

Archwilydd Cyffredinol Cymru  
Auditor General for Wales

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Via email: [AAT@frc.gov.uk](mailto:AAT@frc.gov.uk)

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Dear Mr Ferris

**Exposure drafts of the revised Ethical Standard and ISAs (UK)**

I welcome the opportunity to provide feedback on the exposure draft Revised Ethical Standard 2019 and ISAs (UK).

For context, it may be helpful if I mention that, as Auditor General for Wales, I am by statute the auditor of most Welsh public sector bodies, and my functions include:

- auditing the accounts of the Welsh Government and its sponsored and related bodies, including Welsh Government-owned companies, NHS bodies and local government bodies (including unitary authorities, police and crime commissioners, national parks, fire and rescue authorities and local government pension funds);
- conducting value for money examinations and studies of Welsh public bodies.

Altogether, as Auditor General, I audit some £22 billion of each of income and expenditure (excluding some £16 billion of each of income and expenditure of the Welsh Consolidated Fund), which is over a third of Welsh GDP. I hope that given my wide-ranging public sector role, I am able to bring a useful perspective to your consultation.

I have set out in the annex to this letter answers to the particular questions that you pose in your request for comments. I would like, however, to emphasise here some key points.

Overall, I think that the exposure draft is in most respects an improvement on the 2016 Standard. Generally, it provides more appropriate restrictions and is

somewhat clearer. There remains, however, significant lack of clarity in aspects of the Standard that make its application to many public sector audits problematic.

However, of most concern to me is the blanket prohibition by paragraph 2.36 of loan staff assignments. This is excessive and leads to an unbalanced Standard, which undermines its credibility.

The blanket prohibition of loan staff assignments contrasts with the liberal regime provided for other services. For example, paragraph 5.122 permits a firm to provide accounting services of a "routine" nature "requiring little or no professional judgement", such as (as set out at paragraph 5.128) "recording transactions for which management has determined the appropriate account classification". But a blanket prohibition of loan staff assignments would mean that trainees or apprentices cannot be provided on loan to provide routine accounting services to help build their experience.

The blanket prohibition of loan staff assignments presents the Wales Audit Office and the wider Welsh public sector with a significant problem if I am to continue to apply the Standard as if my audits fell within the definition of statutory audit. We have developed training and apprenticeship schemes that have, as an integral feature, short (6 month or less) secondments to a variety of public bodies, including bodies audited by the Auditor General. These schemes not only provide a good grounding to trainees and apprentices in practical accounting so as to inform future audit development, they also practically help Welsh public bodies address resourcing issues. As it does not feature in the impact assessment, we believe that the FRC has not taken account of the harm that would be caused by the blanket loan staff assignment prohibition in terms of the deleterious effect on these training schemes. We should, therefore, be grateful if you would reconsider the prohibition provided by paragraph 2.36.

I acknowledge that there may be a case for restricting loan staff assignments where such assignments involve partners and senior employees who would tend to be involved in matters of management decision-making. We consider that, as with the 2016 Standard, a revised Standard that prohibited loan staff assignments that involved management roles would be proportionate and appropriate.

Finally, I do not think that commencement for periods starting on or after 15 December 2019 is appropriate. To operate in accordance with the principles of public law and to provide fair and reasonable regulation, the FRC must properly consider the consultation responses that it receives and revise the draft accordingly, and that will take time. With a consultation response deadline of 27 September 2019, I cannot see how the FRC can properly consider the consultation responses, revise and publish the draft, and give firms adequate time to make arrangements in response to it by 15 December 2019. Such a timetable is especially problematic given the likely disruption that will be caused to firms and public audit agencies on the UK's exit from the EU. I consider that a more appropriate effective date would be December 2020.

I hope that this response is helpful. I should be happy to discuss any of the above matters.

Yours sincerely

**ADRIAN CROMPTON**

**Auditor General for Wales**

## **Annex: Responses to FRC questions**

*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?*

I am not completely clear as to where the revised definition of an 'objective, reasonable and informed third party' is within the draft. However, I do find the additional text on the application of the test usefully informative. For example, I think the clarification that the perspective should not be that of another practitioner helpfully broadens the consideration and should lead to more effective evaluation.

I think it would be helpful if the FRC provided further guidance, or at least suggestions, as to how the assessment should be done in practice. Should firms, for example, retain a small panel of investors and public interest stakeholders? It would also be helpful to have, perhaps in a separate document, worked examples of the application of the third-party test.

The definition of public interest stakeholders seems somewhat less than fully transparent. Rather than citing "stakeholders of a company for the purposes of meeting directors' obligations under s172 of the Companies Act 2006", it would be handier to refer to "members, employees, suppliers and customers".

*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, I agree with the measures, and I believe that they should lead to more ethical outcomes in the public interest. I consider that requiring firms who do not follow the opinion of the Ethics Partner in respect of public interest entities to report the matter to independent non-executives and the Competent Authority should be a significant deterrent to inappropriate courses of action. However, it would be helpful to specify who should make the report. I also think that these provisions could be usefully strengthened by requiring the Ethics Partner to report failure to follow opinion to independent non-executives in relation to any engagement, not just public interest entities.

*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.*

It is clear quite some effort has been made to simplify the structure and the text. The reduction from 120 pages to 100 is welcome. It is good to see the removal of tortuous 10 line sentences, such as paragraph 4.30 of the 2016 Standard. Generally, the changes are helpful, but more could be done—see, as one small example, the definition of public interest stakeholder at paragraph I14 (as mentioned under Q1).

There remains lack of clarity in the definition of public sector audit scope in para I1 (see footnote(\*) to footnote 1. It is not clear whether the definition includes statutory examinations and studies of the economy, efficiency and effectiveness in the use of resources (e.g. under section 135 of the Government of Wales Act 2006) or just the auditor's conclusion (satisfaction) as to arrangements for securing economy, efficiency and effectiveness (e.g. under section 61 of the Public Audit (Wales) Act 2004). It appears from the glossary definition of *public interest assurance engagements* (which only covers audit of financial statements, investment circulars, review of interim financial information and client asset assurance) that statutory examinations and studies of economy, efficiency and effectiveness are not in scope.

There is also ambiguity as to the scope of the application of the Standard as described in the Preface (page 5). The Preface says that the Standard applies to the audit of financial statements and other public interest assurance engagements in both the private and public sectors. This masks the fact that while the application of the Standard to certain types of audit, particularly Companies Act 2006 audits, has a statutory foundation, for much public sector audit, the application of the Standard is at the discretion of the relevant auditor general.

The definition of "statutory audit" is also itself problematic. The Glossary defines "statutory audit" as an audit performed pursuant to the EU Audit Directive and Regulation or otherwise designated by national law as a statutory audit". Section 1210 of the Companies Act defines "statutory auditor" (and "statutory audit" accordingly) as persons appointed pursuant to Part 16 of that Act, or certain provisions of the Building Societies Act 1986 or the Friendly Societies Act 1992. Most public sector audits are, however, required by other legislation, but such legislation does not actually designate them as "statutory audits". To date, the Auditor General for Wales and other public sector auditors have dealt with this by applying the Standard to their audits on a discretionary basis regardless of this lack of clarity, but this is not a satisfactory position. And it is increasingly difficult to justify.

Converting the still somewhat lengthy Standard into bitesize material suitable for training and continuing professional training purposes remains a significant task for the Ethics Function, and, indeed, we doubt that the description of the cost estimate set out in the impact assessment in this respect is realistic. For example, "familiarisation and training with revised standards (ethical and auditing) ... 10

hours for 64 small firms". It seems likely that there are more than 64 small firms affected.

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

Yes.

*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?*

There appear to be two questions here, so I am answering as follows:

*(a) Do you agree with the additional prohibitions we are proposing to introduce in learning from the experience of enforcement cases like BHS?*

Generally, yes, but with one very significant exception: the blanket prohibition by paragraph 2.36 of loan staff assignments. This is excessive and leads to an unbalanced Standard, which undermines its credibility.

The blanket prohibition of loan staff assignments contrasts with the liberal regime provided for audit-related services, non-audit services and additional services. For example, paragraph 5.122 permits a firm to provide accounting services of a "routine" nature "requiring little or no professional judgement", such as (as set out at paragraph 5.128) "recording transactions for which management has determined the appropriate account classification". But a blanket prohibition of loan staff assignments would mean that trainees or apprenticeships cannot be provided on loan to provide routine accounting services to help build their experience.

This blanket prohibition of loan staff assignments presents the Wales Audit Office and the wider Welsh public sector with a significant problem if I am to continue to apply the Standard as if my audits fell within the definition of "statutory audit". We have developed training and apprenticeship schemes that have, as integral feature, short (6 month or less) secondments to a variety of public bodies, including bodies audited by the Auditor General. These schemes not only provide a good grounding to trainees and apprentices in practical accounting so as to inform future audit development, they also practical helping Welsh public bodies address resourcing issues. As it does not feature in the impact assessment, we believe that the FRC has not taken account of the harm that would be caused by the blanket loan staff assignment prohibition in terms the deleterious effect on

training schemes. We should, therefore, be grateful if you would reconsider the prohibition provided by paragraph 2.36.

I acknowledge that there may be a case for restricting loan staff assignments where such assignments involve partners and senior employees who would naturally tend to be involved in matters of management decision-making. We consider that, as with the 2016 Standard, a revised Standard that prohibited loan staff assignments that involved management roles would be proportionate and appropriate.

*(b) If the more stringent PIE provisions are to have a wider application to non-PIE entities, which entities should be subject to those requirements?*

It would seem appropriate to apply such provision to significant infrastructure entities, such as listed utilities. Similarly, it seems there is a strong case for applying such provisions to large employers, e.g. those with over 5,000 employees.

Applying the prohibitions to political parties and connected entities, such as donors, would also help improve wider public confidence in the integrity and objectivity of the audit profession. As the legislative framework for audit is a result of political process, any non-audit work provided to political parties (but particularly if provided at less than full cost) risks tainting public confidence in the audit framework. (While it is somewhat beyond the scope of the question, I should say that I consider that there is a case for providing restrictions on political activities of auditors across all sectors.)

*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)?*

Yes. This seems appropriate.

*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?*

Yes. This seems appropriate.

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

It is not clear what is FRC staff guidance within the application material.

*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?*

The additions to the application material seem generally helpful, but in many places it would be clearer to provide more definitive language, particularly through more use of "should" in place of "may".

*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.*

Yes. The changes seem appropriate, but further changes would be beneficial. In particular, it would be useful if ISA (UK) 250 A required the auditor to undertake broader work to address threats to legal compliance, such as by requiring auditors to review "whistleblowing" disclosures (public interest disclosures by employees, per the Employment Rights Act 1996).

*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?*

Yes. This seems appropriate.

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

Yes. This seems appropriate.

*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?*



I do not think commencement for periods starting on or after 15 December 2019 is appropriate. To operate in accordance with the principles of public law and to provide fair and reasonable regulation, the FRC must properly consider the consultation responses that it receives and revise the draft accordingly, and that will take time. With a consultation response deadline of 27 September 2019, I cannot see how the FRC can properly consider the consultation responses and revise publish the draft and give firms adequate time to make arrangements in response to it by 15 December 2019. Such a timetable is especially problematic given the likely disruption that will be caused to firms and public audit agencies on the UK's exit from the EU. I consider that a more appropriate and realistic effective date would be December 2020.