

SLEEPING WITH THE ENEMY: HOW MAJOR AUDIT FIRMS ARE PURSUING THEIR OWN CLIENTS

Introduction

The big audit firms are risking conflicts of interest by taking on commissions from the major software suppliers to search out evidence for legal claims against their own clients. The activity – ‘software audits’ or ‘software license reviews’ – are audits carried out for software vendors in order to establish how software usage compares to the licenses in place; invariably, this results in claims for ‘under-licensing’.

The amounts then demanded by the software vendors can be very high – sometimes running to seven or eight figure sums – even in respect of corporates with high compliance controls and a commitment to be fully licensed. The claims often result in highly confrontational disputes which, although rarely litigated, are overlaid with the possibility of litigation for contract breach or infringement of copyright.

A survey of public bodies carried out by Cerno discloses that all of the big four audit firms (‘Firms’) maintain and actively promote specialist divisions to run software audits for software vendors. Some of these Firms are, accordingly, then pursuing corporates and public bodies for which they are also the statutory auditors raising issues as to independence, objectivity, conflict and code breaches.

What are software audits?

Software audits or 'software license reviews' are assessments as to the extent to which a corporate or organisation is using business software and to what extent the licenses they have cover such usage.

The major software vendors – Oracle, SAP, Microsoft, Adobe and IBM – all regularly trigger such audits under the contractual rights available to them in their license agreements. The rights generally extend to requiring the customer to run 'scripts' (a forensic inventory over the IT infrastructure), disclose documentation and permit access to the auditor.

Who commissions these audits?

The audits are initiated by the software vendors that supplied the software technology and applications to the corporate.

These are habitually, and cyclically, carried out by Oracle, SAP, Microsoft, Adobe, IBM and others.

What is the audit process?

The process often takes 3 months or more and is an intensive exercise carried out to a high degree of depth and detail by the auditor.

Following detailed examination and evidence collection, the auditor produces an 'Effective License Position (ELP)' or 'SAM (Software Asset Management) Baseline Review'.

From this, there is exposed all under-licensing of the corporate. This is the evidence that is then utilised by the software vendor, with the auditor sitting alongside, to assert and then pursue a financial demand on the corporate.

The demand crystallizes a liability on the corporate, with payment required under the license terms generally within 30 days. Necessarily, the customer needs to remediate the under-licensing by settling the demand either on the basis of its contractual liability to the software vendor or on the basis that continued usage of the software licenses, with insufficient licenses, infringes the software vendor's intellectual property rights.

No account is taken of 'over-licensing' where, for some products, it has acquired too many licenses for a particular product or application. No credit or offset is permitted to offset the under-licensing liability.

Apart from the explicit financial demand with remedies for non-payment, there is in parallel a tacit concern that continued non-compliance with software license payments renders the customer susceptible to the software usage being terminated; this would or could jeopardise critical business operations.

What is the software audit purpose?

There is one purpose to this exercise: to generate revenue for the software vendor.

Result of software audits

Where under-licensing is identified, the software vendor will, based on the evidence obtained by the Firm, seek to enforce its contractual rights to obtain financial payments for:

- Unpaid license fees – this can be at a rate of up to 125% of list price;
- Support and Maintenance for the current year;
- Two years' back support (typically at 22% of license costs for each year); and
- Audit costs.

What are the extent of the liabilities uncovered?

Software under-licensing can present a material impact to a corporate's financial position.

Although many hundreds of software audits are carried out each year by each software vendor, few figures are publicised as to the liabilities uncovered.

However, some figures show the extent for those where, occasionally, figures are available:

1. In 2016, German software vendor, SAP AG, brought proceedings against Diageo Plc in the English High Court¹. The claim was for license fees alleged to be payable and/or damages for infringement of copyright. The claim totalled UK£58m.

The judge, Mrs Justice O'Farrell, adjudged, in March 2017, that Diageo were liable to SAP. The case was finally settled on a confidential basis.

2. Budweiser brewer, ABN-Inbev, acknowledged in SEC (Securities and Exchange Commission) filings in 2017² that proceedings had been brought against it, also by SAP, for US\$600m. The matter was referred to arbitration. No details are available as to any settlement.

The authors of this report, specialists in software licensing matters, have been involved in multiple software license disputes. Amounts claimed included:

- FTSE 100 company: £21.2m (Microsoft)
- Leisure company: £5.8m (Oracle)
- European charity: €3.2m (Oracle)
- Financial services business: £4.5m (IBM)
- Investment bank: £3.6m (IBM)

¹ SAP(UK) Limited v Diageo Great Britain Limited HT-2015-00340; [2017] EWHC 189 (TCC)

² UNITED STATES SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 FORM 20-F Annual Report for the fiscal year ended 31 December 2016: Anheuser-Busch InBev SA/NV at p.154

It will be seen therefore that the amounts can be high. In all cases, the amounts sought are unexpected and have not been subject to any provisions in the financial statements.

The process leading to final settlement, after delivery of a first draft ELP, is often highly confrontational. The software vendor is insistent on their position, often maintaining that they are the only arbiters of their licensing position. The customer is aggrieved not only by reason of the amount of the claim but also that long-term relationships are disregarded in the process. They are further aggrieved by the intense difficulty in obtaining a correct correlation between software usage and licenses in place (see **The confrontational nature of the audit** below)

The conflict

The software vendors habitually utilise professional services firms to carry out their audits:

Typically, the major vendors, in the United Kingdom, use the following Firms:

- Microsoft: KPMG LLP, PricewaterhouseCoopers LLP or Ernst & Young LLP;
- SAP: Deloitte LLP or Ernst & Young LLP;
- IBM: Deloitte LLP or KPMG LLP.

The conflict arises from the possibility (or fact) of these Firms also potentially being the statutory auditors for the customer that they are pursuing on behalf of the software vendor.

The evidence that the Firms collate is used as evidence to establish demands for under-licensing fees, back-support payments and penalties. The Firms are heavily and continuously involved with calls and settlement meetings, often involving the customer, the Firm and representatives from the software vendor.

The software license reviews therefore carried out establish clear potential conflicts of interests in the contractual and regulatory relationship between the Firm and its two clients (its statutory audit client and the software vendor):

- Acting on behalf of the software vendor, the contractual arrangements require the Firm to obtain evidence, and to justify, any shortfalls in software licenses held by that customer; this immediately translates into demands for arrears of license fees, back support and penalties payable by the customer;
- Acting on behalf of the customer: to audit the company accounts; to identify liabilities and necessary provisions; and to deliver other professional services as may be agreed.

The Firm's role, for the software vendor, is essentially to find and collate evidence of under-licensing with the expectation and intent that this then be utilised in a potential damages claim by the software vendor against the customer.

EY's brochure³ for this service, addressed to software publishers, for instance, acknowledges that '*We understand that revenue generation is a key objective for your review...*' and that '*A review can help you to recover lost revenue.*'

It is therefore considered that either or both of (a) the role of the statutory auditor, and/or (b) the Firm's broader role (eg in consultancy engagements) as a trusted and professional adviser to its corporate client, is in conflict with its alternate responsibilities direct to the software vendor to further the software vendor's competing commercial interests.

The confrontational nature of the audit

Few corporates or public bodies are determined to ignore their obligations to fully license their software usage.

However, there are a number of factors that together militate towards a situation of inevitable non-compliance:

- 1. Shifting technologies:** technology and IT infrastructures are constantly being altered and refined. The introduction of new mechanisms such as virtualisation, use of Docker technologies, establishment of mirrored disaster-recovery or back-ups, upgrades to server hardware, and moves to a private or public cloud, all have unexpected licensing implications;
- 2. Lack of clarity around license terms⁴:** although it might be expected that, for each software program, there is a single license agreement, there are often embedded links and incorporation of many other policies, white papers, partitioning policies, guidance and other materials simply archived on the software vendor's web-site;
- 3. Ambiguity and opacity:** the structure and wording of many license agreements were first established years, sometimes decades, previously, and rarely correlate accurately or clearly to the ways in which organisations with contemporary infrastructures run their technology and applications. Key concepts such as 'processor' or usage' are sometimes not defined even though these are central to the legal entitlement to license fees;
- 4. Lack of judicial guidance:** organisations are always concerned about the reputational risk of any license dispute - allegations of under-licensing can be characterised as infringement of intellectual property rights. Settlements however made with the software vendor, based on evidence supplied by the auditor, are often expressed to be confidential meaning that any successful arguments raised to reduce the claim(s) are rarely publicised or known.

³ Software License Forensics: An Investigative Approach to Publisher Licensing Reviews' (EY: 2012)

⁴ EY reported in 2012 that 'Complexity of contracts and user rights' was a factor for 50% of those customers struggling to achieve compliance.

Auditor's contractual and regulatory obligations

These are multiple and include both direct contractual (and tortious) responsibilities to the client as well as regulatory and statutory responsibilities:

1. The contractual engagement

Typically, auditor engagements will be established through an engagement letter. These are generally drafted largely to protect the audit firm. Although they may include declarations that:

- the firm *'neither owes nor accepts any duty to any person other (the client)'*, and that
- the firm will *'maintain our independence and objectivity throughout the audit'*

such engagements still inevitably have implied duties of trust, confidentiality and avoidance of conflicts.

2. The statutory responsibility

Auditors are bound by the duties in ss.495 and 496 Companies Act 2006 to, inter alia:

- report that the annual accounts *'give a true and fair view'* of the financial statements;
- *'have been properly prepared in accordance with the relevant financial reporting framework; and*
- *have been prepared in accordance with the requirements of (the)Act (and, where applicable, Article 4 of the IAS Regulation).'*

3. ICAEW Code of Ethics

ICAEW is the supervisory body, in the United Kingdom, for Deloitte⁵, KPMG⁶, PricewaterhouseCoopers⁷ and EY⁸.

Its guidance includes extensive references to the avoidance and management of conflict issues described as *'when a professional's own interests or the interests of his or her client conflict with the Professional's obligations to act in the interests of another client'*.

Extracts from this Code are included in the Appendix.

Risks of conflict can be exposed where a software audit is intimated, or part-way through, and the Firm's investigations show potential software under-licensing liabilities. How and to what extent should this information, and the corresponding financial liability, be made known or shared within the Firm to those carrying out the statutory audit?

The Code insists on a principle of objectivity that *'imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.'*

It is difficult to see how the two separate obligations of confidentiality⁹ necessarily imposed – one in favour of the client in respect of the audit engagement – and one in favour of the software vendor under their engagement – can be reconciled.

The ICAEW Code maintains that *'a professional accountant's advice and work must be uncorrupted by self-interest and not be influenced by the interests of other parties'*.

Clearly there is this possibility where a Firm has obligations towards its software vendor client but seeks to moderate this by reason of its continuing relationship to the customer either as statutory auditor or as a firm supplying other business services to it eg IT services

4. FRC's Ethical Standard 2016:

There is an overriding ethical standard promulgated by the Financial Reporting Council (FRC) in respect of the audit of financial statements and other public interest assurance engagements.

It is read in the context of its Statement *'The Financial Reporting Council – Scope and Authority of Audit and Assurance Pronouncements'* which sets out the application and authority of this standard.

The FRC's Ethical Standard applies to audits of financial statements and other public interest assurance engagements in both the private and the public sectors.

The Standard requires both independence of mind and independence in appearance, described respectively as:

Independence of Mind

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism.

and

Independence in Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional scepticism has been compromised.

The Standard is guided and constructed on the basis of overarching principles, namely:

The firm, its partners and all staff shall behave with integrity and objectivity in all professional and business activities and relationships.

⁵ Deloitte LLP and Deloitte NWE LLP;

⁶ KPMG LLP, KPMG Audit Holdings Ltd, KPMG Audit LLC, KPMG Audit Plc, KPMG Channel Islands Limited and KPMG Holdings Ltd;

⁷ PricewaterhouseCoopers LLP, PricewaterhouseCoopers LLC and PricewaterhouseCoopers CI LLP;

⁸ Ernst & Young LLP, Ernst & Young LLC and Ernst & Young Europe LLP;

⁹ ICAEW Code of Ethics 100.5: Confidentiality - to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

Integrity - being trustworthy, straightforward, honest, fair and candid; complying with the spirit as well as the letter of applicable ethical principles, laws and regulations; behaving so as to maintain the public's trust in the auditing profession; and respecting confidentiality except where disclosure is in the public interest or is required to adhere to legal and professional responsibilities.

Objectivity – acting and making decisions and judgments impartially, fairly and on merit (having regard to all considerations relevant to the task in hand but no other), without discrimination, bias, or compromise because of commercial or personal self-interest, conflicts of interest or the undue influence of others, and having given due consideration to the best available evidence.

In relation to each engagement, the firm, and each covered person, shall ensure (in the case of a covered person, insofar as they are able to do so) that the firm and each covered person is free from conditions and relationships which would make it probable that an objective, reasonable and informed third party would conclude the independence of the firm or any covered person is compromised.

Independence – freedom from conditions and relationships which, in the context of an engagement, would compromise the integrity or objectivity of the firm or covered persons.

Integrity or objectivity (and therefore independence) would be compromised if it is probable (more likely than not) that an objective, reasonable and informed third party would conclude that the threats, arising from any conditions or relationships that exist (taking into account any conflicts of interest that they may cause, or generally be perceived to cause, or otherwise, and having regard to any safeguards implemented), would impair integrity or objectivity to such an extent that it would be inappropriate for the firm to accept or continue to perform the audit or other public interest assurance engagement unless the threats were eliminated or further reduced or unless more, or more effective, safeguards were implemented.

These overarching principles are further enlarged by the General Requirements and Guidance (Part B – Section 1) which include multiple ancillary obligations as to, inter alia:

- Establishment of policies and procedure;
- Implementation of these
- Effective operation of these;
- Responsibilities of the Ethics Partner;
- Identification and assessment of threats to integrity, objectivity or independence;
- Identification and assessment of safeguards;
- Communication with those charged with governance; and
- Documentation of threats that could impair independence.

The FRC states that *'consideration of whether the ethical outcomes required by the overarching principles and supporting ethical provisions have been met should be evaluated by reference to the perspective of an objective, reasonable and informed third party'*

Where litigation takes place or might follow, the FRC comments as follows:

'When litigation takes place, or appears likely, between the firm or a member of the audit team and the audit client, self-interest and intimidation threats are created. The relationship between client management and the members of the audit team must be characterised by complete candour and full disclosure regarding all aspects of a client's business operations'

What might be the view of *'the objective, reasonable and informed third party'* where the Firm is:

- at the same time as being a statutory auditor to a business,
- also collating evidence for another client (the software vendor) under the guise of a software license review/software audit for a potential financial claim against that client?

In our view, it is that the overarching principles are not met, and the other standards referred to above are breached.

Cerno findings

From requests made¹⁰ to various public authorities, a number of bodies are being subjected to software audits on behalf of a third party (the software vendor) by the same Firm that is their statutory auditor:

Local Authority	Statutory Auditor	Software audit carried out by	for Software vendor
Watford Borough Council	Ernst & Yong LLP	Ernst & Yong LLP	Microsoft
Sheffield City Council	KPMG LLP	KPMG LLP	Microsoft
Three Rivers District Council	Ernst & Yong LLP	Ernst & Yong LLP	Microsoft
Windsor & Maidenhead	KPMG LLP	KPMG LLP	Microsoft
University of Salford	KPMG LLP	KPMG LLP	SAP
Darlington Borough Council	Ernst & Yong LLP	Ernst & Yong LLP	Microsoft
Blackpool Council	KPMG LLP	KPMG LLP	Microsoft

The above represents only a sample of public bodies where, by reason of the availability of responses under the Freedom of Information Act 2000, the identity of the Firm involved in carrying out of a software audit and the relevant statutory auditor has been obtained.

The same conflict issues may arise with any corporate or other organisation that has been the subject of a software license review. This will invariably include all FTSE 250 companies and many private sector companies.

If any such company has been subject to such a software audit, then it can readily investigate whether the same had been carried out by its own statutory auditor.

¹⁰ Freedom of Information requests made to councils and universities August-October 2018;

What are the risks?

Quite apart from the apparent regulatory breaches that we have referred to above, there are, we submit, numerous practical risks in a Firm acting as statutory auditor and, at the same time, accepting a commission from a third-party software vendor to carry out a software audit on that same client.

These risks may be (or may be perceived to be):

1. The Firm, as statutory auditor, choosing to overlook the identification of latent software license liabilities in order to avoid any encroachment into the area of the software audit carried out by other personnel within the same firm;
2. The Firm, as statutory auditor, negligently ignoring latent software liabilities whilst being evidently able to ascertain those by reason of its publicised expertise in this area;
3. A perception by the client that investigations by the Firm in its capacity as statutory auditor will, in breach of confidentiality obligations, be passed on or used by the Firm's software vendor customer(s) in order for it to choose who to audit;
4. The possibility that, where the client does not settle with the software vendor, that the Firm will presently need to give evidence as to unlicensed usage, against the client, whilst at the same time the Firm continues as its statutory auditor;
5. The Firm breaching its confidentiality obligations to its software vendor client by disclosing, to its separate audit function, possible settlement provisions for the outcome of the software audit;
6. The Firm, in its capacity as a supplier to the software vendor, obtaining information internally via worksite or other searches from the Firm's audit investigations and then utilising this to the detriment of the client elsewhere namely for the software audit;
7. The Firm, in its capacity as statutory auditor, choosing to not investigate any latent software licensing liability (which might otherwise have an impact on the financial statements) by reason of it failing to bring across the necessary expertise from its software forensics team(s);
8. The Firm, in its capacity as statutory auditor, otherwise limiting any steps or actions it would otherwise take by reason of it realising that it has separate duties of confidentiality and contractual obligations between its audit client and its software vendor client;
9. A client considering that, prudently, they should not challenge any findings or evidence obtained by the Firm in the software audit since these will have been obtained by its own statutory auditor with whom the client has a high degree of trust; and
10. The Firm intimating to its software vendor client its knowledge, obtained through close working in the statutory audit engagement, as to the risk appetite or other likely decisions to be made by the client when faced by a high demand for software license fees.

Equivalent concerns may also be similarly recited here where a Firm does not have an audit engagement but is otherwise supplying consultancy services to the client, whilst at the same time also acting for the software vendor.

Cerno recommendations

In order that such evident conflicts may be avoided and to further entrench auditor independence and integrity, we recommend the following:

1. No Firm should, either whilst retained by the client, or for a period of 3 years from ceasing so to act, for statutory or internal audit purposes, carry out any software license review or software audit for or on behalf of a software supplier to that client;
2. No Firm should, either whilst retained by the client, or for a period of 2 years from ceasing so to act, for the purposes of IT projects or software asset management, carry out any software license review or software audit for or on behalf of a software supplier to that client;
3. When carrying out any statutory audit or internal audit function, the Firm should, utilising its license management capability, carry out checks and examinations, on behalf of the client, as to its potential liabilities for software under-licensing;
4. Firms should not seek to manage the conflict(s) by seeking consent to act for both parties: although informed client consent can manage conflicts in certain circumstances, it is submitted that the explicit and obvious conflicts here between the client and the software vendor are so great that consent obtained by any Firm will be insufficient to sanitise the opposed positions;
5. Firms should assess, now, those clients against whom software license reviews have been carried out, or that have been commissioned but not yet implemented, and compare this to a listing of (a) its statutory audit clients and (b) those non-audit clients where the firm has delivered or is delivering IT asset or project management services;
6. Audit committees should request information from their statutory auditor, and their own Chief Information Officer, of the identity of any Firm that carried out a software audit for the company's software supplier with a view to ascertaining what notification(s) and/or consents, if applicable, were obtained;
7. The Ethics Partner of each Firm should conduct their own investigations as to the evident potential conflicts, and any potential ethics or contractual breaches, and report appropriately to their clients, the FRC and/or their supervisory body;
8. The Financial Reporting Council should call on all Firms to disclose all those engagements, undertaken for and on behalf of software vendors as software audits or software license reviews, against that Firm's own audit clients; and
9. The matters raised in this report should be addressed by the FRC's Audit Quality Review Team when carrying out any audit quality inspections on Firms pursuant to its responsibilities under the Statutory Auditors and Third Country Auditors Regulations 2017;
10. Similarly, any further findings should be shared with the Competitions and Markets Authority in its present 'Statutory Audit Market Study' launched on 9 October.

About Cerno

Cerno Professional Services www.cerno-ps.com is an independent consultancy comprising legal, technical and commercial specialists focussing on software licensing. Its principal work is defending corporates and public authorities from the financial impact of software audits carried out by the major software vendors. It further advises on the optimisation of technology deployments, and corresponding license arrangements, with a view to minimising software costs.

Methodology

Freedom of Information requests were sent to 747 local councils, metropolitan councils, Welsh Authorities and universities in August-September 2018 requesting information as to:

- (a) whether they had been subject to a software audit carried out on behalf of any of Microsoft, SAP, Oracle or IBM within the last 3 years and, if so
- (b) the name of the consultancy contracted to such software company to carry out the audit.

472 bodies replied.

154 bodies confirmed that they had been the subject of a software audit by one of Microsoft, SAP, Oracle and/or IBM within the last 3 years, of which 46 had been carried out by one of Deloitte, EY, PricewaterhouseCoopers or KPMG on behalf of those software vendors. Two councils had 2 audits each.

Of those 46 audits carried out: EY carried out 12; Deloitte, 10; KPMG, 18; and PricewaterhouseCoopers, 6.

Seven such audits (15%) were carried out by the relevant authority's own statutory auditors: details of the authorities identified are shown in the report (Cerno Findings).

APPENDIX

ICAEW CODE OF ETHICS

220 Conflicts of Interest

220.1 A professional accountant in public practice shall take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may create threats to compliance with the fundamental principles. For example, a threat to objectivity may be created when a professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client. A threat to objectivity or confidentiality may also be created when a professional accountant in public practice performs services for clients whose interests are in conflict or the clients are in dispute with each other in relation to the matter or transaction in question.

Subject to the specific provisions, there is, however, nothing improper in a professional accountant in public practice having two clients whose interests are in conflict.

220.2 A professional accountant in public practice shall evaluate the significance of any threats and apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level. Before accepting or continuing a client relationship or specific engagement, the professional accountant in public practice shall evaluate the significance of any threats created by business interests or relationships with the client or a third party.

A test is whether a reasonable and informed observer would perceive that the objectivity of professional accountants or their firms is likely to be impaired. The professional accountants or their firms shall be able to satisfy themselves and the client that any conflict can be managed with available safeguards. Attention is also drawn to the ethical conflict resolution process in Part A.

220.3 Depending upon the circumstances giving rise to the conflict, application of one of the following safeguards is generally necessary:

Notifying the client of the firm's business interest or activities that may represent a conflict of interest and obtaining their consent to act in such circumstances; or

Notifying all known relevant parties that the professional accountant in public practice is acting for two or more parties in respect of a matter where their respective interests are in conflict and obtaining their consent to so act; or

Notifying the client that the professional accountant in public practice does not act exclusively for any one client in the provision of proposed services (for example, in a particular market sector or with respect to a specific service) and obtaining their consent to so act.

220.4 Professional accountants' attention is drawn to section 240 Fees and other types of remuneration and section 241 Agencies and referrals which provide additional guidance on the ethical and legal considerations relating to these areas, including fiduciary relationships and accounting for commission and other benefits.

The professional accountant shall also determine whether to apply one or more of the following additional safeguards:

The use of separate engagement teams;

Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing);

Clear guidelines for members of the engagement team on issues of security and confidentiality;

The use of confidentiality agreements signed by employees and partners of the firm; and

regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

220.4a Where a conflict of interest arises, the preservation of confidentiality, and the perception thereof will be of paramount importance. Therefore firms shall deploy safeguards, which generally will take the form of information barriers. These information barriers may include the following features:

Ensuring that there is, and continues to be, no overlap between the teams servicing the relevant clients and that each has separate internal reporting lines;

Physically separating, and restricting access to, departments providing different professional services, or creating such divisions within departments if necessary, so that confidential information about one client is not accessible by anyone providing services to another client where their interests conflict;

Setting strict and carefully defined procedures for dealing with any apparent need to disseminate information beyond a barrier and for maintaining proper records where this occurs.

The professional accountant shall ensure that the adequacy and effectiveness of the barriers are closely and independently monitored and that appropriate disciplinary sanctions are applied for breaches of them. The overall arrangements shall regularly be reviewed by a designated senior partner.

Professional accountants shall note that it has been suggested by the courts that in some circumstances information barriers must be constructed as part of the organisational structure of the firm to be effective, rather than on an ad hoc basis.

220.4b If client service issues render it impracticable to put in place such safeguards or suitable alternatives, it is important that relevant parties, who have conflicts of interest which may result in threats to preservation of confidentiality, are made aware of and agree to the professional accountant continuing to act for them.

220.5 Where a conflict of interest creates a threat to one or more of the fundamental principles, including objectivity, confidentiality, or professional behaviour, that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the professional accountant in public practice shall not accept a specific engagement or shall resign from one or more conflicting engagements.

220.6 Where a professional accountant in public practice has requested consent from a client to act for another party (which may or may not be an existing client) in respect of a matter where the respective interests are in conflict and that consent has been refused by the client, the professional accountant in public practice shall not continue to act for one of the parties in the matter giving rise to the conflict of interest.

FRC's Ethical Standard for Auditors

In the case of audit engagements, it is in the public interest and, therefore, required by this Code of Ethics, that members of audit teams, firms and network firms shall be independent of audit clients.

290.5

The objective of this section is to assist firms and members of audit teams in applying the conceptual framework approach described below to achieving and maintaining independence.

290.6

Independence comprises:

(a) independence of Mind

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism.

(b) independence in Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional scepticism has been compromised.

When the professional accountant determines that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the professional accountant shall eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement.

A professional accountant shall use professional judgment in applying this conceptual framework.

Actual or Threatened Litigation

290.231

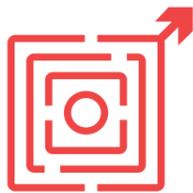
When litigation takes place, or appears likely, between the firm or a member of the audit team and the audit client, self-interest and intimidation threats are created. The relationship between client management and the members of the audit team must be characterised by complete candour and full disclosure regarding all aspects of a client's business operations. When the firm and the client's management are placed in adversarial positions by actual or threatened litigation, affecting management's willingness to make complete disclosures, self-interest and intimidation threats are created. The significance of the threats created will depend on such factors as:

- The materiality of the litigation; and
- Whether the litigation relates to a prior audit engagement.

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

- If the litigation involves a member of the audit team, removing that individual from the audit team; or
- Having a professional review the work performed.

If such safeguards do not reduce the threats to an acceptable level, the only appropriate action is to withdraw from, or decline, the audit engagement.



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The interpretations in this report represent opinion only of Cerno and derive from responses given to it by those organisations that responded to it pursuant to FOIA requests. The information therefore can and should be verified by the Firms mentioned.

The findings have been put forward so as to enable Firms, software publishers and relevant supervisory bodies and regulators to investigate the factual backdrop, to consider what conflicts, if any, are raised, and how and to what extent, these are (or may, in the future) be, managed or sufficiently controlled.