

Consultation on Revisions to Ethical and Auditing Standards 2019

A public consultation issued by FRC

Comments from ACCA to FRC

27 September 2019

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The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; audit; pensions; education; and corporate governance and corporate social responsibility. www.accaglobal.com

Further information about ACCA's comments on the matters discussed here can be requested from:

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GENERAL COMMENTS:

ACCA welcomes the opportunity to comment on the proposals issued by the FRC. We are pleased to note that the proposed revisions follow the work done by IESBA in its restructured code that came into effect in June 2019.

We are also supportive of the FRC's initiatives in responding to the changing expectations of users of financial information following the recent audit and corporate failures, the decline in audit quality as well as the other changes impacting the UK audit landscape recognised in the consultation paper. However, we do have some detailed concerns with some of the proposed changes and these are reflected in our response to the specific questions below.

SPECIFIC COMMENTS:

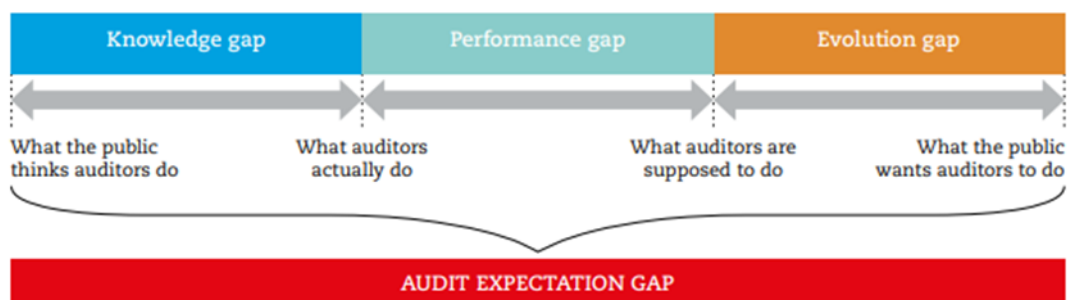
Question 1: Do you agree with the revised definition of an 'objective, reasonable and informed third party' and with the additional guidance on the application of the test?

Definition

We agree with the revised definition of an objective, reasonable and informed third party as it requires such a party to be informed about the respective roles and responsibilities of an auditor, those charged with governance and management of an entity. This follows ACCA's position set out in our recent thought leadership report *Closing the expectation gap in audit*¹.

In this publication we split 'the expectation gap' in audit into three components: the knowledge gap, the performance gap and the evolution gap and then address each of these separately.

The knowledge gap as noted in the graph below refers to the difference between what the public thinks auditors do and what auditors actually do purely based on knowledge. For example, there has been a lot of criticism regarding the non-audit services that auditors provide to existing audit clients, however many lack the knowledge of the existing regulatory restrictions that are currently in place regarding non-audit services.



¹ https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf

We find that the definition is broadly consistent with the IESBA Code. However, we note that the IAESBA's code paragraph 120.5 A4 states that the reasonable and informed third party 'does not need to be an accountant' whereas the proposed definition in the Revised Ethical Standard UK paragraph I14 states that such a person 'is not another practitioner'. The revised standard could perhaps be clearer as to why it has diverged from the IESBA requirement in this way.

Additional guidance

In supporting the additional guidance provided, we also draw attention to our comments in response to the recent Brydon consultation which are relevant to this matter:

- There will always be an information asymmetry between the entity and the auditor with the entity having much better knowledge about its business than the auditor does.
- The objective, reasonable and informed third party test is an evaluation of the appropriateness of the professional accountant's conclusions in an impartial manner. It involves, therefore, a consideration of whether another party, weighing up all the relevant facts and circumstances that an accountant is expected to know or could reasonably be expected to know at the time a conclusion was reached, would reach the same conclusion.
- The test should also avoid the risk of cognitive bias referred to in our research *Banishing bias? Audit, objectivity and the value of professional scepticism*², such as hindsight bias - once people know that something has happened they overestimate how easy it should have been to predict it at an earlier point. This can in turn lead to the auditor's failure to identify a matter being portrayed as resulting from a lack of professional scepticism.

Question 2: Do you agree with our proposed measures to enhance the authority of Ethics Partners, and do you believe this will lead to more ethical outcomes in the public interest?

Yes, we agree with the measures and consider that they should also enhance the transparency of the challenge provided by the Ethics Partner function.

Question 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?

ACCA's thought leadership report *Thinking Small First: Towards better auditing standards for the audits of less complex entities*³ proposes that ISAs could be drafted using simpler language and a simpler structure that starts with the most basic requirements and builds up. The report identifies that this approach would benefit regulators and the general public as well as auditors. Although the above mentioned report refers to ISAs we believe that this is applicable in the case of the Ethical standard too. We therefore support the effort made by the FRC in restructuring and simplifying the Ethical standard. This also follows the work done by IESBA in its restructured code which came in effect in June 2019, particularly the auditor independence standard. The aim of IESBA and FRC are therefore aligned with the requirements differentiated from the application material.

² https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/pi-banishing-bias-prof-scepticism.pdf

³ https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Supporting-SME-audit/pi-SME-auditing-standards.pdf

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

ACCA consider that the proposal to introduce a permitted list of services that the auditors of PIE audits can provide should be reconsidered for the following reasons:

- 1) Insufficient time has passed to fully assess the impact of the 2016 reforms, including the 70% cap fee cap as supported by many audit firms and professional bodies who responded in the November 2018 Call for Feedback.
- 2) Although the introduction of a permitted list of services might make the application regarding non-audit services more straightforward, it creates further inconsistency with the EU Audit legislation, which provides a list of prohibited services rather than a list of permitted services. Depending upon the direction Brexit will take, this could create future issues for the UK in terms of third country auditors' equivalence with the EU Audit legislation.
- 3) As the consultation paper emphasises, the FRC remains committed to a principles-based regime for the provision of non-audit/additional services. Introducing a permitted list of services, however, seems more of a shift towards a rules-based approach.

ACCA does however consider that the introduction of the list of services required by UK law or regulation and exempt from the non-audit services cap referred to in paragraph 5.40, to be very useful for practitioners and for an objective, reasonable, informed third party. This is because it clarifies which non-audit services should not be taken into account when considering the 70% fee cap.

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?

We consider that the appropriate application of the conceptual framework should recognise the heightened public interest and the impact on independence. In our view, simply prohibiting activities will not only encourage a tick-box' approach but risks unintended consequences, delays in the provision of expert advice, additional costs etc.

Furthermore, allowing particular services does not mean that practitioners do not identify, assess and evaluate threats. The conceptual framework should still be applied as the significance of the threat may mean that practitioners cannot safeguard their independence.

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)?

We agree with the removal of the reliefs for SMEs in Section 5 of the standard since, as noted in the consultation document, they were not widely used because they are in conflict with the IFAC membership obligations for Forum of Firms members.

In regards to Section 6 of the standard, we support the retention of reliefs for small entities. However, we also support the retention of reliefs for medium sized entities too as we are not certain from the information provided what, if any, issue has been identified in the case of medium sized entities that would require such change.

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?

Since these are non-audit services that have no direct or inconsequential effect on the financial statements we don't support the removal. Instead, we suggest further guidance should be provided to avoid unhelpful interpretations rather than their removal.

The proper application of the conceptual framework should address the issues where there is a heightened public interest. The issue appears to be in the application and not the principle which could be addressed by appropriate application material.

Question 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 agree with the inclusion of the FRC staff guidance and that it improves clarity of the requirements.

We also note that there is still room for guidance to sit outside the Ethical Standard allowing its update to be easier and timelier.

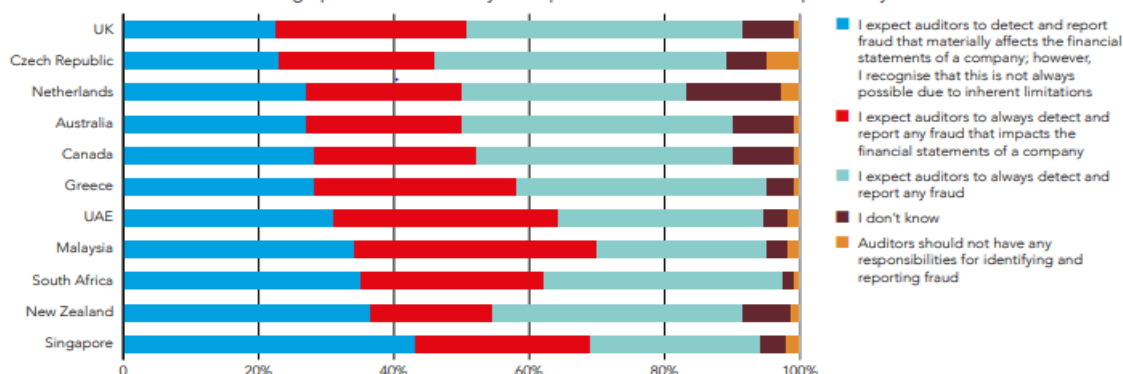
Question 9: Do you agree with the inclusion of FRC staff guidance within the application material of the auditing standards, and has this improved clarity of the requirements?

Yes, we agree with the inclusion of the FRC staff guidance and that it improves clarity of the requirements.

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.

The findings from our report *Closing the expectation gap in audit*⁴ found that the general public expects more from auditors in respect of fraud with an aggregated 35% wanting auditors to 'always detect and report any fraud' as shown in the graph below. In the UK 41% of the respondents chose that option. We therefore welcome the FRC's initiative to enhance the information provided in the auditor's report in relation to irregularities and fraud.

FIGURE 3.5: Which of the following options best reflects your expectations of the auditor's responsibility for fraud?



The proposed Paragraph 700.29-1 requires that the auditor's report shall explain to what extent the audit was considered capable of detecting irregularities, including fraud. In our view, the requirements could be set out more clearly to avoid giving the impression that irregularities including fraud should always be detected, regardless of materiality.

⁴ https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf

In some industries multiple cases of quantitatively immaterial fraud can happen quite regularly for example, in the insurance sector. The standard should be drafted to ensure that the disclosure requirements placed upon auditors of such entities are balanced, providing meaningful but proportionate disclosures to the users of the audit report.

Question 11: Do you agree with the proposed additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit Matters and increased disclosure around materiality?

As we also noted in our response to ED-(UK) 570 (Revised), according to the findings of ACCA's research *Key audit matters: unlocking the secrets of an audit*⁵ in addition to KAMs being useful for investors, the following three additional benefits of KAM were identified:

- Disclosure of KAM stimulates better governance
- Disclosure of KAM supports better audit quality
- Disclosure of KAM encourages better corporate reporting

However, as part of the discussions during the research mentioned above we noted that firms at times found it challenging to describe exactly how they had addressed KAMs. We therefore support the initiative, but additional guidance may be required to support practitioners, particularly in applying the requirements of paragraph 16 1 (b).

We support the enhancement to the increased disclosure around materiality as per the proposed para 16-1 i) as this will provide the users with more complete information. This should help narrowing the audit expectation gap.

Question 12: Do you agree with the revisions we have made to ISA (UK) 720, including the enhanced material setting out expectations of the auditor's work effort in respect of other information?

We agree with the revisions and the enhanced material.

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?

The suggested changes to the standards will require significant investment in time by firms to support implementation. And as recognised in the consultation paper, some of the areas explored in the paper are also relevant to the reviews that are still ongoing, in particular as Sir Donald Brydon's Independent review into the Future of Audit, which is likely to bring about further change in audit in the UK.

We also recognize, though, the importance of acting, and being seen to act, on a timely basis to the concerns raised with regard to audit quality and auditor independence in the UK.

These potentially competing factors need to be balanced carefully in assessing the appropriate effective date for the revised Ethical and Audit Standards. We suggest that the FRC balance carefully the feedback received by stakeholders to this consultation in deciding upon the appropriate implementation timetable for the revised Standards.

⁵ https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Key-audit-matters/pi-key-audit-matters.pdf