EY Global Limited
6 More London Place
London
SE1 2DA

Tel: +44 20 7980 0000
Fax: +44 20 7980 0082
ey.com

Building a better working world

Mr. Ken Siong
International Ethics Standards Board for Accountants
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

1 March 2018

Dear Mr. Siong:

Fees Questionnaire

Ernst & Young Global Limited, the central coordinating entity of the Ernst & Young organization, fully supports the Board's efforts to promote ethical behavior by professional accountants, whether in business or public practice, and we appreciate the Board's desire to understand the impact on auditor independence of every aspect of the audit. Accordingly, we can understand the Board's intention to better comprehend the possible threats to independence that could be associated with inappropriate levels of fees, whether this relates to the level of audit fees, the level of fees from non-audit services to audit clients, or the level of fees from non-audit services to non-audit clients. Due to the complexity of the subject we prefer to provide our views by means of this letter rather than completing the Board's questionnaire.

The IESBA Code of Ethics already identifies and addresses the threats to independence that may derive from an inappropriate level of fees.

These include:

1. Section 240 "Fees and Other Types of Remuneration" lays out the ethical requirements regarding fees for all professional services provided by professional accountants in public practice. This section states that a professional accountant may quote "whatever fee is deemed appropriate" and that quoting a fee lower than another accountant is "not in itself unethical". Nevertheless, threats to fundamental principles (professional competence and due care) are created when a fee is so low that it may appear to be difficult to comply with applicable technical and professional standards.
2. Section 290.215 – 222 describes the independence requirements under the Code as they relate to threats to auditor independence deriving from fee dependency, overdue fees and contingent fees and the potential safeguards that may be implemented to reduce any such threats to an acceptable level. This section discusses the threats created when revenues from a single audit client represent a significant portion of the total revenues of a firm, an office or an individual partner and the safeguards that can be implemented to reduce the independence threats to an acceptable level.
3. Section 290.223 – 224 prohibits key audit partners from being evaluated and compensated for their efforts in selling non-audit services to their audit clients to address any related independence threats.

As discussed in more detail below, we believe that these provisions and the underlying principles are still current and address the fundamental risks discussed in the IESBA fee questionnaire.

Determining the right level of audit fees

We agree that fees that are excessively low could present a threat to fundamental principles. In particular, they may present a threat to the principle of professional competence and due care. For example, low fees could create economic pressure on audit engagement teams to reduce procedures. However, audit firms make pricing decisions that are driven by a variety of factors. For example, an audit firm may decide to offer a lower fee to facilitate entry into a particular geographical market or to gain a foothold in a certain industry.

Of course, whatever the pressures or fee decisions, an audit requires compliance with a uniform set of professional standards. These standards represent an important safeguard against the threat to professional competence and due care because they must be complied with whatever the fee that is charged.

Accordingly, it is important that the effort needed to perform the work be evaluated properly and the engagement economics resulting from the proposed fee are considered in the engagement acceptance decision. The audit firm's system of quality controls should include policies and procedures that ensure that such an evaluation is undertaken. This is often accomplished through the application of engagement economic thresholds which when exceeded require an assessment of engagement acceptance at organizational levels beyond the engagement partner.

Fee dependency

As noted above, Section 290.215 – 222 describes how fee dependency can represent a threat to fundamental principles. In particular, it describes the safeguards that are required to address such threats where fees from a single public interest entity audit client exceed 15% of the total fees received by the firm. We believe that these provisions remain appropriate.

In relation to other forms of fee dependency such as where one particular client represents a significant portion of the fees of an office or an individual partner, the threats associated with such a situation are best addressed through the organizational structure of the firm and, in particular, the way profits are shared. It is not uncommon in an audit firm that a particular client represents a major portion of the revenues of one office or one partner. This may be due to the location of the client and be unavoidable. In addition, the audit of a major multi-national company will frequently require one or more partners devoting all or a substantial part of their time to that client. In such situations a key factor in reducing the threats that are associated with dependency are organizational mechanisms that ensure that an individual partner's earnings are not dependent on one client.

In addition, ISA 220 *Quality Control for an Audit of Financial Statements* lays out requirements for consultation and engagement quality control that help ensure that the audits are performed in accordance with professional standards.

Level of non-audit fees to audit clients

We believe that the prohibition on key audit partners (KAP) from being evaluated or compensated for selling non-audit services to their audit clients has significantly reduced the self-interest threat associated with the sale of non-audit services to an audit client. These provisions have effectively removed the incentive for KAPs to sell non-audit services to their audit clients.

We also note that the restrictions on non-audit services that can be performed for an audit client have significantly reduced the revenues from non-audit services to audit clients. For example, auditors have for many years been prohibited from undertaking significant IT design and implementation services and internal audit outsourcing for public interest entities and have been restricted in performing such services for non-PIEs. As such, we believe that many of the self-interest threats associated with performing non-audit services to audit clients have largely diminished.

Nevertheless, we believe that providing *permitted* non-audit services to audit clients, that do not create significant threats to independence, help improve audit quality because in doing so audit firms can develop a deeper understanding of the audited company including its business model, strategy, risk, competitive position and industry. This furthers the auditor's insight and competency and can enhance professional skepticism, thereby increasing audit quality. In addition, most companies value the objective, insightful advice provided by their auditor.

Non-audit fees as high percentage of the firm's revenue in relation to audit fees.

Audit firms have traditionally provided a variety of non-audit services to both audit clients and non-audit clients. Providing non-audit services helps audit firms attract and retain talent by providing a wide range of opportunities for such talent to develop and improve their skills on cutting-edge advisory projects. These skills can then be used on audits to address some of the complex business issues and uncertainties faced by audit clients. For example, tax rules are complex and evolving and require the knowledge of people who have deep expertise in tax laws and cross-border complexities. Valuations are becoming a key part of accounting models and are of increasing importance to investors. IT systems are more complex than ever, given cyber and other risks that exist. Over the longer term, recruiting and retaining specialists and other experts can ensure an adequate supply of qualified professionals that will enable auditing firms to continue to fulfill their public interest obligations.

In summary, selling non-audit services, whether to audit clients or non-audit clients, enables audit firms to develop knowledge and skills that are needed to audit complex companies while contributing to the success of a multi-disciplinary professional service model which helps the long-term viability of firms and allows for funding of investments, including technological advances, which support audit quality.

Conclusion

We believe that the provisions of the Code are still current and mitigate the fundamental threats associated with the level of fees, fee dependency and non-audit services. However, we do believe that the Code could provide more discussion on how an audit firm's organizational structure and internal policies and procedures can mitigate remaining threats.

We would be pleased to discuss our comments with members of the International Ethics Standards Board or its staff. If you wish to do so, please contact Bob Franchini (+39-02-7221 22014).

Yours sincerely,

Ernst + Young Global Limited

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