

26 September 2019

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For the attention of James Ferris
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Dear Mr Ferris

Post Implementation Review – 2016 Ethical and Auditing Standards – consultation on proposed changes to Ethical and Auditing Standards

We are pleased to respond to your consultation on proposed changes to Ethical and Auditing Standards, following the post implementation review of the 2016 standards. We have responded to the specific questions posed in the consultation in turn below, but also have some overall observations.

We expressed our concerns in our response to the post implementation review that the 2016 Ethical Standard was difficult to interpret with the drafting often being confusing, leading to a lack of clarity in some cases about what the Standard was trying to say. Whilst we believe that to some extent the revisions to the Standard have addressed this point, there are still a number of areas where the requirements are not clear and where we have concerns about how the Standard either should be interpreted, or will be interpreted in practice, both by firms and by ARGA when it ultimately replaces the FRC. We are particularly concerned about the changes to the prohibitions in respect of taking a management role and those for providing accounting (and specifically book-keeping) services and have explained our concerns in our detailed responses.

We are particularly concerned about the very short time frame for implementation of the revised requirements, given that the proposed effective date is for accounting periods beginning on or after 15 December 2019. Given that the consultation period closes on 27 September 2019 and the FRC will then need to consider the responses, make any necessary changes to the draft and issue the final Standard, this does not leave very much time for either audit firms or audited entities to get to grips with the new requirements and make the necessary changes to policies and procedures. Some of the changes – particularly in the event of a strict interpretation of the requirements – will lead to audit firms having to make significant changes to the way that they operate their businesses and this is not something that can be achieved overnight.

Moore Kingston Smith LLP
Chartered Accountants and Business Advisers
Devonshire House, 60 Goswell Road, London EC1M 7AD
020 7566 4000 www.mooreks.co.uk

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Registered office: Devonshire House, 60 Goswell Road, London EC1M 7AD

In addition, given that the requirements may well need to change again following the conclusion of the various different reviews of the audit market, we would propose an effective date for the changes of no earlier than accounting periods beginning on or after 15 January 2020. In order to meet the proposed December 2019 effective date firms will essentially be required to make changes to their policies, procedures and strategy before the final standard is even released, with the prospect of having to then make further changes in the event any of the requirements in the final revised Standard differ from those in the draft.

We would also observe that a number of the new requirements in the revised Standard are not being consulted on at all. For instance, we are concerned about the new requirement for firms to report all breaches to the FRC, as competent authority, on a quarterly basis. We would presume that this only applies to firms that are regulated directly by the FRC, i.e. those that undertake PIE audits; to extend it to all firms would be entirely disproportionate.

We are also concerned about the requirement for the Standard to be applied across the board to the audits of all groups, including components located outside the UK, in preference to the IESBA code and regardless of the ethical requirements in the relevant overseas jurisdictions. We believe this is completely disproportionate and will be extremely difficult if not impossible to enforce in practice. Applying the IESBA code should be sufficient.

Finally, as noted in our response to the post implementation review, we still believe that the FRC/ARGA, together with the professional bodies, need to educate both practitioners and other stakeholders (not just institutional investors) in what they believe a good audit looks like. Guidance needs to be provided on how to ensure a complex audit goes right, rather than the FRC/ARGA simply taking punitive action when something has gone very wrong. In short, the FRC/ARGA needs to be an improvement regulator not simply an enforcement regulator if the quality of audit is truly to improve as the FRC wishes it to.

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 do not have any objection to the revised definition which makes it clear that the spirit, as well as the letter, of the standard should be adhered to. It is also helpful that the guidance clarifies the decision should be taken based on information available at the time of the assessment, rather than with the use of hindsight (i.e. when something has gone wrong).

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 have no objection to the proposed measures to enhance the authority of ethics partners and we believe that they will help to emphasise the importance of the ethics partner, and the ethics function, both within audit firms and to audited entities.

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

We agree that the revised standard appears to be easier to interpret, which should therefore help deliver a higher standard of compliance, although we still believe that the standard should have been redrafted in the same way as the Clarified ISAs to further improve its understandability. We also agree with the removal of the detailed requirements relating to Investment Circular Reporting Engagements from the various sections of the Standard.

However, there are a number of areas of the revised Standard where it is still unclear what the standard is really trying to say. For instance, the prohibitions in respect of taking a management role now refer to the audit firm being prohibited from 'playing any part in management decision making'. It is not at all clear what 'playing any part in management decision making' actually means and our concern is that it could be interpreted in a very restrictive way, not least by ARGA once it takes over from the FRC as the main regulator to the profession. Indeed it could be read as prohibiting almost any sort of strategic or general business advice to an audited entity and whilst this is not our interpretation of the new requirement, we therefore think that further clarification is required.

Similarly, in paragraph 4.2 there is a new requirement to disclose a consistent shortfall between fees and costs, and safeguards applied, to those charged with governance of the audited entity. We presume that in this context 'cost' refers to charge out rates and other expenses such as disbursements rather than actual salary costs, but as currently drafted it could be read both ways. If it does refer to charge out rates it would also be easy for firms to circumvent the letter, if not the spirit, of the requirements simply by reducing charge out rates for a specific assignment. We are not disagreeing with the new requirement, which will help to discourage practices such as 'low balling', but do think clarification is needed.

Finally, it is not clear in paragraph 5.122 what 'requiring little or no professional judgement' means in the context of providing accounting (and specifically book-keeping) services to an audited entity. We are concerned that this could be interpreted in a very restrictive way which would have a significant impact on how many firms run their businesses, given that outsourcing is very much a growth area at the moment. More clarity is therefore needed.

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

We have some concerns with the introduction of a permitted list of services rather than a list of prohibitions. Firstly, we are not aware of significant issues having arisen in practice as a result of the 2016 Standard being drafted based on prohibitions. Secondly, a list of permitted services will need to be updated regularly – the types of services that an audit firm may provide both to entities that it audits and those that it does not audit are constantly evolving and we are concerned that a 'white list' may act as a disincentive for firms to innovate. In order to avoid stifling innovation we believe the FRC needs to implement a pre-clearance procedure for approval of new services which could be provided to a PIE which could then be added to the white list.

We do acknowledge that the introduction of a permitted list of services should make it clearer both to auditors of PIEs and to the PIEs themselves what services are or are not permitted, therefore making it less likely that inadvertent breaches will arise.

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?

In our view it would be more logical, given that there is to be consultation on a revised definition of PIE, for any decision on whether to extend PIE prohibitions more widely to be deferred until that consultation is complete.

Which entities are captured by the revised definition of PIE clearly is yet to be determined but should be based on capturing those entities that genuinely pose a systemic risk in the event of a collapse, for instance very large private companies. We do not believe that the prohibitions should be extended to listed companies that pose no significant systemic risk, for instance small market capitalisation AIM and NEX companies.

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 do not agree with the removal of the reliefs for SME listed non-PIEs as these were a proportionate solution for those companies which also, in our experience, helped to improve the quality of their financial reporting. We are aware that the reliefs were not able to be taken when the auditor was a member of the Forum of Firms but there are plenty of audit firms which are not members. Removing the reliefs because some firms cannot take advantage of them seems to be somewhat unfair to those firms that can. If the FRC believes that the reliefs are no longer appropriate in the current audit climate then it should say so rather than basing the removal on the fact that some firms were precluded from using them.

We agree with the retention of the reliefs for small entities – whilst we do not think these are widely used in practice, this does not mean that they should not be retained for those companies and audit firms that do wish to use 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 an inconsequential effect on the financial statements?

No, we believe that the reliefs should be maintained. As noted in our response to the post implementation review, we do not see any benefit to removing the derogation and do not believe it has created significant issues in practice in respect of maintaining independence.

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

We do not have any objection to the changes made to the ARD cross references.

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

We are concerned that this may set a precedent of staff guidance material becoming standard setting by default, whether included in the application material or not. If the standard needs to be amended in future then it should be changed rather than issuing additional requirements via guidance material or the guidance material becoming additional standards by the 'back door'.

10. Do you agree with the changes we have made to ISAs (UK) 700, 250A and 250B, 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 do not agree with the requirement for the auditors of all entities to report on the extent to which the audit is capable of detecting irregularities, including fraud (which we presume includes fraudulent financial reporting as well as misappropriation of assets). As with the proposal for a tailored conclusion on going concern to be included in all audit reports, on which we have commented separately, we believe this is disproportionate for the audits of owner-managed businesses which make up a great deal of the UK economy and where there is little to no systemic risk; it will add to the costs for the audited entity for little real benefit and in our opinion will simply lead to the use of boiler-plate text in the audit report rather than the tailored analysis we presume the FRC is expecting.

Moreover we believe that the level of understanding by stakeholders in owner-managed businesses of what constitutes fraud (particularly financial reporting fraud) and what the auditor is required to do in respect of fraud, is generally not sufficient and therefore this requirement will simply lead to an increased expectation gap and the perception that the auditor should be able to identify all frauds affecting the entity, however immaterial.

In our view this requirement (and the proposals for the audit report in respect of going concern) should be limited to PIEs, listed companies and those companies that the FRC or its replacement designate as 'other public interest entities'.

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?

We do not have any objection to the proposed additional reporting requirements, provided that these are restricted to listed entities and not extended to all audits.

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 do not have any objection to the proposed revisions.

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 agree with an effective date of accounting periods beginning on or after 15 December 2019. As noted in our introductory remarks, some of the proposed changes to the Ethical Standard potentially have significant implications for accountancy firms including the possible need for strategic changes in how their businesses are run. Such changes may disproportionately impact medium size and smaller firms who do not have the same level of resources, either strategic or technical, as the larger firms. Given that the consultation period does not end until September 2019, and the FRC will then need to consider the consultation responses, it is highly likely that the final standard will not be issued until shortly before, or even after, the first accounting periods affected by the standard have begun. This is simply not enough time for major strategic changes to be implemented.

Even the changes to auditing standards, whilst having less of an impact, will still require training and guidance to be provided so that both audit firms and audited entities understand the impact of the changes.

Finally, given the fundamental reviews of the audit market which are currently in progress it is highly likely that further changes will need to be made in due course and it would be more effective – and lessen the burden both on audit firms and audited entities – if significant changes were being made in one go rather than being 'drip fed'.

As a result of these factors, we would propose an effective date for the revised standards of no earlier than accounting periods beginning on or after 15 January 2020.

We hope our comments are useful to you. If you have any questions, then please contact either Martin Muirhead (Senior Partner) Moira Hindson (Ethics Partner) or Tessa Park (Technical Partner).

Yours faithfully

Moore Kingston Smith LLP