

# NASBA

**AUDIT FEES AND ENGAGEMENT PROFITABILITY:  
A THREATS AND SAFEGUARDS APPROACH TO STRENGTHEN  
COMPLIANCE WITH STANDARDS OF ETHICAL BEHAVIOR**

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**Discussion Paper**  
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## EXECUTIVE SUMMARY

The 2009-2010 charge of the NASBA's Ethics and Strategic Professional Issues Committee is:

**Monitor and evaluate the issues of the AICPA's Professional Ethics Executive Committee (PEEC), to harmonize ethics standards of State Boards of Accountancy with other regulatory bodies, to promote the development and adoption of UAA ethics provisions uniformly among the states, and to share with state boards emerging ethics and other professional issues.**

This issue has been debated for decades and is a common discussion topic among CPAs who are under pressure to comply with increasing regulatory requirements, but at the same time bid competitively for work. Accusations of "low-balling" and its adverse impact on the public and the profession have long been an "elephant in the room" in discussions among regulators and private-sector standard setters wary of anti-trust ramifications. Regardless of the reluctance, this is an issue whose time has come and must be dealt with.

One role of ethics codes is to help practitioners identify pitfalls and thereby avoid unethical behavior. When making a decision about engagement acceptance and continuance, the level of fees or anticipated profits may pose a threat to compliance with ethical behavior. Threats may result when, for example:

- Fees are too low to reasonably perform an engagement and comply with standards.
- Inadequate fees pose a threat to subordination of judgment, independence, integrity and objectivity.
- A firm, office, or partner is financially dependent on an individual client.

When practitioners identify threats they should determine whether appropriate safeguards are available to eliminate or reduce the threat to an acceptable level. This paper discusses the types of safeguards that might be applied to ensure ethical behavior is not compromised. Safeguards might include:

- Instituting adequate systems of quality control, including acceptance and continuance of engagements.
- Requiring adequate supervision and review of engagements.
- Allocating a reasonable amount of time to complete the engagement.
- Assigning qualified staff to the engagement team.
- Participating in quality reviews, e.g., concurring or second partner reviews.
- Consulting with technical specialists on issues involving significant judgment.
- Discussing relevant risks and applied safeguards, with those charged with governance of the client.

Whether fees or profits associated with an attest engagement are unusually large or small is not, by itself, an ethics violation. However, such conditions may indicate a risk of unethical behavior. This paper explores relevant threats and appropriate safeguards in such situations, considers potential peer review solutions, and discusses anti-trust considerations. Finally, the report concludes with recommendations to interested parties.

## INTRODUCTION

The NASBA Ethics and Strategic Professional Issues Committee studied the ethical issues associated with performing an audit, or other attest services, below cost. Initially, the Committee identified several significant ethical issues posed when a firm quotes a very low audit fee or a fee expected to result in a significant loss. Once the Committee exposed its initial ideas to comment and feedback from various State Boards of Accountancy, it became apparent that a wider scope of issues should be addressed. For instance, there may also be a significant threat to independence, integrity and objectivity when fees and profitability are too large. Both situations are addressed below.

The Committee made a concerted effort to view this issue through the eyes of the investing public rather than practitioners. As accountants, it is easy to get tied up in discussions of how to calculate profitability. The nuances of such a discussion, however, are often lost on the investing public. In general, it is reasonable to think an audit firm would know how it has priced an audit. Firms closely monitor and measure profitability on individual engagements and know what their costs are. From a public protection standpoint our focus is on the extreme cases: 1) where fees are clearly less than that required to do a job in accordance with applicable professional standards, and 2) when fees represent a significant portion of firm revenues.

Performing attest services below cost, or at a large profit, is not, by itself, an ethical violation.<sup>1</sup> The public would expect that most accountants do not intend to lose money in performing services absent a compelling business reason to the contrary. Some reasons may indeed be acceptable. However, acceptable business reasons must not outweigh the public interest and it is important to recognize significant threats to ethical conduct. Acceptable business reasons must be matched with appropriate safeguards to ensure ethical behavior is not compromised.

The following discussion explores threats to independence, integrity and objectivity, due professional care, compliance with professional standards and available safeguards to ensure appropriate ethical conduct. Many of the safeguards represent activities auditors routinely apply. Nevertheless, the Committee concluded that existing professional standards do not sufficiently address the issues raised above.

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<sup>1</sup> In general, "below cost" is understood to be a price placed on a service that is less than the seller paid to deliver the service.

## THREATS AND SAFEGUARDS APPROACH

Recently, the AICPA Professional Ethics Executive Committee (PEEC) adopted a threats and safeguards approach as part of its *Conceptual Framework for AICPA Independence Standards*. In addition, it has approved a similar non-authoritative *Guide for Complying With Rules 102-505* (these include substantially all AICPA ethics rules other than independence). The AICPA threats and safeguards approach has been patterned after standards developed by the International Ethics Standards Board of Accountants (IESBA).<sup>2</sup>

The broad based “threats and safeguards” concept can be helpful in resolving a variety of ethical issues not explicitly covered in codes of conduct. The threats and safeguards approach is from the perspective of a *reasonable and prudent person* who possesses both *knowledge and experience*, which is inherently appealing.

The public interest is well served when practitioners recognize significant ethical risks and put appropriate safeguards in place to ensure professional judgment is not compromised. When considering the threats and safeguards approach, in no circumstance can the threats and safeguards approach be used to circumvent or overcome specific prohibitions or requirements in existing ethical standards, e.g., a direct financial interest in an attest client. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.<sup>3</sup>

### ***1. Fees are too low to reasonably perform an engagement and comply with standards***

As noted, there may be valid reasons why firms may choose to bid a very low fee on an audit or attest engagement. In some cases, audit firms may be in a slow season and the work allows a contribution toward fixed payroll costs while allowing staff to keep busy and refine their skills. Alternatively, the firm may bid an audit below the cost necessary to perform the work for access and exposure to members of a board of directors in hopes of attaining additional and more profitable work. In some cases, an audit firm may absorb a loss in an initial audit with the hope the engagement will become profitable in the long run.

However, performing an engagement for fees inherently too low to allow the firm to reasonably comply with standards is a significant threat to due professional care and compliance with professional standards. Numerous State Board of Accountancy members have noted low fees as a common denominator involving inadequate audit work. In addition, if managers are measured on engagement realization, and fees are quoted at a very low level, an audit manager may be put in a position where it is difficult or impossible to perform the work required by standards and

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<sup>2</sup> See Appendix B for the PEEC and IESBA threats and safeguards approach to ethical issues.

<sup>3</sup> AICPA, *Code of Professional Conduct*, ET §100.01.03 and .05(c)

earn the expected realization. When fees are unreasonably low, some auditors assert they actually performed the work but did not document it.

It is important that an audit firm recognize the threat to due professional care and compliance with professional standards at the outset of an engagement and put appropriate safeguards in place to ensure the public is protected. Such safeguards might include:

- Instituting an adequate system of quality control, including approval of acceptance and continuance of engagements by those responsible for managing the auditing firm, preferably those that otherwise have no participation in the audit.
- Requiring adequate supervision and review.
- Allocation of a reasonable amount of time to complete the engagement.
- Assigning qualified staff to the engagement team.
- Requiring disclosure to those charged with governance of the client that the:
  - Fee is so low a loss is anticipated in order to reasonably comply with standards.
  - Safeguards applied to reduce the threat of noncompliance to an acceptable level.

If adequate safeguards are in place to ensure a firm complies with standards then the public should be protected. During discussion at the NASBA 2010 Regional Meetings, a number of individuals expressed concern over audits which appear to be profitable at the outset, only to subsequently require more work than expected, i.e., an engagement expected to be profitable turns into a loss. First, this is not the extreme case that is of primary concern. Secondly, this is a good example of where a firm recognized the risk and put compliance with ethical standards above profitability. Whether the firm realized it or not, the threat was identified and appropriate safeguards were applied.

The Committee believes where fees are significantly low, there is a presumption that performing an audit for a very low fee, or performing an audit at a loss, is a significant threat to due professional care and compliance with professional standards. Indeed, virtually all firms when addressing client acceptance or continuance, ask the question, “Does the prospective fee justify pursuing the engagement in light of the anticipated cost of obtaining and conducting the engagement?”<sup>4</sup>

The IESBA also recognizes the threat to due care from performing an audit for a very low fee (see Section 240 in its code of conduct, reproduced at Appendix C-1).

In summary, the Committee believes the threat of very low fees can be mitigated by appropriate safeguards to ensure that due care is exercised and the audit or attest engagement complies with professional standards.

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<sup>4</sup> Another example is the engagement acceptance form in PPC’s *Audit Guide on Nonpublic Companies* (ASB CX-1.1). It asks, “Does the engagement fail to meet the firm’s standards from an economic standpoint?”

## ***2. Inadequate fees pose a threat to subordination of judgment and independence, integrity and objectivity***

As discussed above, there may be legitimate business reasons audit firms choose to bid a very low fee on an audit or attest engagement. However, low fee situations may also threaten independence, integrity and objectivity. For example, an auditor might subordinate judgment to the client rather than devote additional time to investigating an audit issue. The Committee recalls disciplinary situations brought to State Boards of Accountancy involving low fee audits where a material issue arose at the end of the engagement. Rather than taking the time to fully investigate a problem, the auditors subordinated their judgment to that of the client. While these situations involve an element of failure to use due care, they are also a result of the firms' failure to act with integrity, objectivity and, arguably, independence.

Further, just as a firm may have overdue fees bearing on independence, performing services below cost may indicate underlying financial considerations that impair independence. There are times when auditors openly talk about "investing in a client" when they perform an audit at a loss. If a firm is "investing" in the future by performing a below cost audit to obtain some other business in the future, a threat exists that the audit firm may subordinate judgment in order to make the "investment" pay off. If the auditor needs to keep the client satisfied in order to get other work, e.g., from the client or from a board member, the auditor may not have an independent mental attitude.

The accounting profession has witnessed these problems with public company audits. Zeff (2003) documents a 30-year span beginning in the early 1970s, where some auditors shifted from making professional judgments in the interest of the shareholder to making those judgments in the interest of management. This trend is also clearly discussed by Baker (2005). There is well documented evidence some of this shift was associated with using the audit as a "loss leader" to more lucrative consulting services, which caused some auditors to lose their independence.

This problem has been addressed for public companies because the Sarbanes-Oxley Act prohibits certain non-attest services. For private company reporting, the issue is less rigorous but is addressed by the AICPA in ET 101-3, *Performance of Nonattest Services*. However, the risk of subordinating judgment in order to gain more profitable work still exists. To increase the margin of safety, a requirement could be adopted to identify the ethical threat and apply appropriate safeguards to ensure professional judgment is not compromised.

We recently witnessed a variation of the threat that inadequate fees pose to subordination of judgment in the purported audit of Bernard L. Madoff Investment Securities (BMIS) by Friehling & Horowitz, CPAs, P.C. A glaring red flag existed when Madoff's multi-billion dollar fund paid Friehling & Horowitz only \$186,000 for its 2008 audit. While the fee was sufficiently low to raise a question of whether an audit could be performed in compliance with professional standards, the engagement probably resulted in a healthy profit. The SEC contended Friehling merely pretended to conduct minimal audit procedures of certain accounts to make it appear it was conducting an audit. Friehling subsequently pleaded guilty to fraud charges associated with

the audit of BMIS. In summary, the “audit” failure was subordination of judgment to the client, significant failure to exercise due professional care, and non-compliance with professional standards.<sup>5</sup> In Friebling & Horowitz, the issue is not whether the attest engagement was profitable or not. The issue is a fee so low the auditor resorted to subordination of judgment and did not perform reasonably expected audit work simply to receive a fee.

The Committee concluded that when an attest engagement is performed for a very low fee or at a loss, there is a real threat to independence, integrity and objectivity. Further appropriate safeguards should be put in place to reduce the threat to the point where professional judgment is not compromised. Such safeguards might include:

- Consultation with technical specialists on issues of significant professional judgment.
- Requiring engagement quality reviews, e.g., concurring, post or pre-issuance reviews.

The threat to independence posed by performing an audit at a loss is specifically recognized in the accountancy statute of Texas (see Appendix C-2). It does not take a threats and safeguards approach, but rather, there is a presumption of impaired independence if the licensee performs, or offers to perform, an attest service for compensation less than the direct labor cost reasonably expected to be incurred in performing the service. The Committee, however, prefers the threats and safeguards approach described above.

### ***3. A firm, office, or partner is financially dependent on an individual client***

When the fees from an attest engagement represent a large proportion of total firm fees, the dependence on a client and concern about losing the work creates an inherent self-interest and/or intimidation threat to independence, integrity and objectivity. A similar threat arises when the fees from a client represent a large proportion of the revenue from an individual partner’s book of business or proportion of the revenue of an individual office of the firm.<sup>6</sup> There also may be circumstances when fees are accepted in excess of that required – solely in the inappropriate response to report what the client may want and to compensate the auditor for not being independent.

Both the AICPA and the IESBA recognize the threat when a large proportion of fees come from a single client. The *Conceptual Framework for AICPA Independence Standards* recognizes a financial self-interest threat to independence exists when there is “excessive reliance on the revenue from a single client.”<sup>7</sup> The IESBA has recently adopted a rule requiring application of

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<sup>5</sup> For more on Friebling & Horowitz see <http://www.sec.gov/litigation/litreleases/2009/lr21274.htm>

<sup>6</sup> This was the case in the Enron audit failure for both the engagement partner and performing office.

<sup>7</sup> AICPA, *Code of Professional Conduct*, ET §100.01.18(c)

the threats and safeguards approach when the amount of fees from an individual client deemed to be a “public interest entity,” exceeds 15 percent of total firm fees.<sup>8</sup>

In general, when total fees from any audit client represent a large proportion of the total firm fees, the IESBA recommends the following safeguards:

- Reducing the dependence on the client.
- Internal or external quality control reviews of the engagement.
- Consulting a third party on key audit judgments.

When fees from a public interest entity audit client exceed 15 percent of total firm fees, the IESBA recommends the firm address the following issues with those charged with governance of the client:<sup>9</sup>

- Disclose that total fees represent more than 15 percent of the total fees of the firm.
- Discuss the safeguards the firm will apply to reduce the threat to an acceptable level, e.g., pre-issuance or post-issuance engagement quality control reviews.

## **OTHER GENERAL SAFEGUARDS**

In addition to the safeguards discussed above, there are a number of general safeguards to help recognize threats to ethical behavior. Examples that might be implemented at a firm level include:

- Firm leadership stressing the importance of ethical behavior and an expectation that members of attest engagement teams act in the public interest.
- Training and timely communication of policies and procedures for identifying ethical threats associated with very low fees or fees representing a significant proportion of firm revenues.
- Documented policies regarding the identification of ethical threats, the evaluation of the significance of those threats, and the application of safeguards.

## **PEER REVIEW CONSIDERATIONS**

Current peer review standards require firms to provide the peer review team with the number of actual hours incurred in the process of selecting engagements for review. However, review teams are not explicitly required to assess the implication of the threats discussed above in the

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<sup>8</sup> International Federation of Accountants, *Code of Ethics for Professional Accountants*, §290.220 - 222

<sup>9</sup> *Ibid.* §290.222



selection process. From a regulatory standpoint, peer reviews could be significantly strengthened if the following were required:

- Conclusion as to whether observed “tone at the top” is consistent with firm ethical policies.
- Review of compliance with client acceptance and continuance policies.
- Compliance with firm criteria related to performing attest services below cost.
- Peer review engagement selection process that includes audits with a higher risk of noncompliance with ethical standards, e.g., engagements with extreme loss or profit situations.
- Conclusion as to whether it is reasonable to assume, given the budgeted and actual hours on an engagement, that professional standards could have been complied with.

### **Anti-Trust Considerations**

The Committee also discussed the implications of the foregoing vis-à-vis existing anti-trust legislation and regulations. The Committee believes the foregoing considerations and the recommendations below represent an appropriate state regulatory response to protection of the public interest and investors. More specifically, a threats and safeguards approach should not be considered as an effort to stifle competition. It is appropriate for a firm to quote a low fee, a fixed fee, or even fees insufficient to cover all costs as long as the related threats are identified and appropriate safeguards are applied and documented.

### **Professional Education and Recognition of Ethical Threats in Professional Standards**

The public would benefit from a more explicit requirement of practitioners to understand and comply with the threats and safeguards approach to resolving ethical conflicts. The Committee is concerned that current ethics standards do not sufficiently address the fee and profitability threats discussed above. In addition, the threats and safeguards approach is not integrated throughout current U.S. authoritative literature covering ethics. The time has come for the ethical impact of fees and profitability on attest engagements, including the threats and safeguards approach, to be better understood by members of the profession and members of State Boards of Accountancy.

## **RECOMMENDATIONS**

The Committee believes the following recommendations should be considered for further analysis by NASBA, the AICPA and other interested parties:

1. Expand ethical standards to address the fee and profitability issues described herein.

2. Encourage, where appropriate, greater integration of the threats and safeguards approach throughout extant ethical standards.
3. Enhance quality control standards to require firms to address the inherent ethical threats created by fee and profitability issues.
4. Enhance peer review standards to require consideration of the ethical threats described above.
5. Assess educational needs involving appropriate use of the threats and safeguards approach in resolving ethical conflicts.

## **APPENDIX A REFERENCES**

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## APPENDIX B THREATS AND SAFEGUARDS APPROACH TO ETHICAL ISSUES

### AICPA ET Section 100 - Conceptual Framework for AICPA Independence Standards

## . Introduction

.01 This conceptual framework describes the risk-based approach to analyzing independence matters that is used by the Professional Ethics Executive Committee (PEEC) of the AICPA when it develops independence standards. Under that approach, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member's professional judgment when rendering an attest service to the client. Key to that evaluation is identifying and assessing the extent to which a threat to the member's independence exists and, if it does, whether it would be reasonable to expect that the threat would compromise the member's professional judgment and, if so, whether it can be effectively mitigated or eliminated. Under the risk-based approach, steps are taken to prevent circumstances that threaten independence from compromising the professional judgments required in the performance of an attest engagement.

.02 Professional standards of the AICPA require independence for all attest engagements. The PEEC bases its independence interpretations and rulings under ET section 100 of the AICPA's Code of Professional Conduct on the concepts in this framework. However, in certain circumstances the PEEC has determined that it is appropriate to prohibit or restrict certain relationships notwithstanding the fact that the risk may be at an acceptable level. For example, the PEEC has determined that a covered member should not own even an immaterial direct financial interest in an attest client.

.03 Because this conceptual framework describes the concepts upon which the AICPA's independence interpretations and rulings are based, it may assist AICPA members and others in understanding those interpretations and rulings. In addition, this conceptual framework should be used by members when making decisions on independence matters that are not explicitly addressed by the Code of Professional Conduct. Under no circumstances, however, may the framework be used to overcome prohibitions or requirements contained in the independence interpretations and rulings.

**.04** The risk-based approach entails evaluating the risk that the member would not be independent or would be perceived by a reasonable and informed third party having knowledge of all relevant information as not being independent. That risk must be reduced to an acceptable level to conclude that a member is independent under the concepts in this framework. Risk is at an acceptable level when threats are at an acceptable level, either because of the types of threats and their potential effect, or because safeguards have sufficiently mitigated or eliminated the threats. **Threats are at an acceptable level when it is not reasonable to expect that the threat would compromise professional judgment.**

.05 The risk-based approach involves the following steps.

a. Identifying and evaluating threats to independence—Identify and evaluate threats, both individually and in the aggregate, because threats can have a cumulative effect on a member's independence. Where threats are identified but, due to the types of threats and their potential effects, such threats are considered to be at an acceptable level (that is, it is not reasonable to expect that the threats would compromise professional judgment), the consideration of safeguards is not required. If identified threats are not considered to be at an acceptable level, safeguards should be considered as described in paragraph .05b.

- b. Determining whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards—Different safeguards can mitigate or eliminate different types of threats, and one safeguard can mitigate or eliminate several types of threats simultaneously. When threats are sufficiently mitigated by safeguards, the threats’ potential to compromise professional judgment is reduced to an acceptable level. A threat has been sufficiently mitigated by safeguards if, after application of the safeguards, it is not reasonable to expect that the threat would compromise professional judgment. [fn.1](#)
- c. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

## Definitions

**.06 Independence** is defined as:

- a. *Independence of mind*—The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.
- b. *Independence in appearance*—The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards [fn.2](#) applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

**.07** This definition reflects the longstanding professional requirement that members who provide services to entities for which independence is required be independent both in fact and in appearance. [fn.3](#) The state of mind of a member who is independent “in fact” assists the member in performing an attest engagement in an objective manner. Accordingly, independence of mind reflects the longstanding requirement that members be independent in fact.

**.08** This definition is used as part of the risk-based approach to analyze independence. Because the risk-based approach requires judgment, the definition should not be interpreted as an absolute. For example, the phrase “without being affected by influences that compromise professional judgment” is not intended to convey that the member must be free of any and all influences that might compromise objective judgment. Instead, a determination must be made about whether such influences, if present, create an unacceptable risk that a member would not act with integrity and exercise objectivity and professional skepticism in the conduct of a particular engagement, or would be perceived as not being able to do so by a reasonable and informed third party that has knowledge of all relevant information.

**.09 Impair**—For purposes of this framework, impair means to effectively extinguish (independence). When a member’s independence is impaired, the member is not independent.

**.10 Threats**—Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise the member’s professional judgment and, if so, the specific safeguards applied to reduce or eliminate the threat, and the effectiveness of those safeguards as described in paragraph .21.

**.11** Threats might not involve violations of existing interpretations or rulings. For example, the circumstance described in paragraph .18b of this framework is permissible in limited instances under current AICPA independence interpretations and rulings.

.12 Many different circumstances (or combinations of circumstances) can create threats to independence. It is impossible to identify every situation that creates a threat. However, seven broad categories of threats should always be evaluated when threats to independence are being identified and assessed. They are self-review, advocacy, adverse interest, familiarity, undue influence, financial self-interest, and management participation threats. The following paragraphs define and provide examples, which are not all-inclusive, of each of these threat categories. Some of these examples are the subject of independence interpretations and rulings contained in the Code of Professional Conduct.

.13 *Self-review threat*—Members reviewing as part of an attest engagement evidence that results from their own, or their firm's, nonattest work such as, preparing source documents used to generate the client's financial statements

.14 *Advocacy threat*—Actions promoting an attest client's interests or position. [fn 4](#)

- a. Promoting the client's securities as part of an initial public offering
- b. Representing a client in U.S. tax court

.15 *Adverse interest threat*—Actions or interests between the member and the client that are in opposition, such as, commencing, or the expressed intention to commence, litigation by either the client or the member against the other.

.16 *Familiarity threat*—Members having a close or longstanding relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client.

- a. A member of the attest engagement team whose spouse is in a key position at the client, such as the client's chief executive officer
- b. A partner of the firm who has provided the client with attest services for a prolonged period
- c. A member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member's firm
- d. A member of the firm having recently been a director or officer of the client
- e. A member of the attest engagement team whose close friend is in a key position at the client

.17 *Undue influence threat*—Attempts by an attest client's management or other interested parties to coerce the member or exercise excessive influence over the member.

- a. A threat to replace the member or the member's firm over a disagreement with client management on the application of an accounting principle
- b. Pressure from the client to reduce necessary audit procedures for the purpose of reducing audit fees
- c. A gift from the client to the member that is other than clearly insignificant to the member

.18 *Financial self-interest threat*—Potential benefit to a member from a financial interest in, or from some other financial relationship with, an attest client.

- a. Having a direct financial interest or material indirect financial interest in the client
- b. Having a loan from the client, from an officer or director of the client, or from an individual who owns 10 percent or more of the client's outstanding equity securities
- c. Excessive reliance on revenue from a single attest client
- d. Having a material joint venture or other material joint business arrangement with the client

**.19 Management participation threat**—Taking on the role of client management or otherwise performing management functions on behalf of an attest client.

- a. Serving as an officer or director of the client
- b. Establishing and maintaining internal controls for the client
- c. Hiring, supervising, or terminating the client's employees

**.20 Safeguards**—Controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat. The nature and extent of the safeguards to be applied depend on many factors, including the size of the firm and whether the client is a public interest entity. [In 5](#) To be effective, safeguards should eliminate the threat or reduce to an acceptable level the threat's potential to impair independence.

**.21** The effectiveness of a safeguard depends on many factors, including those listed here:

- a. The facts and circumstances specific to a particular situation
- b. The proper identification of threats
- c. Whether the safeguard is suitably designed to meet its objectives
- d. The party or parties that will be subject to the safeguard
- e. How the safeguard is applied
- f. The consistency with which the safeguard is applied
- g. Who applies the safeguard

**.22** There are three broad categories of safeguards. The relative importance of a safeguard depends on its appropriateness in light of the facts and circumstances.

- a. Safeguards created by the profession, legislation, or regulation
- b. Safeguards implemented by the attest client
- c. Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements

**.23** Examples of various safeguards within each category are presented in the following paragraphs. The examples are not intended to be all-inclusive and, conversely, the examples of safeguards implemented by the attest client and within the firm's own systems and procedures may not all be present in each instance. In addition, threats may be sufficiently mitigated through the application of other safeguards not specifically identified herein.

**.24 Examples of safeguards created by the profession, legislation, or regulation**

- a. Education and training requirements on independence and ethics rules for new professionals
- b. Continuing education requirements on independence and ethics
- c. Professional standards and monitoring and disciplinary processes
- d. External review of a firm's quality control system
- e. Legislation governing the independence requirements of the firm
- f. Competency and experience requirements for professional licensure

**.25 Examples of safeguards implemented by the attest client that would operate in combination with other safeguards**

- a. The attest client has personnel with suitable skill, knowledge, and/or experience who make managerial decisions with respect to the delivery of nonattest services by the member to the attest client
- b. A tone at the top that emphasizes the attest client's commitment to fair financial reporting
- c. Policies and procedures that are designed to achieve fair financial reporting
- d. A governance structure, such as an active audit committee, that is designed to ensure appropriate decision making, oversight, and communications regarding a firm's services
- e. Policies that dictate the types of services that the entity can hire the audit firm to provide without causing the firm's independence to be considered impaired

**.26** *Examples of safeguards implemented by the firm*

- a. Firm leadership that stresses the importance of independence and the expectation that members of attest engagement teams will act in the public interest
- b. Policies and procedures that are designed to implement and monitor quality control in attest engagements
- c. Documented independence policies regarding the identification of threats to independence, the evaluation of the significance of those threats, and the identification and application of safeguards that can eliminate the threats or reduce them to an acceptable level
- d. Internal policies and procedures that are designed to monitor compliance with the firm's independence policies and procedures
- e. Policies and procedures that are designed to identify interests or relationships between the firm or its partners and professional staff and attest clients
- f. The use of different partners and engagement teams that have separate reporting lines in the delivery of permitted nonattest services to an attest client, particularly when the separation between reporting lines is significant
- g. Training on and timely communication of a firm's policies and procedures, and any changes to them, for all partners and professional staff
- h. Policies and procedures that are designed to monitor the firm or partner's reliance on revenue from a single client and, if necessary, cause action to be taken to address excessive reliance
- i. Designating someone from senior management as the person who is responsible for overseeing the adequate functioning of the firm's quality control system
- j. A means of informing partners and professional staff of attest clients and related entities from which they must be independent
- k. A disciplinary mechanism that is designed to promote compliance with policies and procedures
- l. Policies and procedures that are designed to empower staff to communicate to senior members of the firm any engagement issues that concern them without fear of retribution
- m. Policies and procedures relating to independence communications with audit committees or others charged with client governance
- n. Discussing independence issues with the audit committee or others responsible for the client's governance
- o. Disclosures to the audit committee (or others responsible for the client's governance) regarding the nature of the services that are or will be provided and the extent of the fees charged or to be charged
- p. The involvement of another professional accountant who (1) reviews the work that is done for an attest client or (2) otherwise advises the attest engagement team (This individual could be someone from outside the firm or someone from within the firm who is not otherwise associated with the attest engagement.)
- q. Consultation on engagement issues with an interested third party, such as a committee of independent directors, a professional regulatory body, or another professional accountant
- r. Rotation of senior personnel who are part of the attest engagement team
- s. Policies and procedures that are designed to ensure that members of the attest engagement team do not make or assume responsibility for management decisions for the attest client
- t. The involvement of another firm to perform part of the attest engagement

- u. The involvement of another firm to reperform a nonattest service to the extent necessary to enable it to take responsibility for that service
- v. The removal of an individual from an attest engagement team when that individual's financial interests or relationships pose a threat to independence
- w. A consultation function that is staffed with experts in accounting, auditing, independence, and reporting matters who can help attest engagement teams (1) assess issues when guidance is unclear, or when the issues are highly technical or require a great deal of judgment and (2) resist undue pressure from a client when the engagement team disagrees with the client about such issues
- x. Client acceptance and continuation policies that are designed to prevent association with clients that pose an unacceptable threat to the member's independence
- y. Policies that preclude audit partners from being directly compensated for selling nonattest services to the audit client

[Issued April 2006, effective April 30, 2007, with earlier application encouraged, by the Professional Ethics Executive Committee.]



## **International Ethics Standards Board of Accountants: Code of Ethics for Professional Accountants** **Conceptual Framework Discussion of Threats and Safeguards**

### *Conceptual Framework Approach*

- 100.6 The circumstances in which professional accountants operate may create specific threats to compliance with the fundamental principles. It is impossible to define every situation that creates threats to compliance with the fundamental principles and specify the appropriate action. In addition, the nature of engagements and work assignments may differ and, consequently, different threats may be created, requiring the application of different safeguards. Therefore, this Code establishes a conceptual framework that requires a professional accountant to identify, evaluate, and address threats to compliance with the fundamental principles. The conceptual framework approach assists professional accountants in complying with the ethical requirements of this Code and meeting their responsibility to act in the public interest. It accommodates many variations in circumstances that create threats to compliance with the fundamental principles and can deter a professional accountant from concluding that a situation is permitted if it is not specifically prohibited.
- 100.7 When a professional accountant identifies threats to compliance with the fundamental principles and, based on an evaluation of those threats, determines that they are not at an acceptable level, the professional accountant shall determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level. In making that determination, the professional accountant shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at the time, would be likely to conclude that the threats would be eliminated or reduced to an acceptable level by the application of the safeguards, such that compliance with the fundamental principles is not compromised.
- 100.8 A professional accountant shall evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.
- 100.9 A professional accountant shall take qualitative as well as quantitative factors into account when evaluating the significance of a threat. When applying the conceptual framework, a professional accountant may encounter situations in which threats cannot be eliminated or reduced to an acceptable level, either because the threat is too significant or because appropriate safeguards are not available or cannot be applied. In such situations, the professional accountant shall decline or discontinue the specific professional service involved or, when necessary, resign from the engagement (in the case of a professional accountant in public practice) or the employing organization (in the case of a professional accountant in business).
- 100.10 A professional accountant may inadvertently violate a provision of this Code. Depending on the nature and significance of the matter, such an inadvertent violation may be deemed not to compromise compliance with the fundamental principles provided, once the violation is discovered, the violation is corrected promptly and any necessary safeguards are applied.
- 100.11 When a professional accountant encounters unusual circumstances in which the application of a specific requirement of the Code would result in a disproportionate outcome or an outcome that may not be in the public interest, it is recommended that the professional accountant consult with a member body or the relevant regulator.

## *Threats and Safeguards*

100.12 Threats may be created by a broad range of relationships and circumstances. When a relationship or circumstance creates a threat, such a threat could compromise, or could be perceived to compromise, a professional accountant's compliance with the fundamental principles. A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle. Threats fall into one or more of the following categories:

- (a) Self-interest threat – the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior;
- (b) Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;
- (c) Advocacy threat – the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised;
- (d) Familiarity threat – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
- (e) Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

Parts B and C of this Code explain how these categories of threats may be created for professional accountants in public practice and professional accountants in business, respectively. Professional accountants in public practice may also find Part C relevant to their particular circumstances.

100.13 Safeguards are actions or other measures that may eliminate threats or reduce them to an acceptable level. They fall into two broad categories:

- (a) Safeguards created by the profession, legislation or regulation; and
- (b) Safeguards in the work environment.

100.14 Safeguards created by the profession, legislation or regulation include:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.
- External review by a legally empowered third party of the reports, returns, communications or information produced by a professional accountant.

100.15 Parts B and C of this Code discuss safeguards in the work environment for professional accountants in public practice and professional accountants in business, respectively.

100.16 Certain safeguards may increase the likelihood of identifying or deterring unethical behavior. Such safeguards, which may be created by the accounting profession, legislation, regulation, or an employing organization, include:

- Effective, well-publicized complaint systems operated by the employing organization, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behavior.
- An explicitly stated duty to report breaches of ethical requirements.

### *Ethical Conflict Resolution*

100.17 A professional accountant may be required to resolve a conflict in complying with the fundamental principles.

100.18 When initiating either a formal or informal conflict resolution process, the following factors, either individually or together with other factors, may be relevant to the resolution process:

- (a) Relevant facts;
- (b) Ethical issues involved;
- (c) Fundamental principles related to the matter in question;
- (d) Established internal procedures; and
- (e) Alternative courses of action.

Having considered the relevant factors, a professional accountant shall determine the appropriate course of action, weighing the consequences of each possible course of action. If the matter remains unresolved, the professional accountant may wish to consult with other appropriate persons within the firm or employing organization for help in obtaining resolution.

100.19 Where a matter involves a conflict with, or within, an organization, a professional accountant shall determine whether to consult with those charged with governance of the organization, such as the board of directors or the audit committee.

100.20 It may be in the best interests of the professional accountant to document the substance of the issue, the details of any discussions held, and the decisions made concerning that issue.

100.21 If a significant conflict cannot be resolved, a professional accountant may consider obtaining professional advice from the relevant professional body or from legal advisors. The professional accountant generally can obtain guidance on ethical issues without breaching the fundamental principle of confidentiality if the matter is discussed with the relevant professional body on an anonymous basis or with a legal advisor under the protection of legal privilege. Instances in which the professional accountant may consider obtaining legal advice vary. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant may consider obtaining legal advice in that instance to determine whether there is a requirement to report.

100.22 If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant shall, where possible, refuse to remain associated with the matter creating the conflict. The professional accountant shall determine whether, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

## International Ethical Standard on Audit Fees

### SECTION 240

#### Fees and Other Types of Remuneration

240.1 When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee is deemed appropriate. The fact that one professional accountant in public practice may quote a fee lower than another is not in itself unethical. Nevertheless, there may be threats to compliance with the fundamental principles arising from the level of fees quoted. For example, 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.

240.2 The existence and significance of any threats created will depend on factors such as the level of fee quoted and the services to which it applies. The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

Examples of such safeguards include:

- Making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee.
- Assigning appropriate time and qualified staff to the task.

### SECTION 290

#### Fees

##### *Fees Relative Size*

290.220 When the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, the dependence on that client and concern about losing the client creates a self-interest or intimidation threat. The significance of the threat will depend on factors such as:

- The operating structure of the firm;
- Whether the firm is well established or new; and
- The significance of the client qualitatively and/or quantitatively to the firm.

The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Reducing the dependency on the client;
- External quality control reviews; or
- Consulting a third party, such as a professional regulatory body or a professional accountant, on key audit judgments.

290.221 A self-interest or intimidation threat is also created when the fees generated from an audit client represent a large proportion of the revenue from an individual partner's clients or a large proportion of the revenue of an individual office of the firm. The significance of the threat will depend upon factors such as:

- The significance of the client qualitatively and/or quantitatively to the partner or office; and
- The extent to which the remuneration of the partner, or the partners in the office, is dependent upon the fees generated from the client.

The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Reducing the dependency on the audit client;
- Having a professional accountant review the work or otherwise advise as necessary; or
- Regular independent internal or external quality reviews of the engagement.

#### Audit Clients that are Public Interest Entities

290.222 Where an audit client is a public interest entity and, for two consecutive years, the total fees from the client and its related entities (subject to the considerations in paragraph 290.27) represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client, the firm shall disclose to those charged with governance of the audit client the fact that the total of such fees represents more than 15% of the total fees received by the firm, and discuss which of the safeguards below it will apply to reduce the threat to an acceptable level, and apply the selected safeguard:

- Prior to the issuance of the audit opinion on the second year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, performs an engagement quality control review of that engagement or a professional regulatory body performs a review of that engagement that is equivalent to an engagement quality control review (a pre-issuance review<sup>2</sup>); or
- After the audit opinion on the second year's financial statements has been issued, and before the issuance of the audit opinion on the third year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, or a professional regulatory body performs a review of the second year's audit that is equivalent to an engagement quality control review (a post-issuance review<sup>2</sup>).

When the total fees significantly exceed 15%, the firm shall determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review is required. In such circumstances a pre-issuance review shall be performed.

Thereafter, when the fees continue to exceed 15% each year, the disclosure to and discussion with those charged with governance shall occur and one of the above safeguards shall be applied. If the fees significantly exceed 15%, the firm shall determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review is required. In such circumstances a pre-issuance review shall be performed.

**Appendix C-2**  
**Texas Statute on Independence and Performing Audits at Less Than Direct Cost**

Sec. 901.458. LOSS OF INDEPENDENCE.

(a) In this section, "direct labor cost" means:

- (1) the total compensation paid to a person who performs services; and
- (2) the employer payroll expenses related to that compensation, including workers' compensation insurance premiums, social security contributions, costs of participating in retirement plans, group insurance costs, and unemployment taxes.

(b) A person creates a presumption of loss of independence if the person:

- (1) holds a certificate or firm license issued under this chapter; and
- (2) performs or offers to perform an attest service for compensation that is less than the direct labor cost reasonably expected to be incurred in performing the service.

(c) This section does not apply to the donation of services to a charitable organization as defined by board rule.