Auditing and ethical standards

Implementation of the EU Audit Directive and Audit Regulation

A Consultation issued by the Financial Reporting Council

Comments from ACCA
19 March 2015

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Further information about ACCA's comments may be obtained from:

David York
Head of Auditing Practice, ACCA
Email: david.york@accaglobal.com

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

www.accaglobal.com

ACCA welcomes the opportunity to comment on the Consultation: Auditing and ethical standards *Implementation of the EU Audit Directive and Audit Regulation* issued by the Financial Reporting Council (FRC).

GENERAL COMMENTS

We note that Articles in both the Audit Directive and Audit Regulation establish provisions that relate to matters that are the subject of the FRC's auditing standards and ethical standards for auditors. We agree with the conclusion expressed in the Consultation that it is appropriate for the application of the provisions that clearly relate to matters currently covered by the FRC's standards to be allocated to the FRC to implement.

We have responded separately to the *Auditor Regulation Discussion document on the implications of the EU and wider reforms* published by the Department for Business Innovation and Skills.

We note that the FRC welcomes stakeholders' views on the possible impacts and benefits relating to Member State options. We are not directly concerned with the operation of auditing standards and ethical standards for auditors and do not comment on the impacts and benefits of proposed changes (and their quantification) beyond expressing our informed views as an accountancy body.

We agree that it is advantageous to all affected parties to avoid multiple revisions to standards over a relatively short period of time. We welcome the FRC's undertaking that, where appropriate and practicable, it will seek to ensure, therefore, that revisions dealt with in the Consultation are made at the same time as those for related International Auditing and Assurance Standards Board (IAASB) revisions.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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ANSWERS TO SPECIFIC QUESTIONS

In this section of our response we answer the specific questions posed in the consultation.

SECTION 1 – AUDITING STANDARDS

Question 1 Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

The FRC should have the power to impose additional requirements in auditing standards because that is necessary to allow tailoring to address national law.

We caution that this should not be seen as giving carte blanche to either continue the existing additional requirements, or to introduce further additional requirements, without there being a substantial case to do so.

We are concerned in particular that the FRC has not hitherto adopted International Standard on Auditing 700 *Forming an Opinion and Reporting on Financial Statements* (ISA 700) but gone ahead with its own standard. While, at the time, the FRC standard was innovative, certain of its innovations have not held sway internationally in the due process of revision of ISA 700 and related standards. For example, a requirement to address materiality in the report was considered by the IAASB but rejected for the international standard.

The argument for international consistency of standards is itself very strong and we believe outweighs any potential benefits of retaining such reporting just for the UK and Ireland. Given that reporting is an area where innovation may be expected from firms, we believe that retaining a requirement to deal with materiality is unnecessary because auditors would be at liberty to include such material in response to user demand.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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SECTION 2 – PROPORTIONATE APPLICATION AND SIMPLIFIED REQUIREMENTS

Question 2 Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

Yes, we believe that the current audit and ethical standards can be applied in a proportional manner. This is not to say that the standards are ideal in that regard, merely that it is possible.

Question 3 When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles 22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available for Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

There is a case for continuing matters currently addressed in Ethical Standard *Provisions Available to Small Entities* as the disclosure of the use of its dispensations has not adversely affected user perception of audit quality.

However, in relation to Articles 22b, 24a and 24b, we feel these are matters that necessarily should be the same for all audits and that simplification is not appropriate.

Article 24a is of interest because it allows for an alternative approach to the application of the existing International Standard on Quality Control (ISQC) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*. It is possible that the IAASB will, at some future time, revise the approach embodied in ISQC 1 and ISA 220 *Quality Control for an Audit of Financial Statements* to allow smaller audit firms to control quality on an engagement by engagement basis. This is impossible for larger firms, which is why the current ISQC 1 and ISA 220 are written in the interlinked manner in which they are.

In the short term, despite an IAASB project to revise ISQC 1, we see little prospect of change of this magnitude and, while we would support the FRC in having the relevant power, any simplification would be premature.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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SECTION 3 - EXTENDING THE MORE STRINGENT REQUIREMENTS FOR PUBLIC INTEREST ENTITIES TO OTHER ENTITIES

Question 4 With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:

(a) should they apply to PIEs as defined in the Audit Directive?

(b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

As the FRC notes in the Consultation, there is considerable complexity in the application of auditing and ethical standards and that has been intentionally compounded by the Audit Directive. We start from the basis that there should be no need to gold plate European requirements. Nevertheless, we recognise that the FRC is concerned with financial markets that are not typical of EU Member States and has hitherto justified the application of more stringent requirements for certain listed entities.

We do not believe that the requirements referred to in this question should be applied to all PIEs. Instead, the regime for all PIEs should result from the application of the provisions in the Directive and Regulation (and ISAs).

The need for the requirements referred to in this question to continue to apply to Listed entities should be reconsidered taking into account the entirety of changes to be introduced. Specific requirements should be continued only if there is an overwhelming public interest case. This might be the case for certain larger listed entities.

Question 5 Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

The application of more stringent requirements in relation to the audits of entities that are not PIEs could be achieved either by the Government designating them as PIEs (with attendant implications) or through the FRC setting the scope of its standards, or, in the case of AIM companies through a market rule.

The views of market participants and other interested parties should be considered, informed by liaison with the EC and other Member States, to determine whether it is possible to achieve a 'level playing field' in Europe.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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Question 6 Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?

We understand that certain user groups may envisage the more stringent requirements applying to entities other than Listed entities (as defined by the FRC) on the basis that they are of considerable public interest.

In keeping with our answers to questions 5 and 6 above, we suggest that the determining factor should be whether a particular entity is in a class designated by Government as a PIE. We have responded separately to BIS on this issue.

SECTION 4 – PROHIBITED NON-AUDIT SERVICES

Prohibition of additional non-audit services to PIEs

Question 7 What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

If one is dealing with perception, then a complete ban on the provision of non-audit services to a PIE will achieve maximum impact. We do not believe that a black list or a white list approach is ideal. The fact that the FRC has suggested a hybrid approach seems to us to recognise that there are certain services that are clearly acceptable, indeed some mandated to the statutory auditor, and there are certain services that are clearly inappropriate. In the mid-ground, existing, and indeed future, services will need assessing for their impact both on actual independence and the perception of independence.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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Question 8 If a 'white list' approach is deemed appropriate to consider further:

(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?

(b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?

In relation to the sub-questions above:

(a) The items on the illustrative list are appropriate and we do not suggest any further.

(b) As we have said above in our answer to question 7, we do not see that a white list on its own is an appropriate solution to independence issues and so this risk would be mitigated by the operation of other provisions.

Question 9 Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

There are no specific services we would suggest. There needs to be a principles-based approach to independence so that a future service – perhaps one currently not capable of being envisioned – would be appropriately accommodated.

Derogations in respect of certain prohibited non-audit services

Question 10 Should the derogations that Member States may adopt under the Audit Regulation - to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

Yes; the concept of materiality must be allowed to influence the assessment of non-audit services. If it does not, audited entities are likely to be disadvantaged, perhaps by incurring unnecessary costs.

Question 11 If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be 'immaterial' sufficient? If not, is there another condition that would be appropriate?

The test of 'no direct, or have immaterial, effect on the audited financial statements ' is correct. However, the test should be explained in order to prevent too narrow a view of materiality being taken to justify 'avoidance'.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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Audit Committee's role in connection with allowed non-audit services

Question 12 For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?

In the absence of specific prohibition, we believe that the approval of the audit committee is an appropriate safeguard in the circumstances envisaged. Our view on this is not affected by whether or not a white list approach is adopted.

Geographical scope of the prohibitions of non-audit services, by the audit firm and all members of its network, to components of the audited entity based outside the EU

Question 13 When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based? If not, what other standards should apply in which other circumstances?

The FRC is well aware of the practicalities of global application of standards and has chosen not to require overseas compliance with its ethical standards but to place an obligation[1] on a firm to be satisfied that other firms involved are objective and that its network firms (not involved in the audit) are required to comply with the current IESBA Code[2], which includes a relevant independence requirement.

We see no change necessary to this particular principle although, in an ideal world, the extraterritorial application of requirements would be feasible.

The mandatory rotation of firms in many countries is likely to lead to group audits involving more firms that are not members of a firm's own network. This should be recognised by extending the requirement relating to network firms so that it encompasses network firms of other audit firms involved in the audit.

[1] Paragraphs 58 to 62 of ES 1 (Revised) Integrity, objectivity and independence.
[2] International Ethics Standards Board for Accountants *Code of Ethics for Professional Accountants.*

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM
T +44 (0)20 7059 5000
F +44 (0)20 7059 5050
www.accaglobal.com

Applying restrictions to other group auditors that are not part of the group auditor's network

Question 14 When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all other auditors whose work they decide to use in performing the audit of the group? If not, what other standards should apply in those circumstances?

The current FRC requirements[3] do not extend to ensuring that (as set out in this question): 'the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all other auditors whose work they decide to use in performing the audit of the group.' Instead, the requirements place an obligation[4] on a firm to be satisfied that other firms involved are objective and that its network firms (not involved in the audit) are required to comply with the current IESBA Code[5], which includes a relevant independence requirement.

Now that mandatory rotation of auditors has been implemented and the periodicity of such rotation varies between Member States and indeed jurisdictions outside the EU, we suggested in our answer to Q13 that the requirements should be strengthened by including within their scope network firms of other audit firms involved in the audit.

We do not believe that the group auditor should be required to go further than this to become satisfied about actual compliance; although where there is significant interaction with certain other auditors, it may be possible to form such a view.

[3] Paragraphs 58 to 62 of ES 1 (Revised) Integrity, objectivity and independence.
[4] Paragraphs 58 to 62 of ES 1 (Revised) Integrity, objectivity and independence.
[5] International Ethics Standards Board for Accountants *Code of Ethics for Professional Accountants.*

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM
T +44 (0)20 7059 5000
F +44 (0)20 7059 5050
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SECTION 5 – AUDIT AND NON-AUDIT SERVICES FEES

Fees for non-audit services

Question 15 Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

It must be accepted that 70% is an arbitrary limit. Other percentages above or below that figure could equally well have been selected. So with no particular comment on the precision of the figure we are happy to suggest that a lower limit need not be implemented.

Question 16 If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

We agree that a power should exist to grant a limited exemption from the cap in exceptional circumstances.

As such circumstances are likely to be rare, we do not believe that criteria should be laid down. While matters must then be considered on a case by case basis, we suggest that the FRC should pay particular attention in its evaluation to the impact on the audited entity were an exemption not to be granted.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

www.accaglobal.com

Question 17 Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms?

We would widen this question to include non-audit services provided by network firms of other firms involved in the audit (see our answer to Q13 and Q14).

To avoid gold plating, we prefer restricting the application of the cap in the manner set out in the Regulation. We agree, however, that there ought to be some means of deterring a network from transferring the provision of non-audit services to a different network firm in order to avoid the cap.

We suggest that guidance to audit committees should indicate that, in considering auditor independence, the transparency and appropriateness of the provision of all non-audit services should be addressed. A similar position should be taken where a firm tries to avoid the cap by creating a 'gap year' to avoid having a three consecutive year basis period for the cap.

Question 18 If your answer to question 17 is yes, for a group audit where the parent company is a PIE, should the audit and non-audit fees for the group as a whole be taken into consideration in calculating a modified alternative cap? If so, should there be an exception for any non-audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?

In view of our answer to Q17, we do not comment on the detail of question 18. We suggest that the FRC applies a principles-based approach rather than one that relies on calculation.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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Question 19 Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances (see paragraphs 5.3 and 5.15)?

The operation of a three year basis period is reasonable as a mechanism to smooth out year-to-year differences and allow a period of transition during which a new auditor might be terminating existing arrangements.

As we indicted in our answer to Q17, a firm might try to avoid the cap by creating a 'gap year' to avoid having a three consecutive year basis period.

To avoid gold plating of the requirement, we suggest instead that guidance to audit committees should indicate that, in considering auditor independence, the transparency and appropriateness of the provision of all non-audit services should be addressed. This consideration should also include the timing of the services.

Total fees for audit and non-audit services

Question 20 Do you believe that the requirements in ES 4 should be maintained?

As indicated by its title, the requirements in ES 4 (Revised) *Fees, remuneration and evaluation policies, litigation, gifts and hospitality* address several circumstances that may create threats to the auditor's objectivity or perceived loss of independence. We interpret Q20 as relating only to the provisions relating to audit and non-audit services, although our thinking may be applied to other aspects of ES 4.

The difference between the position under the Directive and the Regulation (and the IESBA Code) and the existing FRC positions is not huge and we doubt whether users would draw any particular adverse inferences about independence from an alignment to the new European norm.

Question 21 When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

In view of our answer to Q20 we do not comment on the application of more restrictive requirements.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

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Question 22 Do you believe that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute an expectation of "regularly" exceeding those limits? If not, please explain what you think would constitute "regular".

An interpretation of what constitutes regularity may be welcomed by some. There is a question as to whether developing an expectation requires an anticipation of future years. The entering into of a long-term contract, for example, might produce such an expectation. We would be suspicious of any arrangements in which limits were exceeded in two consecutive years, unless the reason was because of a particular service of considerable magnitude that spanned a year end. We would perhaps therefore regard two years as a better test, unless such circumstances were identified.

SECTION 6 – RECORD KEEPING

Question 23 Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?

We see no need to change from the current arrangements under which firms meet the requirements of their professional bodies.

If such a change were to be made, International Standard on Quality Control (UK and Ireland) (ISQC (UK and Ireland)) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* would be an appropriate vehicle.

SECTION 7 – AUDIT FIRM AND KEY AUDIT PARTNER ROTATION

Audit firms

Question 24 Do you believe that the FRC's audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?

We find the imposition of responsibility on auditors to be intellectually attractive but, given that there is to be a statutory responsibility on the audited entity, we fail to see how in effect doubling the regime is time and cost effective for society overall.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

www.accaglobal.com

Key audit partners

Question 25 Do you believe that the requirements in ES 3 should be maintained?

ES 3 was issued at a time when there was no mandatory tendering or rotation of audit. The rotation of key personnel must now, we believe, be seen as part of a 'package' together with the provisions affecting firms.

This is why we firmly suggest that the FRC should be content to realign with the IESBA Code and Article 17(7) of the Regulation (which might be summarise 'as seven years on, three years off'). Because of the 'package effect' we do not believe that user perceptions of independence will be significantly affected.

Question 26 When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

In view of our answer to Q25, we do not answer of the detail of this question.

CONSULTATION STAGE IMPACT ASSESSMENT

Question 27 Are there any other possible significant impacts that the FRC should take into consideration?

We are confident that the FRC has identified the areas where significant impact may occur and we do not suggest, therefore, other matters to take into consideration.

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

www.accaglobal.com

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29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM

T +44 (0)20 7059 5000
F +44 (0)20 7059 5050

www.accaglobal.com