ICAEW
REPRESENTATION 98/19

FEEDBACK STATEMENT AND IMPACT ASSESSMENT: POST IMPLEMENTATION REVIEW OF THE 2016 AUDITING AND ETHICAL STANDARDS

Issued 27 September 2019

ICAEW welcomes the opportunity to comment on the Feedback Statement and Impact Assessment: Post Implementation Review of the 2016 Auditing and Ethical Standards published by the Financial Reporting Council on 15 July 2019, a copy of which is available from this link.

These are not normal times for audit and we agree that there is a lack of public confidence in the audit of entities in the public eye that needs radical action to address. It is the overall outcome of the government co-ordinated programme looking at audit change, most significantly including the outputs from the Brydon review that will impact on public confidence. One set of amendments to standards in isolation affecting all audits, that may need amending again in short order causing further disruption, will not achieve this.

The curtailed consultation period and the short time frame for implementation has resulted in a rushed set of proposals, which have missed an opportunity to remove many confusing aspects of the existing Ethical Standard (ES) and make the FRC's standard class-leading. The proposals do not seem to be rooted in evidence and the impact analysis is fundamentally flawed, particularly in respect of the cost to business meaning that no attempt has been made to minimise it.

It would be most appropriate to make changes to the ES when indications are clearer as to the key outputs from the Brydon and BEIS reviews, to allow for a co-ordinated approach and a substantially improved set of standards that the future ARGA would be proud to adopt. The delay need not be for years: initial outputs are expected from the Brydon review by the end of the year and a delay of not more than twelve months should allow time for a co-ordinated approach, and the key issues with the ES to be worked through, resulting in a significantly better and more appropriate document.

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KEY POINTS

1. There is a lack of public confidence in the audit of entities in the public eye. We agree that change may be needed in a number of areas that the standards being consulted on seek to address, as well as the areas which the more wide-ranging Brydon review of audit and the BEIS review of the CMA proposals are considering. However, it is the overall effect of audit change resulting from these government co-ordinated reviews that will impact on public confidence not one set of amendments to standards in isolation.
2. In the meantime, as regards the FRC Ethical Standard (ES), we cannot agree with the introduction of the changes proposed in the FRC's Feedback Statement and Impact Assessment (the consultation) on the timetable envisaged:
    a. Many of the indicated changes to the ES (for example what would be a sensible definition of Audit Related Services) overlap with and pre-empt areas of audit being looked at by the Brydon and BEIS reviews;
    b. The timing has resulted in a rushed set of proposals, which have missed an opportunity to remove many confusing aspects of the existing ES and make the FRC's standard of a class-leading quality that the future ARGA would be proud to adopt;
    c. The curtailed consultation period and the short time frame for implementation will inevitably result in rushed planning and application by audit firms and inevitable short-term breaches, particularly in view of the proposed extension of the extraterritorial reach of the standard to non-network audit firms and international parents of UK PIEs;
    d. The impact analysis is fundamentally flawed. In particular the cost to business, at a time of uncertainty in the British economy, has not been considered meaning that no attempt has been made to minimise it;
    e. The prospective extension of the sweeping prohibition on public interest entity (PIE) audits to other entities of public interest is envisaged to occur before the FRC consults on what sort of entities would be included within the latter category. This will create significant and unnecessary uncertainty.
3. It would be most appropriate to make changes to the ES when indications are clearer as to the key outputs from the Brydon and BEIS reviews. This would allow a co-ordinated approach. The delay need not be for years: initial outputs are expected from the Brydon review by the end of the year and a delay of not more than twelve months should allow time for a co-ordinated approach, and the key issues with the ES to be worked through, resulting in a significantly better and more appropriate document.
4. The definition of PIE and potential expansion to some other entities of public interest (OEPIs) was raised by Sir John Kingman. A fuller debate is required on what entities would fall in and out of scope before the FRC proposes extending additional rules or prohibitions to these latter types of entity.
5. We believe that many of the proposals are poor examples of proportionate regulation. For example:
    f. The feedback in the consultation is somewhat sketchy, despite the paper's title, and it is not clear that the FRC has focused the proposed changes on the causes of audit failure. Our reading of published information from FRC findings is that they are usually poor application of standards, rather than a problem with the requirements themselves. Public concern notwithstanding, the justification for a number of increased prohibitions for **all** audits is wholly unclear: there seems to be no evidence of a need from an actual or perceived independence perspective.

g. Similarly many of the auditing standards changes relate to increased disclosures by auditors which owners of small and medium sized business are unlikely to see as adding value to their company.

h. The existing ES includes provisions that adjust the prohibitions from SME listed entities, and certain inconsequential transactions. These have been useful measures to ensure proportionate regulation and we do not agree with their removal.

i. A number of additional prohibitions are applied to all audits. It is unclear that there is a public concern about the audits of SMEs and we do not believe that the changes display an understanding of how the quality of the financial statements of such entities is enhanced.

6. Despite our significant reservations about the proposals, if the FRC decides to go ahead, the description of the permitted services in respect of PIE audits needs to be reviewed. As written in the draft revised ES, the services seem to be defined very narrowly and exclude a number of activities where engaging an alternative provider would be costly and unnecessary, such as private reporting accountant work. We cannot believe such potential disruption to capital markets was intended. The adverse impact on business can be minimised by ensuring that the permitted services align with circumstances where the auditor is the most appropriate to provide the service and the work can be performed without compromising independence.

7. As regards the auditing standards changes, we believe firms could potentially adapt to them in time for December 2020 year ends, though a number of the issues summarised above, particularly in respect of the overlap with the scope of the Brydon review, apply.

8. ICAEW is itself a professional regulator and it is in all of our interests for regulation of the accountancy and audit profession to be appropriate, understandable, efficient and enforceable. We discuss our concerns that this has not been achieved with the proposed revisions in more detail.

ANSWERS TO 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?

9. The application of the perspective of the 'objective, reasonable and informed third party' (ORITP) is fundamental to the maintenance of independence in appearance, which in turn is a key element of trust in audit. The additional guidance is useful but raises some questions about its practical applicability which it would be helpful to clarify in any revised ES.

10. The sentences in paragraph I14: 'Such a person is …and is not another practitioner… The perspective offered by an informed investor…..with diversity of thought being an important consideration' seem to imply that the FRC is envisaging canvassing the views of one or more real life individuals, perhaps from outside of the firm, rather than by standing in the shoes of a hypothetical ORITP (as the International Ethics Standards Board for Accountants (IESBA) Code, and perhaps the next sentence in the ES starting 'The assessment that a firm makes…' seems to envisage). While this may be appropriate for some major considerations on high profile entities (though 'diversity of thought' itself raises questions about the extent of opinion gathering expected), the latter approach is a wholly more proportionate action for the application of the ORITP test in the vast majority of circumstances where it should be applied.

11. The ES notes that the ORITP is informed about 'respective roles and responsibilities' of various parties. This is a much narrower set of knowledge than the 'relevant facts and circumstances that the accountant knows, or could reasonably be expected to know' that the IESBA code refers to. We do not believe this narrowing was intended, as the bullet point factors further along in paragraph I14 seem to widen out the matters to be taken into account again.

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?

12. It is not clear from the consultation whether the FRC has found instances of inappropriate overruling of Ethics Partners. We are not aware that this is a significant issue. Nevertheless, the proposed enhancement measures are a reasonable enhancement to any revised version of the ES, if applied proportionately. The new requirement in paragraph 1.15 to report all instances where Ethics Partners (EPs) are overruled to the competent authority is an instance where proportionality needs to be applied. We are not aware that audit firms are wilfully ignoring or overruling their EPs but given that there are around 100,000 statutory audits a year in the UK[1], it would perhaps be appropriate to restrict this, at least in the first instance, to audits of PIEs and similar entities.

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

13. The FRC states in the consultation that the revised ES should be easier to understand and apply. We welcome the intent of this as we have been concerned that some of the existing ES has overlapping requirements and inconsistent styling, particularly where it implements the EU requirements. However, whilst what has been done to improve matters in the proposed revised ES has generally been useful in as far as it goes, there continue to be a large number of overlapping and/or confusing requirements in the ES, where no action has been taken to improve understanding. Presumably because of the apparent and unnecessary rush referred to in our major points and question 13 below, the opportunity has been missed to produce a truly clear and class-leading document. This and a co-ordinated approach to the wider reviews of audit by Brydon and BEIS could still be achieved by applying a sensible timetable and using the time to address the concerns discussed in this response.

Audit

14. As regards areas in the existing ES where clarity and usability could be improved but have not been, we have included a number of detailed comments in the 'Additional Points' section of this response (paragraph 64 onwards).

15. Some efforts have been made to ease navigation and understanding of the ES by removing what is presumably considered to be surplus explanatory material. In some instances where the removed material did little more than repeat the associated requirement nothing has been lost and the ES reads more easily. In a number of other instances, particularly in section 5, the material removed, whilst perhaps not 'need to know', is certainly 'useful to know' material in particular circumstances. It would be helpful to include the material in Staff Guidance Notes. Examples from the existing ES that we believe fall into this category include paragraphs 5.64, 5.94, 5.115, 5.119, 5.130, and 5.141.

[1] 'Developments in Audit 2018' - FRC

Investment Reporting Circular Engagements (ICREs)

16. We note the proposed revised approach to ICREs, in which the detailed ICRE-specific requirements and/or application notes peppered through the existing ES, are mostly replaced by a more general injunction to apply the auditor independence requirements, but only in the context of certain individuals, transactions and subject matter. This undoubtedly streamlines matters for auditors, by reducing the amount of irrelevant information in the ES to be navigated through. However, when applying the ES to specific ICRE engagements, while there is some guidance on the application of the general approach in paragraph I8, a number of significant questions of practical application arise, which need to be clarified. These include:

    j. As the scope of individuals covered states: 'and where required by this Ethical Standard, the firm' (paragraph I8b), the extensive list of non-audit service (NAS) prohibitions applying to all audits, for example, could be interpreted as applying to all such services to non-audit clients where a reporting accountant role might be undertaken. Is this what is intended?

    k. Similarly, the absolute prohibition on contingency fees in paragraph 4.8 could be interpreted as applying to all NAS to non-audit clients where a reporting accountant role might be undertaken. Again, is this what is intended?

    l. The requirements in I8-1 and 5.17 overlap significantly though using slightly different words – often a recipe for confusion. Is the former necessary?

    m. The guidance in paragraph I8-4 on which entities independence is to be assessed in the context of, refers to parties from whom instructions are taken and other entities directly involved in the transaction. Such entities are likely to include investment banks and similar entities with widespread interests. This is recognised in the existing ES, as it includes a statement that ongoing business relationships with such entities are generally unlikely to be a problem. This has now been removed, leading to the need for some potentially very wide independence searches. It would be helpful to re-instate the guidance, for clarity.

    n. The discussion in section 1 of the revised ES on communication with those charged with governance still includes a specific reference to ICREs at paragraph 1.57. This requires communication every time a significant independence judgement is made, with 'any other persons the firm may be instructed to advise'. 'May' potentially covers a very open ended set of circumstances: the firm may, for example, be unclear as to who advice is to be given to, until after key decisions have been made. It would be helpful to be clearer on the extent of probability that the FRC envisages attaches to 'may'.

17. Our preference is and has always been to reinstate a separate standard to address independence in ICRE engagements. However, if this is not proceeded with, it will be important to have further guidance on how some requirements are to be interpreted and applied, as illustrated above. This could either be by additional notes as part of I8 or, given the relatively small number of firms undertaking ICRE work, in one or more Staff Guidance Notes.

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

18. While there is a clear need to reconsider the status quo in respect of many aspects of the audits of PIEs, we have serious concerns about the timing and cost to business and the economy of the proposed default 'prohibited unless specifically permitted' approach to NAS service provision for PIE audits. These aspects are discussed further under question 5

below. Were this proposal to be proceeded with, notwithstanding the arguments against, the definitions of 'audit related services' and other services 'for which the auditor is an appropriate provider' become of critical importance.

19. 'Audit related services' are defined in paragraph 5.36 of the revised ES, and other services 'for which the auditor is an appropriate provider' in 5.39. However, 5.40, in discussing permitted services for PIE audits, appears to re-present these in a slightly different format, with an indication of which services would be subject to the 70% fee cap, but in some instances different discussion from that in 5.36 and 5.39. Having the same matter discussed slightly differently in different places is a recipe for misunderstanding and confusion. For example, paragraph 5.39 discusses a range of services which include those required by UK law or regulation, but does not set that as an absolute limit. So, for example, private reporting accountant work is permitted provided it passes the ORITP test. The first set of services under paragraph 5.40, however, is included under a heading which specifies that the services are 'required by UK law or regulation'. This implies that private reporting accounting work would not be permitted along with a long list of other work where it is most sensible for the auditor to carry out the activity, such as SOX 404 reporting or reports required by non-UK regulators. We cannot imagine that such disruption to capital markets and other work was intended but this illustrates the perils of two sets of descriptions.

20. The draft list of permitted services is very narrow, particularly if the interpretation that paragraph 5.40 seems to imply (see above) is followed. The extension of the cooling in period for internal audit in the overriding prohibitions in appendix B, which is introduced by footnote to paragraph 5.40 but with no explanation as to the reason, exacerbates this. Ultimately, the impact on business can and should be minimised by permitting services where the auditor is the most appropriate to provide the service and the work can be performed without compromising independence. This is what the second bullet point of paragraph 5.39 is alluding to, though it should be recognised that there can be a number of reasons why the auditor is the most appropriate to provide the service beyond a relevant understanding, including for example timing and confidentiality. The additional 'required by UK law or regulation' caveat that 5.40 seems to apply is in our view unnecessary and unnecessarily costly.

21. Assuming there is meant to be a relationship between the two discussions it is important to align the narrative. It would assist clarity to ensure the full discussion is in paragraphs 5.38 and 5.39, with a reference back from 5.40.

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?

Prohibitions applicable to PIE audits

22. We wholeheartedly agree that there is a confidence issue with the audit of entities in the public eye. There is a need to undertake a thorough review of what the audit of such entities entails and we have made proposals to the Brydon review around user-driven assurance. In terms of what changes might need to be made to the standards that underlie audit, it is important that they dovetail with the outcome of Brydon. While we argue that retaining the status quo is not a long or even medium term option, we do not agree with what is being proposed, at least for now. We address timing further under question 13.

23. In terms of the actual objective mind-set of an auditor, the principles based approach that underlies the existing ES allows for all circumstances that can threaten such behaviour already, in a thorough and robust manner, countering legalistic avoidance. In doing so, it avoids the cost and time inefficiencies that wholesale prohibitions can bring, where services could most appropriately be provided by the auditor and where any independence threat could be addressed. When it comes to perception of independence, we accept that principles alone do not seem to command full public confidence, their robustness and efficiency notwithstanding. The FRC asserts in the somewhat sketchy feedback within the consultation that recent reviews and investigations have indicated the need for this additional general prohibition. However, our reading of the published findings from recent high profile audit investigations by the FRC indicates the problem is principally one of application of auditing and quality control requirements rather than an underlying problem with the independence provisions in the current ES. If there is unpublished evidence, this should be produced as the proposed change to a 'prohibited unless permitted' approach is very significant and it is not clear that it will result in fewer audit failures which are a significant contributor to the current lack of public confidence in the product.

24. We have previously asked the FRC to undertake a root-cause analysis on large audit failures – we reiterate this call here. Efforts should be directed to change any identified failing standard or application area – but we need to understand the causes to ensure changes are targeted and effective.

25. It is important to recognise that there would be a considerable cost to the proposed changes to the ES for business and the economy. The provision of NAS by audit firms to PIE entities that they audit has been declining for some years[2]. The specific public concern around NAS provision is already being addressed through reluctance by audit committees to engage auditors except where there are good reasons for the auditors to provide the service. The FRC impact assessment asserts that there is a net zero cost of the extended prohibitions to accountancy firms. However, whether or not the changes result in a zero-sum game (or even net gains through higher fees) for accountancy firms overall, it is very clear that the cost to businesses and their shareholders has been ignored in the impact assessment. This is particularly so given the very narrow definition of permitted services discussed under question 4 above:

    a. Small PIEs in particular, with limited spare management capacity, will incur extra management time and cost in selecting additional service providers and getting them up to speed on matters that the auditors know already. Elsewhere the FRC has sought to simplify audits and lighten the burden for SMEs and this seems to take an inconsistent approach.
    b. Increased transaction/execution risk would be caused by delays to timetables as a result of getting new advisers up to speed on certain transactions that might not fall within the definition - with consequent cost and time disadvantages for participants and investors in London's capital markets and to British companies looking to raise capital.
    c. Increased NAS prohibitions for auditors will inevitably lead to a negative impact on competition as firms will assess whether it is worth being involved in audit tenders, or holding themselves free to engage in NAS provision as non-auditors.

26. Overall, given the natural reduction in NAS from audit firms to PIEs that they audit and the concurrent Brydon review which could introduce more sweeping changes to address confidence, we do not believe that adoption of an approach which will lead to increased cost

[2] 'Key facts and Trends in the Accountancy Profession - July 2018' (figure 36) - FRC

at a time of particular uncertainty for the British economy is justified, particularly as the existing approach is wholly robust if properly applied.

Other entities of public interest (OEPIs)

27. Entities within the scope of FRC Audit Quality Review are proposed to be defined as OEPIs and thus subject to the PIE independence requirements. This will include non-SME AIM companies, Lloyds syndicates, and many non-EEA companies listed in the UK. In addition, the ES suggests that OEPIs can also include entities which are not PIEs but are 'nevertheless... of significant public interest to stakeholders' without giving further guidance. Given the significant differences proposed between the independence requirements for PIE (and potentially OEPI) audits and other audits, it is important for firms and businesses to be clear which category audited entities would fall within and for entities not to find themselves being switched between categories unless there is a fundamental shift in their nature.
28. We understand that BEIS will be consulting on the definition of a PIE following a recommendation from the Kingman review. We also note that the FRC is proposing to consult on what non-PIE entities the PIE requirements should cover and believe that would be appropriate. However, in the meantime none of that is helpful for entities which may or may not be OEPIs and which have a 31 December 2020 year end, as the draft ES proposes to apply PIE NAS prohibitions to OEPIs straight away. We believe the application of the PIE requirements to OEPIs should be deferred until there is greater clarity on this.
29. As regards the consultation, many audit firms use internal risk grading systems addressing, for example, entities which would be of national news interest. We believe firms can make a valuable contribution from their own experience of risk rating audit engagements for this debate.

Prohibitions applicable to all audits

30. Although the focus of the consultation has been on PIE and OEPI audits, the consultation notes extended internal audit NAS prohibitions for all audits. A detailed review has indicated further apparent increases in other prohibitions (some of which are discussed below), which are not referred to in the consultation. No clear justification is given as to why the proposal includes additional blanket prohibitions on work in these areas for all audits. The existing provisions address circumstances where threats are likely to arise already. We are not aware of evidence of the current provisions being misused and we do not see that there is a perception concern with non-PIE audits. Indeed we believe these changes will be counterproductive. The ultimate aim of independence is improved quality of financial statements. For smaller entities, enabling appropriate professional support is likely to be more relevant to survival and success than increasing compliance obligations. The alternative to the auditors providing an additional service is usually no-one undertaking it at all.
31. We note that the short period exception for loan staff has been removed, as has the requirement for there to be a significant degree of subjectivity for the prohibition on litigation support work for non-listed audits to have effect. These changes were unpublicised in the consultation document, but the same considerations apply as above.
32. A number of new paragraphs are introduced, for example at 5.18, which prohibit playing 'any part in the management decision-taking' of the entity. This could be considered to be a formalisation of what was implicit (or in the case of some services explicit) in the existing ES. However, while PIE audits were already subject to a broadly worded prohibition from the EU Regulation, for other audits, the prohibition has otherwise tended to be worded along the lines of, for example paragraph 5.108(a) of the proposed ES 'the service would involve the

firm taking on a management role…'. We believe the intention and scope of the latter was reasonably well understood and addressed the underlying threat, and is consistent with the IESBA terminology of not 'assuming a management responsibility'. The words 'any part' are potentially and unnecessarily endlessly wide in prospective interpretation. For example, could a suggestion to those charge with governance that a provision should be increased be considered a breach of this provision?

33. The requirement for firms to have policies relating to gifts and hospitality relating to entities which 'are subsequently likely to become an entity relevant to an engagement', leaves open the question as to when the FRC considers 'likely' to apply. This is, again, a potentially very widely drawn requirement and the degree of likelihood envisaged could usefully be clarified.

34. We note that the prohibition on contingent fees for some tax NAS has now been widened to cover all NAS to audited entities. We have not seen any evidence suggesting that, given the other requirements and safeguards around fees charged to audited entities, there is an actual threat to audit quality from the existing requirements. The change may render some urgently needed potential services which could help the entity, particularly in the area of corporate finance, unviable. This potential adverse effect is exacerbated by the removal of the discussions in paragraphs 4.11 and 4.18 of the existing ES which clarify that risk-related variations do not constitute contingent fees. It would at the very least be helpful to reinstate these, or add it to the discussion on differential fees in the definition of contingent fees.

35. Overall in the context of non-PIE audits, where there does not seem to be a major public confidence concern, we wonder whether the FRC has seriously considered the purpose of audits, ie, to enhance the quality of the financial statements subject to the audit process. Independence is but one aspect of the process, which to maximise effectiveness needs the auditor to work with the entity to ensure the best information is produced and presented. Indeed the increased level of prohibitions could lead to the smallest companies opting out of audit where possible, or increasing pressure to raise audit exemption thresholds further. It would be helpful for the FRC to consult a number of SME auditors in order to fully understand the nature of services provided, which ones enhance quality and which operate to its detriment.

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)?

36. We disagree with the withdrawal of these provisions. We note the FRC's assertion that the relief was little used due to IESBA requirements being stricter. Anecdotally, we have heard that the relief is used: while this might not be widespread, that does not make it unimportant to those who do use it. The provisions in the existing ES are sensible and proportionate and we do not believe this is an area of the market where there are significant public concerns that need addressing by their removal. As regards the IESBA requirements, there is an IFAC public interest override option, which ICAEW has invoked, which allows firms to apply domestic regulatory requirements rather than those in the IESBA code. We understand that IESBA's forward agenda includes reviewing the definition of a PIE with the intention of making it more principles based.

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?

37. We do not agree with abolishing the clause that allows services with an inconsequential effect to be provided. The FRC alludes in the consultation to 'unhelpful interpretations' in the context of the derogation overall, without being specific as to whether this applies to 'direct'

or 'inconsequential' effect. However, the concept of 'trivial and inconsequential' in the existing ES is, unhelpfully, not expanded upon but suggests amounts well below borderline significance and services falling into this category are by their nature unlikely to influence behaviour. Retaining an allowance for these would deal with a lot of instances where obtaining services from another provider would be disproportionately costly.

38. As regards 'direct effect' the abolition of the distinction raises questions about the impact of the requirements in the context of a syndicate situation. The practical consequences of the existing ES requirements have been discussed at length at the FRC Technical Advisory Group meetings. Careful consideration needs to be given in redrafting the Staff Guidance Note on this subject, to avoid unintended consequences.

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

39. In general we agree with the changes which remove references to the Audit Regulation and Directive and replace these with references to UK law. We note that this assumes that from the date of implementation the UK has exited from the European Union. The current date of exit, 31 October 2019, comes just one and half months before these changes are proposed to apply from. Recent parliamentary legislation means that there is a significant risk that the UK's departure from the European Union will occur after the proposed date of implementation of these changes. This will require further updates to the language as EU law will remain in force.

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?

40. As a general principle, we believe that in order to ensure international consistency of auditing standards, UK pluses should be kept to a minimum. The addition of FRC staff guidance would create further UK divergence from international auditing standards.

41. We do agree that including the FRC staff guidance makes the standards easier to use by consolidating guidance into one place. However, we believe doing so has the risk of elevating guidance to the level of mandatory standards. Staff Guidance Notes are intended to support practitioners in making judgments on application; they are not standards. This should be emphasised, so that auditors are not found in breach of the auditing standards if their interpretation on guidance differs from the regulator. Given the risk of staff guidance being viewed as mandatory, we call for the FRC to ensure any further additions of staff guidance to be subject to further consultation and review.

42. As an alternative to adding the staff guidance into the standards, the FRC could publish one compendium document, which compiles all Staff Guidance Notes, as well as the rolling review. Having this in one document would provide a benefit not only to UK users, but to international auditors, who may not be familiar with all relevant UK guidance. We believe this would have the same benefits of the proposed inclusion without the risk of elevating guidance to the level of the standards.

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.

Changes to ISA (UK) 700

43. While we agree with the principle of increasing disclosure on fraud, we do not agree with extending the requirement for reporting on the extent to which the audit is capable of

detecting irregularities, including fraud, to all audits. We believe disclosing the extent to which the audit is capable of detecting irregularities will introduce significant boilerplate language on generic methodology, rather than provide meaningful disclosure. There may be some regulated industries with specific fraud risks where this can provide some insights.

44. For the majority of audits, especially smaller audits, we expect to see similar looking disclosures, which provide limited value or insight. From a business perspective, owners and management will be unlikely to see any value in this increased boiler plate, and the increased cost of drafting and review will simply reduce audit margins or increase prices to business, without adding value.

45. For larger audits cost is often dismissed as a non-issue but for small and medium sized businesses the cost of an audit has real implications to the business and its profitability. Regulators should bear in mind the cost impact of changes for all audits on businesses and the economy as a whole.

46. There is also a risk that the requirement to discuss whether the audit is capable of detecting irregularity may increase expectation gaps with users, who may read into the disclosure as assurance that there is no fraud in the accounts, rather than a statement on the methodology of the audit.

Changes to ISA 250 Sections A & B

47. We agree with the proposed amendments in general to these standards. However, the drafting language in ISA (UK) 250 Section A paragraph 13-1 should be reviewed. The ISA (UK) sets out the auditor's obligations in relation to laws and regulations in two different categories of laws in regulation in paragraph 6. These are broadly those limited to direct effect on the financial statements and indirect impacts on ability to operate or avoid material penalties that could have a material impact on financial statements.

48. The proposed language in 13-1 however, suggests that the audit 'shall consider whether there are any indications of non-compliance with laws and regulations' more generally, rather than in these specific areas. This broader drafting in 13-1 could be read as auditors being required to consider all laws and regulations, including those without any material impact on the financial statements. In contrast, paragraphs 14 and 15 on obtaining audit evidence and performing procedures mirror the requirements in paragraph 6. We ask the FRC to update the drafting to ensure 13-1 is consistent with paragraph 6 in the final changes.

49. We also ask the FRC to review in detail paragraph A11-2. The consideration of qualitative factors is not linked solely to matters identified. This could be interpreted as the auditor being required to plan the audit to detect non-compliance with laws and regulations with an immaterial financial impact.

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?

Significant judgments in respect to Key Audit Matters

50. We are uncertain of the impact and intention of the changes to ISA (UK) 701 in relation to providing disclosure on significant judgments in relation to Key Audit Matters. This could be read as one of two types of disclosures being required:

    o. Disclosures on assumptions in the audit, for example, on discount rates or other factors on the specific calculations of materiality and performance materiality; or

    p. Close call judgments during the course of the audit.

51. If interpretation a applies, we believe this would not depart significantly from the disclosures that auditors already make on materiality and we support this although, in view of the minor nature of this amendment do not see that it need be made immediately. However, if interpretation b is intended, further clarification would be required, either in any standard or in its application guidance. Without this clarity, the ambiguity is likely to lead to inconsistent application and resistance from management on these additional disclosures. If this is the FRC's intention, then auditors will need the support of clear requirements on increasing disclosure on sensitive areas to management. We note however, that Sir Donald Brydon is consulting on whether key audit matters should be enhanced and therefore, believe the FRC should wait for his review to conclude.

Increased disclosure of performance materiality

52. Many auditors already voluntarily provide performance materiality disclosures. Auditors keep clear documentation on the factors considered in calculating performance materiality and we believe auditors will be able to provide this information readily in their disclosures without significant cost or boilerplate.
53. However, the consultation states that performance materiality shows the auditor's assessment as to the effectiveness of internal control in the entity. We disagree with this assertion. ISA (UK) 320 sets out the requirements for calculating performance materiality. ISA (UK) 320 makes no reference to internal controls.
54. Instead, performance materiality is set out as an exercise of professional judgment, which reflects the auditor's understanding of the entity, the auditor's risk assessment procedures, previous audit misstatements, and the expectations for misstatements in the current period. Performance materiality may also be set for particular classes of transactions, account balances or disclosures.
55. While internal control is an aspect of an auditor's assessment of the entity, performance materiality calculations consider wider aspects and are judgmental in nature. Describing it as an assessment on the effectiveness of internal controls misleads investors on the meaning of performance materiality.
56. Clarifying the term 'where relevant' on key observations in respect of significant risks of material misstatement
57. We support this proposed amendment.

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?

58. ISA (UK) 720 is a challenging area for firms and a number of matters were highlighted in the recent FRC thematic review report on other information. ICAEW will be happy to work with the FRC staff to agree what further practical guidance can be provided to firms in this area. With respect to any changes to ISA (UK) 720 itself, we believe the FRC should await the findings of the Brydon review which is considering auditor responsibilities in respect of other information further. At that point it should be considered whether any changes are required to the audit model that should be reflected in the standard.
59. If the FRC makes changes to the ISA (UK), we ask the FRC to clarify the proposed language in paragraph A36-5. As currently drafted it does not make reference to the procedures being done in the context of the audit work, and therefore, could be interpreted as requiring a full audit of other information.

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?

60. The FRC cites public confidence as a rationale for urgent change. We believe that it is the overall effect of the more sweeping changes being considered for audit by the Brydon review, and other current audit initiatives, which will impact on confidence – not an early, isolated adjustment to one set of standards. Indeed the consultation states that the FRC considers that it would not be appropriate to take action to cut across the Brydon review and the BEIS consideration of the CMA proposals – yet that is exactly what the FRC is doing.

61. For example, the definition of audit related services and the potential anti-competitive effect of the wider NAS prohibitions may be relevant to the CMA proposals, including the operational splitting of the big audit and accountancy firms, which BEIS is consulting on. Also, a number of proposed changes to the auditing standards, in terms of mandatory disclosures on fraud, performance materiality and significant judgments, overlap and pre-empt aspects of the Brydon review.

62. The proposed timing gives the FRC little time to analyse, digest and adjust for the responses to this consultation particularly as the FRC is in the process of changing its top team and board in preparation for transition to ARGA. We question whether there will be time for proper due review process, including being looked at overall by the new team to ensure that the standards are of a quality that the future ARGA would be proud to endorse.

63. The whole FRC consultation process, particularly in respect of the ES, seems very rushed – an action which inevitably leads to unintended consequences, errors and half measures. As well as being more appropriate in the context of the wider economy and reviews referred to above, a delay would allow more time to address the following issues:

    a. The proposals contain significant change for PIE and OEPI audits, with a significant cost to business (see comments under question 5). Yet the consultation period has been shortened to under ten weeks, reducing effective feedback, and the final standard is likely to be issued under eight weeks before it applies, reducing the ability to prepare and implement the changes in an orderly way. Audit firms, for example, would need to change instructions to component auditors (particularly in view of the extension of extraterritoriality of the ES and the continuing differences between the ES and the IESBA Code of Ethics). The timescales would also impact businesses, which are likely to need to review and update their non-audit services policies with short notice. Their audit retendering plans could also be impacted as any firms who provided internal audit services would not now be able to tender for the work.
    b. No consideration seems to have been given to including sensible transitional measures for existing NAS provision and contingent fee arrangements. With the timetable envisaged by the FRC, firms may well have contractual arrangements that will become prohibited in mid-contract.
    c. Similarly the proposals: extend the scope of the ES to non-network firms involved in group audits (and the ES includes a number of significantly more prohibitive specific requirements than the IESBA Code, for example in financial interests); and bring SME listed entities and entities which will be categorised as OEPIs into substantially more restrictive sets of requirements. We do not believe the consequences of these changes have been fully understood: it is difficult to see, for example, how the requirement could be applied practically to non-UK parents of UK PIEs. In addition a number of non-network firms involved in the group audit may need to learn the requirements of the ES from scratch. If the revised ES is applied as drafted, time needs to be allowed for the

practicalities of these aspects to be worked through (including by the FRC), planned for, communicated to international networks and other firms and audited entities, and applied.

d. As noted under question 3 and in more detail below, an opportunity could have been taken, and still can be, to improve the clarity and understandability to a much greater degree than has been the case – the new IESBA Code for example, is widely accepted as resulting in a major improvement in understanding but that involved a complete rewrite of style and content, if not of substance.

e. It would be most appropriate to make changes to the ES when indications are clearer as to the key outputs from the Brydon and BEIS reviews. This would allow a co-ordinated approach. At the very least, a delay of not more than twelve months should allow time for better co-ordination with the Brydon and BEIS outputs and the key issues with the ES to be worked through. This would result in a significantly better document being issued.

64. For the ISA changes, we believe firms could potentially adapt to them in time for December 2020 year ends, though a number of the issues summarised below apply. In respect of the ES, we do not say that change may not be necessary as part of the overall suite of audit re-consideration. However, we do not believe that the proposed rushed timing for the revised ES is at all justified or necessary when the existing approach properly applied is wholly robust. A delay will allow for: better co-ordination with the Brydon and BEIS reviews, once it is more evident what their intentions are; an opportunity to make the revised ES significantly clearer; allow firms to plan for implementation properly and avoid the at-best, technical breaches inevitable with a short implementation timetable; and allow refinement to be made to ensure the minimum necessary impact on business at a time of particular uncertainty for the British economy.

ADDITIONAL POINTS

Impact analysis

65. The extent of the benefit of the proposed changes in terms of likely enhancement to the credibility of financial statements is unclear in the impact analysis. What is clear is that there will be a cost. We have referred in paragraphs 23 to 25 above to the mistaken exclusion of the impact on business from the impact analysis. In respect of practitioners, the consultation document includes an impact assessment and estimated cost of £13m. We do not believe that the impact assessment fully captures the costs of implementing these significant changes. For example, the FRC has estimated each practitioner will require only 2 hours to learn all of the proposed changes. These are extensive changes across both the auditing and ethical standards and two hours are not sufficient to review and implement these changes to a high standard. It also only estimates one hour for additional reporting on fraud per engagement. If the FRC wants meaningful, non-boilerplate disclosure, this will require more than one hour per audit. Furthermore, the costs include an off-setting saving by putting the guidance into the standards – although easier to find, they will still require the same amount of time reading. We believe the FRC needs to re-review the cost of the changes, especially with the impact on small and medium sized audits and companies in mind.

66. Specific paragraphs of the ES

(references are to paragraph numbers in Part B of the proposed ES unless otherwise stated)

67. There remains potential confusion in having duplicate paragraph numbering in Parts A and B of the ES. Those in Part A could be re-referenced easily.

68. Following the introduction in the draft revised ES of formal prohibitions on taking part in management decision-making (see paragraph 32 above), we note an inconsistent approach has been taken to referring specifically to undertaking a management role in prohibition paragraphs. For example, the specific prohibition has been removed from what is now 5.95, presumably on the grounds that it is now dealt with in 5.18, but it has been left in what is now 5.103. The standard could be rationalised by adopting a treatment throughout in line with 5.95.

69. 1.21 includes a new requirement to inform the competent authority quarterly and those charged with governance 'on a timely basis', of all breaches of the ES in respect of all audits. We wonder whether those charged with governance in particular will really wish to know about every breach, even in respect of minor technical matters. It would be more effective to focus on breaches which could realistically impact on independence, were safeguards not to be applied.

70. 1.29 includes a discussion on the management threat which has been shortened compared to the existing ES. In particular the discussion on informed management has been deleted. While a definition of informed management remains, it is not as extensive as the discussion that was included in the existing ES, so if more reliance is to be placed on the definition, it would be useful to add discussion from the existing paragraph 1.29.

71. 1.47-1.48 are positioned under a heading 'Other Firms Involved Engagements'. Though unchanged from the existing ES, we believe there may be, perhaps, an 'in' missing from this title.

72. 2.3 and 2.4 of the current standard (derived from the EU Directive) feature a significant but difficult to comprehend overlap between two sets of financial interest prohibitions. The revised standard has not addressed this at all. It would be helpful to recast these in terms of the different personnel impacted. Having received a number of queries on this, we would be happy to discuss this further.

73. 2.20 sets out that accepting a loan from or making a loan to an audited entity creates unacceptable threats. 2.23 however, allows for such loans in the ordinary course of business under certain circumstances. We do not disagree with the premise of 2.23 but 2.20 should perhaps be adjusted to refer to the ordinary course of business, to ensure consistency.

74. 2.25 and 2.26, which set out the key business relationship requirements, are another example of overlapping requirements partly derived from the EU Audit Directive. These could be simplified in terms of understandable text without changing the underlying requirements.

75. 4.2 requires disclosure to the audit committee of situations where there is a shortfall compared to the 'full cost' of an audit. The footnote to the paragraph clarifies that this should include fixed costs, but it is unclear how, for example, overhead recharges should be treated. Guidance would be helpful in this area to ensure consistency of approach.

76. 4.47 includes additional wording that, as drafted, would preclude an audit firm, acting in its capacity as administrator, from pursuing an audited entity for a routine and trivial matter (such as recovery of trading debts). We cannot believe that it is intended or necessary for the prohibition to apply other than for material/subjective matters and request the drafting be clarified accordingly.

77. 5.35 includes a typing error as it still refers to paragraphs 4.15R and 4.16R.

78. 5.40 also includes a typing error in footnote 51: 'and extended cooling period…'

79. 5.76 to 5.81 prohibit and discuss certain tax advocacy work. This was discussed at the FRC TAG meetings and guidance was included in the FRC Rolling Record (page 6). While much of the Rolling Record commentary replicated what is in the existing ES, the last sentence is useful additional material and could be included with the ES.

80. 5.122(b) and 5.126 discuss the type of accounting services that may be provided. The reference in the existing ES to services of a 'technical, mechanical or informative' nature has been amended to 'routine or mechanical'. We assume this is a technical change to align with IESBA Code wording. However, to the general user, any change in wording will result in a question as to whether there is intended to be a change in the substance of a requirement. It would be helpful to clarify the intent in this respect.

81. Appendix B includes the list of prohibited services derived principally from the EU Audit Regulation. While its purpose is explained in 5.40 footnote 51, it would help to avoid misunderstanding to add a sentence to the appendix itself, putting it in context. As it stands, the appendix seems to list all those NAS which are prohibited for auditors to provide for PIE audits, which could be misleading if 5.40 has not been read first.

82. Appendix B also refers, as noted previously, to a 'cooling in' period in respect of internal audit services – an extension beyond the current requirements. It is important to be clear, should this continue into a final revised ES, how this should be treated from a transitional perspective.

83. Glossary: 'Audit Engagement' includes a reference to the EU Regulation and Directive. There are a number of other references to EU legislation throughout the draft ES. We note the FRC statement in the consultation that references to UK legislation relating to EU Exit will be updated where necessary. We hope that this includes these references to EU legislation.

84. Glossary: 'Covered Person' received some attention during the FRC TAG meetings and guidance was included in the FRC Rolling Record (page 4). Some of this useful material could be included with, or at least cross referenced from, the definition.

85. Glossary: 'Partner' again received some attention during the FRC TAG meetings and guidance was included in the FRC Rolling Record (pages 7/8). Some of this useful material could be included with, or at least cross referenced from, the definition.

86. Glossary: 'Key Audit Partner', as defined, does not make it clear that the term is only relevant in the context of PIE audits. The only place this becomes clear is in Appendix 1 of the FRC Rolling Record, as the term's usage was discussed extensively at the FRC TAG meetings. It would be helpful to clarify this in the definition.