

**Auditor Independence and NAS:
A comparative Analysis of Selected
Current Regulatory Frameworks**

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Abstract

There is a widespread public perception that the provision of NAS undermines auditor independence. In order to protect auditor independence, the regulatory frameworks of many countries include regulations and guidelines which auditors are required to observe. This paper provides a comparative analysis of selected regulatory frameworks. Regulatory frameworks, with respect to independence, make distinctions between independence of mind and in appearance. It is clear from the analysis of the frameworks that the provision of NAS can threaten both independence of mind and in appearance. There are some NAS for which no safeguard seem to be adequate and which are therefore subject to prohibition. On the other hand, for some non-audit services the threats are not so clear-cut, and auditors are then required to apply professional judgment so that the seriousness of the threats is balanced against the effectiveness of specified safeguards.

Auditor Independence and NAS: A comparative Analysis of Selected Current Regulatory Frameworks

1 Introduction

In many countries the accounting profession themselves sets the rules applicable to members of the profession, and the profession itself regulates compliance with these rules. The profession regulates its members in relation to matters such as qualification, monitoring, complaints and discipline – requiring them to observe appropriate regulations and byelaws, including the profession’s code of ethics. Compliance with the code of ethics, and hence the principles relating to independence, is mandatory. Members can be subject to disciplinary action and/or the imposition of generally sanctions for breaches of (or non-compliance with) the Code. These sanctions vary in severity between fines and/or exclusion from membership. If members of the public, or other regulatory bodies, judge that self-regulation is not working, or is inadequate, then there is always a possibility that outside regulators will step in, as happened in the US in recent times.

In order to protect auditor independence, regulatory frameworks in various countries lay down regulations and guidelines which auditors are required to observe. This paper analyses the provisions contained in current regulatory frameworks in the United Kingdom (UK), the United States of America (US), New Zealand (NZ), Australia (AU), the European Commission (EC), the International Federation of Accountants (IFAC) and in Bangladesh - concerning professional independence in general, and the provisions that are specifically related to non-audit services.

2 Significance of NAS

It is argued by many researchers (e.g. Arrunada, 1999) that it is more economic for auditors to provide other additional services to their clients, since the auditor already has a good knowledge of the client’s business. The members of the Institute of Chartered Accountant in England and Wales (ICAEW) believe that unnecessarily restricting the provision of non-audit services would have an

unintended, adverse effect on the underlying quality of the audit through restrictions in knowledge and skills¹.

In many countries audit firms provide NAS to clients which are additional to the audit, but there are often restrictions on particular services and also the *caveat* that care must be taken not to perform management functions or to make management decisions. The scope of services provided by audit firms to their audit (and non-audit) clients has increased greatly (Oliverio and Newman, 2003). It is evident from the research literature (e.g. Beattie and Fearnley, 2003) that in some cases, fees received for non-audit services exceed the amount received from audit work. The significance of NAS is illustrated in the following tables. An analysis of fee income of the Big Five firms in 1990 and 1999 in the US is shown in table 1 and the percentage of UK companies purchasing NAS (by service category) from incumbent auditor and from elsewhere is shown in table 2:

Table 1

Analysis of fee income of the Big Five firms in the US: 1990 and 1999

Service Category	% of total fee income -1990		% of total fee income -1999	
	All clients	SEC audit client	All clients	SEC audit client
Accounting & Audit	53	71	34	48
Tax	27	17	22	20
Consulting	20	12	44	32
Total	100	100	100	100

Reported in Ramsay (2001, p58)

Source: Beattie, V. and Fearnley, S. (2003)

¹ http://www.icaew.co.uk/index.cfm?AUB=tb2I_50259,MNXI_50259&CFID=1183285

Table 2

NAS purchase (by service category) by UK listed companies in 1995

Service Category	% Purchasing from Incumbent Auditor*	% Purchasing from Elsewhere*
Corporate Tax	82	26
Accounting Advice	80	6
Due diligence	73	27
Corporate Finance	20	59
Accounts preparation Assistance	44	11
IT	16	50

* Percentage do not generally sum to 100% since some services will not be purchase at all by some companies, while other services may be bought from both the incumbent auditor and other.

Source: Beattie, V. , Brandt, R. and Fearnley, S. (1996)

Table 3 below provides the data from a recent survey conducted by the *Accountancy Age* (June 2002, pp. 18-19) and reported in Beattie and Fearnley (2003). The table shows the different kinds of NAS provided by large audit firms and the relationship to total fee income.

Table 3

Analysis of fee income by service category: 2001-2002

Firm	Total fee Income £ m	Audit/ Accounting %	Tax %	Consulta -ncy	Insolvency %	Corporate Finance %	Other %
Deloitte & Touche	822.0	30.2	23.2	25	15.1	-	6.5
KPMG	1372.6	30.2	20.1	24.8	5.3	6.6	13.0
Ernst & Young	722.2	39.6	38.6	-	-	21.8	-
Grant Thornton	204.5	30.7	30.7	-	18.6	10.8	9.2

Source: Beattie, V. and Fearnley, S. (2003)

Two distinct contractual relationships exist when audit and NAS are provided to the same client - and there is a danger that at times these distinct relationships may become blurred by the audit firm and by the directors (Beattie and Fearnley, 1998). Under the heading of NAS, a range of services is offered by audit firms to their clients. Among others, these services are: systems and IT; staff training; payroll services for SMEs; risk management advice; taxation consultation (including tax compliance and forward tax planning advice); corporate recovery and insolvency; legal; forensic and litigation support; mergers and acquisitions; transaction support and follow up (including due diligence and initial public offerings); recruitment and human resource advice and/or provision, and portfolio monitoring.

When audit and non-audit services are provided to the same client, the provider needs to be careful not to jeopardise their independence because there are

occasions where independence may be threatened or appear to be threatened by the provision of services other than the audit. Provision of some of these services might provide either a real or perceived threat to auditor independence. Therefore accounting professional bodies of various countries set out rules and regulations to identify these possible threats to auditor independence. They also offer guidance to offset the effects of anomalies and potential threats to independence for all parties.

3 Approaches Adopted in Developing Regulatory Frameworks for Establishing Auditor Independence

There are various approaches to the achievement of auditor independence. One approach is to regulate the auditor very tightly with detailed rules about what is permissible in auditing practice. This is referred to as the ‘rule based approach’. One version of this approach is to allow auditors some limited freedom to engage in selected (extra) professional involvement with their clients, as has been adopted by the SEC in the US. Another version is to prohibit auditors from any involvement with their client other than the performance of the strictly statutory audit.

There are two possible sides to the argument for this latter version. One side is based on the strength of legal regulations and requirements, which could be very effective if rigidly implemented. The other side is based on the assumption that if non-audit services (NAS) are prohibited, ignoring a client’s specifically NAS needs, then the auditor could possibly be placed in a dependent position and becomes reliant on the audit client’s fee. There would then be a ‘reduced’, though strictly monitored, service offered - which has the effect of limiting the auditor’s role, and therefore his income.

Another approach is to set independence guidance for auditors using a conceptual framework. As this approach is based on an analysis of fundamental principles, it is also known as ‘principles approach’. This approach was pioneered in the UK and Ireland in 1996 (ICAEW, 2004a) by the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants of Scotland (ICAS) and the Institute of Chartered Accountants in Ireland (ICAI). It has been the basis of much of the ethical guidance currently implemented by these institutes. This approach now forms the basis of the auditor-independence section of

the IFAC Code of Ethics, and has also been adopted by the EC as well as many other countries (ICAEW, 2004a). Ethical guidance based on this framework includes illustrative examples of threats that might arise, and provides appropriate measures for dealing with them.

4 Regulatory Frameworks Relating to Auditor ‘Independence of Mind’ and ‘Independence in Appearance’

Strict independence for the accounting profession is wider than auditor independence. ‘Independence’ and ‘objectivity’ are closely related, and together form the absolutely fundamental principles of accounting and auditing practice. The fundamental principles of objectivity and independence impose on all members of the accounting profession requirements to be impartial, intellectually honest, and fair. There should be no prejudice, bias, conflict of interests, or any other factor which might compromise objectivity in respect to the operation of professional duty.

Because of the nature of the work, independence in relation to the statutory audit has a particular and specific implication. For, in this type of work, auditors have access to private and financial information, the detail of which is confidential, while the outward assessment of which is made public as information expressed in a financial statement. Auditors form and express an opinion on the truth and fairness of the information contained in ensuing financial statements, and are therefore likely to have an impact on the financial and business dealings of both the client and users of the financial information.

Provisions in the regulatory framework for auditors, with regard to “independence” make distinctions between ‘independence of mind’ and ‘independence in appearance’. Table 4 states established definitions, and comments on “independence” as laid down in the selected regulatory frameworks. Due to insufficient detail about the distinctions between ‘independence of mind’ and ‘independence in appearance’ in the manual of professional ethics published by the Institute of Chartered Accountants of Bangladesh in 1993, it is not possible to include Bangladesh in this table.

It is clear from the definitions that all regulatory frameworks recognise the importance of auditor independence, and that they share the terminology of

‘independence of mind’ (or independence in fact) and ‘independence in appearance’. In addition, all frameworks recognise that ‘independence of mind’ is not observable and verifiable in advance. The SEC’s rule states that: ‘independence of mind’ cannot be measured by looking into isolated evidence. It requires concrete evidence of the elements of each circumstance to establish the breach (or otherwise) of ‘independence of mind’. To judge ‘independence in appearance’, most of the selected frameworks emphasise a reliance on the belief (or otherwise) of a “reasonable and informed third party” (e.g., IFAC, ICANZ, ICAEW, Australia, EC) - coupled with the opinion of investors (cf. the SEC rules).

Table – 4

Definitions and comments about independence expressed in a selection of regulatory frameworks

Frameworks	Distinctions between ‘independence of mind’ and ‘independence in appearance’	Comments
IFAC Code 2003	<p><i>Independence of mind</i> – the state of mind that permits the provision of an opinion without being affected by influences that impairs professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; (Section 8.8, (a), 2003) and</p> <p><i>Independence in Appearance</i> – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s, Integrity, Objectivity or professional scepticism had been impaired (Section 8.8 (b), 2003)</p>	<p>The use of the word “independence” on its own may create misunderstandings. Standing alone the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic financial and other relationships. This is impossible as every member of society has relationship with others. Therefore, the significance of economic, financial and other relationship should be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable. (Section 8.9, 2003)</p>
ICANZ Code of Ethics:	The definition of Independence of Mind is similar to IFAC definition.	Independence is an essential requirement for members performing certain types of assurance engagement such as

Independence in Assurance Engagement, August, 2003	<i>Independence in Appearance</i> – (a) the avoidance of facts and circumstances any product or judgement of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement; or (b) a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of assurance engagement.	the external audit or review of a financial report. Independence also applies to some other professional services. (ICANZ Code of Ethics 2003, Paragraph 36)
UK (ICAEW ethical guide) 2005	The Institute of Chartered Accountants in England and Wales (ICAEW) has implemented a new Statement 1.201: Independence in Assurance Engagement, in its Guide to Professional Ethics. Much of the Statement relates to independence when carrying out assurance engagements other than audit, and this will apply to such engagements commencing on or after 1 April. The definition and interpretation of Independence in Mind and in Appearance in section 3.1 (a) & (b) of this new statement is same as IFAC 2003 definition and interpretation of <i>Independence in Mind</i> and <i>in Appearance</i> . [News released on February 9, 2005]	
Australia	The interpretation and definition of <i>Independence of Mind</i> and <i>in Appearance</i> under principle 12 & 14 of Australian code of ethics (2002) is similar to IFAC definition and interpretation.	
EC, 2002	<i>Independence of mind</i> – Objectivity (as a state of mind) cannot be subject to external verification, and integrity cannot be	Independence is not an absolute standard which statutory auditors must attain, free from all economic, financial and

	<p>verified in advance (1.2). The state of mind which has regard to all considerations relevant to the task but no other (Annex A1).</p> <p><i>Independence in Appearance</i> – The avoidance of fact and circumstances which are so significant that a reasonable and informed third party would question the statutory auditor’s ability to act objectively (Annex A1).</p>	<p>other relationships that could appear to entail dependence of any kind. Such a state is manifestly impossible as everyone has some dependency or relationship with another person (Annex A1).</p>
<p><u>US</u> SEC Rules</p>	<p><i>Independence of mind</i> – Objectivity is a state of mind and except in unusual circumstances a state of mind is not subject to direct proof. Usually it is demonstrated by reference to circumstantial evidence (Discussion of Final Rules. C. The General Standard for Auditor Independence).</p> <p><i>Combined Statement on independence of mind and in Appearance</i> – The Commission will not recognise an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgement on all encompassed within the accountant’s engagement (Part</p>	<p>In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client and not just those relating to reports filed with the Commission (SEC, part 210.2.01(b))</p>

<p>AICPA</p>	<p>210.2.01 (b))</p> <p><i>Combined Statement on independence of mind and in Appearance</i> – Objectivity is a state of mind, a quality that lends value to a member’s services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member’s objectivity in rendering attestation services. (ET section 55 .01)</p>	<p>The maintenance of objectivity and independence requires a continuing assessment of client relationship and public responsibility. A member who provides auditing and other attestation services should be independence in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest. (ET section 55.03)</p> <p>It is stated in the Public Company Accounting Oversight Board’s (PCAOB) Bylaws and Rules relating to Professional Standards that a registered public accounting firm, and its associated person, shall comply with independence standards as described in the AICPA’s Code of Professional Conduct Rule 101, and interpretations and rules thereunder to the extent not superseded or amended by the board; and Standards Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2, of the Independence</p>
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		<p>standards Board, to the extent not superseded or amended by the board.</p> <p>It is also mentioned that the Board's Interim Independence Standards do not supercede the SEC's auditor independence rules. Depending on restrictive nature of the rule of the SEC i.e. whether the SEC's rules are is more restrictive or less restrictive than the Board' Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule. (Source: http://www.pcaobus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/Rules%20-%20Section%203%20-%20Professional%20Standards.pdf).</p>
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Sources: Beattie, V. and Fearnley, S. (2003); Code of Ethics of Institute of Chartered Accountants of New Zealand 2004, IFAC website (http://www.ifac.org/Members/Downloads/2003_Ethics.pdf), ICAEW website, EU website and AICPA website.

5 Regulatory Frameworks Relating to Auditor Independence and the Provision of Non-Audit Services

5.1 ICANZ, IFAC, UK, EC, and Australian Frameworks

The publication by IFAC of the revised Code of Ethics for Professional Accountants is in line with the conceptual approach to auditor Independence earlier followed in the UK. The ethical guidance based on this approach includes illustrative examples of possible threats to independence that may arise, and the appropriate safeguards to deal with them. New Zealand has basically followed the IFAC rules as the basis of their requirements and Australia has done the same². In May 2002, the European Commission published a Recommendation titled “Statutory Auditors’ Independence in the EU: A set of Fundamental Principles” (for details please see <http://www.iasplus.com/resource/euaudit.pdf>). Along with other issues, it addresses the provision of non-audit services to audit clients and the disclosure by companies of audit and non-audit fees.

There is no objection to a firm providing advisory services to a company (in addition to the audit) under the ICAEW’s Professional Ethics guideline. However, there are occasions where independence may be threatened, or appear to be threatened, by the provision of services provided to a client other than the audit. Therefore, due care must be taken to ensure a professional distance from the management functions and decisions of an audit client.

The regulatory frameworks of IFAC, ICANZ UK, Australia and EC all identify the following five threats to independence. These threats are: self interest; self review; advocacy; familiarity and intimidation. Out of these five potential threats intimidation is the only threat which does not arise from the provision of NAS because it covers the possibility that a member of the audit team may be deterred from acting objectively and exercising professional scepticism by threats or by fear of an influential or overbearing client.

² Corporate Law Economic Reform program (CLERP), PAPER 9: Corporate Disclosure: Strengthening the financial reporting framework, September 2002.

5.1.1 Outline of the four types of threats may occur as a result of NAS

A brief outline of the four types of threats which may still occur as a result of NAS - are as follows.

The self-interest threat

An auditor's independence may be threatened if a firm or a member of the audit team benefits from a financial interest or some other self-interest conflict with an audit client. This could arise, for example, from a direct or indirect interest in a client; or from a fear of losing the client. In other words, all work that creates a financial relationship between the auditor and the audit client may create a self-interest threat. The perceived threat to independence grows with the amount/size of the ensuing fee payable, and the self-interest caveat is thus increased further by providing NAS to the audit client³. But the most significant dimension of any threat, real or perceived, is likely to be the size of the total fees payable earned from a client in relation to the whole fees of the auditing firm.

The self-review threat

This relates to the difficulty of maintaining objectivity when conducting a self-review procedure. This can arise when any product or judgement from a previous audit (or non-audit) assignment needs to be challenged, or re-evaluated in reaching the current audit conclusions; or when a member of the audit team has previously been a director or officer of the audit client, or was employed in any position likely to affect the subject matter of the audit engagement.

Therefore an auditor should give careful consideration to every issue bearing on the self-review threats. This includes the materiality of the amounts involved (in relation to the financial statements) and the degree of subjectivity inherent in any judgement of the elements concerned⁴.

³ Though regulatory body believes that the perceived threat to independence increased further by providing NAS to the audit client and related fees payable, the results of the empirical studies on the impact of NAS provision on auditor independence perceptions offer conflicting results.

⁴ Evidence from experimental studies of actual auditor independence suggests that auditor behave more independently and some time become more critical when faced with the self-review threat (see Corless and Parker 1987; Dopuch and King 1991; Davidson and Emby 1996)

The Advocacy Threat

Advocacy in a simple sense is where a firm supports its clients' interests. But advocacy can take a 'sharpened' form where the firm supports its client in a conflict or adversarial situation. For instance, advocacy in any sharpened form is likely to threaten an auditor's independence, and appears to be incompatible with the particular objectivity required by the audit-reporting role. This separation of roles is vital to auditor credibility.

Therefore, if a firm, or a member of the audit team, becomes an advocate for (or against) the audit client's position in any adversarial proceedings (or situations) there may be serious ethical compromise. Examples of this confusion of roles may occur when acting as an advocate on behalf of the client in litigation; or when the client litigates against the auditor; when dealing in or promoting shares (or securities) issued by the client, etc. These activities are obviously considered likely to impair/compromise auditor independence.

The familiarity or trust threat

By virtue of the close relationship with an audit client, its directors, officers and employees, there is a risk that the auditor may be influenced by the client's business ambience. This caution against over-familiarity must also include the influence of a client's personality and other personal qualities. There is the danger that these factors may subsequently contribute to excessive trust in that client. In this situation the auditor runs the risk of becoming too sympathetic to the client's interests, and because of this the objective testing of the client's representations and claims may be insufficient. An auditor should be extremely careful not to go beyond the advisory role and not drift into influencing the management sphere. Such a drift is potentially damaging to both parties.

Each of the above threats may arise in relation to the auditor's own person. But problems may ensue from the relation to a connected person. For instance, such relationship as a member of his/her immediate family, a partner, a spouse, or any other person who is close to him for other reasons - such as past or present associations in business, or some private informal obligation, contract, or indebtedness.

5.1.2 Safeguard to Offset Any Threat to Independence

Existing regulatory frameworks also suggest that when significant threats are identified, auditors should always consider the use of appropriate safeguards and procedures to reduce such threats to an ‘acceptable’ level. Auditors should be prepared to demonstrate that in relation to each identified threat, they have taken appropriate measures to preserve their objectivity. The nature of the safeguards to be applied will vary, depending upon the circumstances, and will be affected by matters such as the significance/degree of the threat, the nature of the audit engagement, the intended/target users of the audit report, and the structure of the firm providing that report. In direct relation to these potential (subjective) problems, auditing safeguards fall into three broad categories. They are:

Those created by the profession, legislation or regulation - that is regulatory safeguards and sanctions originating from legal or professional requirements. For example, professional standards, recognised prohibitions, disclosure requirements, ethical guidelines, oversights, monitoring of disciplinary processes and actual enforcement.

Safeguards within the audit client – for example: approval by other persons (when management appoints the audit firm); audit committee providing appropriate supervision/oversight; clear communication in regard to an audit firm’s services (fuller disclosure of the value and nature of non-audit services bought from the auditor); and the employment of well-qualified staff to ensure that all members of the audit team make appropriate decisions.

Safeguards within the audit firm’s own systems and procedures- There must also be safeguards within the audit firm’s own systems and procedures. That is, safeguards which can either extend across the firms total operation, or for engagement-specific auditing. For example, well documented independence policies regarding the identification, evaluation and application of safeguards to minimise threats; internal policies and procedures to monitor compliance with the said documented policies; policies and procedures to monitor and implement quality control of the audit engagement; availability of independent consultation

procedures; internal review of partners; division of responsibilities; policies and procedures enabling staff to communicate with senior level auditors (without censure) regarding any concerns with the issues of independence, objectivity and fair-dealing practice.

The first two categories of safeguards are not within an audit firm's control. Finally, if the safeguards available are insufficient to reduce the threats to independence to an 'acceptable level', or if a company chooses not to eliminate the contaminating activities or interests which contribute to creating that threat - then the only course of action available to the audit firm is to refuse to perform, and withdraw from the audit engagement.

5.2 Recent Events: US Regulatory Framework

Late 2001 saw the collapse of Enron Corporation and in 2002 WorldCom disclosed that fraudulent accounting practices has been employed over a period of several years and in mid 2002 filed for bankruptcy. The results of these scandals (and others) seriously impacted on the capital market and the impact was so severe that more direct and urgent action by government was claimed to be warranted and as a result President George W. Bush, in July 2002, signed of legislation titled "the Sarbanes-Oxley Act 2002". One of the impacts of the legislation has been to remove aspects of self regulation from the accounting profession.

Title II of the Act, entitled "Auditor Independence" makes it unlawful for an auditor to provide specified non-audit services to audit clients, and allows the supply of NAS only with the approval of company's audit committee. The Act requires rotation of the lead audit partners at least every five years. Appendix – 1 provides further details. In giving effect to the Act, the SEC developed detailed rules regarding auditor independence, and these became effective from 6 May, 2003. They are intended to enhance the independence of accountants who audit and review financial statements and prepare attestation reports that are subsequently filed with the SEC.

These rules focus on key aspects of auditor independence. They are: allowance for the provision of certain non-audit services; the ability and

responsibility of the audit committee to insulate the auditor from pressures that may be exerted by management; the potential conflict of interest that may inadvertently be created when a former member of the audit engagement team subsequently accepts a key management position with the audit client; and the need for clear and effective communications between the auditor and audit committee. In addition, an accountant is not seen as independent (from an audit client) if any audit partner receives any form of ‘compensation’ based directly on selling engagements to that client for services other than audit, review, and attestation services (Sealy-Fisher, V. 2003).

5.2.1 Scope of Services Provided by Auditors under SEC Rules

The SEC's principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client.

Section 10A(g) of the Sarbanes-Oxley Act of 2002 states that it shall be unlawful for an audit firm, performing an audit service, to provide to that same client, contemporaneously with the audit, any non-audit services; including the nine categories of service set forth in the Act. The Act also states that the provision of any non-audit service, including tax services, that is not described as a prohibited service, can be provided by the auditor without impairing the auditor's independence – but *only if* the service has been pre-approved by the audit committee.

In US, some commented (e.g. Arthur Levitt, former SEC chairman) that the SEC should prohibit audit firms from performing most, if not all, non-audit services. Others supported a less stringent approach. The prohibited services contained in the SEC's rules only apply to non-audit services provided by independent auditors to their audit clients. These rules do not limit the scope of non-audit services provided by an accounting firm to a non-audit client. It should be noted that under the Act, on behalf of investors, the power is removed from the management and the responsibility falls on the audit committee to pre-approve all audit and non-audit services provided by the auditor.

5.2.2 The categories of prohibited non-audit services in the Act

The nine categories of prohibited non-audit services included in the Act are:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems - design and/or implementation;
- Appraisal or valuation services, 'fairness' opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resource engagement;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other service that the oversight board determines, by regulation, is not permitted.

5.3 Bangladesh Regulatory Framework on Non-audit Services

Besides providing statutory audit service, many chartered accountant firms in Bangladesh also provide various types of non-audit services. Two of the most important non-audit services are management consultancy services and tax advice. As in other countries, there is widespread concern that the provision of non-audit services may impair auditor independence. In November 1993, the Institute of Chartered Accountants of Bangladesh (ICAB) published a manual entitled *Manual of Professional Ethics*. This is still the only published document, and the only authoritative published manual on professional ethics. As prescribed in the ICAB's ethics manual, a chartered accountant can provide non-audit services either by forming a specialist department within the firm, or by the formation of either a separate firm or an unlimited liability company (ICAB 1993, p.51). Ethical conduct

of the members of the Institute is determined and guided by the definition of “professional misconduct” in Schedule ‘C and D’ of this manual. (see in Appendix - 2)

The political, cultural and geographical climate in Bangladesh is such that many people ignore the law in respect of their activities. Recently, the ICAB conducted a survey by interviewing some of the persons and organisations connected with and affected by the chartered accountancy profession. The report on the survey revealed that some chartered accountants undercut their colleagues in respect of professional fees, which is in violation of a directive issued by ICAB. It was also revealed in the survey that there are not uncommon instances of the signature of some chartered accountants in practice being forged by unscrupulous persons, resulting in dubious audit reports being issued. This has created an unwarranted bad reputation for the profession as a whole. Surprisingly the survey also has revealed that as to ethics, there is no perceived shortcoming in the present provisions. However, it is stated in the report that “unethical and sub-standard performance of a few in the profession has raised people’s eye brows” (ICAB, 2003b).

In order to check unethical activities in the profession, the following recommendations which have been suggested following the survey report (ICAB, 2003b): like the ICAEW, the Institute should lay down some fundamental principles; a system of surveillance should be introduced by the ICAB on the performance of its members; a consensus between ICAB and business community needs to be reached so that, in the case of a private limited company, a chartered accountant firm should not be allowed to audit for more than five consecutive years.

The ICAB has admitted that ethical problems arising in the field of management consultancy are complex (ICAB 1993, p.51). Schedule ‘D’ of the by-laws sets out the regulations for members engaged in non-audit services, for example, management consultancy and mechanised accounting or computer services. But unfortunately this schedule does not set out the nature and types of management consultancy services in detail. As a result, unlike recent regulatory frameworks such as UK, IFAC, ICANZ, and the SEC, there is no detailed regulation relating to those services in Bangladesh. According to this schedule any services for management, except auditing and tax work, may be considered management consultancy services.

Also, the schedule does not provide professional guidance as to the nature of tax services that a professional may perform for his client. The salient features of this schedule, pertaining to members becoming engaged in management consultancy services, are:

- A member, whether or not in practice, must obtain the prior consent of the ICAB council to engage in management consultancy services even if not engage in audit. This appears to be a very strict rule compared to other countries. However, the criteria that the ICAB apply have not been disclosed and anecdotal evidence indicates that the consent is easily obtained.
- Any member, as well as the firm or company with which he/she is associated, is required to abide by the rules for professional conduct in the relationships with clients, the public, fellow members, and the Institute set down by the Institute (in respect of remuneration, confidentiality, substantial interest, negligence, clients money and pricing).
- An employee member is held responsible for any action of his employer which contravenes the rules for the professional conduct of the institute if he is a party thereto.
- Each member is responsible from the ethical standpoint for the conduct of a company and its directors and officers as if the company were a firm in which he is a partner.
- A member (or a partner of in any firm in which he is a partner) should not accept auditing, taxation, or any other conventional accountancy work from any client introduced to him for non-audit services by the client's own professional accountant.
- As a matter of professional courtesy, a member should communicate with the existing client's professional accountant (or consultant) - informing him of the special work he has been asked to undertake in the event of the introduction for non-audit work other than through the existing professional accountant.

6 Recommended Treatment of NAS in Selected Regulatory Framework

The table 5 shows how the regulatory frameworks of IFAC, New Zealand (NZ), ICAEW, Australia, EC, and SEC (US) address the threats to independence posed by provision of NAS. Due to insufficient detail about the regulation relating to NAS (by service category) in the professional ethics manual of ICAB, it is not possible to include Bangladesh in this table to make a meaningful comparison with others. It is also to be noted in the table that none of the frameworks offers guidance on all the types of services identified. Where a particular service is not referred to in the framework, in the table it is referred as ‘no specific guidance’ but in fact it might be ruled out by implication. This means that in the absence of specific and transparent rules or guidelines, providers of non-audit services may be found simply to default to their own understanding.

It is clear from the table that the absolute prohibitions are for activities which clearly demonstrate exercising management authority and auditing one’s own work. However, for other services where it is not clear whether there is a risk to independence, the auditors are required to apply judgement considering the extent of the whole relationship with the client and whether safeguards are available to mitigate the risk. SEC has the least flexibility, and in particular imposes the most restrictions on internal audit activities and prohibits actuarial services and broker/dealer services whereas, in other frameworks, no specific guideline is provided on this issue. Where prohibited, there is no scope for an independent professional judgement (by the auditor) about the seriousness of the threat and the effectiveness of available safeguards which could be applied before proceeding with any NAS. This may be due to the fact that independence requirements in the US are in the form of specific rules that are, in fact, set out by the SEC itself – while other regulatory frameworks are reliant on a principles-based approach. Although the rules are derived from underlying principles, it is compliance with the rules themselves, rather than the underlying principles that is taken as the test of independence.

But, although every endeavour is made to ensure that the rules are kept up-to-date and comprehensive, even a rule-based approach will always be open to circumvention. Unprincipled auditors will find new and more inventive ways of

complying with the form of the rule rather than the moral substance of the rule. Such avoidance of the spirit of the professional ruling will vary from dubious practice to outright dishonesty.

Table – 5 : Recommended Treatment of NAS in Selected Regulatory Framework

Types of NASs Referred to in Frameworks	Regulatory Frameworks					
	IFAC	NZ	ICAEW	Australia	EC	SEC
Exercise management authority	No	No	No	No	No	No
Determine client implementation of auditor’s own recommendations	No	No	No	No	No specific guidance	No specific guidance
Report in a management role to client governance body	No	No	No	No	No specific guidance	No specific guidance
Custody of client assets	Normally No	Normally No	Normally No	Normally No	No specific guidance	No specific guidance
Supervise client employees in normal activity	Normally No	Normally No	Normally No	Normally No	No specific guidance	No specific guidance
Prepare accounting records and financial statements for public interest entities	Normally No	Normally No	Normally No	Normally No	Normally No	Normally No
Valuation services and other expert services	No if material	No if material	No if material	No if material	No if material	Normally No
Taxation services	Yes	Caution	Caution	yes	No specific guidance	No specific guidance
Internal audit services	Caution	Caution	Caution	Caution	Caution	Normally No
IT services & Financial information	Caution	Caution	Caution	Caution	Normally No	Normally No

technology systems						
Temporary staff assignments	Caution	Caution	Caution	Caution	No specific guidance	No specific guidance
Litigation support services	Caution	Caution	Caution	Caution	No if material	No specific guidance
Legal services	Normally No	Normally No	Normally No	Normally No	No specific guidance	No
Recruiting senior management & HR	Caution	Caution	Caution	Caution	No	No
Corporate finance and similar	Caution	Caution	Caution	Caution	No specific guidance	No specific guidance
Actuarial services	No specific guidance	No specific guidance	No specific guidance	No specific guidance	No specific guidance	Normally No
Broker/dealer services	No specific guidance	No specific guidance	No specific guidance	No specific guidance	No specific guidance	No

Sources: Beattie, V. and Fearnley, S. (2003), Code of Ethics of Institute of Chartered Accountants of New Zealand 2004, and the Institute of Chartered Accountants in England and Wales new Statement 1.201: Independence in Assurance Engagement, in its Guide to Professional Ethics .

Note: No = prohibited;
Normally No = prohibited except in very limited or exceptional circumstances;
No if material = only permitted if the figures involves are not material to the financial statements;
Caution = threats and safeguards of each case should be considered before proceeding;
Yes = permitted
No specific guidance = not referred to as NAS in the framework, therefore no specific guidance provided.

Compared with other frameworks, IFAC is the most comprehensive and, as noted earlier, Australia and New Zealand have basically followed the IFAC rules. It should be noted in particular that both ICAEW and ICANZ recognise that providing taxation services may create a threat to the professional independence of the auditor and therefore their framework require considering the threats and safeguards before proceeding. Except for SEC rules, all other frameworks indicate that pertinent judgements need to be applied to measure the risk of impairing auditor independence associated with certain activities.

However, further disclosure of the composition of NAS, including the justification of concomitant fees payable, would facilitate observers in making some informed judgements about the appropriateness of extra services provided by an audit firm to their client. (Beattie and Fearnley 2003).

6.6 Conclusion

There is a widespread public perception that the provision of NAS undermines auditor independence. It is also clear from the analysis of the above mentioned frameworks that the provision of NAS threatens both independence in fact and in appearance. There are some NAS for which no safeguard seem to be adequate and which are therefore subject to prohibitions. On the other hand, for some non-audit services where threats are not clear-cut, the auditors are required to apply professional judgments so that the seriousness of the threats is balanced against the effectiveness of available safeguards. The aim of these frameworks is to meet the expectation of knowledgeable, well informed third parties or investors. But it is not clear about the level of knowledge these individuals are expected to have and how they should acquire this knowledge as there is little in the public domain about how auditors behave (Beattie and Fearnley 2003).

The regulatory frameworks, to a greater or lesser extent, recognise that auditor independence is not and cannot be an absolute standard. Ethical standards may tend to decrease when a population is regularly faced with political and social change. Moreover, the struggle, simply for survival, tends to override attention to ethical considerations. This leads to aggressive competition among auditors for

clients, and the frequent undercutting of costs in their practices. In this competitive climate, there is no incentive to observe and comply with ethical practice. Therefore sometime the combination of culture, climate and politics becomes a powerful force against ethical practice in a profession. These forces can be difficult to understand when living in a 'developed' state or nation. For this reason, in Bangladesh, there needs to be a firm application of ethical standards, not only required by law, but actively enforced.

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Appendix - 1

SARBANES-OXLEY ACT 2002: PROHIBITED CATEGORIES OF NON-AUDIT SERVICES (NAS)

SOx Prohibited Categories of NAS	SEC Rules
Bookkeeping or other services related to the accounting records or financial statements of the audit client.	Prohibition on bookkeeping or other services related to the audit client's accounting records or financial statements – this would place the auditor in the position of auditing the audit firm's own work.
Financial information systems design and implementation.	The rules prohibit an auditor from providing any service related to the audit client's information system, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. These rules will not preclude an auditor from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records as long as those services are pre-approved by the audit committee.
Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.	Appraisal or valuation services or fairness opinions – the rules will prohibit an auditor from providing such services unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.
Actuarial services.	Actuarial services – prohibited when they involve the determination of amounts recorded in the financial statements. An auditor may assist a client in understanding methods, models, assumptions and inputs used in computing an

	amount.
Internal audit outsourcing services.	Prohibited where they relate to the client's internal accounting controls, financial systems or financial statements unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.
Management functions or human resources.	Management functions – an auditor must not act, temporarily or permanently, as a director, officer, or employee of an audit client, or perform a management function. Human resources – an auditor cannot be involved in recruiting, or recommending, a specific candidate for a specific job.
Broker/dealer, investment adviser or investment banking services.	Broker/dealer services – an auditor cannot act as a registered (under the Securities Exchange Act 1934) or unregistered broker/dealer.
Legal services and expert services unrelated to the audit.	Legal services – an auditor cannot provide any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a jurisdiction. Other expert services are not prohibited. Prohibition on expert services provided in any litigation, administrative or regulatory proceedings, as this would involve the auditor acting as an advocate for the audit client. Auditors may appear as expert witnesses and may, for example, provide factual testimony on work done for audit clients before bodies such as the SEC and the Internal Revenue Service.
Any other service that the Public Company Accounting Oversight	Although out with the rules themselves, the SEC has been guided by four principles. An auditor is not independent when the auditor:

<p>Board determines, by Regulation, is impermissible.</p>	<ul style="list-style-type: none"> - has a mutual or conflicting interest with the audit client; - audits his/her own firm's work; - functions as management or an employee of the audit client; - acts as an advocate of the client. <p>Tax services have been specifically considered. Auditors may provide tax compliance, tax planning and tax advice to clients, subject to audit committee pre-approval. But auditors cannot represent an audit client in tax court or other advocacy situations.</p>
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Appendix - 2

SCHEDULE 'D'

MANAGEMENT CONSULTANCY

REGULATIONS:

Subject to the prior consent of the Council, a member may act as proprietor, partner or director of a management consultancy firm or an unlimited company:

Provided that a member already engaged in the practice of management consultancy either through a firm or an unlimited company at the date of commencement of the Order shall not be required to obtain fresh consent of the Council.

CODE OF ETHICS:

A member engaged in management consultancy-

(1) shall not advertise or solicit for work or issue any circular, calendar or publicity material;

(2) shall not issue brochures, except to existing clients or in response to an unsolicited request;

(3) shall not use designatory letters indicating qualifications of the director; and members of the company on letter-heads, note papers or professional cards except as provided in Paragraph (10) of Part I of Schedule 'C';

(4) shall not refer to associated firms of management consultants on their letter-heads or professional cards or announcements or vice-versa;

(5) shall not adopt a name or associate himself as a partner or director of a firm or a company whose name is indicative of its activities;

(6) shall not use the designation CHARTERED ACCOUNTANT(S) for his management consultancy firm or company;

(7) shall not share profits or remuneration in a manner contrary, to Paragraphs (3) and (4) of Part I of Schedule 'C' except when he associates with non-members as stated in regulation 13 of this Schedule;

(8) shall not accept, nor shall a partner in any firm in which he is a partner accept, auditing, taxation or other conventional accountancy work from any client introduced to him for management consultancy services by the client's own professional accountant;

(9) may write a personal letter or make a direct approach to another member of the profession in practice offering his firm's or company's services;

(10) may only use the term 'MANAGEMENT CONSULTANT(S)' where he is connected with an organisation in the management consultancy field as proprietor, partner or director. This is intended to exclude such terms as "BUSINESS CONSULTANT", "ADVISORS TO MANAGEMENT" "INDUSTRIAL CONSULTANT", etc.;

(11) shall abide by the rules of professional conduct of the Institute and shall ensure that the firm or company with which he is associated either as proprietor, partner or director abide by those rules;

(12) shall be responsible from the standpoint of ethics for the conduct of the company and its directors and officers as if the company were a firm in which he is a partner. Further an employee member shall be held responsible for any action of his employer which contravenes the rules of professional conduct of the Institute jibe is a party thereto;

(13) may associate with non-members for the rendering of various management consultancy services as long as such non-members observe the bye-laws and code of professional ethics of the Institute;

(14) shall communicate as a matter of professional courtesy with the existing professional accountant or consultant informing him of the special work he has been asked to undertake in the event of an introduction for management consultancy work other than through the existing professional accountancy;

(15) shall not do under the guise or through the medium of a company or firm anything which he is not allowed to do as an individual.

(ii) MECHANISED ACCOUNTING OR COMPUTER SERVICES:

In addition to the rules of ethics applicable to management consultancy work, the following rules shall apply to mechanised accounting or computer services:

(1) Such services shall not be advertised nor shall there be soliciting other than by direct communication with other member of the profession who an in practice.

(2) A member offering such services shall not accept auditing, taxation or other commercial accounting work from any client introduced to him by the client's own professional accountant for the provision of mechanised accounting or computer services.

(3) A member shall communicate as a matter of professional courtesy with the existing accountant notifying him of the special work he has been asked to undertake in the event of an introduction for mechanised accounting or computer services other than through the existing accountant.