



Financial Reporting Council Consultation

FEEDBACK STATEMENT AND
IMPACT ASSESSMENT

Post Implementation Review of the
2016 Auditing and Ethical Standards

RESPONSE FROM ICAS TO THE FRC

27 September 2019

Background

ICAS is a professional body for more than 22,000 world class businessmen and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

ICAS welcomes the opportunity to respond to the Financial Reporting Council's (FRC) Feedback Statement and Impact Assessment: Post Implementation Review of the 2016 Auditing and Ethical Standards.

Timing – the way ahead

We question whether now is the best time to introduce further changes to International Standards on Auditing (ISAs) (UK) and to the FRC's Ethical Standard. A key feature of our responses to the various reviews has been the need to ensure that they are all appropriately coordinated to reduce the risk of any unintended consequences. We therefore believe that there is merit in the FRC waiting until the Brydon review has concluded to better determine what changes, if any, are required to its respective standards. This would allow for a more holistic revision of the ISAs (UK) and ethical standards to be undertaken following the recommendations from the Brydon review. The current consultation process and proposed subsequent implementation of the finalised revisions appears rather rushed, given the potential impact of some of the proposals.

Simplifying the FRC's Ethical Standard / e-Standards

Whilst we welcome the simplification exercise which has been undertaken, we believe that a full detailed review is required. We also remain of the view that there would be merit in the FRC creating true e-versions of its standards, which should contain hyperlinks to definitions, related standards and guidance etc. This would add to the user's experience and help to digitalise the FRC outputs.

Non-assurance services

In our response to various recent consultations we have set out our preference for introducing a prohibition on auditors providing non-audit services to their FTSE 350 audit clients (subject to them being able to provide a small permitted list of services to such clients). We still believe that this is the most appropriate scope for such a prohibition. Additionally, we believe that greater clarity is required as to what services would be included on the permissible list to ensure that there is greater transparency in relation to what non-audit services are specifically allowed to be provided.

Impact Assessment

Whilst we appreciate the difficulties in preparing an impact assessment, we have to question whether the potential costs of the proposed revisions fully take into account the cost to business as opposed to just the audit firms. We would also question some of the assumptions used in determining the anticipated costs for audit firms e.g. estimating just 2 hours of continuing professional development to understand the breadth of the changes appears rather optimistic.

Definition of a Public Interest Entity

The report by Sir John Kingman on his review of the FRC recommended that the Government should review the UK's definition of a Public Interest Entity (PIE). Additionally, we are aware that this is a very topical matter across the globe. The International Ethics Standards Board for Accountants (IESBA) has just established a working group to consider this topic and the International Auditing and Assurance Standards Board posed questions on this subject matter in a recent consultation paper. In light of the above, we believe it is essential that a much fuller debate is held on what constitutes a PIE and indeed, on what constitutes an "other entity of public interest (OEPI)".

Specific 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?

Response to Question 1:

We believe that the objective reasonable informed third party (ORITP) is not a constant but rather a concept by which consideration needs to be given to the specific circumstances to determine against which mindset the applicable ORITP provisions need to be considered. Whilst we welcome certain aspects of the proposed definition e.g. "diversity of thought" and "...not hindsight", we question whether it is too narrow in its focus. The perspective through which a scenario is to be assessed would very much depend on the specific circumstances. Whilst in some scenarios this may well be one of the parties stated, in others it might be that of another practitioner. We would also highlight that in certain circumstances it could be argued that a shareholder or potential investor in the audited entity may not be objective due to the self-interest threat that will apply. There is a need to steer clear of supporting a notion that it needs to be a specific group of people with a particular group of skills.

We do believe there would be merit in drawing from the IESBA definition of a reasonable and informed third party e.g. "...Such consideration is made from the perspective of a reasonable and informed third party, who weighs **all the relevant facts and circumstances** that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made." This in our view is clearer regarding the matters that should be considered by the person concerned.

The objective, reasonable and informed third party is, as one would expect, referred to at various places in the ethical standard. We believe that it would be helpful to the user for this term to be defined in the glossary.

We would also draw your attention to the guidance issued by ICAS on 'Conflict of Interest'¹ earlier this year. ICAS believes that greater emphasis needs to be placed on ethical and public interest aspects, such that the question becomes whether the firm or member "should" undertake an engagement which involves a conflict of interest as opposed to "could". Appropriate application of this guidance in our view would remove much of the perception issues that have arisen.

¹ ICAS Guidance on Conflict of Interest (2019), <https://www.icas.com/ethics/ethics-and-the-power-of-one/new-guidance-on-conflict-of-interest-best-practice-for-firms>

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?

Response to Question 2:

We are supportive of this approach. We welcome the inclusion of the proposed additional content in paragraph 1.15 which we believe provides increased gravitas to the role of an Ethics Partner.

“1.15 If differences of opinion arise between the Ethics Partner and persons consulting them, the firm’s policies and procedures for dealing with and resolving differences of opinion shall be followed. **If in following those procedures, the firm concludes that the opinion of the Ethics Partner is not to be followed where it relates to an engagement on a public interest entity, the matter shall be reported to the firm’s independent nonexecutives and to the Competent Authority. The engagement partner shall also report this matter to those charged with governance.**”

We would however highlight that another reason for delaying the FRC's proposals is that these could then take account of any changes that may be made to the governance of the audit firms by the Government following its assessment of the Competition and Markets Authority's proposals.

Question 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?

Response to Question 3:

We welcome the efforts that have been made to restructure and simplify the Ethical Standard. We do believe that this has helped to improve the clarity of the requirements in some regards. However, we believe that ultimately a full and comprehensive rewrite is necessary. This should, however, be deferred until completion of the Brydon review to allow a holistic and comprehensive revision to take place. We also believe that given the ever-increasing digitalisation of business and society, consideration should be given to putting the FRC pronouncements on to a proper e-platform. Such a move would help facilitate easier use by users.

We would also welcome the reintroduction of a separate standard to cover the ethical requirements for practitioners undertaking Investment Circular Reporting Engagements (ICREs). Whilst we appreciate the proposed revised ethical standard now appears easier for auditors to read and understand, for those performing ICREs we are not convinced that this is the case.

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

Response to Questions 4:

In our response to various recent consultations we have set out our preference for introducing a prohibition on auditors providing non-audit services to their FTSE 350 audit clients (subject to them being able to provide a small permitted list of services to such clients). Whilst supportive of a “permitted list” approach, we believe that greater clarity is required as to what services would be included on the permissible list to ensure that there is greater transparency in relation to what non-audit services are specifically allowed to be provided.

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?

Response to Question 5:

Whilst in principle we are not opposed to considering whether the scope of such prohibitions should be extended to a wider group of entities we believe that such a matter should be dealt with in a separate consultation. Such a consultation should ensure that there is complete transparency with regards to all the changes which are being proposed and their potential impact. We would again emphasise that we believe such considerations should be deferred until the completion of the Brydon review. Where changes are being extended to a wider group of entities it is essential to ensure that the full impact of such changes is fully considered. We are not convinced that this objective has been achieved in this consultation.

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)?

Response to Question 6:

Reliefs for SMEs in Section 5 of the FRC ES

We believe that further work is required of the FRC to establish how widely these reliefs are used and the impact of their removal. A proper analysis of their use is required before a decision should be made. If, following that review such reliefs for “SME Listed” category entities are not found to be widely used, then we would be supportive of their removal.

Reliefs for ‘small’ entities in Section 6 of the FRC ES

We are supportive of retaining the reliefs for small entities in Section 6 of the Standard.

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?

Response to Question 7:

As we have stated previously, we believe that the scope of this derogation is limited and relies on the application of judgement, therefore, in order to address any perceived independence issues, it may be more appropriate to remove it entirely from the Ethical Standard.

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

Response to Question 8:

We agree with the proposed changes to the Audit Regulation and Directive references within the ISAs (UK).

We would, however, highlight that the ongoing uncertainty with regards to when the UK will exit the EU may have an impact on when any such changes should become applicable.

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?

Response to Question 9:

In principle, we agree that the inclusion of the FRC staff guidance within the body of the standards helps to clarify certain of the requirements and is therefore beneficial to the user. However, we do accept that there is a danger that doing so gives the impression that the staff guidance carries the same authority as the actual standards which is not the case. On balance, as we believe including such guidance makes the standards easier to use, we are supportive of this approach.

We do believe, however, that a more interactive digital solution could be provided whereby the relevant sections in the standards are linked to the appropriate staff guidance where further information and guidance is located. A similar approach is being adopted by the IESBA as it continues its development of its e-Code.

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?

Response to Question 10:

We are concerned about the proposed extension of the requirement for auditors to report on the extent to which their audits are capable of detecting irregularities, including fraud, which their audits are capable of detecting irregularities, including fraud. The proposals would extend this requirement to all audits. We are not convinced about the value of the inclusion of such a statement for all audits. In practice, this would likely take the form of a generic statement and, as a result, boilerplate commentary, providing little, if any, value or purpose to users. Nor do we believe that this proposal is representative of a scalable approach to the ISAs (UK).

Furthermore, at a time when the future scope of audit is being considered as part of the Brydon review, we do not consider that now is an appropriate time to incorporate additional narrative disclosures within the auditor's report. We believe that it would be sensible to wait for the recommendations emerging from the Brydon review which may suggest further amendments and revisions to the auditor's report, for example graduated audit findings.

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?

Response to Question 11:

Significant judgements in respect of Key Audit Matters

We agree that additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit matters, will be useful and help drive greater consistency and transparency in the market. However, we are not convinced that selective revisions should be made at present to the ISAs (UK) before the completion of the Brydon review as per our comments below.

Increased disclosure of performance materiality

We are not convinced about the proposal for increased disclosure around materiality, specifically the reference to performance materiality.

Materiality itself is not well understood and we are unsure as to whether performance materiality can be clearly and succinctly articulated to be easily understood. It relies upon a significant amount of judgement, which may not be capable of being explained in a succinct manner, thereby resulting in a disproportionate increase in the length of the auditor's report. There is therefore the trade-off between ever longer audit reports and increased transparency. We believe that at present this is matter which should be left to the judgement of the auditor concerned.

In addition, the FRC consultation refers to the specification of performance materiality as demonstrating the internal auditor's assessment of the effectiveness of internal control in the entity. ISA (UK) 320, Materiality in performing and planning an audit, makes no reference to internal control in either the requirements or the application material. Instead, it states that the determination of materiality, including performance materiality, is a matter for professional judgement. We acknowledge that this determination may be influenced by a number of factors, including the entity's control environment, but we would caution against the FRC creating the misleading impression that it involves the auditor's assessment of the effectiveness of an entity's internal controls.

Furthermore, at a time when the future scope of audit is being considered as part of the Brydon review, we do not consider that now is an appropriate time to incorporate specific additional narrative disclosures within the auditor's report. We believe that it would be sensible to wait for the recommendations emerging from the Brydon review which may suggest further future amendments and revisions to the auditor's report, for example graduated audit findings.

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?

Response to Question 12:

With regard to the revisions made to ISA (UK) 720, including the enhanced material setting out expectations of the auditor's work effort in respect of other information, it is not clear whether the proposed revisions will address the weaknesses identified in the *FRC's Audit Quality Thematic Review: Other Information in the Annual Report*, specifically those related to the auditor's work effort and the inconsistency in the firms' procedures. The revisions appear to be focused on the issues of materiality and the reporting requirements in relation to other information as opposed to the actual procedures. Therefore, we question whether these amendments will be sufficient to deal effectively with the weaknesses highlighted by the FRC in the way that the standard is applied.

In addition, we note that the final sentence in paragraph A7-1 in the Application Material uses the phrase 'may consider' in relation to terms other than 'material' that should form part of the assessment of the materiality of other information. Examples of such terms given in the consultation document include 'key', or 'principal'. We are concerned that the choice of the term 'may consider' is insufficiently clear. Furthermore, we do not believe that it is necessary to include specific examples of terms other than material that might form part of the assessment of the materiality of the information. We believe that this assessment should be left to the auditor's professional judgement.

As a result, we would propose replacing the final two sentences of paragraph A7-1 with alternative wording as follows:

'The auditor shall exercise professional judgement when determining which of the other information would be considered material'.

Once again as stated previously, we do not consider that now is an appropriate time to incorporate additional narrative disclosures within the auditor's report. We believe that it would be sensible to wait for the recommendations emerging from the Brydon review which may suggest further amendments and revisions to the auditor's report, for example graduated audit findings.

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?

Response to Question 13:

As we have stated in some of our earlier responses to questions in the consultation, we question the rationale behind the FRC issuing such a consultation at a time when there are a number of other reviews underway into the audit market that might impact upon these proposals. We would suggest that it would be advisable for the FRC to wait until the Brydon review has concluded before proceeding with any of the proposed revisions to the ISAs (UK).

If the FRC decides to go ahead with its revisions then with regards to the proposed implementation date of audits of accounting periods commencing on or after 15 December 2019, we believe that this may be too short a timescale for all firms to have taken the necessary steps to ensure compliance. Given that the proposed changes will not be reflected in standards until the final quarter of the year, we believe that this is a very tight implementation period. We therefore believe that there would be merit in deferring the implementation period at least until at least the audit of periods commencing on or after 15 December 2020. Such an approach would also help to ease the transition for audit firms and businesses.



CA House 21 Haymarket Yards Edinburgh EH12 5BH
enquiries@icas.com +44 (0)131 347 0100 icas.com