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Exposure Draft – Proposed Revisions to the Fee-related Provisions of the Code

The Financial Reporting Council (FRC) welcomes the opportunity to comment on this exposure draft. As the UK's Competent Authority for Audit, our mandate includes: the setting of auditing, assurance and ethical standards; inspection of public interest entity audits and enforcement action against auditors. We also oversee the accountancy profession in regulation of its members and take public interest misconduct cases where conduct falls below expected standards (e.g. where practitioners fail to comply with the fundamental principles and requirements set out in the Code of Ethics). The FRC also is responsible for setting the UK Corporate Governance Code and its associated guidance.

We support the aim of IESBA to enhance the fee-related provisions of the Code, in particular those relating to non-audit services provided to an entity by its auditor. Concerns raised by Parliamentary Committee enquiries into high profile corporate failures in the UK have highlighted high levels of fees for non-audit services as a threat to the integrity, objectivity and independence of auditors and a belief that audit quality may be compromised as a result. They have also expressed concerns that audit fees are sometimes set at levels which do not fully cover the cost of the audit to be delivered, with a detrimental impact on quality. As a result, we are concerned that IESBA's proposals do not go far enough to address the threats created by proportionately high levels of fees for non-audit services; to enhance the transparency of such fees for stakeholders; or to address the risk of audit fees being set at too low a level to support a high quality audit.

Given the importance of these concerns, we believe IESBA could go further in strengthening the revised requirements and related application material it is proposing. We identify specific issues and suggested actions below in our responses to the questions asked in the Exposure Draft, including:

- There should be a more explicit requirement that an audit, or other engagement for an audit client, is not accepted where the fees would give rise to unacceptable threats to independence. (see Q2)
- It should be made clearer that the ability to perform an engagement to an appropriate (high) standard should not be compromised by fees that are too low. (see Q3)

- With regard to the proportion of fees other than audit, if IESBA does not want to establish a cap, there should be more emphasis on evaluating the threats where the ratio is more than 1:1. (see Q5)
- There should be stronger restrictions on fee dependency on a single client. There are no safeguards that can reduce the threats to an acceptable level where a firm has an ongoing fee dependency on a single client. Some relief in relation to non-PIE clients may be given for a new firm seeking to establish itself, but not exceeding two years. (see Q7 – Q10)
- There should be stronger transparency requirements, with exceptions only permitted where necessary to comply with law or regulation. (see Q11 and Q12)

In the attachment to this letter we also give some comments on the clarity of the language and use of the term "audit", which could be improved; and explain our view that there should be an outright prohibition on contingent fees charged for a non-assurance service provided to an audit client. The FRC has included this prohibition in our revised ethical standard.

Responses to request for specific comments

Evaluating Threats Created by Fees Paid by the Audit Client

1. **Do you agree that a self-interest threat to independence is created and an intimidation threat to independence might be created when fees are negotiated with and paid by an audit client (or an assurance client)?**

Yes. For example, self-interest threats and actual or perceived threats to independence can arise when:

- There are high levels of fees from one client as a proportion of a firm's total income or the basis on which a partner's profit share is determined.
- Fees for non-audit services provided to an audit client are high in relation to the audit fee.
- Fees are, or are perceived to be, too low to enable a high quality audit.
- Fees for completed services/work are overdue.
- There are contingent fee arrangements.

2. **Do you support the requirement in paragraph R410.4 for a firm to determine whether the threats to independence created by the fees proposed to an audit client are at an acceptable level:**

- (a) **Before the firm accepts an audit or any other engagement for the client; and**
- (b) **Before a network firm accepts to provide a service to the client?**

The objective of the requirement should be that an audit or other engagement for an audit client is not accepted where the fees would give rise to unacceptable threats to independence. We believe this should be made clearer in the wording. As currently worded, there is not an explicit prohibition on accepting such an engagement. The requirement appears also to suggest that the threats are not considered until after the fee has been determined and proposed to the client. The threats need to be taken in to account when the firm is determining the fee that it will propose.

While threats to independence may arise from proportionally high fee levels, it is also important to recognise that overly low fees may result in an actual or perceived threat to the ability to

perform an engagement in accordance with all applicable engagement and ethical standards. We recommend that IESBA introduce a requirement that the firm shall be satisfied and able to demonstrate that the engagement has assigned to it sufficient partners and staff with appropriate time and skill to perform the engagement in accordance with all applicable engagement and ethical standards, irrespective of the engagement fee to be charged. This could be included in Section 330 of the Code, which currently only addresses this threat by way of application material (paragraphs 330.3.A1 – 330.3.A4).

3. **Do you have views or suggestions as to what the IESBA should consider as further factors (or conditions, policies and procedures) relevant to evaluating the level of threats created when fees for an audit or any other engagement are paid by the audit client? In particular, do you support recognizing as an example of relevant conditions, policies and procedures the existence of an independent committee which advises the firm on governance matters that might impact the firm's independence?**

See the second part of our answer to Q2. It is important to ensure the ability to perform an engagement is not compromised by fees that are too low. If this is intended to be covered by the second bullet of the list in paragraph 410.4.A2, that is not sufficiently clear. Also, it would be more appropriately covered by a requirement.

Furthermore, in relation to the list in paragraph 410.4.A2, it would be more helpful if it was reworked and more clearly presented as examples of factors than may increase the level of threats. For example, the words "taking into account the firm's commercial and market priorities and position" at the end of the second bullet point could be interpreted as a factor that may be used to justify a particular level of fees – the key message should be that the firm doesn't allow its commercial and market priorities and position to cause it to take on engagements and/or set fees that would give rise an unacceptable threat to independence.

Similarly, it is not clear what message is intended to be conveyed by the words "and the apparent emphasis they and client management place on the quality of the audit and the overall level of the fees" at the end of the third bullet. The key message should be that the firm does not succumb to pressure to reduce the quality of its work in order to reduce the fees. It should also be made clear that it is not acceptable to set a "loss leader" audit fee for commercial reasons to win business as this could give rise to actual or perceived threats to audit quality.

An independent committee within the firm, which advises the firm on governance matters that might impact the firm's independence, may help address issues that impact independence, but to engender trust, stakeholders would need transparency as to the make-up of the committee, how it operates, fees paid, the nature of the advice it gives and how the firm responds to that advice.

Impact of Services Other than Audit Provided to an Audit Client

4. **Do you support the requirement in paragraph R410.6 that a firm not allow the level of the audit fee to be influenced by the provision by the firm or a network firm of services other than audit to the audit client?**

Yes. We have such a requirement in our Ethical Standard.

Proportion of Fees for Services Other than Audit to Audit Fee

5. **Do you support that the guidance on determination of the proportion of fees for services other than audit in paragraph 410.10 A1 include consideration of fees for services other than audit:**
- (a) **Charged by both the firm and network firms to the audit client; and**
 - (b) **Delivered to related entities of the audit client?**

We agree that when identifying and assessing threats to independence it is necessary to take account of fees for non-audit services charged by network firms and also non-audit services delivered by the firm and its network to related entities of the audit client. In our ethical standard we apply a cap on fees for non-audit services that can be provided by a firm and its network to a public interest entity and its controlled undertakings. For the firm alone, the cap also applies in relation to non-audit services provided to a parent undertaking.

We note IESBA's explanation for not proposing fee caps in the Code, although we would welcome more discussion as to why the views of stakeholders other than regulators carry more weight. The statement that "the Code is a body of standards intended for global application" does not provide a satisfactory reason for not applying a cap, especially if IESBA actually considered a cap to be appropriate to address the general concerns that high levels of fees for non-audit services compared to the audit fee are an actual and perceived threat to integrity, objectivity and independence. Of course, regulators may have the ability to impose more stringent requirements in their own jurisdictions, but that undermines the perceived worth of the Code and makes global harmonisation more difficult.

Notwithstanding IESBA's view that it is not appropriate for the Code to establish a cap, paragraphs 410.10.A1 and 410.10.A2 could give more robust guidance to assist the evaluation of threats. For example, the first factor listed in A2 is simply "the ratio fees for services other than audit to the audit fee". We recommend stronger guidance that when the ratio is more than 1:1 the firm give specific consideration to whether the threats to independence of the firm, or any member of its network where relevant, are at a level where independence is not compromised or, if necessary, put in place appropriate safeguards such that independence is not compromised, which may include the firm or member of its network not providing the non-audit service. This would not establish a cap but would help ensure appropriate attention is given to the threats.

We are concerned that the guidance in paragraph 410.10.A3 that a safeguard might be a review of the audit work by a reviewer who was not involved in the audit or non-audit service could be seen as an easy option that could lead to threats not being appropriately evaluated. Such review is unlikely to address the concerns of stakeholders, particularly when the reviewer comes from the same firm. If this guidance is retained, it need to make clear that such an assessment should be considered from the perspective of an objective, reasonable and informed third party.

Fee Dependency for non-PIE Audit Clients

6. **Do you support the proposal in paragraph R410.14 to include a threshold for firms to address threats created by fee dependency on a non-PIE audit client? Do you support the proposed threshold in paragraph R410.14?**

We agree that a threshold should be established. Our ethical standard imposes a more restrictive threshold and other conditions than IESBA is proposing, including not acting as the provider of the engagement if the threshold will be regularly exceeded (more details are given

in our response to IESBA's 2018 Fees Questionnaire).

7. Do you support the proposed actions in paragraph R410.14 to reduce the threats created by fee dependency to an acceptable level once total fees exceed the threshold?

No, the proposed actions are inadequate to address the threats created by fee dependency effectively. They need to be made significantly more restrictive. In the UK, we require that the audit firm should not provide the service if the threshold will be regularly exceeded rather than determine whether it can apply 'safeguards'. We do not believe there any safeguards that can reduce the threats to an acceptable level where a firm has an ongoing fee dependency on a single client. A review by a professional accountant, with appropriate experience, who is not a member of the firm expressing the opinion on the financial statements may be an appropriate safeguard for a new firm that is seeking to establish itself, but we would still limit exceeding the threshold to a period of not more than two years.

It is not clear why R410.14 is allowing the auditor the choice of a 'hot' (before sign-off) or 'cold' (after sign-off) review of the fifth year audit. If such a requirement is to be implemented it should be for a 'hot' review.

The requirement in paragraph R410.15 allows the audit firm in effect to choose whether to have independent reviews for each of the intervening years before the next fifth year audit review. We are not confident this will engender an appropriate mind-set in the auditor but simply lead to long term fee dependency on a single client being regarded as acceptable 'normal' practice as long as there is some form of independent review every five years.

Fee Dependency for PIE Audit Clients

8. Do you support the proposed action in paragraph R410.17 to reduce the threats created by fee dependency to an acceptable level in the case of a PIE audit client?

No, they should be more restrictive. Our ethical standard imposes a more restrictive threshold and other conditions than IESBA is proposing, including not acting as the provider of the engagement if the threshold will be regularly exceeded (more details are given in our response to IESBA's 2018 Fees Questionnaire).

The requirement in paragraph R410.17 is too weak in allowing the firm expressing an opinion on the financial statements to determine whether an engagement quality review, performed by a professional accountant is not a member of the firm, might be a safeguard to reduce the threats to an acceptable level. If the threats are not at an acceptably low level the firm should not act as the auditor. We do not believe there are any safeguards, including review by an external reviewer, that can reduce the threats to an acceptable level where a firm has an ongoing fee dependency on a PIE client.

9. Do you agree with the proposal in paragraph R410.19 to require a firm to cease to be the auditor if fee dependency continues after consecutive 5 years in the case of a PIE audit client? Do you have any specific concerns about its operability?

Such a dependency should not be permitted to continue for as long as 5 years.

10. Do you support the exception provided in paragraph R410.20?

No. We do not accept that there will be circumstances where there is only ever one viable firm that could carry out an audit engagement of a particular PIE in the public interest. If it's possible

to find an appropriate independent engagement quality reviewer who is not a member of the audit firm it should be possible to find another firm that could undertake the engagement. We understand that this may necessitate increased costs, for example for travel and subsistence of the auditors, but that should be an accepted cost of being a PIE in such a location. This is primarily an issue of competition and choice and we believe such matters should be the responsibility of the relevant regulatory body in the jurisdiction to address. IESBA appears to recognise this in sub-paragraph (a) which stipulates that the firm should consult with, and obtain the agreement of, an independent regulatory body or professional body in the relevant jurisdiction.

Transparency of Fee-related Information for PIE Audit Clients

- 11. Do you support the proposed requirement in paragraph R410.25 regarding public disclosure of fee-related information for a PIE audit client? In particular, having regard to the objective of the requirement and taking into account the related application material, do you have views about the operability of the proposal?**

No. Greater transparency is required in the auditor's report where the information is not given in the financial statements, about the nature of, and fees for, particular non-audit services. Disclosing just the total amount of fees only provides stakeholders with information that may help them understand the self-interest threat in relation to high levels of fees but no information that may help understand other threats or the nature of the relationship the auditor has with the client. The application material in paragraph 410.25.A5 that the firm "might" also discuss with the client whether disclosure of other information relating to fees might enhance users' understanding of the fees and how they might influence the firm's independence is not strong enough.

IESBA should disclosure of information that would help stakeholders obtain an understanding of fee and service-related threats to the auditor's independence. That should be the default position with an exception only where national law or regulation prohibits disclosure. Failing that, IESBA should at least elevate paragraph 410.25.A5 to a requirement for such a discussion with the client. In our own jurisdiction, companies are required to disclose fees paid to the auditor for 'audit related services', other assurance services, tax compliance service, tax advisory services, internal audit services, services related to corporate finance transactions and other non-audit services.

- 12. Do you have views or suggestions as to what the IESBA should consider as:**
- (a) Possible other ways to achieve transparency of fee-related information for PIEs audit clients; and**
 - (b) Information to be disclosed to TCWG and to the public to assist them in their judgments and assessments about the firm's independence?**

See our answer to Q11 regarding disclosure in either the financial statements or the auditor's report. For TCWG, the auditor should disclose the nature and related fees of all non-audit services provided by the firm and members of its network to the audited entity and its related entities. That is information that will assist TCWG form their own assessment of the threats to the auditor's independence. The requirement in paragraph R410.23 focuses only on the amount of such fees - the matters that are identified in paragraph 410.23.A1 as "might" be communicated should also be required to be communicated unless such communication is prohibited by law or regulation. Information regarding services provided to a parent entity should also be disclosed to TCWG where relevant to understanding threats to the auditor's independence.

Anti-Trust and Anti-Competition Issues

13. **Do you have views regarding whether the proposals could be adopted by national standard setters or IFAC member bodies (whether or not they have a regulatory remit) within the framework of national anti-trust or anti-competition laws? The IESBA would welcome comments in particular from national standard setters, professional accountancy organizations, regulators and competition authorities.**

We do not believe these proposals would give rise to anti-trust and anti-competition issues. We are concerned that IESBA has gone too far in seeking to avoid such issues and consequently proposed requirements that are not as robust as they should be. As identified in our other answers there are areas where IESBA should be more restrictive, with exceptions provided where compliance would be prohibited by national law or regulation.

Proposed Consequential and Conforming Amendments

14. **Do you support the proposed consequential and conforming amendments to Section 905 and other sections of the Code as set out in this Exposure Draft? In relation to overdue fees from an assurance client, would you generally expect a firm to obtain payment of all overdue fees before issuing its report for an assurance engagement?**

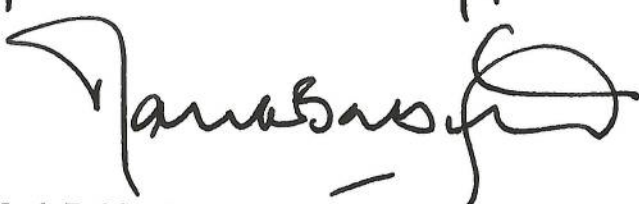
As we have commented in our responses to other IESBA EDs (including those that addressed the structure of the Code), we believe the same independence requirements should be applied to other public interest assurance engagements as are applied to audit engagements.

We would not require payment of all overdue fees as a condition of issuing an assurance engagement report. However, where the overdue fees cannot be regarded as trivial we would require the firm to consider whether it can accept or continue an engagement or whether it is necessary to resign. Our ethical standard includes a requirement to that effect. Where a firm does not resign, appropriate safeguards should be applied such as review by a partner with relevant expertise who is not involved in the engagement.

15. **Do you believe that there are any other areas within the Code that may warrant a conforming change as a result of the proposed revisions?**

We have no comments on other possible conforming changes.

If you have any questions on our response, or wish to discuss any of our observations in more detail please contact me on m.babington@frc.org.uk or +44-20-7492-2323.

Yours sincerely,


Mark Babington
Acting Director,
UK Auditing Standards and Competition

Other comments on the proposals

Clarity of language and use of the term 'audit'

In our responses to the Structure EDs, we explained that it is inappropriate for the term "audit" to be taken to include "review". IESBA chose to ignore our position and just noted that "adopting organisations, if they so wished, could choose to distinguish "audit" and "review" separately in their versions of the Code". However, we now see that IESBA is recognising that there can be circumstances where a distinction needs to be made between audit and review, including in this ED where particular proposals are intended to make specific reference to the fee for the audit of the financial statements only (i.e. not including a review of the financial statements or an audit of special purpose financial statements). IESBA's proposed solution is to use the expression "fee for the audit of the financial statements" when "audit" really is only audit and not also "review". We do not believe that this introduces sufficient clarity given that elsewhere in the Code it says "audit" is to be taken to include "review" – with that in mind, IESBA's proposed wording could easily be interpreted by some practitioners, who do not read paragraph 410.3.A3 each time they go to another part of the Code, as "fee for the audit/review of the financial statements".

We struggle to understand IESBA's position as this is not an overly complicated matter to address. In the course of our revision of the FRC Ethical Standard we addressed a similar issue by referring generically to 'engagements' whilst being precise about the specific application to different types of engagement (whether audit or not) where they differed. Our standard is designed to apply to all engagements for which we issue performance standards (and so is broader in scope than audit and review engagements).

Contingent fees

Paragraph R410.9 in effect permits a contingent fee to be charged for a non-assurance service provided to an audit client if the fee is not material to the firm or network firm providing the service, or if the outcome of the service is not dependent on a future or contemporary judgment related to a material amount in the financial statements. In our view there should be an outright prohibition on a firm and any of its network firms providing any non-assurance service to an assurance client, wholly or partly, on a contingent fee basis. Providing non-assurance services on a contingent fee basis, can give rise to a perception that the firm's interests are so closely aligned with the entity that the integrity, objectivity and independence of the firm could be, or seen to be, compromised.