

## Request for Comments

Comments are invited in writing on all aspects of the Exposure Drafts of the revised Ethical Standard and ISAs (UK). In particular, comments are sought in relation to questions 1–14 below:

**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?

Yes.

**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?

Yes.

**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?

We do not have an opinion on this matter.

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

Audit firms have started to indicate that they would no longer provide non-audit services to FTSE-350 audit clients (see KPMG announcement November 2018), and anecdotal evidence points to Audit Committees also implementing stringent policies in this regard. We are concerned about becoming prescriptive (particularly within the areas of Corporate Finance) and the lack of choice. Many companies will need an audit firm, remuneration consultants, corporate finance services (e.g. working capital) which may lead to a lack of choice on future audit tenders.

**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?

The intention to expand the PIE list to include AIM listed entities would restrict the “challenger” audit firms, who rely heavily on auditing entities not currently considered to be a PIE firm, from building their audit and non-audit practices to the extent that they can close the gap on the Big4. We see the extension of the PIE list as much more detrimental to the challenger firms and contradictory to increasing competition in the audit marketplace by growing challenger firms to scale.

**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)?

The removal of reliefs for SMEs is consistent with the already applicable IESBA international code of ethics restrictions so should have little practical impact. Alignment of regulations across regulatory bodies is welcomed.

**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?

In practice, anecdotal evidence suggests that Audit Committees rarely used the derogation and have only done so for trivial engagements. We would prefer to retain the flexibility to use such services, particularly for subsidiaries in offshore locations where the choice of non-audit service provider may be even more limited.

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

We do not have an opinion on this matter.

**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?

We do not have an opinion on this matter.

**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.

Further effort needs to be made on the part of the FRC and the audit profession to educate the media, the public and investors as to the exact capabilities of a statutory audit to detect deliberate instances of fraud. As such we support the changes made but would prefer to see such a statement by the auditors not buried within the audit report.

**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?

The specific examples mentioned including describing the significant judgments in respect of how Key Audit Matters were addressed during the audit and enhanced disclosures in respect of materiality, including the specification of performance materiality, to show the auditor's assessment as to the effectiveness of internal control in the entity both seem reasonable extensions of the current audit report format.

However, there needs to be careful consideration given to the current length of these reports as the overall usefulness to, and impact on, investors and other stakeholders would appear to be inversely related to the length of the reports themselves.

**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 see this as a substantive change. Whilst clarity over the requirements over the auditor's work effort on 'other information' included within annual financial reports is welcome, the increase in auditor verification in this area may lead to the audited company requiring increased resources to respond to the increase in audit procedures, an increase in audit costs and further pressure on companies to deliver their already overlong annual report and accounts in a timely manner.

**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?

This date appears to be too soon. With the consultation closing on 27 September 2019 it appears impracticable for respondents to assess whether the FRC have adequately addressed their concerns in the timeframe available which will inevitably result in a reduction in overall respondents as some potential respondents will assume that, due to the limited timeframe, their responses will not be adequately considered.

Further, with certain substantial changes required to audit procedures and approach, audit firms may not have the necessary resources in place, as these things are planned well in advance, to adequately

implement any enhanced audit procedures, particularly around the other information in an annual report and accounts outside the financial statements.

Finally, the impact of these changes may be enhanced by delaying them and combining them with any outcomes from the "Brydon review" report that is imminent.

### **Other Comments Outside the Scope of the Questions Above**

We note the following observations with regard to the wider context of regulation, both in the audit profession and as how it relates to the information produced in an annual report.

These comments highlight themes of over-regulation, unintended consequences of incremental regulation to wider competition in the audit environment, costs of compliance, and the lack of focus on real business issues within a statutory audit.

#### *Lack of Competition in Audit Environment Due to Independence Rules*

Due to the increased independence and audit rotation regulations firms are now looking to keep at least one of the Big-4 "clean" from any engagements. This essentially means that as one of the Big4 is the incumbent auditor and prohibited from nearly any other type of engagement, a further two are usually contracted to the company in other commercial, accounting or taxation advice and therefore excluded from participating in a future audit tender. This leaves only one member of the Big-4 able to tender which makes it a fairly pointless exercise lacking commercial competitiveness.

Sports Direct noted that the difficulties of selecting a new auditor related to the need to keep the members of the Big-4 "clean" from an independence point of view. Deloitte already conducted tax and advisory work for Sports Direct; EY had expressed reservations because of its role as administrator to House of Fraser, which meant a possible conflict of interest; PWC had told Sports Direct it did not wish to be considered in the wake of a string of fines relating to audit work for companies such as department store chain BHS and KPMG informed Sports Direct that it could not take on the work owing to "an existing portfolio of clients". Sports Direct noted that it did not believe a firm outside of the Big 4 would potentially be able to cope with such an audit in the future.

The need for greater independence regulation of auditors has essentially nullified the potential for the audit rotation regulations to have their desired effect. Audit rotations will be almost predictable for most of the FTSE-350.

#### *Joint Audits*

Current proposals for joint audits, involving a challenger firm and a member of the Big-4 could have the following negative and unintended consequences:

- Increase in audit fees due to duplicated reviews\*.
- A reduction in audit quality as there is inevitably more overhead spent on co-ordination rather than performing the audit.
- A potential for audit gaps to appear between the procedures performed by the firms.
- Eliminated the challenger firm from bidding for lucrative non-audit services on the engagement due to independence rules.
- No effective way to regulate the division of the audit leading to the Big-4 taking the complex tasks and the challenger firms focusing on simpler areas which does not result in an improvement in the ability of challenger firms to complete a full audit.

\*It should be noted that Parmalat had a joint audit with a challenger firm auditing the business where the fraud occurred. The Big-4 firm took much adverse criticism despite the opinion being clear that the Big-4 firm had no responsibility for that audit.

## *Audit and Reporting Focus*

The collapse of Thomas Cook highlights that reporting, and audit governance, is being dragged away from issues that core stakeholders, namely shareholders and employees, consider important such as the ongoing sustainability of the business model and financial viability of the company. In their latest Annual Report and Accounts Thomas Cook Group plc devoted four pages to their business model and eight pages to people, environmental sustainability, diversity and values. We would suggest that the priorities in reporting have become skewed away from reporting on important issues related to the sustainability of a business' operating model towards areas, although important in the overall understanding of a how a business operates, are less critical to the survivability of the enterprise itself. With regards to the FRC's change to the ethical and auditing standards, there is a danger that audit teams are similarly distracted from the key financial matters when reviewing the "front end" of an annual report and accounts.

Further, emphasis on historical accounting areas such as valuation of acquired intangibles, that have no impact on the underlying performance of a company, can distract auditors and companies from qualitative reporting. Technical areas such as these take considerable time and investment on the part of both the company and the auditors that could be better spent as this remains a very low priority for investors.

We believe that a change in approach is needed to adjust the audit emphasis from one where historical balances and positions are reviewed to one where the auditor takes much more interest in the future prospects of a company through review of forecast and budgets to substantiate business models, going concern and viability statements. This latter emphasis would be of much more importance to current and potential investors.

The incidence of high profile corporate failures appears to be increasing despite the introduction of the viability statement even as audit independence rules and other regulations have tightened. We believe that the FRC should radically review the type of assurance that is expected from audit engagements as there is a significant disconnect in understanding of the role of audit between the public and the audit practitioners themselves.

Yours sincerely,

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