

Contingent Fees

Background

The Code (ED paragraphs 290.216-219) describes a contingent fee as a fee calculated on a predetermined basis relating to the outcome of a transaction or the result of the work. It provides that a firm should not enter into a contingent fee arrangement in respect of an audit or other assurance engagement since this creates unacceptable self-interest and advocacy threats. The Code also provides that a firm should not enter into a contingent fee arrangement for a non-assurance service if the fee was contingent on the result of the audit engagement. For other types of contingent fee arrangements for non-assurance services provided to an assurance client, the Code adopts a threats and safeguards approach.

The Code makes no distinction between entities that are of significant public interest and those that are not.

Comparative Positions

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

All positions are consistent that a contingent fee should not be charged in respect of an audit engagement (and in the case of the Code in respect of all assurance engagements).

There are differences in approach with respect to contingent fees charged in respect of non-assurance services provided to an audit client:

- The PCAOB prohibits a firm from charging a contingent fee for any service provided to an audit client;
- The AICPA prohibits a firm from charging a contingent fee for any professional service provided to an audit client. Fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. A fee is considered determined based on findings of governmental agencies if the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member's client. Such an expectation is deemed not reasonable in the case of preparation of original tax returns;
- Canada prohibits a firm from charging a contingent fee for any professional service provided to an audit client if the fee constitute an influence, interest or relationship which impairs or, in the view of a reasonable observer, would impair the professional judgment or objectivity of the firm with respect to the audit engagement;
- The EC recommendation adopts a threats and safeguards approach, similar to the existing position in the Code;
- The APB states that contingent fee arrangements for non-audit services provided to an audit client may create threats to independence. The APB prohibits contingent fees with respect to three types of non-audit services:

- Tax services – where (a) 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 (b) the outcome of the tax services is dependent on the application of tax law which is uncertain or has not been established and the outcomes involves a future or contemporary audit judgment relating to a material balance in the financial statements of the audit client;
- Corporate finance services – where (a) 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 (b) the outcome of the corporate finance services involves a future or contemporary audit judgment relating to a material balance in the financial statements of the audit client; and
- Transaction related services – where (a) 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 (b) the outcome of the transaction related services involves a future or contemporary audit judgment relating to a material balance in the financial statements of the audit client.

Discussion

Nature of the Threat

The Task Force (TF) has considered the nature of the threat created by contingent fee arrangements with an audit client.

The TF is of the view that performing an engagement for a contingent fee for an audit client creates a self-interest threat in that it puts the firm in a position of wanting the same outcome as the client. It is similar to the threat created if an audit firm has a financial interest in an entity and the audit client (or director, officer or controlling owner) has a financial interest in that entity (ED ¶290.111) and similar to the position with close business relationships (ED ¶290.131 – 123).

The TF is of the view that the existing position in the Code that a firm should not enter into a contingent fee arrangement in respect of an audit or other assurance engagements continues to be appropriate. Such an arrangement would create an unacceptable self-interest threat.

The TF considered the threat created when a firm performs a non-assurance engagement for an audit client for a contingent fee. The TF is of the view that there are two elements to the threat:

- The contingent fee puts the firm in the position of wanting the same outcome as management, creating a self-interest threat. If the amount of the contingent fee was material to the firm, the TF is of the view that this would create so significant a threat safeguards could not reduce the threat to an acceptable level – accordingly, a firm should not enter into such an arrangement with an audit client; and

- If the contingent fee relates to a matter which is material to the financial statements this creates an acceptable threat to independence because the firm is in the same position as the client in that it wants the same outcome as the client

Entities of Significant Public Interest

The TF considered whether Section 290 should contain a more restrictive requirement for an audit client that is an entity of significant public interest. It considered whether, for example, there should be a complete restriction of performing any non-assurance service for a contingent fee to such clients. The TF was of the view that provided that fee is not material and the transaction is not material to the financial statements safeguards may be available to reduce the threat to an acceptable level.

Section 291 Other Assurance Engagements

Section 291, which addresses independence requirements for assurance engagements that are not audit or review engagements, currently contains the same guidance for contingent fees as Section 290. The TF is of the view that the guidance and restrictions on contingent fees are equally applicable to all assurance clients, irrespective of whether the client is an audit or review client or another type of assurance client.

Recommendation

The TF recommends that Section 290 should contain the following with respect to contingent fees:

1. No change to the existing description of a contingent fee.
2. No change to the existing restriction regarding performing an audit engagement for a contingent fee.
3. Restricting providing a non-assurance service to an audit client for a contingent fee if the contingent fee is material to the firm or the transaction is material to the financial statements.
4. Maintaining the existing requirements that for other types of contingent fee arrangements the significance of the threat should be evaluated and safeguards applied to reduce the threat to an acceptable level.

The TF recommends that Section 291 contain the same guidance – with respect to a contingent fee for a non-assurance service the restriction would relate to a contingent fee that was material to the firm and to a transaction which was material to the subject matter information of the assurance engagement.

Action requested

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

Appendix A

Comparative positions – for information

SEC/PCAOB

Rule 3521 – A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for a contingent fee or a commission or receives from the audit client, directly or indirectly, a contingent fee or commission.

The term contingent fee means:

- (1) Except as stated in paragraph (2) below, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service;
- (2) Solely for the purposes of this definition, a fee is not a “contingent fee” if the amount is fixed by the courts or other public authorities and not dependent on a finding or result.

US – AICPA

A member in public practice shall not

- (1) Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm performs,
 - (a) an audit or review of a financial statement; or
 - (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or
 - (c) an examination of prospective financial information; or
- (2) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

The prohibition in (1) above applies during the period in which the member or the member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.

Except as stated in the next sentence, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.

A member's fees may vary depending, for example, on the complexity of services rendered.

Definition of Terms

- (a) Preparation of an original or amended tax return or claim for tax refund includes giving advice on events which have occurred at the time the advice is given if such advice is directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of a return or claim for refund.
- (b) A fee is considered determined based on the findings of governmental agencies if the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member's client. Such an expectation is deemed not reasonable in the case of preparation of original tax returns.

Examples

The following are examples, not all-inclusive, of circumstances where a contingent fee would be permitted:

1. Representing a client in an examination by a revenue agent of the client's federal or state income tax return.
2. Filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position.
3. Filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Internal Revenue Taxation (\$1 million at March 1991) or state taxing authority.
4. Requesting a refund of either overpayments of interest or penalties charged to a client's account or deposits of taxes improperly accounted for by the federal or state taxing authority in circumstances where the taxing authority has established procedures for the substantive review of such refund requests.
5. Requesting, by means of "protest" or similar document, consideration by the state or local taxing authority of a reduction in the "assessed value" of property under an established taxing authority review process for hearing all taxpayer arguments relating to assessed value.
6. Representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute.

The following is an example of a circumstance where a contingent fee would not be permitted:

1. Preparing an amended federal or state income tax return for a client claiming a refund of taxes because a deduction was inadvertently omitted from the return originally filed. There is no question as to the propriety of the deduction; rather the claim is filed to correct an omission.

Canada

Rule

- .1 A member or firm engaged in the practice of public accounting or in a related business or practice shall not offer or engage to perform a professional service for a fee payable only where there is a specified determination or result of the service, or for a fee the amount of which is to be fixed, whether as a percentage or otherwise, by reference to the determination or result of the service, where the service is:
 - (a) one in respect of which professional standards or rules of conduct require that the member be and remain free of any influence, interest or relationship which, in respect of the engagement, impairs the member's professional judgment or objectivity or which, in the view of a reasonable observer, would impair the member's professional judgment or objectivity; or
 - (b) a compilation engagement.
- .2 Rule 215.1 does not apply to a professional service for a fee fixed by a court or other public authority or to a professional service in respect of any aspect of insolvency practice, including acting as a trustee in bankruptcy, a liquidator, a receiver or a receiver-manager.
- .3 Other than in respect of an engagement described in Rule 215.1, a member or firm engaged in the practice of public accounting or in a related business or practice may offer or engage to perform a professional service for a fee payable only where there is a specified determination or result of the service, or for a fee the amount of which is to be fixed, whether as a percentage or otherwise, by reference to the determination or result of the service, provided:
 - (a) the fee arrangement does not constitute an influence, interest or relationship which impairs or, in the view of a reasonable observer, would impair the professional judgment or objectivity of the member or a partner of the member in respect of an engagement described in Rule 215.1(a); or
 - (b) the fee arrangement is not one which influences, or in the view of a reasonable observer would influence, the result of a compilation engagement performed by the member or a partner of the member for the same client, and
 - (c) the client has agreed in writing to the basis for determining the fee before the completion of the engagement. -

Interpretation

- 2 When providing a professional service for a fee payable only where there is a specified determination or result of the service, or for a fee the amount of which is to be fixed, whether as a percentage or otherwise, by reference to the determination or result of the service ("contingent fee"), a member or firm must bear in mind the requirements of Rules 202, 203, 205 and 206. These rules require a member or firm to perform services with integrity and due care; to sustain professional competence in all functions in which the member practises; not to associate with any letter, report, statement or representation which the member knows or should know is false or

misleading; and to comply with the generally accepted standards of practice of the profession

- 3 Rule 215.1 prohibits a contingent fee arrangement where the member or firm providing the service is required to be free of any influence that would impair professional judgment or objectivity in respect of the particular engagement. This means that a contingent fee arrangement is not permitted for an assurance or specified auditing procedures engagement. In addition, a compilation engagement may not be performed on a contingent fee basis.
- 4 A member or firm also must ensure that a contingent fee arrangement in a client engagement does not, in the view of a reasonable observer, create an influence which would impair professional judgment or objectivity with respect to another engagement for the same client which requires objectivity on the part of the service provider. For example, a member may be seen to have compromised professional judgment or objectivity with respect to an audit where the member in giving an opinion may be seen to be supporting a material amount which is reported in the client's financial statements and upon which a contingent fee for the member or the member's firm is based.
- 5 The following examples of engagements undertaken on a contingent fee basis are provided as guidance to assist members and firms in determining whether their professional judgment or objectivity may be compromised with respect to the types of engagements for which objectivity is required by the rules of professional conduct or would be seen to influence the result of a compilation engagement.

Examples of engagements which, if undertaken on a contingent fee basis, would not normally be seen to impair professional judgment or objectivity with respect to another engagement for the same client which requires objectivity on the part of the service provider (such as an audit or review of financial statements) are:

- commodity tax refund claims;
- assisting with tax appeals and preparing notices of objection to tax assessments and reassessments; and
- executive search services.

Examples of engagements which, if undertaken on a contingent fee basis, may be seen to impair professional judgment or objectivity with respect to another engagement for the same client which requires objectivity on the part of the service provider (such as an audit or review of financial statements) are:

- valuation engagements which involve the expression of a professional opinion;
- assisting with the purchase or sale of all or part of a business;
- financing proposals, the success of which is dependent, in whole or in part, upon the client's financial statements or the client's future oriented financial information;

- litigation support and forensic investigations which use financial statements or other financial information of the client or result in reports which impact on or bear a relationship to the client's financial statements;
 - business interruption insurance claims; and
 - re-engineering or efficiency studies, the results of which could materially impact on the client's financial statements or other financial information.
- 6 The examples in paragraphs 4 and 5 are not intended to be exhaustive or conclusive in determining whether a particular engagement may be undertaken on a contingent fee basis. A member must always exercise professional judgment in concluding whether a particular engagement may be undertaken on a contingent fee basis in accordance with Rule 215.3.
- 7 If the application of Rule 215.1 prohibits an engagement from being provided on a contingent fee basis a member or firm is not precluded from having regard at the time of billing to criteria which include:
- (a) the level of training and experience of the persons engaged in the work;
 - (b) the time expended by the persons engaged in the work;
 - (c) the degree of risk and responsibility which the work entails;
 - (d) the priority and importance of the work to the client;
 - (e) the value of the work to the client; and
 - (f) any other circumstances which may exist (e.g. fees fixed by a court or other public authority, fees in insolvency work and the administration of estates and trusts which, by statute or tradition, are often based on a percentage of realizations and/or assets under administration).

Value billing should not be used, however, to justify what is in substance an otherwise inappropriate contingent fee arrangement.

- 8 Members and firms are cautioned that professional engagements may be subject to standards of other professional bodies or organizations which must be considered in determining whether contingent fees are appropriate for a particular engagement.

EC Recommendation

1. Fee arrangements for audit engagements in which the amount of the remuneration is contingent upon the results of the service provided raise self-interest and advocacy threats which are considered to bear an unacceptable level of independence risk. It is therefore required that:
- (a) audit engagements should never be accepted on a contingent fee basis; and
 - (b) in order to avoid any appearance of contingency, the basis for the calculation of the audit fees must be agreed each year in advance. This should include scope for variation so as to take account of unexpected factors in the work.

Statutory audit work performed in the public interest is inherently unsuitable for fee arrangements where the Statutory Auditor's remuneration depends on either any

performance figure of the Audit Client or the outcome of the audit itself. Audit fees that are fixed by any court or governmental body do not constitute contingent fees.

2. Threats to independence may also arise from contingent fee arrangements for non-audit services which the Statutory Auditor, the Audit Firm or an entity within its Network provides to an Audit Client or to one of its Affiliates. The Statutory Auditor's safeguarding system (see A. 4.3.2) should therefore ensure that:
 - (a) such an arrangement is never concluded without first assessing the independence risk it might create and ensuring that appropriate safeguards are available to reduce this risk to an acceptable level; and
 - (b) unless the Statutory Auditor is satisfied that there are appropriate safeguards in place to overcome the independence threats, either the non-audit engagement must be refused or the Statutory Auditor must resign from the Statutory Audit to allow the acceptance of the nonaudit work.

Self-interest, self-review and advocacy threats to a Statutory Auditor's independence also arise when the fee for a non-audit engagement is dependent upon a contingent event. This applies to all contingent arrangements between the Statutory Auditor, the Audit Firm or an entity within its Network, and the Audit Client or any of its Affiliates. Dependency on a contingent event means, for example, that the fee depends in some way on the progress or outcome of the project or the attainment of a particular performance figure by the Audit Client (or its Affiliate).

In assessing the extent to which contingent fee arrangements pose a threat to statutory auditor independence, and the availability of suitable safeguards, the Statutory Auditor should consider amongst other factors: the relationship between the activity for which the contingent fee is to be paid, and the conduct of any current or future audit; the range of possible fee amounts; and the basis on which the fee is to be calculated.

In performing this assessment, the Statutory Auditor should consider, *inter alia*, whether the amount of the contingent fee is directly determined by reference to an asset or transaction value (e.g., percentage of acquisition price) or a financial condition (e.g., growth in market capitalisation) the measurement of which will be subsequently exposed to an audit examination and whether this increases the self-interest threat to unacceptable levels. On the other hand, independence threats will generally not arise in situations where there is no direct link between the basis of the contingent fee (e.g., the starting salary of a new employee when a recruitment service is provided) and a significant aspect of the audit engagement. Where a Governance Body exists, the Statutory Auditor should disclose contingent fee arrangements to that body in accordance with the principles set out under Section A. 4.1.2.

UK – APB

General

- 7 An audit should not be undertaken on a contingent fee basis.
- 8 A contingent fee basis is any arrangement made at the outset of an engagement under which a pre-determined amount or a specified commission on or percentage of any consideration or saving is payable to the audit firm upon the happening of a specified event or the achievement of an outcome (or alternative outcomes). Differential hourly fee rates, or arrangements under which the fee payable will be negotiated after the completion of the engagement, do not constitute contingent fee arrangements.
- 9 Contingent fee arrangements in respect of audit engagements create self-interest threats to the auditors' objectivity and independence that are so significant that they cannot be eliminated or reduced to an acceptable level by the application of any safeguards.
- 10 The audit fee ordinarily reflects the time spent and the skills and experience of the personnel performing the audit in accordance with all the relevant requirements. It does not depend on whether the auditors' report on the financial statements is qualified or unqualified.
- 11 The basis for the calculation of the audit fee is agreed with the audit client each year before significant audit work is undertaken. The audit engagement partner explains to the audit client that the estimated audit fee is based on the expected level of audit work required and that, if unforeseen problems are encountered, the cost of any additional audit work found to be necessary will be reflected in the audit fee actually charged. This is not a contingent fee arrangement.
- 12 The audit firm should establish policies and procedures to ensure that the audit engagement partner and the ethics partner are notified where others within the audit firm propose to adopt contingent fee arrangements in relation to the provision of non-audit services to the audit client or its affiliates.
- 13 Contingent fee arrangements in respect of non-audit services provided by the auditors to an audit client may create a threat to the auditors' objectivity and independence. The circumstances in which such fee arrangements are not permitted for such non-audit services are dealt with in APB Ethical Standard 5.
- 14 In the case of listed companies the audit engagement partner should disclose to the audit committee, in writing, any contingent fee arrangements for non-audit services provided by the auditors or their network firms.
- 15 In the case of a group audit of a listed company, which involves other auditors, the letter of instruction sent by the group audit engagement partner to the other auditors

requests disclosure of any contingent fees for non-audit services charged or proposed to be charged by the other auditors.

Tax services

- 68 The audit firm should not undertake an engagement to provide tax services to an audit client wholly or partly on a contingent fee basis where
- (a) 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
 - (b) the outcome of those tax services (and, therefore, the entitlement to the fee):
 - (i) is dependent on the application of tax law which is uncertain or has not been established; and
 - (ii) involves a future or contemporary audit judgment relating to a material balance in the financial statements of the audit client.
- 69 Where tax services, such as advising on corporate structures and structuring transactions to achieve a particular effect, are undertaken on a contingent fee basis, self-interest threats to the auditors' objectivity and independence may arise. The auditors may have, or may appear to have, an interest in the success of the tax services, causing them to make an audit judgment about which there is reasonable doubt as to its appropriateness. Where the contingent fee is determined by the outcome of the application of tax law, which is uncertain or has not been established, and where the tax implications are material to the financial statements, or is dependent on a future or contemporary audit judgment relating to a material balance included in the audited financial statements, the self-interest threat cannot be eliminated or reduced to an acceptable level by the application of any safeguards.

Corporate finance services

- 99 The audit firm should not undertake an engagement to provide corporate finance services to an audit client where:
- (a) the engagement would involve the audit firm taking responsibility for dealing in, underwriting or promoting shares; or
 - (b) 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
 - (c) such corporate finance 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 corporate finance services (and, therefore, the entitlement to the fee) involves a future or contemporary audit judgment relating to a material balance in the financial statements of the audit client; or

- (d) the engagement would involve the audit firm undertaking a management role.
- 104 Where a corporate finance 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 corporate finance services. 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 corporate finance services is dependent on a future or contemporary audit judgment relating to 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.

Transaction related services

- 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 or contemporary audit judgment relating to a material balance in the financial statements of the audit client; or
 - (c) the engagement would involve the audit firm undertaking a management role.
- 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 or contemporary 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.