

December 2019

FEEDBACK STATEMENT AND IMPACT ASSESSMENT :

Revisions to the UK's Auditing and Ethical Standards

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Executive Summary

1. This paper sets out the Financial Reporting Council's final revisions to the UK's Auditing and Ethical standards. These revisions are the result of our Consultation on exposure drafts of revised versions of the Standards which ran over the summer.
2. Our key objectives are to enhance confidence in audit by setting standards to drive high-quality work, which is carried out by independent and rigorous auditors who are free of conflicts of interest. Well-publicised audit failures and corporate failures have had an adverse impact on public confidence which our proposals seek to address. They will help to ensure that consideration of the public interest both drives audit work and the culture of UK audit firms. We are seeking to meet these objectives within the current legal, regulatory and financial reporting frameworks applicable in the UK.
3. We received 44 separate responses to our Consultation, supplemented by a significant amount of additional stakeholder outreach. This included a large number from audit firms/practitioners and the professional accountancy bodies, but also from preparers/corporates, investors and the public sector.
4. As we noted in our Consultation document, as a matter of policy we have not included matters that would run the risk of either cutting across Sir Donald Brydon's ongoing review on the quality and effectiveness of audit, or anticipated Ministers' consideration of recommendations made by the Competition and Markets Authority (CMA) and Sir John Kingman to drive audit reform. However, where we have identified audit weaknesses or failings as a result of the FRC's own inspection and enforcement work, we have proposed revisions to address these urgently.
5. A significant number of respondents to our consultation, mainly practitioners and accountancy professional bodies, expressed concerns that our proposals were either pre-empting the outcome of those other reviews or risked creating a 'piecemeal' approach to reform. Given the uncertainty over the timescale for the implementation of recommendations from those reviews, and given the evidence base we have from our inspection and enforcement work, we are not persuaded of the case to delay our work. We believe that it would be irresponsible not to take action to address recurring issues which undermine stakeholder confidence, and in some cases lead to audit failure which we have already identified. Therefore, we are making revisions based on the current scope of audit. The revised standards complement our new Going Concern standard, issued in September 2019 (and is effective for audits of periods commencing on or after 15th December 2019).
6. Respondents also expressed concern about the proposed effective date for the Ethical Standard of 15th December 2019, and the lack of transitional arrangements. We have revised the effective date for the Ethical Standard to 15th March 2020 and have included transitional provisions. The effective date for changes to ISAs (UK) remains 15 December 2019.

Introduction

7. The FRC is committed to acting as a proportionate and principles-based regulator and balances the need to minimise any adverse impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work to maintain investor and wider stakeholder confidence in audit. In order to deliver on this commitment, we consult widely when proposing changes to Standards, and carry out additional and wide-ranging outreach activity.
8. In addition to the revisions included in this statement, we consulted separately on a revised ISA (UK) 570 covering *Going Concern*. This standard was issued in September 2019, with an effective date for financial reporting periods commencing on or after 15th December 2019. The revised Auditing and Ethical standards include conforming amendments to align them with our changes to ISA (UK) 570.
9. In the Ethical Standard, we have also taken account of revisions to IESBA's Code of Ethics, which came into effect on 15 June 2019. Our long-standing approach is that the FRC Ethical Standard remains no less stringent than the Code. Some of the changes we have made reflect the continuation of that policy.
10. The Consultation on the exposure drafts of the revised Ethical and Auditing received 44 individual responses. A significant number were from audit firms/practitioners, and from the professional accountancy bodies, but we also received responses from corporates/account preparers, investor representatives, public sector bodies and individual members of the public.

Table of Responses

Category of Respondent	Number
Audit Firms/Practitioners	13
Professional Bodies	6
Corporates/Preparers	11
Investors	6
Think Tank	1
Public Sector	5
Private Individuals	2
Total	44

11. This document provides a summary of the feedback we have received and sets out our response, including any significant amendments made to the exposure drafts. All of the responses received are available on the FRC website. In addition to the comments on the timing of the review covered in the Executive Summary, we received detailed commentary on many aspects of the exposure drafts. In respect of the key changes:

- **Simplifying and restructuring the Ethical standard in order to support consistent application and enhanced compliance.**

There was broad support in the consultation for our objective to make the Ethical Standard less complex and less duplicative. However, a significant number of respondents raised queries about the practical effect of our revisions, and also whether certain changes to prohibitions were intended or unintended consequences of re-drafting. The three key issues identified were in relation to:

- Reporting Accountants – our objective was not to further restrict the types of services Reporting Accountants can provide beyond those which were allowable under the 2016 Ethical Standard. We have therefore amended the text of ES 2019, to clarify those services which are likely to be permitted, and which of those services are subject to the non-audit services fee cap.
- Contingent Fees – we have added additional text to clarify what a ‘contingent fee’ is. We will prohibit their use.
- The definition of ‘Internal Audit Services’ – The FRC believes the term ‘internal audit services’ is well understood, given it has been included in standards and in the EU Audit Regulation, and we have not provided further explanatory material in the final standard. Auditors are prohibited from providing internal audit services to entities they audit.

More detailed commentary is included below in connection to Consultation **Question 3**.

- **Re-defining the ‘objective, reasonable and informed third party’ (ORTIP) test which is a core element of the Ethical Standard. [ES 2019 para I14]**

Responses to the consultation indicated broad agreement with our proposal. Stakeholders who rely on audited financial information, particularly investors, were supportive that the ORITP should not be the perspective of another practitioner. Many practitioners and professional bodies expressed concerns that our proposal goes beyond the IESBA Code by excluding the practitioner perspective from consideration. We believe that it will promote greater diversity of thought when auditors and reporting accountants are considering the application of ethical principles and judgements, and this is consistent with the position taken by the FRC in responding to IESBA consultations.

We have therefore finalised this part of the Ethical Standard based on our original proposal, with some minor editorial amendments as described below (in our more detailed review of responses to consultation **Question 1**).

- **Enhancing the role and authority of Ethics Partners within the audit firms [ES 2019 para 1.12-1.38]**

A large majority of respondents agreed with the revisions made to enhance the authority of the Ethics Partners. We have, therefore, not made any significant changes to the exposure draft when finalising the Ethical Standard. (**Question 2**)

- **Introducing of a list of permitted services (rather than a list of prohibited services) that auditors of Public Interest Entities (PIEs) can provide to the entities they audit. These are services which are closely related to the audit and/or required by law and regulation.**

The views of respondents were split between those in favour and those opposed to the introduction of the list. Main areas of concern related to the clarity of any principles-based list of permitted services. In response to these concerns we have worked closely with stakeholders to provide greater clarity.

On the extraterritorial implications of the revisions to the Ethical Standard we note that:

- The permitted services requirement applies only in respect of a UK parent of a UK PIE entity. This reflects the government's legislation in preparation for EU exit. Given the current uncertainty, the Standard will include references to UK rather than EU legislation, but with an explanatory table in a Technical Note showing the EU requirements that would apply prior to exit and also in any transitional period.
- The requirements of the standard apply to all members of the audit firm's network, regardless of whether a particular network firm is involved in the related PIE audit. This reflects the FRC's objective that the firm and its entire network should be able to demonstrate sufficient independence from an audited entity. This also reflects the IAASB's proposals for Quality Management and Group Audits. (Question 4)
- Expanding the scope of the non-audit services requirements applicable to PIEs to also cover other entities which are clearly of significant public interest (drawing on lessons learned from the BHS enforcement case). In light of the constructive feedback provided, we have arrived at a definition, however, we have deferred a decision on its adoption until Sir Donald Brydon has issued his report on the Quality and Effectiveness of Audit, early in the New Year.
- **Strengthening certain ethical prohibitions and requirements which relate to auditor independence, including the provision of non-audit services, for the auditors of all listed entities.** These amendments address changes made to the IESBA Code, but also address issues which adversely impact on auditor independence where we have chosen to be more stringent.
 - Introducing absolute prohibitions on contingent fees; the provision of internal audit services; and recruitment services (including loan staff assignments).

Many audit practitioners and professional bodies expressed concerns at our proposals to introduce absolute prohibitions in these areas. However, we believe that in each case these services represent a threat to independence and objectivity which cannot be managed through safeguards. All prohibitions have therefore been implemented in the revised Standard. (**Question 5**)

- Removing exemptions from certain more stringent FRC ethical requirements for the provision of otherwise prohibited non-audit services for the auditors of SME listed entities.

A minority of respondents, including some investors; expressed concerns about the proportionality of this measure. However, our feedback had identified that audit firms who are members of the Forum of Firms, did not use the reliefs as they were contrary to their IFAC membership obligations. As the reliefs also made the text of the standard more complex, there is good reason to remove them. The revisions also align the FRC Standard with the IESBA Code. **(Question 6)**

- Retaining Section 6 of the Ethical Standard, which provides certain reliefs from prohibitions for the auditors of small unlisted companies.

The FRC believes the retention of reliefs for small entities to be appropriate and proportionate regulation. The Ethical Standard has therefore been finalised on that basis. **(Question 6)**

- Removing the derogation for auditors, allowing them to provide certain otherwise prohibited non-audit services where they have an ‘indirect’ or ‘inconsequential’ effect of the financial statements.

A clear majority of respondents agreed with our proposed change, confirming that the derogation is little used and confusing, and welcomed the greater clarity from removing it. **(Question 7)**

- **Enhancing auditor reporting, including significant judgements relating to the work done to address Key Audit Matters and materiality.**

A majority of respondents supported our proposals to enhance auditor reporting, including through the disclosure by the auditor of performance materiality. We did not address the Kingman recommendation for ‘graduated findings’, pending the completion of Sir Donald Brydon’s independent review. The revised ISA (UK) 701 has not therefore been significantly changed from the exposure draft. **(Question 11)**

- **Clarifying and enhancing requirements in the auditing standards including:**

- Enhanced work effort and reporting in respect of irregularities in law and regulation, including fraud.

Respondents to our Consultation were broadly supportive of enhancements in this area, however audit practitioners expressed the view that expanding additional reporting requirements to all audits would lead to the use of excessive and unhelpful boilerplate language. The FRC does not envisage that the additional requirements in ISA (UK) 700 should automatically lead to a prevalence of ‘boilerplate’ language in the audit report. Where audit firms feel that the language in their reports is becoming ‘boilerplate’ in nature, they should seek to review and improve their reporting processes so that audit reports provide salient information to users.

- Greater clarity over the auditor's work effort on 'other information' included within annual financial reports.

In response to feedback we have deleted additional application material that was considered to be confusing by some respondents, to ensure that there is clarity about the scope of the auditor's work in respect of statutory 'other information', as required by the revised **paragraph 14-2**.

Impact Assessment

The FRC is a principles-based regulator and is committed to issuing proportionate Standards and Guidance that support the provision of high-quality, independent audit. The requirements proposed in these Exposure Drafts have been developed in response to particular issues and concerns in respect of auditor independence, reporting and the adequacy of audit work effort.

In making these revisions we have had regard to the FRC's 'Principles for the development of Codes, Standards and Guidance which include:

- there is a clearly defined issue relevant to the FRC's mission and responsibilities;
- the change is the most appropriate way to address the issue;
- one or more of the following conditions is met:
 - a change is necessary to comply or align with a legal requirement; or
 - a change is required in the light of developments in international standards or in legislation or regulation; or
 - the risks to the public interest of not acting are significant, for example, a risk of systemic and/or market failure; or
 - it is possible to eliminate or significantly simplify a current requirement; or
 - it is necessary to clarify a current requirement; or
 - it is possible to create significant additional benefits in the public interest; or
 - a change is necessary to underpin the effectiveness of the FRC's enforcement and disciplinary activities;
- the anticipated benefits of the change outweigh the costs.

With reference to these Principles, the FRC concluded that these revisions are necessary as the risks to the public interest of not acting are significant. Given the risk posed to investors and other stakeholders, where confidence in audit is undermined because of concerns over auditor independence and audit quality, the FRC has concluded that it is appropriate to strengthen ethical requirements. Stronger stakeholder confidence as a result of the changes we have proposed will deliver significant, but unquantifiable benefits.

Some consultation respondents were critical of aspects of our Impact Assessment, including estimates of the costs to business, and to our estimates of the time required by practitioners to align their methodologies, documentation and training to the revised Standards. While we recognise that there is always an element of uncertainty in any estimate of future costs, our assessment drew on baseline information used to estimate the costs of the 2016 Audit Reforms.

We are not convinced that companies will experience significant increases in costs by having to procure non-audit services from different providers. It seems to us counterintuitive for some respondents to argue – on the one hand – that a 'white list' of permitted services is not required because companies are increasingly procuring non-audit services from firms other than their auditor; but that any additional limitations placed on auditors will significantly increase costs to business.

The estimated cost of these changes is set out in the following table.

Impact	Assumptions	Cost Impacts	Estimated Cost (£000)	Recurring (Y/N)
Familiarisation and Training with revised standards (ethical and auditing).	Updating guidance by technical managers/partners (90%/10%) 500 hours for 6 large firms; 50 hours for 30 medium firms; 10 hours for 64 small firms. A discount of 25% applied to reflect the fact that audit firms update technical/methodology material on an annual basis.	Audit firm	1,044	N
Familiarisation and Training with revised standards (ethical and auditing).	Familiarisation of audit practitioners with standards estimated at 2 hours per practitioner. Other assumptions consistent with Impact 1, but a discount of 40% applied since practitioners are required to maintain CPD, and an aspect of familiarisation with standards would have taken place anyway.	Audit firm	2,965	N
Introduction of a permitted non-audit services list for PIE auditors.	We do not believe that there will be significant incremental costs as a result of this proposal. Although there is the potential for some additional tendering costs for previously allowable services, the feedback we have received has indicated that the market was already moving towards this outcome. Loss of revenue from the provision of such services cannot be considered a qualifying cost, since the likely outcome of changes in the market is a redistribution of this revenue rather than a significant decrease. We also note that greater clarity about what services may or may not be provided is likely to reduce internal procedures - including for example ethical consultations within the firms.	N/A	0	N/A
Removal of SME reliefs from the Ethical standard.	The feedback we received in our Call for Feedback indicated that very little practical use was being made of these reliefs. Changes to the IESBA Code, also made it difficult to maintain certain reliefs. We estimate that some costs will arise for audit firms in terms of refreshing processes and procedures, however, only to the extent of the benefit used in the 2016 impact assessment.	Audit firm/ audited entity	54	Y
Enhanced auditor reporting requirements. Additional reporting requirements in respect of materiality, KAMs and misstatements apply to all entities who are required to comply with ISA (UK) 701.	Based on 2,800 engagements (PIE audits and other listed), with an additional requirement of 2 hours of partner time and 2 hours of manager time (based on estimated hourly rates)	Audit firm	6,160	Y
As a clarification of the auditor's responsibilities on other information - and at a more granular level - we believe this will drive more consistent practice across the firms and therefore likely increase work effort.	The FRC's 2018 thematic review of the work carried out by auditors on 'other information' identified significant inconsistencies in work effort and methodology. Some will need to significantly increase the work they do in this area. For PIEs we have assumed additional hourly costs of 1 manager & 3 team member hours; for listed entities 1 manager and 2 team member hours; for other entities 0.5 manager and 1 team member hour, with 50% of engagements requiring additional work effort based on our thematic review.	Audit firm	1,432	Y

Enhanced work effort: law and regulation, including fraud. The most significant impact is likely to be our extension of the requirement to report on the extent to which an audit is capable of detecting material irregularities relating to non-compliance with regulation, including	This is an additional reporting requirement which requires auditors to provide disclosure in their auditor's reports and ensure that their work effort is consistent with those disclosures. The incremental cost will be for non-PIE audits only since PIE auditors are already required to comply. We have assumed 1 additional manager hour per affected engagement.	Audit firm	2,152	Y
Benefits to auditors from having standards and guidance in a single place, with the incorporation of TAG material and relevant staff guidance.	Benefit scaled at 20% of relevant familiarisation costs.	Audit firm	(802)	N
		Total	13,005	
One off costs (£000):	3,207			
Recurring costs (£000):	9,744			

Analysis of Consultation responses and detail of proposed revisions to the exposure drafts

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?

Responses to this question indicated broad agreement with the revised definition supporting the ‘objective, reasonable and informed third party’ (ORITP) test. [ES 2019 para 114] Stakeholders who rely on audited financial information, particularly investors, were very positive that the ORITP test should not be from the perspective of another practitioner. Many practitioners welcomed clarity on the fact that any judgements should be made based on information available at the time not with the benefit of hindsight.

However, many audit firms and the majority of professional bodies, were concerned that this proposal goes beyond the requirements of IESBA Code of Ethics. Although the ORITP test is well established the FRC is promoting greater diversity of thought when considering perspectives on ethical issues that auditors encounter. By excluding practitioners from this test, the FRC is seeking to reduce any conformity bias that might exist in firm’s decision-making processes. Reducing bias, both actual and perceived, in ethical decisions aids in improving both the outcome and the perception of the process. This position is consistent with the FRC’s feedback to IESBA when they have consulted on revisions to the Code of Ethics.

A number of audit firms suggested that the FRC establishes an ORITP panel which might be consulted when coming to judgements on ethical matters. The FRC believes that the assessment should not be a process, but a reasoned assessment and judgment by the audit firm, and that a firm cannot wholly, or partially, delegate the process of professional judgement with regards ethical concerns. We have however, provided a framework for an auditor or audit firm to use when making such an assessment.

Some respondents questioned the use of s172 of Companies Act 2006 as authority for including “other public interest stakeholders” within the group of individuals who views might be considered best support to an effective evaluation. The FRC believes the group whose views might best support an ethical consideration should be as broad as reasonably possible in the circumstances of that entity. We have therefore retained the reference to s172 CA 2006 as being indicative of the range of stakeholders who may need to be considered, whilst refining the language to suggest that auditors ‘may’ wish to consider s172 rather than ‘will’.

We have also clarified that the ORITP test applies to reporting accountants as well as auditors.

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?

A large majority of respondents agreed with the revisions made to enhance the authority of the Ethics Partners. Most practitioners were accepting that this increased authority was a positive step and that the provisions contained within **paragraph 1.15** of the Ethical Standard in relation to reporting to the Competent Authority would further enhance the Ethics Partner’s mandate. Some respondents queried whether reporting directly to the Competent Authority should be limited to issues relating to PIE clients. We have therefore clarified reporting requirements both in respect of decisions to override the views of the Ethics Partner, and for all breaches of the Ethical Standard that the reporting line should be to the FRC for PIE audit

firms or the Recognised Supervisory Body for non-PIE audit firms to whom the FRC has delegated regulatory tasks as applicable.

Investors agreed that these revisions encouraged an ethics positive culture within audit firms, enhancing trust in reports provided by auditors. Investors also expressed a desire to see the matters which should be reported to the competent authority extended to include instances where the Ethics Partner was not consulted in a timely manner on independence issues (which would be a breach and therefore covered). The professional bodies also, for the most part, agreed with these revisions.

The FRC believes that enhancements to the Ethics Partners authority will emphasise the need for careful and considered ethical decision making. Whilst firms may not routinely overrule their Ethics Partner directly, these revisions will help to reduce the risk of more subtle or perceived attempts to influence the Ethics Partner and reinforce their position as an authority within the firm. The FRC sees the revisions as, in many cases, simply codifying best practice.

Scalability of these revisions was also raised, with some concerns as to how smaller audit firms might apply these provisions. The FRC does not believe that the provisions in relation to Ethics Partners would be disproportionately difficult for smaller audit firms to apply. With appropriate training and consideration of the risks associated with the clients the firm takes on, firms of any size should be able to effectively apply the requirements in relation to Ethics Partners.

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?

There was broad support for the FRC's objectives to simplify and make the Ethical Standard clearer and less complex. From practitioners in particular, there was recognition that improvements have been made creating a more accessible standard, including the removal of duplicative text relating to reporting accountants. However, a significant number of respondents raised queries about the practical effects of our revisions, and whether the change to a list of permitted non-audit services would lead to unintended consequences. Some practitioner respondents raised concerns about the sections relating to the work of reporting accountants, and in particular transaction services which were included in the list of 'permitted services' for the auditors of PIEs.

Detailed commentary is included below in respect of the editorial changes we have made connected to the list of permitted services, which are intended to clarify which services the FRC intended to include on the PIE auditor 'white list'. We have also responded to the following detailed areas of concern as follows:

- Reporting Accountants – some respondents expressed the view that in removing the duplicative material relating to the work of Reporting Accountants, we had potentially increased prohibitions on the types of services which can be provided. Our objective in undertaking this review of the Ethical Standard was not to further restrict the types of services Reporting Accountants can provide beyond those which were allowable under the 2016 Ethical Standard. However, it is clear that there is inconsistent understanding of the requirements of that standard and how the non-audit services cap applies to the work of reporting accountants. We have amended the text of the

Standard, particularly **paragraphs 5.39 and 5.40**, to clarify those services which are permitted.

- Reporting Accountants – applicability of ethical provisions – one of the methods used to simplify the text of the ES as a whole was to remove duplicative and confusing material relating to the work of reporting accountants to a single section at **18**. We believe that **18** provides a strong principles-based framework for reporting accountants to apply the ES to their work.
- Contingent Fees – there was some concern that removal of explanatory text included in the 2016 Standard made it more difficult to understand the definition of a ‘contingent fee’. We do not agree, and have prohibited the use of contingent fees for non-audit and audit related work, but for the avoidance of doubt have amended the text of the exposure draft to clarify that:

Differential hourly fee rates, or arrangements under which the fee payable will be negotiated after the completion of the engagement, or amended to cover changes to work, risk or responsibility identified as necessary during the engagement, and which do not change the outcome of the engagement do not constitute contingent fee arrangements. A reduced fee payable where an engagement is aborted or prematurely terminated also does not constitute a contingent fee arrangement. [ES 2019 Para 4.7]

- Internal Audit Services – respondents raised concerns that our prohibition on statutory auditors providing ‘internal audit services’ was insufficiently precise and could potentially scope into the prohibition other services which are currently allowed. [**ES 2019 Para 5.44**] The FRC believes that the nature of internal audit functions and services linked to that function is well understood, and that there is a significant risk that a range of internal audit services could be provided but badged as something else to avoid the prohibition. The standard was therefore finalised on the basis of our original proposals.

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

There were a wide variety of responses to this Consultation question, from those strongly in favour of additional limitations to the types of non-audit services auditors can provide, and who welcomed the clarity of this approach, to those fundamentally opposed to the objective and/or execution of the proposal. Some respondents also suggested that changes of this kind should be contingent on the completion of the CMA/BEIS; Kingman; and Brydon reviews. Many practitioner respondents argued that should this proposal go ahead then the FRC should provide greater clarity about those services which are permissible. We have also considered this requirement, taking into account the views of the BEIS Select Committee which has reported on Audit in the UK, and which has expressed concerns about the impact on quality and independence, of auditors who are distracted by commercial non-audit relationships.

As set out in question 3 above, there was particular interest in the drafting of **paragraphs 5.39 and 5.40** of ES 2019. In response we have:

- Further clarified the text of those paragraphs in order to ensure that the prohibitions operate at a principles-based level and align with the policy set out in the way in which the EU Audit Regulation and Directive was implemented in the UK. The requirement

also reflects the commitment made by the largest audit firms to the BEIS Select Committee in that respect.

Respondents also raised concerns about the extraterritorial application of the provisions of ES 2019 in two key respects:

- The list of permitted services applies only in respect of a UK parent of a UK PIE entity. This reflects the government's legislation in preparation for EU exit. Given the current uncertainty, the Standard will include references to UK rather than EU legislation, but with an explanatory table in a Technical Vote showing the EU requirements that would apply prior to exit and also in any transitional period.
- The requirements of the Standard apply to all members of the audit firm's network, regardless of whether a particular network firm is involved in the PIE group audit. This reflects the FRC's objective that the firm and its entire network should be able to demonstrate sufficient independence from an audited entity and is consistent with the IAASB's approach in developing the new Quality Management and Group Audit standards.

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?

Respondents welcomed the proposal, subject to being able to address two key concerns:

- We proposed that the non-audit service prohibitions applicable to PIEs should also apply to other entities which are of significant public interest, however we did not define those entities. Broadly speaking, respondents were supportive of this objective but concerned that any definition was clear and provided reasonable medium-term certainty for both audited entity and auditor. We have, therefore, developed a detailed definition, but the FRC Board has deferred a decision to approve it pending the publication of Sir Donald Brydon's report to ensure that there is no risk of the standard including proposals which contradict his recommendations.
- The outright prohibitions over contingent fees, the provision of internal audit services and recruitment services (including loan staff arrangements), were flagged by some practitioners as being a disproportionate approach to the threat to independence (in spite of the fact that some of the changes were IESBA requirements).

In response, we have provided clarification about the definition of a 'contingent fee' basis to clarify that it does not cover arrangements whereby a fee can vary based on additional risk or engagement scope. However, we believe that any non-audit service where the provider of assurance has a vested financial interest in the outcome of the subject matter of that engagement gives rise to a threat to independence which cannot be mitigated.

In respect of loan staff arrangements we received particularly strong representations from public sector bodies that our proposed prohibitions would represent a significant problem given their unique roles as statutory auditors of public bodies – both in terms of the development of their own staff with relevant sector experience, and potentially

in terms of service and policy delivery by the audited bodies. Subsequent discussions suggested that such arrangements were not in all cases 'loan staff arrangements', but specific engagements which are permitted by the current provisions within the standards. We propose, therefore, to maintain the prohibition we proposed, with limited flexibility for short secondments for staff from national audit agencies where the secondment does not involve any management responsibilities.

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)?

Section 5 of the 2016 Ethical Standard included exemptions in respect of certain FRC more stringent requirements regarding non-audit services for the auditors of 'SME listed entities'. [ES 2016 5.47-5.164] Further reliefs for the auditors of 'small' unlisted entities were set out in Section 6. We specifically consulted on whether the Section 5 reliefs should be removed and whether Section 6 should be retained in its entirety.

15 of the 23 respondents who commented on this question supported both proposals. Many noted that, in their experience, the reliefs were not widely used and were, anyway, in conflict with IFAC Forum of Firms membership obligations and could not be used. A minority of respondents, including some investors; expressed concerns about the proportionality of this measure and whether this was going further than required.

The FRC believes that removing the reliefs for 'SME listed entities' aligns better with the IESBA Code requirements and reduces complexity in the Standard. No evidence was submitted in the course of our consultation that these exemptions are currently in widespread use, and that their removal could cause disruption in UK capital markets. The FRC also believes that the retention of reliefs for small entities is evidence of proportionate regulation. The Standard has therefore been finalised on that basis.

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?

The 2016 Ethical Standard included a derogation allowing for the provision of certain prohibited services by a PIE auditor, where, "*they have no direct or, in the view of an objective, reasonable and informed third party, would have an inconsequential effect, separately or in the aggregate on the audited financial statements*". [ES 2016, para 5.168R] Our stakeholder outreach suggested that this derogation was confusing for auditors and audit committees, particularly when making judgements around the 'inconsequential' effect of specific non-audit services. We therefore consulted on removing the derogation.

A clear majority of respondents agreed with our proposed change. [16 agreed, 6 disagreed, 4 commented but did not clearly express a view] This included a majority of the practitioners, investors, corporates and professional bodies who specifically responded to this question.

Those who agreed, confirmed that the derogation is little used and confusing, and welcomed the greater clarity from removing it. Some respondents, including some investors, expressed concerns about a potential increase in the cost of some non-audit services because of the need to seek alternative providers. However, no direct evidence has been provided in support of those concerns.

A minority of respondents also raised the issue of non-audit services provided to lending syndicates. A new Appendix has been added to the revised Standard which incorporates existing FRC staff guidance on *The Auditor's Provision of Restructuring Services to Public Interest Entity Participants in Bank Lending or Bond Funded Syndicates*. [SGN 01/2018]

Question 8: Do you agree with the inclusion of FRC staff guidance within the application material of the Ethical Standard, and has this improved clarity of the requirements?

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

The majority of respondents to these questions were audit practitioners or professional bodies who welcomed the incorporation of FRC staff guidance, developed to assist with the implementation of the 2016 revisions. This means the standards are a 'one stop shop' for relevant material. Some respondents identified specific pieces of the existing staff guidance which could be more fulsomely reflected in the revised standards. As a result, we have made the following revisions:

- The Ethical Standard now includes an Appendix, Incorporating the staff guidance in respect of restructuring services provided to PIE Participants in Bank Lending or Bond Funded Syndicates; and
- Various other detailed matters were addressed in the ISAs (UK).

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.

Irregularity, including fraud, is an area where there is an expectations gap between the work auditors are required to do, and the expectations of users of audited financial statements is potentially the widest. Recent corporate failures have also drawn attention to this area.

Respondents to our Consultation were broadly supportive of enhancements in this area. Some investors believed that auditors' responsibilities with regards detection of fraud were not given sufficient focus by audit firms and welcomed these revisions as an attempt to address this. However, a number of concerns were raised by other stakeholders in respect of our specific proposals. Many audit practitioners expressed the view that expanding the reporting requirement about the extent to which an audit was considered capable of detecting irregularities to all audits would lead to the use of excessive and unhelpful boilerplate language.

It is the auditor's responsibility to ensure that their auditor's report is clear, unambiguous, relevant and tailored enough such that it is useful to the users of the report. The FRC does not envisage that the additional requirements in ISA (UK) 700 should automatically lead to a prevalence of 'boilerplate' language. Where audit firms feel that the language in their reports is becoming 'boilerplate' in nature, they should seek to review and improve their reporting processes so that audit reports provide salient information to users.

Responses in relation to ISA (UK) 250 A and 250 B were generally positive and most welcomed further guidance in respect of reporting to regulators, with some requesting that this guidance is added to and expanded upon.

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?

A majority of respondents supported our proposals to enhance auditor reporting requirements for listed entities, PIEs and those entities which voluntarily comply with the UK Corporate Governance Code.

Our revisions to ISA (UK) 701:

- require auditors of all entities within scope to describe the ‘significant judgements’ made in respect of how Key Audit Matters were addressed in the course of the audit; **[ISA (UK) 701, para 13 (b)]**

As part of our consultation we noted that Sir John Kingman has recommended that a form of ‘graduated findings’ be introduced, where the auditor would be additionally required to give a view on management’s decisions in areas that are key audit matters, including for example whether they were considered ‘optimistic’ or ‘cautious’. We further noted that Sir Donald Brydon’s review will be giving further consideration to this idea.

Pending the conclusion of the Brydon Review, there was broad support for the proposal 15 of the 25 respondents who answered this question being clearly supportive of the changes proposed. Of the 2 investor respondents, 1 was in support and 1 expressed support for graduated findings. Given this, we will proceed with this change to ISA (UK) 701, to enhance the transparency of auditor reporting and provide users of financial statements with more information about the significant judgements made in the course of dealing with Key Audit Matters.

- Require auditors to provide enhanced disclosures in respect of materiality, including the specification of performance materiality. **[ISA (UK) 701, para 16-1].**

We found greater support still for our proposed enhancements to disclosures around materiality in the auditor’s report, including performance materiality. [18 respondents were in favour, 5 disagreed, and 1 expressed no definitive view] Those who disagreed were – in the main – practitioners and professional bodies. In their view, the key risk linked to our proposal was the difficulty auditors would have in explaining the concept of performance materiality in a way which would be meaningful to the users of auditor’s reports.

Performance materiality is a fundamental concept in the application of ISAs (UK) to an engagement, providing important insights into the auditor’s assessment of the effectiveness of internal control in an audited entity. Some firms already disclose performance materiality on a voluntary basis, and we do not therefore accept the argument that it is not possible to explain the concept – and how it has impacted on the audit – in an understandable manner.

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?

A narrow majority of respondents were in favour of our changes to ISA (UK) 720 [12-8], but many practitioners and professional bodies raised concerns about whether – and to what

extent – we were changing the scope of the audit to require a ‘full audit’ of statutory information. They felt that any such scope extension would pre-empt the Brydon review, and could have a significant impact on the extent of work required.

We disagree that we are seeking to change the scope of an audit in this respect. The status of other information is a matter for legislation. However, what we are seeking to do is address poor audit practice identified through the AQR Thematic Review on how auditors were complying with the requirements in ISA (UK) 720. The additional application material we have included should help in this respect.

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?

In relation to the revisions of the Ethical Standard, a majority of respondents believed that an effective date of 15 December 2019 was too soon after the close of the consultation process and did not allow enough time for the impact of the revisions to be properly assessed and changes implemented. This was the view of most audit firms and some other stakeholders (including corporates).

The FRC has therefore revised the effective date for the Ethical Standard to **periods commencing on or after 15 March 2020**. This means that, it will apply to the audit of companies with periods ending on 31 March 2021. Many respondents also expressed concerns about the lack of transitional arrangements for non-audit services already in progress at the effective date, and for the tightening of the ‘cooling in’ period for the provision internal audit services, where an auditor is appointed, having previously been the internal auditor of the company. **Paragraphs 1.69-1.72** of the Ethical Standard have therefore been amended to clarify that:

- Non-audit services which were permitted by the previous version of the Ethical Standard, may continue until completed in accordance with the original *engagement* terms, subject to the application of appropriate safeguards;
- The extended cooling in period required by Appendix B (b) (h) relating to the provision on services relating to internal audit does not have retrospective application.

By contrast, respondents broadly agreed that the effective date of the ISA (UK) revisions was feasible. This ensures alignment with the separate revisions to ISA (UK) 570 on *Going Concern*, and as such the FRC has elected to proceed with an effective date of 15 December 2019 for the revised ISAs UK.

Financial Reporting Council

December 2019

Respondents to the Consultation

BDO LLP

Crowe LLP

Deloitte LLP

Duncan & Toplis

EY LLP

Grant Thornton UK LLP

HW Fisher

KPMG LLP

Kreston Reeves LLP

Mazars LLP

Moore Kingston Smith LLP

PwC LLP

RSM Audit UK LLP

Association of Accounting Technicians

Association of Chartered Certified Accountants

Chartered Accountants Ireland

Chartered Governance Institute

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

Ahli Bank

Anglo American PLC

Clarion Events

Computacentre PLC

London Stock Exchange Group

Park Group PLC

Royal Bank of Scotland PLC

Rentokil Initial PLC

Santander PLC

Unum

The 100 Group

Association of Investment Companies

British Private Equity and Venture Capital Association

Corporate Reporting Users' Forum

Hermes

The Royal London Group

Schroders

Wellcome Trust

Audit Scotland

Auditor General for Wales

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NHS Wales Finance Academy

Society of Welsh Treasurers

Mr David Taylor

Ms Mira Makar



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