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27 September 2019

By email to: AAT@frc.org.uk

Dear Mr Ferris,

Post Implementation Review of the 2016 Auditing and Ethical Standards

We welcome the opportunity to set out our views on the FRC's post implementation review of the 2016 Auditing and Ethical Standards. We agree with the FRC's overarching objectives of enhancing confidence in audit, strengthening independence and ensuring that public interest is at the heart of audit firms' culture in the UK.

The FRC's review comes at an important and sensitive time. We recognise that there is a fundamental need to restore trust in audit because of its crucial role in underpinning confidence in business and capital markets, which in turn drives economic growth, trade and prosperity. Audit makes a significant contribution to the UK economy and, at this critical juncture as the UK looks to exit the EU, it is essential that any reforms build on and enhance the UK's global reputation for high standards of corporate reporting, auditing and governance, without undermining the attractiveness of the UK as a place to do business.

In this context, we note that there are a number of options for change currently being considered, including the recommendations proposed by the Competition and Markets Authority (CMA) and by Sir John Kingman, in addition to the fundamental review being led by Sir Donald Brydon which is due to report later this year. We believe that it is critical that there is effective coordination of the output of each of these interconnected reviews - specifically those recommendations which may be proposed by Sir Donald Brydon - so they form a

package of complementary and consistent measures which work together to provide a strong and coherent regulatory framework for the UK statutory audit market.

We believe that unilateral changes, such as those proposed by the FRC in relation to the Ethical Standard, could potentially cut across or contradict recommendations from these other reviews.
As a result, we believe the FRC's proposed revisions to the Ethical Standard are premature and potentially counterproductive to the overall aim of enhancing confidence in audit. We are not aware of any reason why the FRC needs to make changes to the Ethical Standard on the timetable proposed. We would therefore suggest that the FRC should defer reaching any conclusions from the current consultation before there has been an opportunity to consider these in the context of the other reviews.

Notwithstanding this we have set out our detailed responses to the FRC's consultation questions in respect of the Exposure Drafts for each of the Ethical and Auditing Standards in the attached Appendix. We specifically highlight the following key points.

(1) Other entities of public interest

We do not agree with the proposed introduction of the new concept in the Glossary for "Other Entities of Public Interest" (OEPI). This new concept would create a new category of entities to which the very stringent prohibitions for public interest entity (PIE) companies would also apply. The practical effect of this is to extend the PIE definition to include a much wider population of entities than is currently the case. The introduction of the OEPI concept would lead to complexity for companies and their Audit Committees as it is unclear to which companies the definition would extend. In addition, BEIS has indicated its intention to consult on the PIE definition with changes requiring legislation, as we explain further below.

We note that, when the Ethical Standard was revised in 2016[1], BIS (now BEIS) was clear that there would be no extensions of the PIE definition beyond the minimum level set out in the EU Audit Directive 2006[2]. Our view is that, in the absence of a clear mandate from government, the FRC should not seek to unilaterally extend the PIE definition as it is proposing to do.

We further note that BEIS, when categorising the recommendations from the Kingman review, stated that "***The Government welcomes the recommendation that the UK's definition***

[1] The Ethical Standard 2016 was revised to implement certain provisions of the EU Audit Regulation 537/2014
[2] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32006L0043

of a Public Interest Entity (PIE) should be reviewed, and will consult on proposals this year."[3] In considering this, BEIS also noted that any proposed changes to the definition would require primary legislation[4]. The current proposal from the FRC effectively circumvents this consultation process and the clear recommendation from BEIS that primary legislation is required to effect such a change. In addition, the proposals would potentially result in two rounds of amendments to the PIE definition in a short space of time, with resultant confusion and complexity for companies and their Audit Committees, particularly given the current lack of certainty regarding which entities would be included within the OEPI definition.

In addition, there are a number of practical consequences which arise from the introduction of the OEPI concept. At an operational level, the definition of an OEPI in the Glossary to the Exposure Draft ties it to the extent of the FRC Audit Quality Review (AQR) scope. The fact that this scope is ultimately at the discretion of the AQR is, in our view, inappropriate and likely to create uncertainty for entities as to whether they could be included within the scope without warning. To avoid this uncertainty, it is critical that there is clarity regarding the principles to be applied in determining whether an entity is to be classified as an OEPI.

When taken together with some of the proposed revisions, such as the "white list" (which includes extra-territoriality provisions), the introduction of a new OEPI concept could have a detrimental impact on the UK as an attractive place to do business in our view, at a time of economic uncertainty with the UK's impending exit from the EU.

(2) Extra-territorial effect

In our view, the proposed extra-territorial application of the Ethical Standard is disproportionate and would create an audit independence regime which would be one of the most restrictive in the world. We suggest that any revisions to the Ethical Standard should ensure that the "white list" only applies to parent undertakings incorporated or formed in the UK.

As currently drafted, the proposed extra-territorial application of the Ethical Standard (in Supporting Ethical Provision 2.4), to all members of the audit firm's network, even if not involved in the delivery of audit engagements, as well as for non-network firms used as part of a UK group audit, is disproportionate and would be ineffective both in preventing corporate

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/784988/independent-review-financial-reporting-council-initial-consultation-recommendations.pdf (page 18)

[4] Ibid. (page 11)

failures and in assisting in improving audit quality, two of the stated drivers of the new standard.

The unique application of the new extra-territorial provisions when compared against comparable jurisdictions within the EU and in other major territories, such as Australia or China, means the proposed revised Ethical Standard would, in effect, become the world's most restrictive audit independence regime. This, coming at a time when the UK is about to leave the EU, is likely to have an adverse impact on the attractiveness of the UK as a place for international companies to do business. Additionally, the unnecessary complexity that the new extra-territoriality rules would create globally could also increase the number of independence issues arising from non-UK firms and thereby diminish users' confidence in the UK auditing regime.

Furthermore, there appears to be a significant inconsistency between the prospective amendments to UK legislation as part of the government's Brexit planning, which limit the application of the "black list" to parent companies ***'incorporated or formed in any part of the United Kingdom***"[5], and the proposed revisions to the Ethical Standard in paragraph 5.40 which apply to parent companies wherever they are incorporated or formed.

This inconsistency is unhelpful and confusing in our view and we suggest that the revisions to the Ethical Standard should be amended to be consistent so that the "white list" only applies to parent undertakings incorporated or formed in the UK.

Failure to make this amendment would have potentially significant extra-territorial implications, and would bring the FRC's Ethical Standard into direct conflict with the regulatory regimes in overseas territories. By way of example, for a UK PIE entity that we audit (for example a bank), which is owned by a non-UK entity (for example, where it forms part of a US-headquartered banking group), the UK "white list" would apply to the US parent entity in the same way that it would for the UK PIE audit entity. The rules would therefore restrict the provision of non-audit services (such as tax services) by the US network audit firm to the US parent entity. This is irrespective of the established auditor independence regime that exists in the US and the position of the US regulators where such services would be permissible.

[5] The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019: http://www.legislation.gov.uk/uksi/2019/177/contents/made

(3) Introduction of an overly narrow "*white list*" of permissible non-audit services

We believe that the introduction of a "white list" of permissible services to PIE audit entities has the potential to help address public concerns regarding perceived conflicts of interest with the provision of non-audit services. This is why we introduced our own voluntary commitment where we agreed to stop providing non-audit services directly to those FTSE 350 companies we audit, unless those services provide those entities with independent assurance.

Nevertheless, we have significant concerns regarding the manner in which the list has been restricted within the Exposure Draft. It is too narrow and fails to allow sufficient flexibility to accommodate changes which may be necessary to implement recommendations made by the other reviews. For example, we believe that the provision of independent assurance should be permissible, even if on an operational matter that is not included in the annual report of the audited entity, provided the Audit Committee has approved the service.

Failure to amend the "white list" for matters such as this risks cutting across, and potentially inhibiting, the Brydon review, which is reviewing, amongst other things, whether the scope of assurance provided by audit firms should be expanded to cover other matters outside of the financial statements. This point is discussed further in the attached Appendix.

The current proposals also fail to recognise that the independence risk of non-audit services provided by a network firm to a parent entity, where that network firm is not involved in the audit of the PIE, are of an entirely different magnitude to those which exist when the network firm is involved in the PIE group audit and the services are provided to controlled subsidiaries. We believe that applying the same "white list" restrictions in both scenarios is not only disproportionate but, in practical terms, may be difficult for the Audit Committee of the EU PIE to control, leading to a wholly unsatisfactory position for the groups concerned.

(4) Factors which support deferring the outcome of the consultation

We support the FRC's desire to reinforce trust and confidence in audit and to strengthen auditor independence but it is essential that any changes to the current regime are undertaken in a considered and proportionate manner.

In our view, a number of factors detract from this overarching intent including: the lack of connectivity between the FRC's proposals and the ongoing reviews of other aspects of the audit market; the impending changes in the FRC's leadership; and the rushed implementation date.

We set out further detail on these below and suggest that the FRC should defer making any final decisions on the proposed revisions to the Ethical Standard pending the outcome of the other concurrent reviews.

Connection with other reviews

Whilst the consultation document is explicit that the FRC does not wish "***to cut across the scope of Sir Donald's [Brydon] review, or to anticipate Ministers' consideration of the independent reviews and subsequent public consultations, which may ultimately require legislation to address***", nonetheless that is, in effect, what the consultation does.

As mentioned above, the introduction of a very tightly prescribed "white list" does not allow for any potential changes or extensions to the nature and scope of assurance provided by audit firms outside the financial statements which may ultimately be recommended by the Brydon review. Similarly, the introduction of a 12 month "***cooling-in***" provision in connection with internal audit services appears to conflict with the CMA's desire to increase choice for companies.

FRC leadership changes

Whilst the FRC has indicated that ***"it would be irresponsible not to take action to address recurring issues which drive poor quality audit, undermine stakeholder confidence in audit or, in more extreme cases, lead to audit failure"*** we question whether the extent of the changes proposed in the Ethical Standard Exposure Draft is appropriate at this time.

If implemented as drafted, the changes proposed in the Exposure Draft would, in our view, have significant adverse effects on UK companies. In light of that, and in the absence of a proven causal link between the provision of non-audit services and any detriment to audit quality, we suggest that it is for the new FRC leadership to determine the true root causes of audit failure to help shape the strategic nature of the proposals that are being put forward.

We would also caution that if implemented in the time frame proposed, the significance of the changes proposed, and the practical difficulties that audit entities and their auditors would have in implementing them, means that the incoming leadership's ability to determine their priorities whilst new in role could be hampered by having to address the unintended consequences of this set of proposals.

Proposed implementation date

The consultation proposes that the FRC's "***intention is that revised standards will apply to the audit of financial periods commencing on or after 15 December 2019"***. The justification for

this being that the changes would, in the view of the FRC, help to prevent potential poor audit quality / audit failures, and as such, should be implemented as soon as possible.

Whilst we agree that action should be taken promptly to resolve known issues, compliance with the proposed Ethical Standard by this deadline will result in significant expense and disruption to UK companies, many of which will be focussing most of their attention on the potential impact of the UK leaving the EU at the same time.

The scale of the proposed revisions mean that it is essential that companies, their Audit Committees and broader stakeholders have sufficient notice before any revisions become effective so they are able to make any necessary changes in an orderly and considered way. In our view, a longer time gap is therefore required between the finalisation of the revisions and the proposed effective date. We have set out further details in the attached Appendix.

We also believe it is essential for it to be explicit that the new regulations, specifically the new provisions on the 12 month cooling-off period for "***services related to the audited entity's internal audit function"*** do not have retrospective effect. Failure to provide this clarity would further exacerbate problems for companies, especially those who are in the middle of audit tenders or who have recently completed such a process for periods starting in 2020 where they have appointed their legacy internal auditor as their new statutory auditor.

Transitional relief

We note that, even with the limited implementation period proposed by the Exposure Draft, there is currently no provision for transitional relief. In our view, this should be reconsidered, particularly given the short period between the proposed publication of the new standards and implementation of them for companies with December year ends. Making changes to address these issues will be essential to ensure that the potential for any disruption for companies and their Audit Committees is minimised.

(5) Lack of clarity in critical areas

We support the FRC's desire to simplify and restructure the Ethical Standard in order to achieve higher levels of understanding and compliance. However, the drafting is ambiguous in a number of areas and we do not believe the changes proposed to the existing Ethical Standard provide users with enhanced clarity.

We have expanded on this in the attached Appendix, but areas of particular concern include:

- Restructuring services and their ongoing permissibility for syndicates involving PIE audit clients;
- Internal audit services and the proposed 12 month cooling-in provisions;
- Threatened and actual litigation and the need to consider litigation brought on behalf of another party;
- Consolidation of the guidance relating to investment circular reporting engagements and the application of the fee cap to both the public and private, reporting required as part of a capital market transaction; and
- Contingent fee prohibition on services in respect of an audited entity.

Conclusion

We support revisions to standards which deliver a proportionate regulatory regime, drive audit quality and foster resilience in the audit market. However, as set out above, we believe that the timing, nature and extent of the changes proposed by the FRC are inappropriate and, more importantly, fail to take account of the critical proposals expected to be announced by, amongst others, Sir Donald Brydon following completion of his review later this year.

If it would be helpful, we would be happy to discuss with you the views we have set out in this letter.

Yours sincerely,

Margaret Cole
Chief Risk Officer and General Counsel

Appendix - PwC's response to the FRC's specific questions

Introduction

As set out in our covering letter, we have significant concerns about the timing of this consultation in light of the other key interconnected reviews which are either still in progress or not yet implemented, most notably the CMA's study of the audit market, and the Kingman and Brydon reviews. We believe that the FRC should defer making any final decisions on the proposed revisions to the Ethical Standard until these reviews have been completed, in order to ensure a comprehensive and cohesive package of measures which will provide a strong and proportionate regulatory framework for the UK statutory audit market going forward.

We have also raised in our covering letter a number of other key concerns including:

- the introduction of the concept of "Other entities of public interest";
- the proposed extra-territorial effect, especially on overseas parents of audited PIE audit entities;
- an overly narrow "white list" that risks cutting across the Brydon review and the potential for any broader development of the reporting agenda over time;
- the timing of the proposed revisions and the need for grandfathering and transition relief to be implemented; and
- a lack of clarity in the proposed drafting of certain key areas.

This Appendix contains answers to the specific questions raised by the FRC in the Feedback Statement and Impact Assessment - Post Implementation Review of the 2016 Auditing and Ethical Standards.

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

We support the extra clarity provided by the FRC in the Exposure Draft to the Ethical Standard paragraphs I14-I15 in relation to the characteristics that an "***objective, reasonable and informed third party***" should possess, and the factors that should be considered as part of any such assessment.

However the final bullet point in I14 asserts "... ***arrangements, policies or procedures implemented by a firm to address any threat to independence may be constructed as a way to circumvent the overarching principles"***. We are not aware of any instances where firms

have sought to circumvent the overarching principles and supporting ethical provisions and, as such, do not believe that this wording is justified or appropriate.

In operating the "third party test" in practice, it is essential that firms are able to make their assessments in good faith, based on the facts known at the time, and not have their judgements and decisions subsequently critiqued with the benefit of hindsight as stated in the second bullet point of I14. In this respect we believe it is essential that audit firms are able to consult efficiently with the competent authority and to receive guidance on such matters where required in a timely manner.

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

We are supportive of the proposed changes which seek to enhance the authority of the Ethics Partner. However, we are not aware of any instances within PwC where the advice or opinion of PwC's Ethics Partner has not been followed. As such, our view is that the necessity for the proposed changes and additional powers is not clear, and consequently we are not convinced that they will directly lead to more ethical outcomes than the existing rules.

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?

We wholeheartedly support the intention to simplify the Ethical Standard. In our opinion a simplified Ethical Standard, if implemented correctly, will assist audit firms, audited entities and their Audit Committees to achieve the FRC's ultimate goal of more ready compliance with the requirements of the Ethical Standard.

Whilst the intent of the FRC is clearly stated, elements of the Exposure Draft remain unnecessarily complicated or ambiguous. Resolution of these areas will be necessary to achieve the overall ambition of delivering a higher standard of compliance.

Examples of the lack of clarity and/or ambiguity include the following:

3.1 Services to banking and restructuring syndicates

We note that paragraph 5.40 includes specific reference to the fact that "***Reporting on covenant or loan agreements, which require independent verification, including to third***

parties with whom the entity relevant to an engagement has a business relationship" continues to be a permissible service, subject to the non-audit services cap, for PIE audited entities.

Whilst this specific confirmation is welcomed, this clarity of position is not replicated in respect of wider restructuring services. We note that there is a footnote to the bullet point mentioned above which refers to the contents of the FRC's Staff Guidance Note (SGN 01/2018), 'The Auditors Provision of Restructuring Services to Public Interest Entity Participants in Bank Lending or Bond Funded Syndicates', but we do not believe that this provides sufficient clarity that the FRC intends for such services to continue to be permissible under the Exposure Draft provisions.

In light of the above, we believe that it is essential that the FRC considers adding a further bullet point to paragraph 5.40 which refers explicitly to the permissibility of restructuring services provided to syndicates. Failure to do so may result in unhelpful ambiguity for Audit Committees of banks and other lenders who may be required to consider such services. Consideration could also be given to refreshing the SGN to make clear that the advice set out within it continues to be relevant post the implementation of proposed revisions to the Ethical Standard.

3.2 Threatened and actual litigation

We note that the Exposure Draft includes new provisions in connection with potential litigation matters "***including where the firm is acting on behalf of another party, for example by acting as administrator which would require the firm to instruct solicitors to take legal action against an entity relevant to an engagement***".

We accept that such provisions may be relevant where the matters in dispute are of such significance that an objective and reasonable informed third party would consider them likely to have an impact on the openness of the relationship between management and the audit engagement team. Where matters do not reach this threshold, we do not believe that the intent of the drafting in paragraphs 4.46 and 4.47 is to prohibit all litigation matters by default. This is, however, not clear from the drafting of these paragraphs, and we suggest that these provisions are amended to be clear that matters which are either immaterial and/or otherwise ordinary arms' length events for an insolvent appointment, such as routine debt collection, remain permissible. Otherwise, this lack of clarity could have unintended consequences for the effective operation of the insolvency market.

We believe clarification should also be provided on what options could be available to a firm in the event that a prospective insolvency practitioner is not reasonably able to foresee potential litigation scenarios at the outset of an engagement, but which nonetheless arise during the conduct of the engagement. We accept that resignation as statutory auditor of the relevant entity is one possibility, but this would seem to be a disproportionate remedy for all instances. This is especially true when there are alternative potential safeguards which may be relevant, including but not limited to the appointment of a conflict liquidator. These additional safeguards are not currently included in the proposed revisions and we would suggest that including examples of alternatives to resignation as auditor would be appropriate.

3.3 Contingent fee arrangements

The introduction of a broader prohibition on contingent fees contained in paragraph 4.10 of the Exposure Draft applies to the provision of "***non-audit / additional services, in respect of an entity relevant to an engagement***". Whilst we note this language is consistent with the terminology contained in paragraph 4.14 of the current Ethical Standard, the omission of the qualifying conditions in subsections (a) and (b) adds a significant degree of ambiguity for users which did not previously exist.

We believe that the prohibition would be clearer if it was amended to refer explicitly to the provision of "***non-audit / additional services to or in respect of an entity relevant an engagement***".

3.4 Differential fee arrangements for diligence engagements

We note that the proposed revisions in the Exposure Draft have removed the current language from paragraph 4.11 which explicitly allowed "***Investigations into possible acquisitions or disposals (due diligence engagements) particularly those performed in relation to a prospective transaction, typically involved a higher level of risk and responsibility. A Firm carrying out a due diligence engagement may charge a higher fee for work relating to a completed transaction than for the same transaction if it is not completed, for whatever reason, provided that the difference is related to such additional risk and responsibility and not the outcome of the due diligence engagement***".

We note that the Glossary of Terms continues to accept that differential fees are not considered to be impermissible contingent fees. That being said, the lack of specific reference to the continued permissibility of the market standard "***abort / success fees***" is another example where the desire to achieve simplicity has actually resulted in potential

additional uncertainty for users. We would therefore suggest that, if there is no intent to remove this type of fee arrangement, that the current wording in paragraph 4.11 is reinstated or, as a minimum, added to the definition of differential fees set out in the Glossary of Terms.

3.5 Proposed revisions relevant to Investment Circular Reporting Engagements (ICREs)

The revised drafting in paragraph I8 of the Exposure Draft to ICREs is another area where we note that the desire for simplification has resulted in the removal of useful clarification language. The removal of this language and its replacement by overarching principles, in our view, diminishes the clarity that exists in the current Ethical Standard. It also potentially complicates the understanding of whether the provision of a specific non-audit service should be assessed, for Reporting Accountant independence purposes, at a Firmwide level or solely by reference to the subject matter being reported on.

Our view is that the proposed references to "***specific transaction, subject matter and subject matter information***" set out in paragraph I8 and sub-paragraph(c) thereof should be referenced in a discrete provision designed to specifically address the application of the rules concerning the assessment of the provision of other non-audit services when conducting an ICRE. This would make it clear how the provisions should be applied and that the "***specific transaction, subject matter and subject matter information***" principle is overarching.

Another notable omission from the proposed new Ethical Standard is the acknowledgment that there may be circumstances where an audit firm is invited to act as Reporting Accountant in situations where it may have had limited time to make an assessment of its independence - as set out in paragraphs 1.39 and 1.40 of the current Ethical Standard. The removal of this key language is unhelpful and could result in confusion for Audit Committees who may feel uncomfortable with standards which are different to those applicable to the acceptance of an engagement to become statutory auditor. We believe that it is essential for the effective operation of the UK's capital market regime that companies retain as much choice as practicable as regards the provider of ICRE services and thus the substance of paragraphs 1.39 and 1.40 needs to be reinstated.

In connection with ICREs, the definitions of 'audit related services' and other services 'for which the auditor is an appropriate provider' are of significant importance. The former is defined in paragraph 5.36 of the revised Ethical Standard with the latter in paragraph 5.39. However, paragraph 5.40, which describes the proposed permitted services for PIE audits, uses slightly different language, which is confusing. We believe that ensuring that companies and their nominated Reporting Accountants have a clear understanding of the requirements of the proposed Ethical Standard is of particular importance to the efficient

operation of the UK's capital markets. Therefore, paragraph 5.40 should be clarified in order to confirm that the services provided as part of a Reporting Accountant engagement (including both public and private reporting) would continue to be permissible for PIE audits, subject to appropriate safeguards being in place and meeting the objective, reasonable and informed third party test. This clarification should also include the deletion of the word "UK" in the references to services required by law or regulation, and clarifying the application of the non-audit services fee cap to such services.

3.6 Approach to different categories of audit

We believe that there is an inherent inconsistency in the application of the "white list" in connection with specific types of audits. We note that paragraph 5.40 specifically allows audit firms to provide "***reporting to a regulator on client assets***" such as CASS audits. These engagements are, in effect, operational audits which are unrelated to the audit of the financial statements; however, similar operational audits (e.g. ISAE3402 controls reports over services organisations) do not appear to be included on the "white list".

This apparent inconsistency is particularly stark for industries such as asset management where many components of their business processes, and therefore their financial controls, are in effect performed by third parties. The inability for the audit firm to provide this type of comfort, but be able to provide similar comfort in respect of CASS, is confusing and illogical. As such we believe the "white list" needs to be clarified to confirm that assurance work done under standards such as ISAE3402 would continue to be permissible for PIE audits.

3.7 Internal Audit Services

We note that the Exposure Draft contains a number of proposed changes to internal audit services.

Notably, there is a proposal in Appendix B which seeks to amend the 12 month cooling in provision which has historically been restricted to non-audit engagements involving the design and implementation of financial information systems and associated financial controls / risk management procedures, to also apply to "***services related to the audited entity's internal audit function".***

This change extends the position prescribed by the EU Audit Directive[6] in connection with such services and, therefore, in our opinion appears to be in direct opposition to the position

[6] EU Audit Regulation 537/14; EU Audit Directive 2014/56

taken by BIS (now BEIS) at the time of the UK's implementation of the EU audit legislation[7] and the revisions to the Ethical Standard in 2016, which was to ensure that there was no "gold-plating" of EU rules by the FRC.

The proposed change also appears to be at odds with the CMA's desire to increase choice for companies by restricting choice for internal audit suppliers and/or creating restrictions on the number of firms who would be able to participate in an audit tender where the audited entity co-sources internal audit services from an audit firm. We are of the view that the existing prohibitions within the existing Ethical Standard are sufficient to address the key independence issues related to the provision of internal audit services to EU PIE companies that we audit. The inclusion of a cooling-off period without a clear rationale is, in our view, unnecessary and would again result in the UK being out of step with its European counterparts at a time when the third country equivalence with the EU is the stated long term aim of the FRC.

We also note that paragraph 5.44 of the Exposure Draft seeks to extend the restrictions on providing Internal Audit Services to all audited entities, irrespective of whether they are PIEs or the lack of reliance that will be placed on the output of this work by the audit team.

Again, no rationale has been provided in the consultation documents for the extension of the prohibitions mentioned above, but given its extended impact, we believe that it would be appropriate for the FRC to set out either in the Glossary of Terms or in additional clarificatory language what is intended to be covered by "***internal audit services"***. This will avoid unnecessary ambiguity in connection with other non-audit services which may share certain investigatory characteristics with internal audit style engagements, but which are not controlled, shaped or commissioned by the internal audit function.

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

Whilst we do not believe that the introduction of a "white list" will assist in improving audit quality in the UK, it may potentially help to address the perception of conflicts of interest associated with the provision of non-audit services by the statutory auditor.

The permitted "white list" of services is broadly consistent with the position which PwC has voluntarily adopted for FTSE350 companies which we audit and their related entities. However, we have significant concerns regarding the manner in which it has been drafted in the Exposure Draft as set out below.

[7] ibid

4.1 Application of "white list" to PIE parent undertakings both in and outside the UK

As currently drafted, paragraph 5.40 of the Exposure Draft extends the application of the "white list" to PIEs and their "parent undertakings", which we understand to include all parent undertakings whether registered or incorporated within the UK or elsewhere.

This apparent extension of the "white list" to parent undertakings outside the UK is in contradiction to the amendments made by The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019[8] which restrict the impact of the Ethical Standard to UK parent companies only.

4.2 Potential contradiction with regulations in other countries

As we set out in our covering letter, this extra-territorial effect would make the application of the proposed Ethical Standard extremely challenging for multinational entities; not only would this require overseas parent entities to comply fully with UK regulations for the first time but in many instances the UK requirements would contradict those that currently exist in other countries, leading to unnecessary confusion for multinational entities.

4.3 Narrowly drafted "white list"

We are also concerned that the range of permissible services set out in paragraph 5.40 is too narrowly drafted and fails to allow flexibility either to implement recommendations from other on-going audit market reviews or, more importantly, to accommodate the potentially changing demands and expectations which stakeholders may have of audit and audit firms in the future (see our response to Question 3 above). As a result, we would strongly advocate that the "white list" include the ability for firms to be able to provide "***Independent assurance (with or without an opinion) provided it is probable that an objective, reasonable and informed third party would conclude that the service would not compromise independence and the audit committee has approved such a service.***"

For the purposes above, independent assurance should include any services in connection with a formal assurance standard, for example, ISAE 3000/3402 or SOC 1/2 which require independence and objectivity akin to that required in a financial statements audit, irrespective of their connection to the Annual Report.

[8] The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019: http://www.legislation.gov.uk/uksi/2019/177/contents/made

4.4 Impact of proposed new definition of "Other entities of Public Interest" (OEPI)

The issues mentioned above are compounded by the proposed introduction of the concept of OEPI. These entities, which we note are not clearly defined in the Exposure Draft, would be subject to the stringent requirements applied to PIEs, including the full scope of the "white list", and its extra-territorial effect. Given the suggested implementation timetable, we do not believe that there would be sufficient time for those private entities subject to this enhanced requirement for the first time, to evaluate its impact properly, and to make appropriate changes in a sensible and orderly manner.

4.5 Determination of which entities will be considered OEPIs

The OEPI definition proposed leaves the identification of entities to be considered as OEPIs at the sole discretion of the FRC and, in theory at least, a company could therefore become an OEPI at any time. This is neither reasonable nor practical. Companies need absolute clarity on whether or not they will be subject to the OPEI restrictions to be able to plan accordingly. In addition, given the impact of this new definition, any future changes must, in our view, be subject to broad stakeholder consultation rather than simple unilateral decision by the FRC.

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 do not agree with the proposed introduction of the new concept of "***Other entities of public interest***" (OEPI) as set out in the Glossary and have a number of concerns with the proposed extension of the "white list" to private companies which may be considered to fall within the OEPI definition. We have listed these concerns below.

5.1 Disproportionate to extend PIE provisions to non-PIE entities

We note that one of the FRC's key justifications for the extension of prohibitions to these entities is to learn from recent enforcement cases such as BHS. Whilst we are supportive of ensuring that lessons from previous cases are learned, we note that very few, if any, of the recent failures or consequent enforcement actions (including BHS) have centred around the provision of non-audit services. As such, the FRC's rationale for extending these more stringent prohibitions to certain private entities classified as OEPIs is, in our view, not proportionate or justified.

5.2 Extension of PIE definition

The application of the more stringent PIE "white list" prohibitions to other entities is, in effect, an extension of the PIE definition. We note that when the Ethical Standard was revised in 2016, BIS (now BEIS) was clear that the Standard should not include any extension of the PIE definition beyond that which was mandated by the EU Audit Directive 2006. This position has been reinforced by BEIS as part of its consultation on the recommendations from the Kingman review, which acknowledged that there may be a need to reconsider the UK PIE definition, but indicated that this would require further public consultation followed by primary legislation to bring any amendment into effect. We therefore believe that a unilateral change in the PIE definition by the FRC, without a clear mandate from Government, is not appropriate.

5.3 Implementation challenges

The current lack of certainty around which entities could, or should, be included in any new OEPI definition creates a number of significant implementation challenges. The definition proposed in the Exposure Draft leaves the identification of OEPIs solely in the purview of the FRC with no regulatory or stakeholder scrutiny of proposed changes. This, in theory at least, could result in an entity becoming an OEPI at any time which is not reasonable or practical. We suggest that the OEPI definition is amended to provide clarity on this key issue and that any subsequent changes to the definition are subject to appropriate consultation with stakeholders.

These issues, when taken with the desire by the FRC to implement these provisions for entities with accounting periods beginning on or after 15 December 2019 would have a significant impact for private companies. Faced with the introduction of these additional prohibitions for the first time, these companies would have insufficient time to assimilate the rules and to make the necessary commercial decisions to ensure compliance with the proposed requirements before they become effective.

5.4 Extra-territorial effect of "white list" of permitted services

All of the issues mentioned above are compounded by the extra-territorial effect of the proposals set out in the Ethical Standard Exposure Draft paragraph 5.40 which include restrictions applying to parent undertakings of the audited entity irrespective of jurisdiction. This additional complexity, coming at a time of increasing economic and political uncertainty in the UK, ultimately risks limiting the attractiveness of the UK as a place for international

companies to have operations. It may also result in the UK being an outlier in terms of regulation compared with both the EU and other international counterparts and further limit choice and competition in the UK, something that was raised as a key concern in the recent Competition and Markets Authority market study.

5.5 Restrictions on certain non-audit services to all entities, irrespective of public interest

In addition to the prohibitions applying to OEPIs, we also note that the Exposure Draft includes additional restrictions on the provision of certain non-audit services, such as Internal Audit, to all audit entities, irrespective of public interest. It would be helpful to understand the rationale for the specific changes.

Question 6: Do you agree with the removal of the reliefs for SME's in Section 5 of the Standard, and the retention of reliefs for "small" entities (in Section 6 of the Standard)?

In our opinion, the provisions in the existing Ethical Standard are proportionate to the risks associated with these types of entities and, as such, we do not believe there is a specific need for the changes being proposed.

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

The FRC's guidance on the operation of the derogation in the UK was set out in the FRC Technical Advisory Group Rolling Record dated 3 May 2017. This guidance was clear that the ***"… circumstances where the derogation can be applied are likely to be limited, as most tax and valuation services covered in paragraphs 5.167R (a)(i), (a)(iv-vii) and (f) will have a direct impact on the financial statements"***. The proposed change in the Exposure Draft is, therefore, a simplification of the rules rather than a fundamental change and, as such, the clarity provided is welcomed.

Question 8: Do you agree with the changes we have made to the Audit Regulation and Directive references within the ISAs (UK)?

We agree with the changes made to the EU Audit Regulation and Directive references in the ISAs (UK), on the assumption that the UK has exited from the European Union at the date of implementation of the standards. Depending on the progress and eventual outcome of the Brexit process, we note that further amendments may ultimately be required.

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

We support the inclusion of material from previously issued staff guidance notes as application material. It is helpful to consolidate such guidance into the standards, rather than having different sources of guidance.

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.

We agree with the majority of the changes proposed to ISAs (UK) 250A and 250B, which provide some greater clarity on the auditor's responsibilities in relation to non-compliance with laws and regulations, and improved guidance on reporting to regulators. However, we have two areas of concern:

Firstly, paragraph 13-1 introduces a requirement that "..***...the auditor shall consider whether there are any indications of non-compliance with laws and regulations***." We believe that it is important that the standard makes it clear that this requirement applies in relation to those laws and regulations that are within the scope of ISA (UK) 250A, i.e. those that have a direct effect, or may have a material effect on the financial statements, rather than in relation to all laws and regulations.

Secondly, in relation to the proposed extended requirement in ISA (UK) 700 for reporting on the extent to which the audit is capable of detecting irregularities to all audits, we believe that greater thought is required on what this requirement is seeking to achieve. Any audit is, to some extent, capable of detecting irregularities, but experience has shown that it can be difficult to describe this in an audit report without appearing to use boilerplate descriptions, particularly for entities in the same industry. We do not believe that this proposal would provide any significant increase in transparency in audit reports, particularly for audits of, for example, less complex entities and wholly-owned subsidiaries. Consequently, we do not see the benefit of extending this requirement.

Notwithstanding these points, it is important to note that, as part of the review into the quality and effectiveness of audit, Sir Donald Brydon is expressly considering what role auditors should play in determining whether the directors are complying with relevant laws and regulations and also whether auditors should be doing more around the risks of fraud. As we highlight in our covering letter, there needs to be effective coordination of the output of all the

different reviews and, as such, it does not make sense to make incremental changes to audit reporting in these areas until we know how Sir Donald Brydon's review will conclude.

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

Although, generally, we support increased transparency in audit reporting, we do not agree with the proposed additional auditor reporting requirements at this time.

We expect that the Brydon review will result in recommendations for improvements in auditor reporting, and Sir John Kingman has recommended a form of "graduated findings". We do not therefore, believe that the FRC should introduce changes, such as the additional reference to "***including significant judgments***" at this stage. Instead, we suggest that it would be preferable to wait for more comprehensive reforms to be made which take into account the conclusions and recommendations of both the Kingman and Brydon reviews.

We do not support the requirement to disclose performance materiality in extended audit reports. In our experience, the application of materiality is not well understood by many users of financial statements, and the inclusion of an additional materiality level could result in confusion as to how materiality is applied, rather than providing greater clarity. The FRC feedback statement notes that the specification of performance materiality "***shows the auditor's assessment as to the effectiveness of internal control in the entity***". Whilst many auditors will take into account their evaluation of internal control in determining performance materiality, there is significant judgement involved in determining performance materiality, and other factors will be taken into account. Therefore, in our opinion it could be misleading if users are led to equate the auditor's determination of performance materiality with their assessment of the effectiveness of the entity's internal controls.

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 acknowledge that the FRC's recent thematic review identified inconsistencies in how firms currently undertake work on the "other information" in the annual report. However, we do not believe that it is appropriate at this stage to attempt to clarify ISA (UK) 720, as this is an area which is likely to be subject to change as a result of the Brydon review. It would, in

our view, be preferable to wait until after the Brydon report is published to ensure that a more thorough and measured revision to the standard can be undertaken.

In relation to the proposed changes, we believe that there is still a lack of clarity in some areas of the standard. In particular, paragraph 22-4 combines Listing Rule requirements and ISA (UK) requirements. This fails to recognise that not all companies that apply the UK Corporate Governance Code (the Code) are subject to the Listing Rules (including those AIM companies that have chosen to adopt the Code in reporting on corporate governance following the change to the AIM Rules). The standard should establish the ISA (UK) requirements first, and then address how those requirements relate to the separate requirements of the Listing Rules, rather than combining the two.

We have no particular concerns with the additional application material relating to the work effort for auditors to obtain appropriate evidence to support statements made by management which the auditor is required by the Listing Rules to review (proposed new paragraph A53-12). However, as noted above, we question the value of making limited updates of this nature at this time.

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?

We do not have any objection to the proposed effective date for the changes to the Auditing Standards provided that the final standards are issued before the end of the year to allow time for necessary changes to be made to our internal guidance and training programmes.

However, we do not support the effective date for the proposed revisions to the Ethical Standard and suggest that any revisions are deferred. There is also a need for transitional provisions to be included in any revised Ethical Standard. We have set out further detail below.

13.1 ***Effective date at a time of business uncertainty***

The effective date proposed by the FRC appears to have been set arbitrarily and does not, in our opinion, provide sufficient time for companies, Audit Committees and broader stakeholders to assimilate the changes and make any necessary business changes in an orderly way. At a time of unprecedented business uncertainty, when companies are focusing their attention on the implications of the UK leaving the EU, it is not appropriate, in our view, to introduce significant changes to the Ethical Standard.

13.2 Coordination with other reviews of the market

Whilst the FRC's consultation document notes explicitly that the Ethical Standard Exposure Draft ***"should not seek to anticipate either Ministers' consideration of the independent reviews [of the UK audit market] and subsequent public consultations"*** the proposed implementation date would effectively do just that. Early implementation of the revised Ethical Standard would not account for, nor allow, effective coordination with the output of the other ongoing reviews, including most notably the review by Sir Donald Brydon which is not likely to report until the end of the year. To act unilaterally in advance of the Brydon report could, in our opinion, be detrimental to the competitiveness of the UK audit market.

We therefore suggest that the proposed revisions to the Ethical Standard are deferred until at least the conclusion of the other ongoing reviews. Only by doing this, and taking account of the final recommendations from these reviews, will the overall framework of audit market regulation in the UK be comprehensive and cohesive.

13.3 A need for transitional provisions

The Ethical Standard Exposure Draft does not include any transitional provisions. Therefore, if implemented as proposed, companies would not have an appropriate opportunity to either fully understand the extent of the new requirements and/or transition existing / committed engagements rendered impermissible under the proposed "white list" to new providers. The impact of this on UK businesses is unnecessary and does not improve audit quality or, in our view, minimise any latent concerns regarding audit independence. We suggest that appropriate transitional provisions are included in the eventual publication / implementation schedule for a revised Ethical Standard to ensure that these issues are fully addressed.