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Dear Mark

BDO LLP response to 'Feedback Statement and Impact Assessment: Post Implementation Review of the 2016 Auditing and Ethical Standards'

BDO LLP is an award winning UK member firm of BDO International, the world's fifth largest accountancy network, with more than 1,600 offices in more than 162 countries. We are pleased to have the opportunity to comment on the 'Feedback Statement and Impact Assessment: Post Implementation Review of the 2016 Auditing and Ethical Standards' by the Financial Reporting Council (FRC).

We agree with the FRC's intention to enhance confidence in audit and to ensure that consideration of the public interest is placed at the core of UK audit firm culture in order to strengthen auditor independence. The proposals to simplify and restructure the Ethical Standard ("ES standard") in order to achieve higher levels of understanding and compliance are welcomed. We do, however, highlight below a number of concerns that we have over the proposed changes:

Timing: we acknowledge the steer given to the FRC by a variety of stakeholders regarding the need for these changes to be made on a timely basis and, in principle, we support this view. The advantages of rapid change however have to be balanced by the risks. In particular, the risk of unintended consequences from a curtailed due process in writing the standard is significant and the risk of unavoidable regulatory non-compliance and market disruption to audited entities, is equally high. These risks are even more acute considering other significant changes that may result from Brexit, the CMA Market Study and the review by Sir Donald Brydon.

Whilst our response indicates our support for the majority of the proposed revisions, we are of the opinion that implementing them will result in a number of fundamental changes for a number of large entities regarding who supplies them with professional services; in many instances this will take some time to properly organise. Equally, for audit firms, many of the changes, for instance those relating to the extraterritorial reach of the Standard, will involve extensive educational initiatives throughout their wider network and complimentary changes to policies, systems and procedures; this too will take time to properly execute.

Even a relative short delay in the implementation date, for instance 4 months, would reduce these risks significantly. This will be even more effective if the proposed wording was to include transitional arrangements for a number of the changes. Without such changes we are of the opinion that the implementation period is too short in the context of allowing the necessary time for both audited entities and audit firms to adjust, and unavoidable breaches will undoubtedly occur; this risks further undermining confidence in audit. It is not in the public interest and we would not consider it to be good regulatory practice.

White list of permitted services: the White List of permitted services to Public Interest Entities and the newly created category of Other Entities of Public Interest is concisely written and seems to allow relatively few non-audit services. Given the expressed view in this area from a number of stakeholders, and the voluntary positions taken by some of the market participants, this is expected. However, as written this would introduce a number of consequences that are perhaps unintended. One of the most seemingly explicit is in relation to permitted services relating to "...reporting required by...a regulator..." in the context of Reporting Accountant work. Reporting Accountant services typically comprise a number of deliverables, some of which are required by regulation and some of which are intended to provide assurance to involved parties in order to enable the transaction to complete. These services are often significantly interlinked and separating them is often impracticable and would add unnecessary friction to the market transaction. From discussions we understand that the wording in this section is intended to be interpreted in a principles-based fashion thus allowing the related services to be provided as part of the Reporting Accountants work; however from reading the wording this is not clear. One important aim of the revision to the Standard is to provide clarity to users and this is an example of where we believe there is a lack of clarity that might lead to differing practices amongst users and undermine the quality of the standard.

Other Entities of Public Interest ("OEPI"): the introduction of OEPI is perhaps one of the most fundamental proposals within the Standard and will be the genesis of significant change to many entities regarding who they procure certain professional services from. The reasons for enhancing the independence standard in relation to a number of large entities that current fall outside the definition of a Public Interest Entity have been well debated and documented over the previous 18 months; the creation of the new OEPI category is a pragmatic way to at least partially address this.

In principle we support this, but in practice we believe that there should be greater due process and stakeholder involvement in its constituents. As currently defined OEPI comprise at least those entities that fall within the FRC's AQR Scope. Being included with OEPI is a significant matter of fact for audited entities and as such it is critical that: it is clear as to which entities are included, the population is, to the extent practical, stable, and; entities can plan ahead by having sufficient warning that they will in the future be part of this grouping. Additionally, due to the increased significance of this definition to audited entities, we believe that changes to the FRC's AQR Scope should in the future have some element of external stakeholder consultation and transparency.

Investment Circular Reporting Engagements "ICREs": the consideration of ICRE is another significant change in the proposed revisions to the Standard. Whilst the separate section at the front of the proposed ES is helpful in decluttering the guidance for audit teams, we believe the simplification is less helpful for reporting accountants acting on ICREs, as it leaves considerable uncertainty about how to apply the proposed ES to such work; we have provided a number of illustrations of this within our detailed response. Some of this lack of clarity can be addressed by re-drafting but some can only be addressed by removing ICRE work completely from the proposed ES, and preparing a separate ES for ICRE work, with rules and guidance more appropriately tailored to such work.

Our detailed responses to the questions raised in the Consultation document are set out below. Should you wish to discuss any aspect of the proposed revision please contact David Isherwood, the firm's Ethics Partner.

Yours sincerely

David Isherwood
Ethics Partner
For and on behalf of BDO LLP

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?

We welcome greater emphasis on the overarching principles of the Ethical Standard and stronger focus on the public interest in the decision making process. The additional ("ES") guidance on the objective, reasonable and informed third party test is useful and should help benchmark expectations of non-auditors as well as promoting more consistent application across the profession. The inclusion of example 'proxies' on who could be an informed third party will be helpful in the decision making assessment.

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?

We believe that the Ethics Partner role is operating effectively at BDO. We do, however, see the benefit of making available a reporting mechanism between the Ethics Partners and the Competent Authority where the advice of the Ethics Partner is not followed with respect to public interest entities and OPEI's. This transparency and openness should promote more ethical outcomes without the need to make a report to the Competent 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?

Whilst certain amendments to parts of the proposed Ethical Standard may help practitioners understand the requirements better, changes to the wording could unintentionally result in creating uncertainty on its interpretation. Notwithstanding this point, the FRC could have taken this opportunity to simplify certain sections of the ES, such as Section 2.3D and 2.4D, which practitioners still find difficult to interpret.

Following the release of the 2016 ES, a number of technical meetings and working groups were set up by the FRC, the profession and other stakeholders to iron out uncertainties and to avoid inconsistencies in its application. We urge the FRC to be mindful that wording changes with a view of purely simplifying the text, where practitioners were generally familiar with the application of the original text, may have unintended consequences of changing the interpretation of the requirement and/or principle, or reopening the interpretation debate. A lack of clarity in the proposed ES will likely reduce trust in auditors and other practitioners.

Other specific areas where there may be uncertainty include:

Paragraph 2.4 in the Supporting Ethical Principles, which covers the extra-territorial impact on group audits, it is unclear as to the extent of how far network firms and other firms are required to comply with the proposed ES on personal independence. For example, how would the requirement in Section 2, paragraph 2.4, where all partners in the audit firm shall not hold a financial interest in the firm's audit clients, apply to network and other firms? What are the chain of command implications? How would this work in a joint audit scenario? Could a similar rule to how the SEC apply personal independence be used instead?

With respect to contingent fees, we note that paragraph 4.18 from the current ES has been removed. The removal of this paragraph may bring uncertainty on whether charging a lower fee where a service relates to a transaction that was either aborted or terminated prematurely and where the rationale for charging a lower fee was to take account of either the reduced risk and

responsibility involved or the fact that less work was undertaken than had been anticipated is prohibited.

The proposed prohibition on internal audit services in paragraph 5.44 may be unclear on the extent of what an 'internal audit service' encompasses. If, however, this was linked to the provision of the internal audit services that are captured by paragraph 5.167R(h), which was discussed extensively at the FRC's Technical Advisory Group meetings and at a Global level with the European Contact Group, this should ensure a more consistent approach is adopted by practitioners.

We also believe it would be helpful to clarify what types of services are caught by the permitted list of non-audit services to public interest entities. For example, from paragraph 5.40, which type of engagement would be included under the following service?

"Services which support the entity in fulfilling an obligation required by UK law or regulation, where: the provision of such services is time critical; the subject matter of the engagement is price sensitive; and an it is probably that an objective, reasonable and informed third party would conclude that the understanding of the entity obtained by the auditor for the audit of the financial statements is relevant to the service, and where the nature of the service would not compromise independence;".

On a separate point, the above extract is an illustration of where the proposed wording needs editorial input in order to enhance its comprehension.

Investment Circular Reporting Engagements

In relation to Investment Circular Reporting Engagements "ICREs", whilst the separate section at the front of the proposed ES is helpful in decluttering the guidance for audit teams, the simplification is unhelpful for reporting accountants acting on ICREs, as it leaves considerable uncertainty about how to apply the proposed ES to such work. To illustrate we note a few of the areas where more guidance is needed for ICREs in the proposed ES:

- Paragraph I8-2 on agreed-upon-procedures leaves uncertainty as to whether several pieces of work typically performed as part of ICRE work are subject to the proposed ES or not.

- What are 'services required by UK law or regulation'? Does this only cover public opinions on ICREs or all work typically undertaken as a package in relation to ICREs, some of which might not be required individually by law or regulation?

- In the existing ES there were paragraphs with no callouts for ICRE work - the implication was that these could be ignored by reporting accountants, but it is now uncertain whether they should be considered, and if so, how. For example, it is unclear whether reporting accountants now need to consider the clauses of the proposed ES dealing with 'additional services', or also those clauses dealing with 'non-audit services'.

- In the circumstances where a firm is requested to undertake the reporting accountant engagement but is not the auditor, there are practical issues of ensuring personal independence of the team and covered persons in the period prior to appointment because the relevant period may commence before the firm is aware that it would be engaged to perform a reporting accountant engagement.

- We informally understand that pre-agreed discounts to fees in the event that a transaction aborts as a result of matters unrelated to the reporting accountant's work (e.g. as a result of market conditions) are not considered by the FRC to be contingent fees, providing it can be shown that any discount ultimately given reflects the elimination of a "high level" of risk that had originally been priced in. If this is the case, this needs to be made clear, as pre-agreed abort discounts could equally be considered to be "fees calculated on a pre-determined basis relating to the outcome or result of a transaction" (paragraph 4.6) and hence appear to be prohibited contingent fee arrangements, which seems to contradictory.

Some of this lack of clarity can be addressed by re-drafting but some can only be addressed by removing ICRE work completely from the proposed ES, and preparing a separate ES for ICRE work, with rules and guidance more appropriately tailored to such work.

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

Notwithstanding that the market has, to a large extent, already moved ahead of the ES in relation to PIEs and the provision of non-audit services, we agree that the use of a permitted list of services for PIEs should promote more consistent application and enhance certainty for audit firms, stakeholders and preparers. By separating the services by those which are exempt from the fee cap and by those which are subject to the fee cap is also welcomed. On the whole, this should assist with monitoring the cap and mitigate uncertainty in its calculation. However, as noted above in question three, to promote even more consistency, it would be helpful to have examples of the provision of services included in this 'permitted list' where it is not explicitly clear, such as services which fall under the 'time critical' scope.

Furthermore, paragraph 5.40 refers to the provision of services to 'the audited entity, to its parent undertaking or to its controlled undertakings'. Clarity is required on the geographical location of the parent undertaking as we understand that this should be limited to the UK following the UK's exit from the EU. In addition, 'parent undertaking' is referred as a singular in this instance so it is unclear if you only need to consider the immediate parent entity or would you need to consider other parent entities in the group.

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?

Whilst in principle we agree with this approach, we urge the FRC to be very clear as to which entities are defined as an 'other entity of public interest' ("OEPI"). We note from the Glossary that the potential types of entities are "*of significant public interest to stakeholders*". However, it is unclear who decides which entities are of significant public interest and, in the absence of an objective list or set criteria, it will be unhelpful to let each practitioner make their own assumptions on this.

The Glossary also states that entities included as an OEPI are those in the scope of the FRC's Audit Quality Review ("AQR"). This may be challenging for a number of reasons:

- Certain entities in AQR scope are caught due to a size criteria. This may fluctuate year-on-year hence bringing entities in and out as being designated as an OEPI. A three year average, as currently applied to identify AIM entities as being in scope, would be helpful to reduce the level of fluctuation.
- If the AQR change their scope, will there be sufficient time for audit firms to exit from any prohibited services and avoid a number of inadvertent breaches?
- We are aware that certain large private entities are subject to AQR inspection but are not formally included in the list of AQR in-scope entities posted on the FRC's website. Therefore, it is currently unclear which entities are within the inspection scope.
- The FRC is at liberty to change their 'scope' year on year with little or no notice and with little due process with respect to gaining the views of external stakeholders. We believe that, given the increased significance that changes to the AQR scope have, such changes should have more of a lead-in time and be subject to wider consultation.

We believe that there should be greater due process and stakeholder involvement in its constituents. Being included with OEPI is a significant matter of fact for audited entities and as such it is critical that: it is clear as to which entities are included, the population is to the extent practical stable, and entities can plan ahead by having sufficient warning that they will in the future be part of this grouping. Additionally, due to the significance of this definition we believe that changes to the FRC AQR Scope should in the future have some element of external stakeholder consultation and transparency.

On a related note, the additional prohibitions proposed for OEPIs are only in respect to non-audit services and, in order to prevent incongruous outcomes, we question if other parts of the proposed ES should also apply. For example, the rotation requirements for an engagement partner on a small market cap listed entity on the AIM or the Channel Islands (TISE) stock exchanges would be five years yet rotation for an engagement partner on a private entity with billions of pounds in turnover could be significantly longer than five; this is in contrast to the situation regarding provision of non-audit services where the large private company would be more restricted than the audit entity listed on AIM.

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)?

Our firm did not ordinarily utilise the reliefs available for SME listed entities due to this conflicting with our membership obligations for IFAC Forum of Firms. We note that "*SME listed entity*" is still included in the Glossary.

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?

With the introduction of a permitted list of services for PIEs, we think that the removal of the derogation is a moot point. In addition, in reality this will have little practical impact since the FRC's Staff Guidance Notes effectively made the derogation unusable under the current ES.

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 can see some merit with the inclusion of Staff Guidance Notes within the proposed ES to support a level playing field amongst audit firms and should aid consistent application. As the notes were drafted under the 2016 ES following requirements brought in by the EU Regulation, it is important that these notes are thoroughly reviewed, and amended where appropriate, before launching the proposed ES to avoid any conflicting guidance and application.

Consistent application of the ES is an important objective and, with this in mind, we would urge the FRC to continue issuing guidance notes post release of the new ES where further guidance is needed to ensure this outcome.

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?

Inclusion of FRC Staff Guidance in Application and Other Explanatory Material can only help improve clarity. In general we would prefer all guidance considered by the FRC to be authoritative to be included in one place.

However, we note that:

- ISA 220 para 7(f)-1 defines "key audit partner" (KAP) as including the statutory auditor designated at the level of material subsidiaries. This suggests that the statutory auditor of a material subsidiary is a KAP (with all the consequences of such a designation) even in situations where the group audit team chooses not to rely on the work of a statutory auditor but either performs an audit, analytical procedures or other specified procedures itself in accordance with paragraphs 26-29 of ISA (UK) 600.

- Paragraph 7(f)-1 also refers to paragraph A2-1 in the Application and Other Explanatory Material although this paragraph is not reproduced in the Exposure Draft. Presumably this paragraph contains the definition of material subsidiaries referred to on page 16 of the Consultation.

- No definition of 'material subsidiaries' is included in the Glossary.

- ISA (UK) 600 para 9(l)-1 reproduces the definition of KAP set out in ISA (UK) 220 but, unlike ISA (UK) 220, it does not cross refer to any application or explanatory material.

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.

Whilst we understand the need to clarify current auditor responsibilities and narrow the expectation gap in relation to the auditor's responsibility to detect fraud we are not convinced that extending the current ISA (UK) 700 requirement in this respect will achieve this or provide users with much in the way of useful information. For the majority of non PIE audits we suspect that resultant paragraphs in the audit report would focus largely on compliance with the

Companies Act and UK tax legislation and would result in increased user of boilerplate language aimed at downplaying the role of audit and in the auditor in fraud detection. For this reason we would recommend that the FRC delays implementation of this proposal until after Sir Donald Brydon's recommendations have been published and considered.

We agree with the proposed changes to ISAs (UK) 250A and 250B.

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?

We agree with the inclusion of a reference to "significant judgements" in para 13 of ISA (UK) 701 and the clarification of the meaning of "relevant observations" in A51-1. Arguably, for audits of PIEs, significant auditor judgements would be considered to be a relevant key observation in relation to a risk described in accordance with para 13-1. However, inclusion of this reference in para 13(b) widens the scope of the requirement to cover all entities in respect of which the auditor is reporting in accordance with ISA (UK) 701 and to all matters considered to be Key Audit Matters, whether or not they represent the most significant assessed risks of material misstatement.

We agree with the inclusion in paragraph 16-1 of performance materiality. This is something we already encourage audit teams to include in audit reports as we consider it provides potentially useful information to users regarding the scope of the audit. However, we note that there is no proposal to include component materiality (or component performance materiality) which we consider would also be useful in describing the application of materiality in determining scope and extent of work carried out in a group audit situation. However, we would urge caution in using performance materiality as a proxy for the auditor's assessment as to the effectiveness of internal control. Whilst it is affected by the auditors understanding of the entity and expectations of misstatements in the current period these are not the only factors that will affect performance materiality it should not be seen as a way of measuring effectiveness of controls or providing a basis for comparison between the control environments of different entities; doing so could be very misleading.

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?

Yes - we agree with the proposed revisions.

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 change proposed for ES, we believe that the effective date is too soon for audit firms and other stakeholders to ensure that they are able to comply on time with the changes being proposed in the consultation. This might be especially disruptive for those entities falling within the new definition of OEPI, where the changes could be very significant indeed.

There are many engagements already in progress, for both PIEs and non-PIEs, which will be prohibited when the proposed ES comes into force. At such short notice, audit firms and audited entities will be left with the choice of whether to cease work, incurring significant costs and disruption, or suffer a breach of the ES that would have to be reported to the FRC and, in many cases, published in audit reports, most of which would not be published until 2021. We consider that implementing revised standards in a time frame that simply cannot safely be complied with is not in the wider Public interest and, if an impact assessment was performed solely in relation to the timetable, the result would be significant.

The challenges in complying, at short notice, with the increased extra-territorial aspects of the proposed ES should also not be under estimated. Not only will Network firms have to exit numerous non-audit service engagements, with audited entities having to seek alternative providers, but the global audit networks will likely need to enhance their systems and procedures to ensure that the extra-territorial aspects of the proposed ES can be complied with.

Compounding this, we also note that there are no proposed transitionary provisions or grandfathering arrangements. It is therefore unclear, for example, if existing contingent fee engagements which will complete under the extant ES but are likely to be paid in the period under the new ES will be a breach.

As noted above, the consequences of not giving sufficient implementation time could result in a high number of breaches of the proposed ES leading to audit reports qualified on independence matters. This risks an unnecessary and unwarranted adverse effect on confidence in the audit market and on audit firms; this coming at a time when confidence in audit is under pressure and therefore this would not be in the public's interest.

We urge the FRC to evaluate the proposed release date of the new ES noting that there appears to be only a couple of months from the date of submitting our responses to the date of release.

In relation to those changes proposed to ISAs, we agree that the implementation date is appropriate.