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Private & confidential
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Dear Mr Ferris

Consultation on Revisions to Ethical and Auditing Standards 2019 – Call for feedback

I am writing on behalf of KPMG LLP in response to the Financial Reporting Council's (FRC) call for feedback in respect of its consultation on "Revisions to the Ethical and Auditing Standards 2019" (Consultation).

We recognise the importance of the changes reflected in the Exposure Drafts of the Revised Ethical Standard and Auditing Standards in strengthening auditor independence and audit quality and welcome the opportunity to comment on the Exposure Drafts.

Before turning to your detailed questions, I have set out some high level observations below.

Timing of changes

Recognising the interaction of the Standards with other reviews

As we noted in our response to the post implementation review of the 2016 Ethical and Auditing Standards which we submitted in February, at this point in time the future holds many uncertainties. The proposed revisions to the Ethical and Auditing Standards are only part of the picture: alongside there are a number of other important initiatives, notably the Department for Business, Energy and Industrial Strategy's (BEIS) consultations on the recommendations of the Competition and Markets Authority's (CMA) Market Study and the independent review of the FRC and Sir Donald Brydon's Independent Review into the Quality and Effectiveness of Audit. The FRC's recommendations should not be considered in isolation. It is important that potential initiatives arising from each of these reviews are considered together to ensure that they are implemented in a consistent and complementary fashion. In deciding on which of the recommendations to take forward, we believe that consideration should be given to the entirety of measures proposed as a result of the recent / ongoing reviews rather than as a series of individual actions considered independently of each other.

While there is merit in the Consultation addressing matters which are unlikely to be dependent on the ongoing reviews, careful thought needs to be given to the merits of any individual change at this point in time, particularly given that some provisions (in particular those of the 2016 Ethical Standard) have only been fully in effect for a limited time period. We set out our specific observations in this regard below.

Ethical standard – timing

Restrictions on services to public interest entities (and other entities of public interest)

We believe that the specific case of non-audit services provided to audited entities provides an example of the need for a considered approach towards changing existing regulation.

KPMG has already taken action in response to stakeholder concerns in respect of those companies with the most significant element of public interest. We were the first firm (in November 2018) to voluntarily commit to discontinue the provision of non-audit services (other than those services that are closely related to the audit) to the FTSE350 companies we audit. We note that at least one of the other Big Four firms has followed our lead in this respect and a further Big 4 firm has also committed to do so. Whilst there is a case for reflecting such an approach within the Ethical Standard, we believe that it is premature to do so before the outcome of the other reviews is known.

Similarly, we believe that it is premature to further extend these restrictions to other entities as is proposed in the Ethical Standard Consultation (eg to extend the restrictions to UK unlisted banks and insurance companies, many of which are part of larger overseas groups) until other changes have been fully defined. We believe that there will be cost and disruption to business from having to make these changes and question whether this cost outweighs the short term benefits around managing 'perceived conflicts of interest' for these entities.

Public Interest Entities ("PIE"s) and Other Entities of Public Interest

The Independent Review of the FRC (FRC Review) has already recommended that consideration is given to the definition of a PIE and we understand that BEIS will be consulting on this later in 2019 which may result in a wider range of entities than at present being treated as PIEs. We recognise that this is an important topic and are supportive of a consultation on this issue noting that there are a number of implications (beyond non-audit services restrictions) that derive from categorisation of an entity as a PIE.

The FRC has asked the general question in the Ethical Standard Consultation (Q5) as to which other entities (non-PIEs) the more stringent PIE non-audit services restrictions should be applied to. We believe that any decision on this question should be taken together with the other wider reviews and not in advance – to ensure that the full implications of any decisions are understood (ie that there are no unintended consequences) and also that there is no undermining of confidence by introducing additional complexity into the Ethical Standard and/or changing definitions within a relatively short period of time only potentially to have to change again once the BEIS

reviews are complete. If the FRC does, however, conclude that an additional category of entity should be introduced into the standard at this time as a result of the feedback from the Consultation, we would ask that it first consults on what the actual proposed change to the definition is and then provides for an appropriate transitional period before the changes become effective. This will allow the additional entities concerned, time to conduct tenders and to select and appoint alternative professional advisors where necessary.

Finally, notwithstanding the above, we note that the glossary to the Ethical Standard Consultation currently defines the new term 'other entity of public interest' as follows:

> 'An entity which does not meet the definition of a Public Interest Entity, but nevertheless is of significant public interest to stakeholders. Entities included within the scope of the FRC's Audit Quality Review, which are not public interest entities, are *other entities of public interest'.*

Given the question of what entities should be considered to be of significant public interest has not yet been determined, we would suggest that in order to remove any ambiguity in how the standards should be applied, the first sentence in the definition should be deleted. We would also request that to the extent that the FRC's Audit Quality Review determines subsequent to the standard being published that they intend to introduce additional entities into their scope, this be undertaken in line with the added insight from the BEIS and Brydon reviews.

ISAs (UK) – clarity and timing

Our focus is on delivering high audit quality. Authoritative, clear auditing standards are one important part of the infrastructure facilitating that, as they reduce the risk of divergence in application, and of differences in expectations between auditors and audit regulators. Thus we support the principle of replacing guidance from different sources into authoritative requirements of the ISA. However, in our view several of the proposed changes to ISAs (UK), whether intended to bring in guidance from other sources or to change the requirements, are not sufficiently clear as to the requirements of the auditing standards and therefore the expectations of auditors.

There are two main aspects to this. The first is that, in light of expectation gaps and to assist in the aim of consistent delivery of high quality audits, we believe that the time is right for the FRC to revisit and consult on whether the approach to language in the standards, which has applied for many years such as "the auditor may", remains suitable or not. Although these current proposals have introduced a number of further instances of "may", this is a wider question about the whole suite of ISAs-UK and ultimately influencing, by taking the lead, the IAASB's ISAs. The question is whether audit quality would be increased by providing auditors and regulators with requirements that are definitive at a more granular level than has applied in the past, thus setting out clearer expectations of what an auditor must do as opposed to what it may do. Such an important exercise would necessarily take time, and we observe that some of the Exposure Draft's proposals may not be fully effective in the meantime.

The second aspect is that some of the proposed amendments to the ISAs (UK) could potentially be open to more than one interpretation. In each case, some interpretations may mean significant change to auditors' responsibilities or reporting; other interpretations would not. Regarding significant change in auditors' responsibilities as a general proposition, we are open to that as we believe that audit could do considerably more than it currently does; for example, our firm is already actively promoting change in some areas - such as graduated findings in audit reports. However, if significant change is intended, then it must be clear as to what that change is, rather than it being open to different interpretations. Aspects of the proposed amendments to the ISAs (UK) that we see as being open to more than one interpretation are discussed in more detail in our response to specific questions. These include:

a) New requirement to describe significant judgements in respect of Key Audit Matters ('KAMs')

   The proposed requirement could mean a wide range of things, ranging from judgements about what procedures to perform to judgements on the point at which assumptions in estimates fall within acceptable ranges. The latter would be what we term "graduated findings". However it is not clear whether that is an appropriate (or the only) interpretation of the proposed requirement. We would welcome changes to the proposal to give clarity as to the expected outcome. For example, if the expected outcome is mandated graduated findings for all long form audit reports (including those that are not PIEs), then our experience indicates that that may be controversial for some, although we would welcome such a clear requirement.

b) Auditor procedures over other information

   Aspects of the proposals could suggest that the auditor is required to perform procedures as necessary to opine on compliance of the other information with statute or other requirements and that there are no misstatements. That would be a very major change to the auditor's responsibilities in relation to the other information. Auditors are required to read the other information in an annual report and consider whether there is a material inconsistency between this and the financial statements or the auditors' knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit. That requirement to consider the other information based on knowledge obtained in the audit remains, leaving the proposed changes seemingly inconsistent. If the intention is the more significant change to the auditors' responsibilities in respect of the other, particularly statutory other, information then we believe that the ISA (UK) requirements would need to be changed further to make this explicit. Such a change would have significant implications for audit effort, resourcing (and perhaps skill set) and timetables.

c) Changes to the auditing standard on consideration of laws and regulations

Proposed changes to the standard on laws and regulations are not always clear on what is expected of the auditor, or what is expected as a result of the proposed changes to the standards. For example, to what extent do the proposals introduce changes to audit risk assessment and planning? Do they have significant implications for audit effort, resourcing (and perhaps skill set) and timetables? We would welcome clear requirements.

In order to ensure consistent application we would welcome revised proposals to provide clarity over the meaning of the requirements of the ISAs (UK) in the above areas. That would also help all interested parties to understand whether the proposals affect areas that fall within other ongoing reviews, in particular Sir Donald Brydon's Independent Review into the Quality and Effectiveness of Audit. If the current ISA consultation does affect areas within the that review then there is a question of whether the current consultation should contribute to that review or introduce changes that may then be subject to further change in the short term. We believe that, if there is any cross-over, the best interests of all concerned would be furthered by giving precedence to Sir Donald Brydon's review.

We also note a number of the proposed changes to the ISAs (UK) could bring discussion of controls and control environments into more aspects of long-form audit reports (e.g. ability of an audit to detect breaches of laws and regulations, key judgements related to KAMs). We understand that control effectiveness is an area of interest to investors, but we recommend caution over a "piecemeal" approach to requiring discussion of controls in audit reports. We support a strengthened framework of internal controls for company management to enable possible auditor reporting on such a framework in the future ("UK SOX"). These changes do not bring that, nor do we believe they are intended to, but we have some concerns that additional references to controls in reporting may make reporting less, rather than more clear in the absence of such change.

Extraterritorial application of the Ethical Standard

We are concerned that, due to the apparent extension of the whitelist non-audit services restrictions set out in paragraph 5.40 to services provided by any member firm in the audit firm's network to the parent of the audited entity (wherever it is domiciled), the requirements are fully extraterritorial. This will be a particular issue for unlisted banks and insurance undertakings where the parent is domiciled and listed in another jurisdiction (for example in the US and already subject to the SEC Regulations). By contrast we note that the revised non-audit services guidance issued by BEIS and the FRC for auditors on Brexit[1] applies the restrictions in paragraph 5.167R of the current Ethical Standard to the **UK** parent of the PIE and to the PIE's controlled undertakings. We understand that the FRC intends that the paragraph 5.40 restrictions should only be

[1] Letter to heads of audit on implication of 'no deal Brexit' dated 22 February 2019.

applied upstream to the ultimate UK parent. We welcome this clarification but consider that it is important that this is made clear in the final Ethical Standard.

We are also concerned that as drafted Supporting Ethical Standard Provision 2.4 could be read as applying all restrictions in the Ethical Standard to the entirety of an audit firm's network (irrespective of whether or not an overseas network firm participated in the group audit). Whilst we agree that the Ethical Standard should be applied to network firms that are component auditors and further that network firms with no involvement in the group audit should not have material relationships with audited entities, we do not agree that the full requirements of the Ethical Standard are required to be applied to a network firm not involved in the group audit in order to safeguard independence (in particular given the complexity of monitoring such a requirement).

Conflicts

We note that it is proposed to amend paragraph 4.47 of the Ethical Standard to make it explicit that a firm needs to resign an audit if there is probable threatened or actual litigation where the firm is acting on behalf of another party, for example where the firm is acting as an administrator and instructs a solicitor to take action against an audited entity. Whilst we support this clarification and agree that the read across of the existing litigation provisions in the Ethical Standard to situations where the audit firm is acting on behalf of a third party are sensible and necessary where the matter in question is material to the audited entity, we are concerned that as drafted this means that an audit firm, as administrators, could never pursue (through litigation) an audited entity (for example recoveries of immaterial trade debts on behalf of a third party) and therefore could not execute their responsibilities as administrator. In our experience, the vast majority of instances of an administrator pursuing an audited entity are matters which are not material to that audited entity. We note that the corresponding Supporting Ethical Standard Provision - SEP 2.11 - is not drafted in such absolute terms, as it includes the language *'....and which would compromise the independence of the firm or any covered persons'* and therefore propose that similar language be included in paragraph 4.47.

Effective date and transitional provisions

We note that the proposed effective date for the new Ethical Standard is 15 December 2019, although firms may complete "*engagements*" for periods commencing prior to that date in accordance with existing ethical standards. We also note that there are no grandfathering or transitional provisions included in the Ethical Standard Consultation. As the consultation period does not close until 27 September 2019, we assume that the final standard will not be published until later in the final quarter of this calendar year. Given the potential significance of some of the proposed changes in the Ethical Standard Consultation, and given the absence of any transitional provisions, we do not believe that the proposed effective date gives sufficient time for those entities with a 31 December year end (in particular) to conclude any inflight services (which would otherwise become prohibited on 1 January 2020) and also to appoint alternative service providers. We are also concerned that the compressed timetable may lead to unintended breaches of the

revised Ethical Standard. We therefore recommend that in order to avoid unnecessary costs to business, transitional provisions are included in the final standard (for example to allow any in-flight services to be completed within a specified grand-fathering period) and also that there is a period of time (we would recommend at least six months) between the final standard being published and the effective date to allow business sufficient time to appoint new professional advisors where necessary.

Finally, if the proposals in respect of the ISAs-UK are intended to achieve significant change (though, as noted, it is not clear whether that is the case) then they too would require a longer lead time than audits of years commencing on or after 15 December 2019. Our earlier observation about cross-over with other reviews is also relevant here.

* * *

Our responses to each of the specific questions asked in the Consultation are set out in Appendix 1. In addition, we have included in Appendix 2 some additional observations / comments on specific aspects of the drafting of the Ethical Standard which we believe it would be helpful to be addressed.

Please do not hesitate to contact me should you have any questions on this response.

Yours sincerely

Michelle Hinchliffe
Chair of Audit

Appendix 1
Responses to specific questions

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. We welcome the additional guidance in the Ethical Standard Consultation on the objective reasonable and informed third party test – noting that the application of this test is fundamental to achieving the overarching principles of the Ethical Standard. It is also helpful that the additional guidance is clear that the test is based on the information available at the time, not information that becomes available with the benefit of hindsight.

   The drafting seems to imply that the FRC is envisaging that firms would seek the views of one or more real life individuals in applying this test - rather than standing in the shoes of the hypothetical third party (which is the IESBA requirement). We do not consider this to be practical for day to day decisions (and would welcome confirmation that this is not the intent), although we believe that there could be a formal role for a panel of investors to help in respect of ensuring a consistent application of this test for any high profile matters.

   We also believe that it would be helpful to acknowledge that the way in which the third party test is applied may differ when it is being applied to a public interest entity (with a wider range of stakeholders) as opposed to a small private company – ie it is not going to be 'one size fits all'. Finally, we believe that the application of the test needs to be the views of any third party – ie one without a particular bias (as such we are concerned that the cross referencing to s172 of the Companies Act suggests that the application of the test might be dependent on, rather than agnostic to, the particular stakeholder referenced in s172 which we do not consider should be the intent).

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. We believe that these are sensible measures that will provide even greater confidence in the ethical outcomes. We would recommend that if any such instances arise, that they should be reported in the regular cycle of breach reporting that firms are already required to make to the FRC.

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

   We welcome the changes made in the Ethical Standard Consultation in respect of the consolidation of the requirements in relation to Reporting Accountants into one section and the restructuring of section 5 into sections 5B and 5C. We believe that overall these changes have made the Ethical Standard easier to interpret. However, we consider that further simplification and clarification could be achieved with a more fundamental reworking of the standard (including in relation to the continued inclusion of the language directly from the EU Regulation and Directive). We also note that SEP 2.4 has been amended to apply the requirements of the Ethical Standard broadly across network firms, even if those network firms are not involved in the group audit. Ensuring compliance with

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this would present significant practical challenges to firms with no clear benefit. We suggest that application of the Ethical Standard to network firms which are not involved in the group audit be limited to matters where there might be a significant or material impact on the consolidated financial statements.

Our detailed comments on the draft standard where we believe that further clarification is required or simplification could be achieved are set out in Appendix 2.

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

No. As explained in the covering letter, we are concerned about formally introducing these restrictions into the Ethical Standard for all PIE audits (including unlisted banks and insurance undertakings) in advance of the completion of all the other related reviews into the audit market as these changes may be inconsistent or unnecessary dependent upon the outcome of those reviews. We note that some large firms have already undertaken to introduce restrictions in relation to non-audit services provided to FTSE 350 companies and their controlled undertakings (arguably the entities of the very highest of public interest). We also note that many UK unlisted banks and insurance undertakings are themselves part of listed overseas groups (which have their own independence regulations and independent regulators) and as such consider that imposing additional regulation (in particular at a time where there is such significant market uncertainty in connection with Brexit) would seem to pose additional burden on those entities without there being a compelling reason to do so. We therefore recommend that the FRC defers making any changes formally in the Ethical Standard until the outcome of all of the other reviews are more certain. Whilst we appreciate that this might result in a short delay in introducing the changes, it should result in an overall package of changes that is more balanced and justifiable from a cost / benefit perspective.

We are also concerned that the restrictions for PIE audits as drafted in the Ethical Standard Consultation have been extended to any services provided by network firms to the worldwide parent (which will impact many unlisted banks and insurance companies that are part of wider overseas groups). We understand that the intention was for the Ethical Standard to align with the Brexit legislation with restrictions applying upstream only to the parent undertakings in the UK.

Finally, we are concerned by the impact of the FRC's proposals to extend the cooling-in provisions for PIEs to include internal audit services. In particular we note that companies who have outsourced their internal audit function will often tender their internal and external audits at the same time and believe that there might be a significant detrimental impact on competition and choice in the market if they are not able to do so because of these new restrictions. Whilst the scope and remit of internal and external audit are very different they are similar in that both provide assurance (albeit over different areas). It is unclear to us what threats to independence the FRC considers the provision of internal audit services generate that are so significant that such services cannot be provided in the year before an audit firm takes on an external audit mandate (in particular given an effective internal audit function needs to be independent of both the controls that they are testing and the management who are responsible for the design of those controls). If this change is not driven as a result of concerns articulated by shareholders, we would suggest

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that before the FRC makes any changes in this regard it seeks to understand the views of shareholders and audit committee chairs (to whom internal audit typically reports) to seek their views on whether or not such a cooling in provision is required and that a thorough consideration of the impact of such a change on competition and choice is made.

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?**

Additional prohibitions proposed for all audited entities

We note that the proposed Ethical Standard includes a number of new restrictions for all audited entities, including prohibiting internal audit services, secondments and all contingent fees. We are supportive of these changes (subject to our overarching comments about the need for there to be appropriate transitional provisions), noting that KPMG has already voluntarily prohibited secondments to audited entities.

Extending PIE restrictions to non-PIEs

We believe that it is premature to extend restrictions applicable to PIEs (ie 'whitelist only' services) to other categories of entity (such as entities within scope for AQR review or other private entities) without any compelling reason why it is necessary to do so at this particular time. As noted in the covering letter we believe that there will be cost and disruption to business from having to make these changes and are concerned that this cost might well outweigh the short term benefits around managing 'perceived conflicts of interest' for these entities.

In addition, we consider that creating another category of entity ('other entities of public interest') at this time is not necessarily going to improve market confidence, as it effectively adds further complexity into the standard by the creation of two tiers of entity of public interest. Specifically, this would introduce a new category where the 'public interest' is deemed to be at such a level that no non-audit services other than 'audit related' can be supplied by the auditor (in line with the requirements for PIEs). However, these entities are not deemed to be of sufficient public interest to be required to comply with the full requirements applicable to PIEs such as needing to tender and rotate their audits.

Rather than introduce a two tier (temporary) classification of public interest entity, we would recommend that the FRC waits until the BEIS consultation on PIEs is completed and there is greater clarity on the legislation that is intended to be passed.

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

We agree with the removal of the reliefs for SME listed entities as we consider that in the interests of maintaining market confidence these entities should be subject to the full ethical requirements applicable to listed entities. In this regard, however, we welcome the clarifying text that the FRC has included in the glossary to the consultation to confirm that entities that have issued listed instruments for structuring purposes only and where the

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instrument is held within the group (such as is common in many private equity structures) need not be treated as if they are listed entities. As a result of this clarification, from our experience, we consider that the removal of the SME listed relief will have a limited impact.

In respect of the reliefs for "small" entities, our position is unchanged since our response to the 2015 consultation on enhancing confidence in audit. Whilst conceptually we consider that all non-PIE unlisted entities should be subject to the same independence standards, we recognise the importance of reducing as far as possible the administrative burden on small businesses to make sure that the standards that they have to adopt are proportionate to their size and operations. Therefore we consider that the reliefs for small entities should be maintained although we have not availed ourselves of them.

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?**

Yes. As we noted in our response to the post implementation review of the 2016 Ethical Standard, the FRC rolling record provides guidance which indicates that there is very limited scope to apply the derogation, so we consider that there is actually little merit in maintaining the derogation. Further we note it would lead to improved simplification and clarity of the standards if there was no derogation available. If the derogation is removed though, some transitional relief should be provided to allow audit firms to complete certain services, for example in relation to tax, which meet the derogation requirements on transition into a new audit appointment.

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

Yes. We believe all relevant guidance materials that the FRC has issued with respect to the 2016 Ethical Standard should be incorporated in full where appropriate in the 2019 Standard.

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 agree with the principle of replacing guidance from different sources with a set of authoritative requirements of the ISAs. Authoritative, clear requirements would reduce the risk of divergence in application, and of differences in expectations between auditors and audit regulators. However, we are concerned that some of the proposed changes to ISAs (UK), whether to bring in guidance from other sources, or to change requirements, are not sufficiently clear as to the requirements of the auditing standards and therefore the expectations of auditors. There are two main aspects to this concern. *Guidance vs requirements in auditing standards*

The ISAs (UK), including in some of the additional text proposed in this Consultation, sometimes uses terms such as "may" or "the auditor considers". For example, "the auditor may explain the extent to which aspects of the auditor's work addressed the detection of

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irregularities...". Our focus is on delivering high audit quality and we want to avoid expectation gaps. Therefore, we believe the time has come to change the equivocal language that has applied for many years. We would welcome definite requirements and clear expectations of what an auditor must do, avoiding terms such as "the auditor may".

The importance of clarity as to outcomes expected from the proposed changes

As explained in the covering letter, we believe that some of the proposed amendments to the ISAs (UK) could potentially be open to more than one interpretation. Some interpretations may mean significant change to auditor responsibilities or reporting whilst other interpretations would not. Some of these changes relate to the inclusion of staff guidance material and others may be new. The proposed amendments to the ISAs (UK) that could potentially be open to more than one interpretation are set out in response to the questions that follow. We believe that lack of clarity could result in different outcomes from those intended.

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.

ISA (UK) 250A

The extent to which an audit must be planned to detect non-compliance with laws and regulations whose financial effect is not quantitatively material

Paragraph A11-2 introduces the requirement to include qualitative factors when considering direct and indirect laws and regulations, regardless of whether the direct effect on the determination of amounts and disclosures is quantitatively material. In our view, the aspects of the audit to which this applies are not clear. The insertion may be to require consideration of disclosures in relation to actual or suspected breaches of identified laws and regulation identified in the course of the audit. However, another interpretation may be that qualitative factors are to be used in the determination of matters which require auditor attention; i.e. in planning the audit to detect non-compliance with laws and regulations whose financial effect is quantitatively immaterial. That second interpretation would be a significant change to the auditors' responsibilities in relation to laws and regulations. ISA (UK) 320 requires the auditor to identify only specific accounts or disclosures for which a lower materiality should be applied – i.e. it is a question of what the misstatement is in rather than the nature of misstatement. We would welcome change to the proposed paragraph to provide clarity over the meaning of requirement, both to ensure consistent application and to understand if this is an area that also falls within other reviews. If it does fall within another review, then we believe that the best interests of all concerned would be furthered by giving precedence to those reviews.

Nature and scope of risk assessment procedures

The list of indicators of non-compliance with laws and regulations has moved within ISA (UK) 250A. In the extant standard these were given in the context of non-compliance that the auditor may become aware of whilst performing other procedures (A-17). The move to A11-1 positions these as relating to risk assessment procedures. These indicators may be difficult (or impossible) to identify through enquiries / board minute review or other

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normal risk assessment procedures. It is not clear whether the relocation of the list of indicators is to highlight aspects that we may become aware of during normal risk assessment procedures. If it is intended to change fundamentally the nature of the risk assessment performed, for example by requiring procedures such as inspecting invoices and reviewing payment for unspecified payments, that is not made clear in the revised standard. In addition, proposed paragraph 13-1 requires the auditor during risk assessment procedures to consider whether there is any indication of "non-compliance with laws and regulations". That requirement is not in the context of the indirect and direct laws and regulations covered by ISA (UK) 250A that are set out in paragraph 6 of that standard. Without additional context or cross references there is a risk that the added paragraph could suggest that all laws and regulations are subject to the same procedures, even if they do not fall within the two categories in paragraph 6. If such a fundamental change to the approach to risk assessment procedures is intended we would welcome change to the proposed ISA (UK) to provide clarity over the meaning of the requirements, both to ensure consistent application and to understand whether these are areas that also fall within other reviews. If it does fall within another review, then we believe that the best interests of all concerned would be furthered by giving precedence to those reviews.

Implications of reference to ISA (UK) 240

Inserted paragraph A18-1 states that where the auditor identifies or suspects that non-compliance with laws and regulations is intentional, the requirements in ISA (UK) 240 apply. ISA (UK) 240 focusses on fraudulent financial reporting and misstatement resulting from misappropriation of assets. Non-compliance with laws and regulations does not fit in either category, unless those charged with governance misstate financial statements, by failing to account for or disclose non-compliance of which they were aware, in order to mislead shareholders. The inclusion of this paragraph does not appear to change the procedures required in respect of such a matter. If this is expected to change the work of auditors, we would welcome clarity as to what the change is intended to be, including to understand if this is an area that also falls within other reviews. If it does fall within another review, then we believe that the best interests of all concerned would be furthered by giving precedence to those reviews.

Changes to ISA (UK) 700

Application material added on explaining in the audit report to what extent the audit was considered capable of detecting irregularities, including fraud.

The guidance added on reporting the extent to which the audit is capable of detecting irregularities emphasises that this is expected to be bespoke and seems to be expected to be extensive. Our expectation is that, given that auditing standards set the approach to this area, in particular for indirect laws and regulations, "boilerplate" content will be unavoidable, notwithstanding the best of intentions to meet the ISA (UK) requirements and information needs of the users. If significant change from the status quo for the current reporting (on EU PIEs only at the moment) is expected then we would welcome clarity as to what is expected of reporting in this area. In addition, it is not always clear how the information that the added guidance says "may" be given supports the overall requirement of explaining the extent to which the audit is considered capable of detecting irregularities including fraud. For example, "matters about non-compliance that were communicated

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within the engagement team" (A39-3). We suggest that presenting shareholders of different types of companies with illustrative examples of this section of audit reports may help to provide clarity over what reporting is or is not desired in this area.

Extension to all reports of the requirement to report on the extent to which their audits are capable of detecting irregularities, including fraud.

We are happy to provide such reporting in audit reports as is useful to shareholders and is required. The benefit of including this wording in audit reports for all entities, in particular for owner managed businesses, is not immediately clear to us, but that is a question for users.

We do see a risk that for audit reports not in the scope of ISA 701 (UK) this change will introduce a long section on irregularities that may inadvertently suggest more emphasis on detection of irregularities in an audit than is the case under auditing standards. Additionally the guidance (see above) on irregularities reporting highlights that this should be bespoke. Although we see difficulties in avoiding boilerplate reporting, the principle of one bespoke section of reporting in an otherwise standard report may also risk contributing to an expectation gap in relation to the purpose of an audit. Given that the *Independent review into the quality and effectiveness of audit* has audit reporting under consideration, we believe that such changes should be deferred for consideration under that review.

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?

Description of significant judgments in respect of Key Audit Matters.

The proposed requirement for the description of key audit matters to address significant judgements made by the engagement team (proposed addition to ISA (UK) 701.13 (b)) could mean a wide range of things, from judgements about what procedures to perform, accounting judgements, to judgements on the point at which assumptions in estimates fall within acceptable ranges. The latter would be what we term "graduated findings". However, it is not clear whether that is an appropriate interpretation of the proposed requirement. Having pioneered graduated findings in some audit opinions, we are supportive of the FRC Review's recommendation that requiring graduated findings should be considered. In order for graduated findings, including greater narrative description of challenge and judgements, to be effective and consistently applied we believe that such an approach needs to be clearly mandated.

We would welcome change to the proposal to give clarity as to the outcome expected here. For example, if the expected outcome is mandated graduated findings for all long form audit reports (including those that are not EU PIEs) then our experience indicates that may be controversial for some, although we would welcome such a clear requirement. Without clarity of the meaning of this addition we anticipate inconsistent application.

Additional guidance on reporting observations where relevant for EU PIEs.

We note the inclusion of the existing guidance from the TAG rolling record on the meaning of "key observations". We also note that "relevant" has been explained to mean relevant to a user (proposed paragraph A51-1). We don't expect a change to audit reporting as a

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result of this inclusion and see this as part of the inclusion of existing guidance into the ISAs (UK). We note that the definition of a key observation as "the conclusion" or "the outcome" indicates an observation as to whether the item subject to the key audit matter is acceptable or not. We do not believe that this wording mandates the provision of what we term "graduated findings", such as indicating the degree of an estimate's caution or optimism. As discussed above, we would support a clear requirement mandating graduated findings and believe that would be required to enable such reporting.

Increased disclosure around materiality

We don't have any comments in respect of the proposed changes to increase disclosure related to materiality other than to note that there is a risk of "boilerplate" disclosures in some respects as judgments underpinning performance materiality can be relatively straightforward.

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?

Paragraph added requiring the auditor to perform procedures relating to other information.

The proposals introduce the statement that the auditor is "required to... perform procedures which assist the auditor to identify a material inconsistency or material misstatement of the other information" with particular reference to statutory other information (proposed 720-A36-5).

As written, this could suggest that the auditor is required to carry out procedures necessary to opine on compliance of the other information with statute or other requirements and that there are no misstatements, based on work to support that. That would be a very major change to the auditor's responsibilities in relation to the other information. Auditors are required to read the other information in an annual report and consider whether there is a material inconsistency between this and the financial statements or the auditors knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit (extant ISA (UK) 720.14, unchanged by the proposals). We would welcome an explanation of how the addition of this paragraph A36-5 in the guidance to the standard is consistent with those basic and long-standing requirements in respect of other information. One interpretation could be that the requirements of the ISA remain the same, and that A36-5 repeats elements of ISA (UK) 720 14-1 and 14-2 without the necessary explanation that this is in context of the work performed in the audit. If, on the other hand, the intention is the more significant change to the auditors' responsibilities in respect of the other, particularly statutory other information, then we believe that the ISA (UK) requirements would need to be changed further to make this explicit. Such a change would have significant implications for audit effort, resourcing and timetables. Moreover, such a change would be something that would fall into the *Independent review into the quality and effectiveness of audit*, and we believe that any such change, being very much the sort of fundamental question that it is tasked with, should be introduced only as part of that review.

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Otherwise, in general we understand that the changes to ISA (UK) 720 are intended to simplify and clarify requirements. We observe that as re-drafted the auditor's additional responsibilities for reviewing UK Corporate Governance Code ("Code") aspects apply only when required by the Listing Rules. I.e. those additional responsibilities relating to the Code don't apply when the entity is a voluntary Code adopter, i.e. not subject to the Listing Rules. This is a narrowing of scope.

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?**

No. As the consultation period does not close until 27 September 2019, we assume that it will be some time late in the final quarter of the calendar year before the final standard is published. Given the potential significance of some of the proposed changes in the Ethical Standard and the ISAs-UK, it is difficult to see how that timing could be successfully achieved.

This is particularly so given the absence of any transitional provisions for existing ongoing non-audit services. We do not believe that the proposed effective date gives sufficient time for those entities with a 31 December year end (in particular) to conclude any inflight services (which would become prohibited on 1 January) and appoint alternative providers and for audit committees to make the necessary changes to their policies and procedures. We are also concerned that the compressed timetable will lead to unintended breaches of the revised Ethical Standard.

We therefore recommend that in order to avoid unnecessary costs to business, that transitional provisions are included in the final standard (for example to allow any in-flight services to be completed within a specified grand-fathering period) and also that there is a period of time (we would recommend at least six months) between the standard being published and the first effective date to allow companies and their audit committees sufficient time to prepare for the changes and appoint new professional advisors in an orderly manner where necessary. We also believe that the final standard must make an explicit statement that none of the new requirements (in particular the new proposed cooling in provision for internal audit services) are intended to be applied retrospectively to statutory audits awarded prior to the effective date of the Ethical Standard.

With respect to the ISAs-UK, part of the challenge is that the effect of the proposals is not clear. Once they have become clear on finalisation it will then be possible to begin implementation, but by then the timescales will most probably be too highly compressed. Second, some of the changes could, depending on what is intended and as noted earlier, have long-term implications for audit effort, resourcing and timetables, thus requiring longer term implementation. Connected with that, and as an over-arching matter, if significant change is intended in a number of areas then this would seem likely to overlap with other reviews and we believe that it would be in the best interests of all concerned if they were taken up within those reviews and their timelines.

Appendix 2
Other Comments on the Ethical Standard Consultation

We have a number of additional observations and comments which we believe it would be helpful to address in the final Ethical Standard which should either remove any ambiguity in the drafting or improve the overall clarity of the Standard.

General

- The introductory text specifying the distinction between bold paragraphs (the actual requirements of the Ethical Standard) and other text has been omitted. We consider that the Ethical Standard would be enhanced by the inclusion of text which explains the distinction between the two.
- When cross-referencing to paragraphs within the Ethical Standard, it would be helpful to distinguish whether the reference is to Part A or Part B.
- In the Ethical Standard "entity relevant to an engagement" is, in respect of an audit, defined as the "audited entity". Under the IESBA Code, "audit client" includes "related entities" (downstream only for unlisted companies). Adopting a similar approach might improve the clarity of which group entities are subject to which restrictions.

Part B
Section 1

- Para 1.22 (e) – We welcome the inclusion of this point for completeness, however, we would appreciate further clarity as to whether the reporting under ISA 700 will continue to apply only to breaches relating to the provision of non-audit services that are prohibited under the EU Audit Regulation or will the requirements of ISA 700 be updated to include additional breaches. If so, we recommend that this be applied only to breaches which are assessed as "significant".
- Para 1.42 – Cross reference to para 4.5 is not applicable (since a contingent fee for an audit engagement is never permitted).
- Para 1.43 – Given the addition of a category of "other entities of public interest" in the consultation draft, it would be helpful if the FRC were to indicate which, if any, of the provisions highlighted in para 1.42 should be applied to such entities in addition to the restriction of the provision of non-audit services to those on the "permitted list" in accordance with para 5.42.

Section 2

- Paras 2.3/2.4 – We suggest that the opportunity is taken to address the difficulties of interpretation and application which arise from the duplication and overlap between these paragraphs following the incorporation of the EU Directive in the 2016 Ethical Standard.
- Paras 2.25/26 – This is a further example where incorporating the drafting of the EU Directive introduced duplicative language and the opportunity could be taken now to simplify the text.

Section 4

- Para 4.2 footnote 35 - Clarity is required as to how this should be applied (whether all partner remuneration should be excluded, since partner remuneration is not really allocated between salary and profit and whether or not it is intended that all fixed costs are attributed to individual audits (as opposed to a proxy amount)).

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- Para 4.10 – In the current FRC Ethical Standard, para 4.18 clarifies that in relation to a due diligence engagement a firm may charge a higher fee for work relating to a completed transaction than if the transaction is not completed, provided that the difference is related to the resulting additional risk and responsibility, not the outcome of the due diligence engagement. We would appreciate the FRC's confirmation that such arrangements would still be permitted subsequent to the total prohibition on contingent fees proposed in the consultation draft.
- Para 4.47 – As drafted, the amendments would preclude an audit firm, acting in its capacity as administrator, from pursuing (through litigation) an audited entity (for example for recoveries of immaterial trade debts on behalf of a third party). We recommend that the drafting is amended to make it clear that this prohibition is intended to apply for material matters which are reasonably foreseeable.
- Para 4.9 – If it is a policy requirement that the audit fee has to be agreed before each recurrence then we recommend that this is included in an emboldened paragraph, clarifying timing, perhaps as before commencing work on the following engagement.
- Para 4.15 – Footnote 36 - the wording 'Commencing on or after 17 June 2016' has been removed compared with footnote 44 of the current FRC Ethical Standard. Presumably this is because more than 3 years have passed since the FRC Ethical Standard was published and the 70% fee cap is now effective for some accounting periods but it would be clearer if the date reference were left unchanged. As drafted, footnote 36 could be read as meaning that the 70% fee cap is only applicable following a change of auditor.
- Para 4.41/4.43 – The use of "likely to subsequently become" without a timeframe would capture a population larger than that where there is a threat to auditor independence. We suggest that it would be better to refer to the provision/acceptance of gifts and hospitality where the entity has indicated its intention to tender the audit and the firm will be invited to participate and intends to do so.

Section 5

- Section 5 B – The heading should be amended to make it clear that this relates to both Public Interest Entities and Other Entities of Public Interest.
- Section 5.C – We recommend that the heading is renamed 'Restrictions applicable to all other entities'. At the moment the title is confusing as it suggests that firms can provide these services to all audited entities (including PIEs).
- Para 5.15 – Compared with para 5.18 of the current FRC Ethical Standard, the right to delegate appears to have been removed. If this is an intended change we would note that it would present practical difficulties (for instance if the audit engagement partner is away from the office).
- Para 5.39/5.40 – Paragraph 5.39 of the draft standard acknowledges that there are services other than "audit related services" for which the auditor of the entity is the appropriate provider. Such services are identified as inter alia "services, including private reporting, that are customarily performed by the reporting accountant to support statements made by the directors, disclosures in a prospectus or circular or, in the case of premium listed issuers, to support confirmations provided by the sponsor to the FCA". Paragraph 5.39 further notes that such services, other than those required by UK law or regulation, are still subject to the 70% cap. We assume that the bullet in the list of permitted services in paragraph 5.40 reproduced below is intended to permit

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such services, however, it would be helpful to both companies and firms if the language were more consistent between paragraphs 5.39 and 5.40 to avoid any confusion as to what is or is not permitted and between which services are or are not subject to the cap:

> *"Audit and other services provided as auditor of the entity, or as reporting accountant, in relation to information of the audited entity for which it is probable 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"*

- Para 5.40 – The first sub-section is headed "Services required by **UK** law or regulation and exempt from the non-audit services cap" but the second bullet deals with parent and controlled undertakings based in a third country and reporting required by law or regulation in that jurisdiction. As noted elsewhere, we understand that the permitted service restrictions are not intended to apply to a parent undertaking outside the UK. In the bullet "engagement" appears in italics as the defined term (ie the audit engagement) whereas it refers to the non-audit service.
- Para 5.44 – It is not clear why the restriction on the provision of internal audit services would apply to a significant affiliate of an audited entity, if the firm is not the (external) auditor of such affiliate, given that for a non-controlled affiliate in particular, the audited entity would only consolidate its share of the results of the affiliate which would have been subject to audit by another firm and no reliance would be placed on any internal audit work performed at the affiliate.
- Appendix B – We would recommend that the cooling-in provision services are included as a specific paragraph in the main body of the standard – rather than being included in Appendix B (in particular the cooling-in provisions for internal audit services (if implemented) which are currently shown as a footnote).
- Appendix B – The inclusion of (h) in the cooling-in provisions described in (b) is not strictly correct since Appendix B is presented (in footnote 51) as being the EU requirements which do not apply cooling in provisions to internal audit.

Reporting Accountants (where the audit firm is not the auditor)

- General – We are supportive of the FRC's approach to simplifying and restructuring the Ethical Standard by consolidating the provisions that relate to Investment Circular Reporting Engagements ("ICREs") into one section. In order that this has the full weight of a "standard", we suggest that paragraph I8 be emboldened. We consider that further clarification or application guidance is required with respect to how other provisions of the Ethical Standard would be applied to "the specific transaction, subject matter and subject matter information" where a firm was not the statutory auditor (and therefore already fully compliant with the requirements of the Ethical Standard). For example, presumably Paragraph 4.10 would not preclude a firm from accepting an ICRE in respect of an entity where there is a pre-existing tax engagement on a contingent fee basis which has no connection with the transaction or the subject matter of the ICRE.

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Glossary

- We note that certain terms used in the Ethical Standard, including 'parent undertaking' and 'controlled undertakings', are not defined in the Glossary. We believe that expanding the Glossary for such terms would enable the Ethical Standard to stand alone, and that providing additional interpretive guidance would assist users in dealing with complex or unusual circumstances or arrangements to enable greater consistency in practice.
- *Persons closely associated definition* – we suggest that the opportunity is taken to amend the persons closely associated definition to remove other relatives who have lived in the same household requirement that was introduced in the 2016 Ethical Standard. However, if this is not adopted, we would welcome inclusion in the Glossary definition of the clarification which has been given in the rolling record that "other relatives" should be applied by reference to direct lineal descent.
- S*enior members of the engagement team* – we believe that it would be helpful to define which roles are intended to be caught by the term senior members of the engagement team. We have interpreted this to mean anyone who takes on the role of in-charge or above on the audit. However, we consider that it would be beneficial to have a common application of this term.
- *Other entities of public interest* – clarification is needed as to at what point an entity would be formally considered to have come within scope for the AQR review and therefore from at what point the additional non-audit restrictions proposed would be applied and what the transitional provisions for any open non-audit services that were previously permitted would be.