

Partner Remuneration

Background

At the June 2005 meeting the IESBA considered guidance drafted by the Task Force with respect to threats to independence that may be created by partner remuneration schemes. The following points were noted:

- The restriction should relate to engagement clients on financial statement audit clients; and
- If the threat is other than clearly insignificant, safeguards should be applied – the Task Force should consider what safeguards would be effective in such cases.

Three jurisdictions address this matter (APB, SEC and Canada), it is not addressed at the EU level.

The matter was also discussed with the IESBA CAG and the following comments were made:

- It is difficult to argue that compensation for selling non-audit services does not impair independence in all circumstances;
- What safeguards can be put in place to reduce or eliminate a threat created by the selling of non-audit services?
- It would be useful if the Code could describe the nature of the threat created;
- It was important that a compensation system fosters and compensates for audit quality.

Discussion

Nature of threat created

The Task Force has discussed the nature of the threat created by remunerating for the selling of non-audit services. The Task Force noted the following:

- Any threat created would likely be a self-interest threat - the APB notes that policies and procedures with respect to remuneration are necessary “to rebut any suggestion that an audit that it has undertaken and the opinion that it has given are influenced by the nature and extent of any non-audit services that it has provided to that audit client.”
- The materiality of the amount of such an element of remuneration would influence the significance of any threat created. For example, if the remuneration represented a fraction of a percentage of the total remuneration of the individual it is difficult to see how it would create a threat to independence that was other than clearly insignificant.
- The discussion at the CAG indicates that some view remuneration for selling of non-audit services as creating threats in all circumstances – a question was raised was whether this in effect represented an absolute threat.
- The Task Force noted that an alternate argument could be made that prohibiting such remuneration could create a threat because the individuals were then 100% dependent on remuneration as the result of the audit services.

On balance the Task Force is of the view that the Code should address partner compensation and should describe the nature of the potential threat in terms of a self-interest threat.

Action requested

Members are asked to consider whether they agree with the recommendation of the Task Force.

Matters that create a threat

The Task Force has discussed what matters might create threats to independence with respect to remuneration systems. The Task Force has noted all of the following could be viewed as creating threats to independence:

- Remunerating for selling of non-audit services to audit clients of the individual (or non-assurance services to assurance clients see discussion below);
- Remunerating for achieving specific targets for an audit engagement (or assurance engagement);
- Remunerating for client retention;
- Establishing objectives for individuals with respect to selling of non-audit services or client retention;
- Promotion decisions which take into account the selling of non-audit services or client retention.

Action requested

Members are asked to consider the above factors and provide guidance to the Task Force as to whether the Code should include these, and any other factors, as matters that create threats to independence.

General discussion or specific restriction

The Task Force is of the view that there are several ways to address the threat.

Option 1 is to address the threat through a generic discussion that the remuneration structure of a firm, depending upon its design, may create threats to independence – for example, if a significant portion of remuneration is based on the selling of non-audit services to an audit client. Accordingly, when designing a remuneration system a firm should assess the significance of any threat created and ensure that, if there are threats that are other than clearly insignificant, safeguards can be applied to eliminate or reduce the threats to an acceptable level. If such safeguards are not available the remuneration system should be changed.

Option 2 is to provide a description of the threat but then to apply specific restrictions on certain types of remuneration to certain individuals.

Option 3 would be a combination of the first two options. In addition to the requirements to ensuring that the remuneration system does not create threats that cannot be addressed by safeguards, specific restrictions on remuneration in certain circumstances.

Action requested

Members are asked to consider the three alternatives presented and provide guidance to the Task Force.

The response to the above question will determine the relevance of some of the following questions.

Individuals to be addressed

The APB requirements apply to the audit team (which is equivalent to the Code definition of engagement team – i.e. it does not as broad as the assurance team and does not include those within the firm who can directly influence the outcomes of the assurance engagement). The SEC and Canadian requirements address audit partners (which include the engagement partner, the engagement quality control reviewer, other partners who provide more than 10 hours audit services and engagement partners of significant subsidiaries).

The Task Force has discussed whether, if there is a specific restriction, it should apply only to the engagement partner or whether the restriction should be broader and address for example the engagement quality control reviewer, or other partners or should even be extended to the whole engagement team.

The Task Force notes that the engagement partner who is the key decision maker and is responsible for the engagement and the report. Accordingly it might be appropriate for a restriction to be applied to the engagement partner and other individuals would be addressed on a threats and safeguards basis.

Action requested

Members are asked to consider the individuals to which restriction should be applied and provide guidance to the Task Force.

Type of entity

The SEC and Canada address only listed entities, and both provide an exemption from the requirements for small firms that audit few listed entities. The APB requirements apply to all audit clients.

Action requested

Members are asked to consider the guidance should apply to all audit clients, only audit clients that are listed entities or all assurances clients

Nature of safeguards

The Task Force has considered what safeguards could address a threat to independence that was other than clearly insignificant. The following safeguards have been identified:

- Involving an additional professional accountant who did not take part in the audit/assurance engagement to provide advice or review the work performed;
- External quality control reviews.

It was also noted that if safeguards were not available to eliminate a threat to reduce it to an acceptable level the remuneration structure would need to be changed.

Action requested

Members are asked to consider the safeguards and provide guidance to the Task Force.

Appendix

SEC requirement

Rule

(8) Compensation. An accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review or attest services. Any accounting firm with fewer than ten partners and fewer than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f))) shall be exempt from the requirement stated in the previous sentence.

Background

e. Compensation. The final rules provide that an accountant is deemed to be not independent with respect to an audit client if any "audit partner" earns or receives compensation in consideration of directly selling engagements to provide any services to that client other than audit, review or attest services. The final rules differ from the proposed rules in three notable respects. First, the proposed rules also would have provided that any accountant is not independent with respect to an audit client if an audit partner earns or receives compensation based on the selling or performance of engagements with an audit client to provide any products or services other than audit, review or attest services. The final rule applies only to compensation based on the direct selling of engagements in the independence determination. Second, several commenters noted that, as proposed, the rules would have precluded a "specialty" partner from receiving compensation when he or she sold services in his or her specialty area. The final rules address this concern because they apply to "audit partners" rather than all partners who are members of the audit engagement team. Third, several commenters indicated the compensation rules might be particularly difficult for smaller accounting firms. To address this concern, the final rules include an exemption for accounting firms with fewer than five audit clients and fewer than ten partners.

Despite these revisions, the provision might affect the compensation plans of those firms that currently reward audit partners of the firm for selling non-audit services to their audit clients. The final rules may result in those revenues being allocated to other persons within the accounting firm. Absent this incentive, auditors may be less inclined to inform issuers of ways to improve their performance or condition through non-audit services. We do not expect, however, that there would be any incremental costs to the firm or to the client.

Canada

194 Rule 204.4(35) provides that a member who is an audit partner of a firm with five or more audit clients that are reporting issuers or ten or more partners, may not earn or receive compensation based on the partner procuring engagements from a reporting issuer audit client of the partner to provide any product or service other than an assurance

service. Rule 204.4(35) does not apply to partners who are not “audit partners” as defined.

195 The prohibition from compensating an audit partner for procuring or selling non-assurance services is not extended to compensation for performing such services and does not preclude an audit partner from sharing in the profits of the audit practice and the profits of the firm. An audit partner’s evaluation may take into account a number of factors directly or indirectly related to selling services to an audit client that is a reporting issuer. For example, an audit partner may be evaluated on the complexity of his or her engagements, the overall management of the relationship with the client including the provision of non-audit services, and the attainment of specific sales goals.

APB – UK

Ethical Standard 4

36 The audit firm should establish policies and procedures to ensure that, in relation to each audit client:

- (a) the objectives of the members of the audit team do not include selling non-audit services to the audit client;
- (b) the criteria for evaluating the performance of members of the audit team do not include success in selling non-audit services to the audit client; and
- (c) no specific element of the remuneration of a member of the audit team and no decision concerning promotion within the audit team is based on his or her success in selling non-audit services to the audit client.

37 Where auditors identify areas for possible improvement in a client they may provide general business advice, which might include suggested solutions to problems. Before discussing any non-audit service that might be provided by the audit firm or effecting any introductions to colleagues from outside the audit team, the audit engagement partner considers the threats that such services would have on the audit engagement, in line with the requirements of APB Ethical Standard 5.

38. The policies and procedures required for compliance with paragraph 36 are not intended to inhibit profit-sharing arrangements. However, such policies and procedures are central to an audit firm’s ability to demonstrate its objectivity and independence and to rebut any suggestion that an audit that it has undertaken and the opinion that it has given are influenced by the nature and extent of any non-audit services that it has provided to that audit client. Because it is possible that, despite such policies and procedures, such factors may be taken into account in the evaluation and remuneration of members of the audit team, the ethics partner pays particular attention to the actual implementation of those policies and procedures and makes himself or herself available for consultation when needed.

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9. The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.
36. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.
40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance and commitment to ethical principles. ...