

Transaction Related Services

Background

In the course of reviewing the examples of non-assurance services set out in paragraphs 290.166 through 290.205, the task force has considered whether it is appropriate to include an additional example dealing with Transaction Related Services.

There is a very significant range of services that an accounting firm might provide in connection with a corporate transaction as an investigating or reporting accountant. There is no generally accepted generic description for such services and it is not clear that a term such as “transaction related services” would necessarily be interpreted to apply to the same services in all countries.

Typically the core component of such services is investigation related work into possible acquisitions or disposals (ie “due diligence investigations”). The services might also include advice and assistance to management in connection with corporate transactions which might not involve the preparation of a due diligence report, for example assistance in preparing a business for sale. Additionally, transaction related services might be considered to include:

- Work in connection with investment circulars, for example private comfort letters in connection with disclosures made in the investment circulars or reports required for publication in the investment circular, for example as required by the EU Prospectus Directive.
- A wide range of work required by statute or regulation in connection with share transactions, eg contribution in kind reports, fairness opinions, financial assistance reports, purchase of own shares reports etc (some of which might also be considered examples of valuation services and which are therefore separately covered in the Code).

Some of the larger audit firms have in recent years been branding some or all of these services with a term such as Transaction Services, but it is unclear that investment circular work would be classified for this purpose as Transaction Services rather than as an audit service.

Transaction related services are clearly distinguishable from Corporate Finance services where the accountant acts as adviser in connection with the management of a corporate finance transaction. Corporate Finance services might attract an advocacy threat as well as the possibility that the auditor will be undertaking a management function, for example if it should commit the client to a particular transaction. These threats do not arise in transaction related work where the auditor is acting as an investigating or reporting accountant, required to act with demonstrable objectivity.

The SEC refers to certain types of transaction work performed by an independent accountant in its discussion of fee disclosures. In the codification to the 2003 rulemaking it clarifies that certain transaction related work is to be disclosed as “Audit Fees”: *“In addition to including fees for services necessary to perform an audit or review in accordance with GAAS, this category also may include services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission.”* Further, in the category “Audit-Related Fees” they include *“assurance and related services (eg due diligence services) that traditionally are performed by the independent accountant. More specifically, these services would include, among others: employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation and consultation concerning financial accounting and reporting standards”*.

Based on the analysis prepared for the Independence Task Force it seems that only the APB in the UK has sought to address transaction related services as a separate category of non-audit service. This may be because in the UK in particular, not only are due diligence services very well established, but it is also traditional for the accountant (quite typically the audit firm) to perform a significant amount of work in connection with capital markets transactions, including the provision of a range of comfort letters (some of which comprise assurance reports), public reports and typically the provision of a due diligence report for new Stock Exchange applicants. The APB provision for Transaction Related Services is reproduced in the Appendix.

Analysis of threats

Given that transaction related work is such a significant part of the total non-audit work performed by accountants, it can only be assumed that the standards setters who are silent on these services do not regard there to be any particular threats to independence arising from the performance of this work. This is also indicated by the SEC’s guidance on the classification of services for fee disclosure purposes. The APB rules prohibit the auditor providing transaction related (and indeed tax and corporate finance services) in certain narrowly defined circumstances. These circumstances which would in fact not be commonly encountered in any service are (a) a situation where the audit partner has, or ought to have, reasonable doubt as to the appropriateness of an accounting treatment that is related to the advice provided (something which would seem to be a problem for any service to any client, not specifically for a transaction related service to an audit client) and (b) a situation where the services are to be provided on a contingent fee which is material to the firm or segment of the firm or where the services are dependent on a judgment relating to a material balance in the financial statements. It is likely that these have been included for completeness and by analogy in particular with the APB’s guidance on corporate finance services, given, in particular, the significance of transaction related services in the UK. It would be inconsistent with the current organization of the IFAC Code for there to be a separate section dealing with the

implications of contingent fees for a particular service. Accordingly, the task force does not recommend that IFAC introduce similar prohibitions.

In relation to transaction related services the nature of the work and the skills involved are similar to that of an audit and there are often synergies with the external audit itself. However, although transaction services related work will not generally give rise to threats to independence, it is recognized that, as with most non-audit services, some threats may arise. For example, a self-review threat may arise where the outcome or consequences of a due diligence investigation may affect a subsequent audit. In such a case, there may be an argument that the auditor would be reluctant to expose an accounting issue as part of a subsequent audit that was not identified during a prior due diligence engagement. However, this threat is not unique to transaction related work and is arguably less significant than the threat to the auditor in reviewing the audit judgments made in the prior year with respect to the preceding financial statements which form the opening balances for the current year's financial statements. In particular, in relation to a due diligence investigation, any self-review threat is typically mitigated by the following:

- due diligence work does not generally involve giving any form of assurance on any of the matters within the scope, for example no assurance is given with relation to the carrying value of assets covered by the due diligence work;
- generally the auditor is reporting on financial statements prepared at a later date than the due diligence work. In the intervening period, management has typically been involved in analyzing the financial statements of the new acquisition, restating them onto its own GAAP, considering the nature of fair value adjustments required in the group accounts etc. It is likely that significant shortcomings in the due diligence work would be identified during this exercise performed by management.

Further, it is likely that any residual threat can be addressed by appropriate safeguards. Examples of such safeguards include:

- the services being provided by personnel who are independent of the audit team;
- any advice provided being led or reviewed by an independent partner within the audit firm.

These safeguards are already provided for within the discussion of mitigating a self-review threat for non-audit services in general and it is questionable whether a separate section is required for transaction related services in order to address this.

The existing Corporate Finance section in the IFAC Code is headed “Corporate Finance and Similar Activities” and it is perhaps unclear what kind of services might be considered to fall within the category of “similar activities”. The existing guidance refers not only to the possibility of advocacy threats but also refers to self-review threats (something perhaps not typically associated with “pure” corporate finance services). In passing the guidance also refers to “assisting a client in analyzing the accounting effects of proposed transactions”, something that is probably closer to an accounting-based

transaction related service than to a corporate finance activity. Whilst it may be possible to extend this guidance to include due diligence and other transaction related services, the disadvantage in this approach is that it might blur the very real distinction between deal management advisory services and transaction related services where the auditor acts as investigating or reporting accountant.

Recommendation to the IESBA

The options available with regards to the Code appear to be as follows:

- make no changes to the Code other than possibly to clarify the meaning of the existing section on Corporate Finance and Similar Activities;
- extend the drafting of the existing Corporate Finance and Similar Activities example within the Code to discuss transaction related services more generally;
- develop a stand-alone example within the Code for Transaction Related Services to sit alongside Corporate Finance work.

Given that no regulator other than the APB has attempted to provide separate guidance for transaction related services and given the position taken by the SEC, it is highly debatable whether IFAC should attempt to draft a separate section dealing with such work in the context of examples which cover non-assurance services and their impact on the auditor's independence. In particular certain transaction related work is likely to be assurance based work (as the SEC fee guidance recognizes) and it is generally the case that all such work is carried out by an accountant who is required to act with demonstrable objectivity. Accordingly, much if not all transaction related work is clearly different from the other categories of non-audit services covered in the examples within the Code.

Further, in the absence of a generally accepted definition of "transaction related services" or similar, it would appear inadvisable to develop a stand-alone example for this work because it may well be read or be applied differently in different countries.

There are also clear disadvantages of including corporate finance services within the same category as transaction related services, in particular because an advocacy threat does not arise in the case of transaction related services. It would seem preferable to clarify what types of "similar activities" might be intended to be covered in this example, or otherwise amend the title of the example to refer only to Corporate Finance work.

The task force recommends that the Code should not be extended to cover transaction related services, but that consideration be given to the need to clarify the application of the Corporate Finance example so that it is clearly distinguished from transaction related services carried out as investigating or reporting accountant.

Illustrative amendments to the Corporate Finance example to achieve this are set out overleaf:

Action requested

Members are asked to consider the recommendation of the Task Force and the illustrative wording.

Illustrative wording

| Corporate Finance Services ~~and Similar Activities~~

| 290.204 The provision of corporate finance services, ~~advice or assistance~~ to an assurance client may create advocacy and self-review threats. In the case of certain corporate finance services, the independence threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an assurance client's shares is not compatible with providing assurance services. Moreover, committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level. In the case of a financial statement audit client the provision of those corporate finance services referred to above by a firm or a network firm would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level.

290.205 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate synergies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice in connection with ~~and assisting a client in analyzing the accounting effects of proposed~~ transactions. Safeguards that should be considered include:

- Policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to provide the services; and
- Ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

Appendix

Extract from APB Ethical Standard 5

TRANSACTION RELATED SERVICES

- 106 In addition to corporate finance services, there are other non-audit services associated with transactions that an audit firm may undertake for an audit client. For example:
- investigations into possible acquisitions or disposals ('due diligence' investigations); or
 - investigations into the tax affairs of possible acquisitions or disposals; or
 - the provision of information to sponsors in relation to prospectuses and other investment circulars (for example, long form reports, comfort letters on the adequacy of working capital).
- 107 When providing transaction related services to an audit client, unless the firm is working with 'informed management'³ and appropriate safeguards are applied, there is a risk that the audit firm undertakes a management role.
- 108 Examples of safeguards that may be appropriate when transaction related services are provided to an audit client include ensuring that:
- the transaction related advice is provided by partners and staff who have no involvement in the audit of the financial statements,
 - any advice provided is reviewed by an independent transactions partner within the audit firm,
 - external independent advice on the transaction related work is obtained,
 - an audit partner who is not involved in the audit engagement reviews the audit work performed in relation to the subject matter of the transaction related service provided to ensure that such audit work has been properly and effectively reviewed and assessed in the context of the audit of the financial statements.
- 109 **The audit firm should not undertake an engagement to provide transaction related services to an audit client where:**
- (a) **the audit engagement partner has, or ought to have, reasonable doubt as to the appropriateness of an accounting treatment that is related to the advice provided, having regard to the requirement for the financial statements to give a true and fair view in accordance with the relevant financial reporting framework; or**
 - (b) **such transaction related services are to be provided on a contingent fee basis and:**

- i the engagement fees are material to the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated; or**
 - ii the outcome of those transaction related services (and, therefore, the entitlement to the fee) is dependent on a future audit judgment relating to a material balance included in the financial statements of the audit client; or**
- (c) the engagement would involve the audit firm undertaking a management role.**

- 110 A self-review threat arises where the outcome of the transaction related service undertaken by the audit firm may be material to the financial statements of the audit client which are, or will be, subject to audit by the same firm. Where the audit client proposes to undertake a transaction, it may be necessary to adopt an inappropriate accounting treatment in order to achieve the desired result. A self-review threat is created if the auditors undertake transaction related services in connection with such a transaction. Accordingly, this Standard does not permit the provision of advice by audit firms to their audit clients where there is reasonable doubt about the appropriateness of the accounting treatments related to the transaction advice given.
- 111 Where a transaction related services engagement is undertaken on a contingent fee basis, self-interest threats to the auditors' objectivity and independence also arise as the auditors may have, or may appear to have, an interest in the success of the transaction. The significance of the self-interest threat is primarily determined by the materiality of the contingent fee to the audit firm, or to the part of the firm by reference to which the audit engagement partner's profit share is calculated. Where the contingent fee and the outcome of the transaction related services is dependent on a future audit judgment on a material balance included in the financial statements of the audit client, the self-interest threat cannot be eliminated or reduced to an acceptable level by the application of any safeguards, other than where the transaction is subject to a pre-established dispute resolution procedure.
- 112 These restrictions do not apply in circumstances where the auditors are designated by legislation or regulation as being eligible to carry out a particular service. In such circumstances, the audit engagement partner establishes appropriate safeguards.