

**Homefield
Walpole Avenue
Chipstead
Surrey
CR5 3PN
01737557453**

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Dear Keith,

Consultation: Auditing and ethical standards

I am responding to the FRC's Consultation Paper on the impact of the new EU legislation on auditing and ethical standards on the basis of my experience as:

- Past APB Executive Director responsible for the first Ethical Standards,
- Past Chair of the IAASB working party that issued an Audit Quality Framework in December 2013, and
- As an active investor in shares including AIM shares.

I attach as an appendix my responses to your specific questions but I would like to make the following general observations.

The need to avoid, as far as possible further complexity

The new EU legislation is extremely complicated. The FRC has a choice of adding to this complexity with additional requirements and refining the application of the legislation in specific circumstances. I believe that as far as is possible, the FRC should strive to avoid further complication and should:

- Challenge itself as to whether current additional UK requirements in both auditing and ethical standards are really needed, eliminate those that are not crucial to audit quality and limit future ones to a minimum.
- Reconsider how best to 'package' the Ethical Standards. Rather than the current ES1 – ES5 (and additional guidance for SME audits) it may be better to base new standards directly on the law (perhaps with separate standards for PIE and non-PIE audits) making it very clear which, if any, additional requirements are being promulgated,
- Where implementation choices exist, give emphasis to simplicity and understandability in making them. There is a danger that the FRC makes legislation, that is already complex, very difficult for auditors to comply with in the UK and, to the extent that they have extra-territorial impact, internationally.

The overriding goal of making improvements to audit quality

Over the years both auditing and ethical standards have become increasingly detailed and 'rule based'. However auditing is a judgemental process which is heavily dependent on the values, skills and experience of the members of audit teams. There is a limit to which these qualities can be mandated through standards. After many years as a standard setter I doubt

that further refinement of standards will greatly improve audit quality and, quite possibly, could have a negative impact on it. I encourage the FRC to avoid adding further detail to its standards and take whatever actions it can to improve audit quality in other ways. In this regard I applaud the emphasis that the FRC places on encouraging audit committees to be actively involved in the external audit and to report on this. Other important areas for FRC action are to:

- encourage audit firms to deploy more experienced audit teams,
- encourage them to employ advanced computerised auditing techniques, and
- strengthen audit firm governance (as is currently happening in the Netherlands)

The threat to audit quality on the new requirements relating to audit firm retendering and rotation.

I have observed with some concern the FRC's move towards requiring the regular retendering of audits and the EC's insistence on audit firm rotation. Both approaches will work well if the criteria for an entity's choice of auditor is maximising audit quality. Both will be catastrophic failures if the main focus is on reducing audit fees. My fear is that, even after the FRC has provided guidance, the likelihood is that minimising audit fees will prevail and audit quality will suffer.

One way of reducing the downward pressure on audit fees might be to show the cost of audit as an allocation of profits (as with dividends) rather than as a charge against profits. This approach was advocated by Paul Boyle, a previous FRC Chief Executive, but I believe, has never been explored as carefully as would be desirable. As well as reducing the obvious incentive to reduce fees in order to increase profits such a presentation would help remind auditors, and audit committees, that the audit is undertaken on behalf of the shareholders.

I hope these thoughts are helpful.

Yours sincerely

JEC Grant

Response to specific questions

Auditing Standards

Question 1

Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

Answer: Yes but sparingly. In my view auditing standards have become overly detailed and further additions and refinements to them are unlikely to result in significant improvements in audit quality. To the extent that auditing standards evolve this should be done on an international basis. If the EU endorses ISAs there will be a European mechanism to provide input to IAASB. The FRC should use this mechanism to improve the ISAs in preference to imposing its own additional requirements unilaterally.

Adding additional 'national' requirements in UK standards does not just impact UK based auditors. It impacts auditors of overseas subsidiaries of UK groups. If the UK over uses its ability to add national requirements other countries will follow suit, complexity will increase significantly and many of the benefits of having international standards will be lost. By exercising restraint the FRC can lead by example in this area.

The FRC, correctly in my view, uses international auditing standards (ISAs) as the basis of its auditing standards. However, over the years there has been constant pressure to add to the specifics of the ISAs and they have become ever more complex and difficult to understand and apply. With over 500 specific requirements the ISAs have become 'rule based' standards that excessively focuss on the audit process. However auditing is a judgemental process and, in my view, further efforts to refine the audit process are unlikely to improve audit quality and indeed may well have a negative impact on it. Auditing standards are part, but only a part, of audit quality. The FRC has the ability to take a number of actions to improve audit quality without needing to add further detail and complexity into auditing standards.

Proportionate Application and Simplified Requirements

Question 2

Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

Answer: Yes. The Auditing Practices Board established a SME audit sub-committee to evaluate the proportionality of the standards before they were mandated and there were a number of outreach exercises to obtain views of smaller practitioners before the standards were finalised. The IAASB also explored this issue as part of its ISA Post-implementation review. That research indicated that about 50% of the auditors of smaller entities thought that the ISAs can be applied in a manner that is proportionate to the scale and activities of smaller entities and about 50% did not. However, there was little agreement within the 50% who thought the standards were disproportionate as to what specific areas caused difficulty or what action should be taken. The UK input to the IAASB research was broadly consistent with the global conclusions.

Question 3

When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles 22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available for Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

Answer: The same requirements should apply to all audits and audit firms regardless of the size of the audited entity. The requirements of Articles 22b, 24a and 24b are important to audit quality for audits of all sizes and are expressed as relatively high level akin to principles. The question is how are these principles applied in practice and how do independent audit inspectors check that the principles have been applied? Specificity in additional guidance or in the inspection process can result in a lack of proportionality for smaller audits or smaller firms. Rather than attempting to simplify the legislation the approach to independent audit inspection of smaller audits should be flexible enough to take account of the need for proportionality. This approach was successfully applied when the ISAs were first implemented in the UK.

Extending the More Stringent Requirements for Public Interest Entities to Other Entities

Question 4

With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:

(a) should they apply to PIEs as defined in the Audit Directive?

(b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

Answer: If the more stringent requirements directly contribute to audit quality (and this needs to be confirmed after debate) they should apply to all PIEs as defined by the Audit Directive

Question 5

Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

Answer: I find it hard to understand why the Government would not want to expand its definition of a PIE to reflect the UKs relatively sophisticated capital markets.

If the Government decides not to widen its definition the FRC should retain its definition of a listed entity. The APB actively debated whether its additional requirements should apply to AIM companies in particular and, with strong stakeholder support, concluded that they should. In order to keep the standards as simple as possible all the more stringent new requirements to be introduced by the Audit Regulation should apply - 'Cherry picking' will just make things too complex.

Question 6

Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?

Answer: Yes. As explained above, if the more stringent requirements in the FRC standards can be justified in terms of audit quality (and this needs to be actively debated) they should apply to all PIEs.

Prohibited Non-audit services

Question 7

What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

Answer: One of the challenges of regulating non-audit services (NAS) is that the details of NASs vary from one client to another and new NAS evolve in response to market needs. Certain NAS may also be needed in emergency situations by clients and the quality of financial reporting can be jeopardised if the auditor is prohibited in providing them. A principles based approach supported by audit committee involvement is therefore more suitable to dealing with this environment than a rigid rule based approach.

The existence of a 'black list' for PIEs seems impossible to avoid given the EU Regulation however I would not support the introduction of a 'white list' of permitted NAS and prohibit all others. As explained above some flexibility is needed to deal with the peculiar characteristics of NAS. Furthermore, threats to independence related to **all** NAS need to be thought about carefully by both the auditor and the audit committee. It would be unwise to downplay the importance of this which inevitably a white list would do as auditors and audit committees would assume that they have been automatically approved by the FRC and no further consideration is needed.

Question 8

If a 'white list' approach is deemed appropriate to consider further:

(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?

(b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?

Answer: A white list is not considered appropriate.

Question 9

Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

Answer: No. However it is vital that threats related to all NAS are carefully considered by the auditor and the audit committee. The FRC has a key role in encouraging and policing this.

Question 10

Should the derogations that Member States may adopt under the Audit Regulation - to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

Answer: No. Immateriality to the financial statements is the wrong concept to dealing with threats to auditor independence. It is immateriality to the auditors judgements that is key and this hard to define and impossible to measure.

Question 11

If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be 'immaterial' sufficient? If not, is there another condition that would be appropriate?

Answer: As explained above I do not believe the derogations should be taken up. Assessing whether the NASs concerned have some impact on auditors judgements will be highly subjective and therefore very hard for auditors, audit committees and audit inspectors to consistently apply.

Question 12

For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?

Answer: Yes audit committee scrutiny will be sufficient.

Question 13

When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based? If not, what other standards should apply in which other circumstances?

Answer: No. As explained in the Consultation Paper, for reasons of practicality the APB allowed auditors of overseas components of UK groups to apply the IFAC (now IESBA) Code of Ethics rather than its own Ethical Standards. This was in an attempt to minimise complexity and to lead opinion as to the importance of international standards more generally. In my view this approach should be retained. Since then the IESBA Code has been strengthened and the prohibitions within it have been more clearly indicated. However, further work is necessary and the FRC should actively promote further strengthening and clarification of the IESBA Code.

Question 14

When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all other auditors whose work they decide to use in performing the audit of the group? If not, what other standards should apply in those circumstances?

Answer: No. Extending the rules in the UK ethical standards (incorrectly described in the Consultation paper as being on 'a principles basis') to other auditors is unnecessary and would be impractical. The IESBA Code provides for adherence to the ethical principles involved.

Audit and Non-audit Services Fees

Question 15

Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

Answer: Yes the 70% cap is already more than sufficient and a lower cap is not warranted. Given the existence of a 'black list' within the Regulation it can be argued that a financial cap for 'permitted' NAS is unnecessary 'belt and braces' and undermines the important role that the audit committee is expected to play. The FRC cannot have it both ways. It cannot expect the audit committee to be engaged with making important decisions and tell them what the answers are!

Question 16

If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

Answer: Yes. There are likely to be situations when, in the shareholders interest, NAS will exceed 70%. If advantage is taken of an extension, the FRC should ensure that appropriate safeguards have been applied and there is proper disclosure of the circumstances in the audit committee's report.

Question 17

Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms?

Answer: The cap should be applied as established in the Regulation. Trying to modify the cap for non-audit services provided by network firms would be extremely difficult and, given the 'belt and braces' nature of the legislation, result in unnecessary complication.

Question 18

If your answer to question 17 is yes, for a group audit where the parent company is a PIE, should the audit and non-audit fees for the group as a whole be taken into consideration in calculating a modified alternative cap? If so, should there be an exception for any non-audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?

Answer: N/a. I do not believe that the cap should be modified.

Question 19

Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances ?

Answer: Yes. Modifying the cap to cater for issues such as new audits is unnecessary given the 'belt and braces' nature of the legislation and over-complicates this issue.

Question 20

Do you believe that the requirements [relating to fee dependency on a single client] in ES 4 should be maintained?

Answer: I find this question very difficult to respond to without knowing whether the current ES4 percentages have any impact in practice. There may also be a conflict between audit quality and audit competition goals.

When APB issued the Ethical Standards it considered that the self interest threat caused by economic dependency on the fees from a single client was an important topic. It was aware that the IESBA Code used 15% but, as the overwhelming majority of UK listed companies were audited by one of the 'Big Four' the APB decided that a more realistic number was needed. Fees in excess of 10% were prohibited and a 5% 'red flag' provision was introduced.

I somewhat doubt whether even these lower percentages are small enough to have any 'bite' given the vast fee income of the major accounting firms. The lower APB percentages may not therefore have any impact in practice on the audit firms that audit main market listed entities. It is possible that they may impact smaller audit firms who audit AIM companies but even this is unlikely.

Research in this area may be needed. It is possible that the only audit firms impacted may be small firms with a small number of AIM clients (or other entities that are classed as PIE). To retain or lower the Es4 percentages would mean that the smaller audit firm would need to resign from the audit. In all likelihood the audit would be taken on by a larger firm.

Question 21

When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

Answer: Once the PIE definition has been established and PIE auditors identified. The FRC should stress test its proposals to understand the impact that they will have.

Question 22

Do you believe that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute an expectation of “regularly” exceeding those limits? If not, please explain what you think would constitute “regular”.

Answer: These are different concepts. The EC regulation looks backward, the Ethical Standards look forward. That said past experience will be a reasonable guide to the future although the FRC may wish to consider how to approach the situation where the auditor knows that there will be a significant increase in the future fee of the PIE in question or if they know of a significant fall in future aggregate firm income.

Record Keeping

Question 23

Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?

Answer: ISQC1 currently requires (paragraph 47) audit firms to establish a policy for document retention and provides guidance to the effect that is normally not less than 5 years. IAASB is currently working on revisions to ISQC1 and this issue, will no doubt, be debated again. Unless the FRC's experience is that audit firms are not retaining documentation for a minimum of five years, the FRC should await the outcome of this debate.

Audit Firm and Key Audit Partner Rotation

Question 24

Do you believe that the FRC's audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?

Answer: As a practical matter it may be helpful to add this to the Ethical Standards so they are consistent with the law. It would be unhelpful if auditors have to read **both** the law and the standards to obtain a full understanding of their responsibilities.

Question 25

Do you believe that the requirements [n relation to the 5 year partner rotation]in ES 3 should be maintained?

Answer: The main issue is whether to retain the audit partner rotation period at five years or to conform it to the seven years in Directive (and the IESBA Code). This topic was extensively debated by the APB when it, by a narrow margin, opted for the shorter period. This topic has recently been reconsidered by IESBA and they have issued an Exposure Draft that retains the seven year period but extends the cooling off period. The IESBA thought process was very coherent but it has yet to be seen how stakeholders respond to the exposure draft.

The APB made its decision to reduce the period to five years based on beliefs and assumptions about the impact the time period had on audit quality. Sufficient time has now passed to explore the impact that this change has had in practice. The FRC should use evidence from its audit inspection activity to assess whether the APB made the right decision. Unless there is a clear positive impact on audit quality can be demonstrated I believe the FRC should adopt the same period as IESBA – even if that involves reintroducing a 7 year period.

Question 26

When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

Answer: Requiring any additional requirements to apply to all PIEs would be the least complex outcome.