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26 September 2019

By E-mail to:

AAT@frc.org.uk

For the attention of James Ferris

POST IMPLEMENTATION REVIEW OF THE 2016 AUDITING AND ETHICAL STANDARDS

We write to offer our comments on the changes proposed following the post implementation review.

Although we support some of the changes proposed, we are concerned that a number of the proposed changes are an inappropriate reaction to the recent widespread criticism of the audit firms and also of the FRC for its regulation of them.

As set out in more detail in our letter of comment on the proposed changes to ISA (UK) 570, we believe that the core issue is that audit has increasingly been seen as a process, which has to be followed, rather than the expression of an opinion based on all available evidence. Many of the proposed changes in this document reflect the FRC's attempts to "get tough" on auditors, largely by adding to the process. We do not think that these changes will improve the quality of audits.

One particular issue is independence. Of course we understand the importance of audit independence and agree that this must be maintained. No question. Where we disagree with many of the comments made by commentators outside the profession is that independence has routinely been compromised and is a major contribution to audit failure. Over recent years the rules on independence have been progressively tightened (although many of these rules have targeted an outside perception of independence rather than the independence and quality of the judgements actually made) but this has had no effect on the perception of the issue. Rather than take further steps on the same lines, a better conclusion would be that the wrong issue is being addressed and that the independence of auditors may not in fact be a major contributor to audit failure.

Our detailed comments on the questions raised in the consultation are set out in an Appendix to this letter.

There is one further general point to make about the proposed changes. The changes replace the specific "cut and paste" references to EU Regulation and Directive with references to UK law on the basis that the requirements of UK law will have superseded the original references by the time that the revised documents come into force. While we welcome that the new references are no longer presented as direct quotes from the legislation and as such are easier to interpret, the relevant changes assume that there will be an "exit day" in advance of the implementation of the revised standards. It is not fully clear that this will be the case and it may be that implementation would need

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to be delayed. It is also possible that these changes may not be implemented in their current form, depending on how the political situation unfolds.

Yours faithfully

MICHAEL COMEAU
TECHNICAL PRINCIPAL



RESPONSES TO CONSULTATION QUESTIONS

Question 1: *Do you agree with the revised definition of an ‘objective, reasonable and informed third party’ and with the additional guidance on the application of the test?*

In principle, the assessment of independence and other ethical outcomes should be determined with reference to the actual professional judgements made, rather than the perception of a third party about the independence of the practitioner. However, we accept that such judgements would be difficult to make and that the third party principle has been well-established for some time. But we are also aware that there is a widely held view among investors and the public that practitioners are necessarily untrustworthy and as such that their views should be disregarded. We do not believe that this is a valid view.

In the proposed definition it would be hoped that the requirement that “such a person is informed about the respective roles and responsibilities of an auditor” would act as some safeguard to ensure that the judgements made would be reasonable, but to preclude “another practitioner” from any say in such decisions is not likely to result in a reasonable conclusion. There will always be difficult judgements to make, and the views of other practitioners who are not involved in the particular circumstances under consideration, combined with those who are not practitioners, would lead to a more reasonable judgement.

If it is not possible to move to a system where it is the quality of the actual judgements made that is assessed, we are content with the expanded guidance so long as the phrase “and is not another practitioner” is removed.

Question 2: *Do you agree with our proposed measures to enhance the authority of Ethics Partners, and do you believe this will lead to more ethical outcomes in the public interest?*

The changes made to the material on the role of the Ethics Partner largely clarify the existing requirements. There is a new requirement in 1.15 of the revised Standard which would, in relation to PIE audits, require matters where the views of the Ethics Partner are overruled to be reported to the competent authority and those charged with governance. This would presumably arise very rarely because in most cases the matter would be debated and a solution agreed between the Ethics Partner and others in the firm. Nonetheless, the existence of this requirement may add weight to the Ethics Partner’s view and hence that partners’ authority.

Question 3: *Will the restructured and simplified Ethical standard help practitioners understand requirement better and deliver a higher standard of compliance? If not, what further changes are required?*

The general principle of this restructuring seems sensible.

Question 4: *Do you agree with the introduction of a permitted list of services which the auditors of PIE audits can provide?*

As a general comment we believe that the perceived lack of independence of practitioners has been overemphasised as a cause for audit failure, and we do not believe that a further tightening of these rules would be beneficial. Having said that, there is a case for the clarifying the rules applying to PIE audits and we agree that the list of permitted services is a clearer expression of the intended dividing line between what is and is not acceptable.

Question 5: *Do you agree with the additional prohibitions we are proposing to introduce – in learning from the experience of enforcement cases like BHS, if the more stringent PIE provisions are to have a wider application to non-PIE entities, which entities should be subject to those requirements?*

If the more stringent provisions are to be extended to a wider group of entities, the definition of which entities are to be covered must be clear. The proposed definition of “Other entities of public interest” is reasonably clear, with its reference to the scope of the FRC’s audit quality review (although some of the components of that definition are

somewhat arbitrary that is unavoidable). We would not support extending the more stringent restrictions more widely than this definition.

For many entities the restriction on the provision of non-audit services simply adds to the cost of obtaining professional advice, where needed, for no real benefit.

Question 6: *Do you agree with the removal of the reliefs for SMEs in Section 5 of the Standard, and the retention of reliefs for ‘small’ entities (in Section 6 of the Standard)?*

We are not aware that the reliefs for SME listed entities are widely used. We strongly support the retention of the reliefs for “small” entities in Section 6 of the Standard.

Question 7: *Do you agree with the proposed removal of the derogation in the 2016 Ethical standard which allowed for the provision of certain non-audit services where these have no direct or inconsequential effect on the financial statements?*

No. The only basis for such restrictions is that any particular non-audit service would have an impact on the financial statements. Any more general issues over independence are already subject to the safeguards established in other sections of the Ethical Standard.

Question 8: *Do you agree with the changes we have made to Audit Regulation and Directive references within the ISAs (UK)?*

We have no particular comments to make beyond the general point made in a covering letter about the possibility that the UK law replacements to EU legislation may not be straightforwardly enacted in the timescale envisaged.

Question 9: *Do you agree with the inclusion of FRC staff guidance within the application material, and has this improved clarity of the requirements?*

Additional guidance will always be welcome and incorporating the existing staff guidance within the Standard will make it easier to find.

Question 10: *Do you agree with the changes we have made to ISAs (UK) 700, 250 A and 250 B, including the extension of the requirement for auditors to report on the extent to which their audits are capable of detecting irregularities, including fraud.*

We would regard the changes proposed to ISA (UK) 250A and ISA (UK) 250B as a clarification of existing requirements, but we strongly oppose the proposed changes to ISA (UK) 700 to require all audit reports to include a general statement on the extent to which the audit work is considered capable of detecting irregularities, including fraud. In practice this is likely to become boilerplate wording with no real content. Alternatively it would add significant costs of the audit which will not be justified by the benefits of such disclosure. In the context of PIEs, where this requirement already applies, the existing wider disclosures give a context for the particular disclosure under consideration. It is difficult to see what advantage the additional disclosures will bring in the context of the audit of smaller entities. We would suggest that these proposals are put on hold pending the conclusion of the Brydon Review.

In our responses to the initial consultation of the Brydon Review, we argued against the idea that “graduated findings” could be applied usefully or objectively. For non-PIE audits we would welcome a return to a simple binary report either simply stating that the accounts give a true and fair view or otherwise giving details of why this may not be the case.



Question 11: *Do you agree with the proposed additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit Matters and increased disclosure around materiality and disclosure of misstatements?*

We have no particular comments on the proposed changes here, except to emphasise again that any benefits that such reporting is understood to have in the context of PIE audits would be less clear in other audits and that for non-PIE audits the cost of providing such reports would be prohibitive.

Question 12: *Do you agree with the revisions we have made to ISA (UK) 720, including the enhanced material setting out expectations of the auditor's work effort in respect of other information?*

We have no particular comment on this.

Question 13: *We are proposing changes to the standards to be effective for the audit of periods commencing on or after 15 December 2019. Do you agree this is appropriate, or would you propose another effective date, and if so, why?*

We responded separately to the consultation on the proposed changes to ISA (UK) 570 (many of which we believe to be unhelpful). Subject to the resolution of the issue concerning the legal changes assumed in the proposed document which are dependent on an "exit date" having occurred, we have no objection to the proposed implementation timetable so long as there is adequate time to make the changes that we have suggested above. We agree that a fairly long transition period is useful.

