is to highlight auditors' ethical obligations under the Code as one of the important considerations in relation to the setting of audit fees, specifically in the context of circumstances where there may be downward pressure on fees. This paper will be of relevance to auditors when considering tendering for a new audit engagement, or when proposing or agreeing fees for recurring audit engagements. The paper may also be of interest to those charged with governance (TCWG), preparers, regulators and audit oversight bodies, investors, and others with an interest or role in the work of auditors and the quality of such work.

2. While this paper focuses on a number of provisions in the Code that are of particular relevance to the matter of downward fee pressure, it does not address other provisions relating to fees that are contained in the Code.

Topics Discussed in this Publication

- Contextual developments giving rise to downward fee pressure
- Key ethical considerations in the Code pertinent to fee pressure or unduly low fees
- Importance of the role of other stakeholders
- National guidance
- Future IESBA actions on fee-related issues

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Introduction

3. Various factors affect audit fees, including the nature, size and complexity of the audit, the reporting requirements for the particular engagement or in the particular jurisdiction, and market competition. At the level of the audit engagement, decreases in audit fees may arise because of a reduction in the audit scope (such as through the entity's divestment of components or business lines), fewer complexities in the audit, and efficiencies in the audit methodology and audit process. However, developments in the external environment in recent years have given rise to new or intensifying challenges for auditors from competitive and business standpoints, leading to audit fee pressures.

4. Specifically, increased tendering in some segments of the audit market has led to heightened competitive pressures especially among larger audit firms, among other consequences. In particular, mandatory firm rotation for audits of listed and other designated entities is now or will soon be in effect in many jurisdictions, including several within the G-20.[2] Also, some jurisdictions[3] have implemented a mandatory tendering regime for audits of certain listed entities. While definitive fee trends have yet to be identified as a result of these developments, there have been reports of evidence of substantial reductions in audit fees as a consequence of audit tenders.[4, 5, 6] Given the global nature of many large audits, with audit fees for component auditors that may be set at the group level, some consequences on fees as a result of these developments have been felt across borders.[7] More broadly, some studies have documented evidence of decreases in audit fees in many instances when entities change auditors.[8, 9]

5. Increased competitive pressures on firms have also arisen in some jurisdictions where regulatory thresholds below which the statutory audit is not required have been rising.[10] Additionally, pressures on audit fees have come from audited entities that have themselves been under pressure to reduce costs in a challenging economic environment, particularly in the aftermath of the global financial crisis.[11]

6. Downward fee pressure created by these trends and developments raises ethical implications from the perspective of the Code. Given this context, this paper underlines the key ethical considerations that auditors of entities of all sizes should be aware of with respect to the setting of audit fees.

Key Ethical Considerations under the Code

7. The setting of audit fees is a commercial matter to be agreed between auditors and audited entities. Indeed, the Code states that when entering into negotiations regarding professional services, an auditor may quote whatever fee is deemed appropriate. It also states that the fact that one auditor may quote a fee lower than another is not in itself unethical.[12] However, the Code does caution that there may be threats to compliance with the fundamental principles arising from the level of fees quoted.[13]

Compliance with the Fundamental Principles

8. The overriding obligation for all auditors under the Code is to comply with the fundamental principles.[14] Of particular importance when auditors face fee pressure or when determining fees to propose or agree for new audit engagements is adherence to the fundamental principles of professional competence and due care, objectivity, integrity, and professional behavior.

Professional Competence and Due Care

9. The Code notes that a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.[15]

10. Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service.[16] Diligence with respect to due care encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis, and in accordance with applicable technical and professional standards.[17] The Code specifically calls for firms to take reasonable steps to ensure that those selected to be part of the engagement team have appropriate training and supervision.[18]

Key Messages

- The public expects a high quality audit regardless of the level of the fee for the particular audit engagement.
- Unduly or unrealistically low audit fees may create threats to compliance with the fundamental principles.
- Efforts to address fee pressure, including through efficiency initiatives, should not be at the expense of maintaining, or taking action to maintain, compliance with the fundamental principles.
- TCWG, management, regulators and audit oversight bodies, and investors in particular have an important role to play in ensuring that financial considerations relating to audit fees do not compromise independence and audit quality. In particular, two-way communication between TCWG and auditors concerning the resources and time needed for the audit engagement may be especially relevant when negotiating audit fees.

11. In times of economic difficulty, auditors may encounter more challenging audit areas that require the exercise of greater professional judgment and skepticism, for example, in assessing whether an entity is able to continue as a going concern, in evaluating asset impairments, and in estimating fair values for illiquid assets. Changes in an entity's business and in financial reporting requirements may also give rise to more complex judgments and the need for additional work effort. Circumstances such as these increase the time and level of experience needed on audit engagements. In these circumstances, the diligence called for under the Code means that regardless of the audit fee, (a) sufficient time must be planned for the audit; and (b) audit personnel of sufficient experience must be deployed to address complex audit areas or areas where significant risks of material misstatement of the financial statements have been identified.

12. The principle of professional competence and due care also imposes an obligation on all professional accountants to maintain professional knowledge and skill at the level required to ensure that audited entities receive competent professional service.[19] The Code explains that the maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. It also explains that continuing professional development enables a professional accountant to develop and maintain the capabilities to perform competently within the professional environment.[20] In an environment of heightened pressures on audit fees and continually evolving business practices and technical and professional standards, an

ongoing focus on, and investment in, continuing professional development by auditors is therefore particularly important to enable them to maintain or enhance their ability to deliver high quality audits.

13. In an environment of continuing fee pressure, auditors may also have taken, or may be exploring, a variety of initiatives to achieve greater efficiencies in the audit process, among other objectives. These initiatives may include "offshoring" certain aspects of the audit to lower-cost locations to reduce costs, and pursuing innovations in audit methodologies such as by integrating additional CAATs ("Computer Assisted Auditing Techniques") and data mining and analytic tools into the audit process. Regardless of the efficiency measures auditors have implemented or may be exploring to address fee pressures, the overriding obligation under the Code is to comply with all the fundamental principles. For example, where auditors have set up, or are contemplating setting up, offshoring arrangements for their audits, the expectation under the Code is that all individuals in the offshore centers have the necessary competence to perform the audit procedures assigned to them, and that their work is appropriately reviewed and meets all the requirements of applicable technical and professional standards.

Objectivity

14. The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.[21]

15. In times of economic difficulty, entities may be under significant pressure to reduce costs. The Code notes that an intimidation threat may be created when an auditor is pressured to inappropriately reduce the extent of work performed in order to reduce fees.[22] Such a circumstance may threaten the auditor's compliance with the fundamental principle of objectivity, as well as the fundamental principles of integrity, professional competence and due care, and professional behavior.

Integrity and Professional Behavior

16. The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships.[23] The principle of professional behavior imposes an obligation on them to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession.[24] The Code in particular requires that in marketing and promoting themselves and their work, professional accountants be honest and truthful.[25]

17. Threats to compliance with the fundamental principles of integrity and professional behavior may be created in an environment of intense competitive pressures. These circumstances may include a temptation to bid an unrealistically low fee in an attempt to win a new client, or a temptation to approach an entity audited by another auditor with an offer of lower fees.

Independence

18. The Code requires all members of audit teams, firms and network firms to be independent of the audited entities.[26] The Code's definition of "audit team" includes all partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform assurance procedures on the engagement (excluding external experts engaged by the firm or by a network firm).[27] In responding to fee pressures, auditors may implement alternative audit processes or, as

noted above, undertake initiatives such as offshoring to meet their obligations while controlling costs. Regardless of how these processes or initiatives are established or arranged, all network firms and individuals participating in the audit need to comply with all the independence requirements applicable to the engagement.

19. Importantly, being independent under the Code means acting with integrity and exercising objectivity and professional skepticism.[28] An adequate audit budget helps support a positive environment that enables engagement team members to act with integrity and exercise objectivity and appropriate professional skepticism, and therefore support their ability to be independent.

20. Being independent under the Code also comprises being independent in appearance, i.e., whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the auditor's integrity, objectivity or professional skepticism has been compromised.[29] Undue fee pressure situations can adversely impact the public's perception of the auditor's independence if such situations result in fee levels that are so low that they create doubt as to whether the auditor can act with integrity and exercise objectivity and professional skepticism.

21. Additionally, the Code prohibits auditors from entering into contingent fee arrangements with respect to audit engagements. It notes that a contingent fee, whether charged directly or indirectly, creates a self-interest threat that is so significant that no safeguards could reduce the threat to an acceptable level. An awareness of the Code's requirement regarding contingent fees is important when auditors facing undue fee pressures to ensure that they do not enter into any such arrangement with the audited entity in an attempt to lower audit fees.

Engagement Acceptance and Continuance

22. The Code requires that before accepting a new client relationship or a specific audit engagement, auditors determine whether acceptance would create any threats to compliance with the fundamental principles.[30] It notes in particular that a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.[31]

23. The exercise of appropriate diligence is therefore important when assessing the nature and extent of resources needed, and therefore what an appropriate fee level might be, for purposes of tendering for a new audit engagement or continuing an existing engagement. The Code specifies a number of relevant considerations in this respect, including:[32]

- Obtaining knowledge and understanding of the entity, its owners, managers and those responsible for its governance and business activities;
- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work to be performed;
- Agreeing on a realistic time frame for the performance of the engagement; and
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted only when they can be performed competently.

24. When the threats to compliance with the fundamental principles cannot be eliminated or reduced to an acceptable level, the application of the conceptual framework under the Code requires auditors to decline the particular client relationship or engagement.[33]

Engagement-Specific Safeguards and the Overall Work Environment

25. In fee pressure circumstances, certain engagement-specific safeguards noted in the Code may also be relevant and may be applied by auditors to address threats to compliance with the fundamental principles created by such circumstances. These safeguards include:

    - Discussing ethical issues with TCWG.
    - Disclosing to TCWG the nature of services provided and extent of fees charged.
    - Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.[34]

26. More broadly, the overall work environment within a firm may assist in mitigating the level of threat to compliance with the fundamental principles in fee pressure circumstances. The Code lists various aspects of the work environment that may assist in this regard, including:

    - Leadership of the firm that stresses the importance of compliance with the fundamental principles and that establishes the expectation that engagement team members will act in the public interest.
    - Documented internal policies and procedures requiring compliance with the fundamental principles.
    - A disciplinary mechanism to promote compliance with policies and procedures.[35]

Communication with TCWG

27. The Code encourages regular communication between auditors and TCWG regarding relationships and other matters that might, in the auditors' opinion, reasonably bear on independence. It notes that this can be particularly helpful with respect to intimidation threats (as may be created, for instance, from management pressure to reduce audit costs).

28. In the context of undue fee pressures, one of the matters that might reasonably bear on independence and which auditors may discuss with TCWG is the adequacy of the audit fees relative to the nature, size and complexity of the particular audit engagements. Auditors may also consider it appropriate to discuss with TCWG the risks that may arise from unduly or unrealistically low fees of breaching the independence and other ethical requirements of the Code. The Code contains a number of requirements for communication with TCWG in circumstances where such a breach does arise.[36]

29. The Code also explains that communication with TCWG enables them to:

    (a) Consider the auditor's judgments in identifying and evaluating threats to independence;

    (b) Consider the appropriateness of safeguards applied to eliminate them or reduce them to an acceptable level; and

    (c) Take appropriate action.[37]

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Importance of the Role of Other Stakeholders

30. Downward fee pressure arising from the external developments noted in the introduction has led to heightened attention and concern among the regulatory,[38, 39] corporate governance[40], [41] and other stakeholder communities regarding the potential adverse implications for audit quality. In this regard, the Audit Quality Framework issued by the International Auditing and Assurance Standards Board (IAASB) notes that there is usually a relationship between the quality of an audit and the quality and quantity of the resources used in its performance (as usually reflected in the audit fee).[42] While auditors have a primary responsibility for the quality of the audits they perform, other stakeholders have an equally important role to play in ensuring that financial considerations in relation to audit fees do not drive actions and decisions that impair audit quality.

31. In particular, it is important that TCWG give sufficient attention to whether adequate audit time and resources are planned for the engagement when audit fees are being negotiated, and that they engage in dialogue with auditors and management in this regard. Management is often highly influential in determining audit fees. While it may rightfully insist on an efficient audit process, it is important that it does not put cost minimization ahead of the performance of a quality audit. Regulators and audit oversight bodies have a role to play in ensuring that financial considerations within firms do not compromise audit quality. And investors have a role to play in demanding quality audits for a reasonable price.

32. The IAASB's Audit Quality Framework further discusses the role of these and other stakeholders in contributing to an environment that positively supports audit quality.

National Guidance

33. In some jurisdictions, national guidance on the topic of fee pressure and related ethical and audit quality considerations may be available. Auditors may find it helpful to refer to such guidance where available, in addition to this staff publication, when considering tendering for new audit engagements, when proposing or agreeing fees for recurring audit engagements, and when planning and performing the audit.

Future IESBA Actions on Fee-Related Issues

34. Pursuant to a commitment in its Strategy and Work Plan 2014-2018 and in response to a call from the Public Interest Oversight Board (PIOB), the IESBA has established a working group to initiate fact finding on fee-related issues in various jurisdictions. Subject to the findings from this initiative, the IESBA may determine the scope and focus of a future project on this topic. Further information as this initiative progresses may be found on the IESBA meetings page.

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About the IESBA

The International Ethics Standards Board for Accountants (IESBA) is an independent standard-setting board that develops and issues high-quality ethics standards and other pronouncements for professional accountants worldwide. Through its activities, the IESBA develops the *Code of Ethics for Professional Accountants*, which establishes ethical requirements for professional accountants.

The objective of the IESBA is to serve the public interest by setting high-quality ethics standards for professional accountants and by facilitating the convergence of international and national ethics standards, including auditor independence requirements, through the development of a robust, internationally appropriate code of ethics.

The structures and processes that support the operations of the IESBA are facilitated by the International Federation of Accountants (IFAC).

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[1] References to the Code in this publication are to the Code extant as of the date of this publication unless otherwise stated. The Code can be accessed at: http://www.ethicsboard.org/iesba-code.

[2] For example, the EU, Argentina, Brazil, China, India, Indonesia, Italy, Saudi Arabia and Turkey

[3] For example, the UK

[4] Financial Director, "Wheel of Fortune: The Audit Fees Survey 2014," February 26, 2014

[5] December 8, 2014 edition of Accounting Today, citing U.S. Public Company Accounting Oversight Board (PCAOB) member and then IFIAR Chairman Lewis Ferguson speaking at the November 2014 Financial Executives International's Current Financial Reporting Issues Conference in New York

[6] European and North American Audit Committee Leadership Networks, "Viewpoints for the Audit Committee Leadership Summit," Issue 27, July 30, 2014

[7] International Accounting Bulletin, "Fee Pressure Still a Top Challenge in South Africa," November 25, 2014

[8] Background paper "Current Trends in the Audit Industry" prepared by the IFIAR Investor and Other Stakeholders Working Group and the Global Public Policy Committee Working Group for the IFIAR panel session, Taipei, April 2015 (citing research from Russell Investments and Audit Analytics: "From 2006 to 2010, 418 companies in the Russell 3000 Index changed auditors, 62% reported a decrease in audit fees. The 418 companies that changed auditors reported a median reduction in audit fees of 11.5% for the first year of the new engagement.")

[9] The Accounting Review, "Fee Discounting and Audit Quality Following Audit Firm and Audit Partner Changes: Chinese Evidence," Hua-Wei Huang, K. Raghunandan, Ting-Chiao Huang and Jeng-Ren Chiou, July 2015 ("Using 9,684 observations from China during the years 2002–2011, we find that there is a significant initial year audit fee discount following an audit firm change when both of the signing audit partners are different from the prior year.")

[10] For example, as part of recent changes to the EU's Accounting Directive, EU member states have the option to significantly increase the size of businesses that will no longer require audited financial statements.

[11] See, for example, International Accounting Bulletin, "Fee Pressure Still a Top Challenge in South Africa" (November 25, 2014); and Australian Securities & Investments Commission (ASIC) Information Sheet, "Audit quality – The Role of Directors and Audit Committees."

[12] IESBA Code, paragraph 240.1

[13] IESBA Code, paragraph 240.1

[14] Integrity, objectivity, professional competence and due care, confidentiality, and professional behavior (IESBA Code, paragraph 100.5)

[15] IESBA Code, paragraph 240.1

[16] IESBA Code, paragraph 130.2

[17] IESBA Code, paragraphs 130.1(b) and 130.4

[18] IESBA Code, paragraph 130.5

[19] IESBA Code, paragraph 130.1(a)

[20] IESBA Code, paragraph 130.3

[21] IESBA Code, paragraph 120.1

[22] IESBA Code, paragraph 200.8

[23] IESBA Code, paragraph 110.1

[24] IESBA Code, paragraph 150.1

[25] IESBA Code, paragraph 150.2

[26] IESBA Code, paragraph 290.4

[27] Glossary of the IESBA Code

[28] IESBA Code, paragraph 290.6(a)

[29] IESBA Code, paragraph 290.6(b)

[30] IESBA Code, paragraphs 210.1 and 210.6

[31] IESBA Code, paragraph 210.6

[32] IESBA Code, paragraphs 210.3 and 210.7

[33] IESBA Code, paragraph 100.9

[34] IESBA Code, paragraph 200.13

[35] IESBA Code, paragraph 200.12

[36] IESBA Code, paragraph 290.46-47

[37] IESBA Code, paragraph 290.28

[38] See, for example, the comment letter from the International Organization of Securities Commissions (IOSCO) in response to the IESBA's consultation paper on its strategy and work plan, 2014-2018 (page 9, noting in particular a concern that the use of low fees by audit firms when competing for an audit engagement can have a negative impact on audit quality if that fee level translates into inadequate audit work).

[39] CFO Magazine, "Declining Audit Fees Raise Risk of Restatements," March 3, 2014 (citing Paul Beswick, Chief Accountant at the U.S. Securities and Exchange Commission, at a Practising Law Insitute conference in February 2014: "… pressure on auditors to reduce fees could lead to subpar audit quality. Fees can put pressure on the nature of the services.")

[40] European and North American Audit Committee Leadership Networks, "Viewpoints for the Audit Committee Leadership Summit," Issue 27, July 30, 2014

[41] European Audit Committee Leadership Network, "Viewpoints: Audit Firm Tendering and Rotation," Issue 37, January 10, 2014

[42] Audit Quality Framework, paragraph 110

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