

December 2014

---

# Consultation: Auditing and ethical standards

Implementation of the EU Audit Directive and Audit Regulation

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

© The Financial Reporting Council Limited 2014

The Financial Reporting Council Limited is a company limited by guarantee.

Registered in England number 2486368. Registered Office:

8th Floor, 125 London Wall, London EC2Y 5AS

## Contents

	<b>Page</b>
Introduction	3
Invitation to comment	6
<b>1 Auditing Standards</b>	<b>11</b>
<b>2 Proportionate Application and Simplified Requirements</b>	<b>14</b>
<b>3 Extending the More Stringent Requirements for Public Interest Entities to Other Entities</b>	<b>18</b>
<b>4 Prohibited Non-audit Services</b>	<b>26</b>
<b>5 Audit and Non-audit Services Fees</b>	<b>42</b>
<b>6 Record Keeping</b>	<b>49</b>
<b>7 Audit Firm and Key Audit Partner Rotation</b>	<b>50</b>
Consultation Stage Impact Assessment	52
Glossary	61



## Introduction

- (i) The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment.
- (ii) In May 2014 the European Commission published a Directive<sup>1</sup> amending the Statutory Audit Directive<sup>2</sup> and a new Audit Regulation<sup>3</sup>. The Audit Directive establishes specific requirements concerning the statutory audit of annual and consolidated financial statements. The Audit Regulation establishes further specific requirements regarding the statutory audit of 'public interest entities'. The new requirements come into effect on 17 June 2016 and will apply to financial years starting on or after that date.
- (iii) The Audit Regulation has the direct effect of law and Member States are required to adopt appropriate provisions to ensure its effective application. The Audit Directive does not have a direct effect in law and Member States are required to adopt and publish the measures necessary to comply with it. The Department for Business, Innovation and Skills (BIS) is seeking views on the implementation of the Audit Directive and Audit Regulation in the UK in its Discussion Document 'Auditor Regulation – Discussion document on the implications of the EU and wider reforms – December 2014'.
- (iv) 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. In relation to a number of these provisions there are Member State options. BIS and the FRC consider that it would be most 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 via development of the audit and ethical standards framework and revision of the relevant standards.
- (v) BIS, in their Discussion Document, are therefore seeking views on whether, in a revised statutory framework, the FRC should be given the specific responsibility to deal with the subject matter of these Articles, including the ability to exercise all the associated Member State options, in accordance with the FRC's usual processes for setting such standards.
- (vi) This FRC consultation document identifies and explains the range of positions the FRC is considering with respect to these Member State options, should it have a delegated power to exercise them, and seeks stakeholder views about them. Any proposed specific changes to the FRC's standards, taking into consideration responses received, will be consulted on in 2015.
- (vii) The positions discussed are intended to be supportive of the FRC's aims for audit, including that:
  - Roles and responsibilities of auditors and audit committees are clear, and aligned with the interests and needs of investors;
  - Audit and auditors are trustworthy, act with integrity, serve the public interest and consistently meet the objectives of audit and audit standards;

---

<sup>1</sup> Directive 2014/56/EU

<sup>2</sup> Directive 2006/43/EC

<sup>3</sup> Regulation 537/2014

- Audit innovates to meet changing business and economic circumstances to improve audit quality;
  - Audit is a sustainable business with adequate capacity, and sufficient levels of competition and choice;
  - Global audits are effectively managed and overseen and quality is consistent across international work; and
  - Audit is subject to appropriate oversight within a clear regulatory regime.
- (viii) As published in its Regulatory Approach, the FRC has regard to the need for its standards to be applied in a proportionate manner in different circumstances. It carries out and publishes impact assessments and adopts, where possible, principles that can be applied appropriately and at reasonable cost. Any decisions about whether to propose new additional requirements in the future that exercise any Member State options within the FRC's remit would be made with regard to the FRC's 'Principles for the development of Codes, Standards and Guidance'<sup>4</sup> which include:
1. there is a clearly defined issue relevant to the FRC's mission and responsibilities;
  2. the change is the most appropriate way to address the issue;
  3. one or more of the following conditions is met:
    - a change is necessary to comply or align with a legal requirement; or
    - a change is required in the light of developments in international standards or in UK or European regulation; or
    - the risks to the public interest of not acting are significant, for example, a risk of systemic and/or market failure; or
    - it is possible to eliminate or significantly simplify a current requirement; or
    - it is necessary to clarify a current requirement; or
    - it is possible to create significant additional benefits in the public interest; or
    - a change is necessary to underpin the effectiveness of the FRC's enforcement and disciplinary activities;
  4. the anticipated benefits of the change outweigh the costs.
- (ix) The areas in which there are relevant Member State options, which are covered in the individual Sections in the consultation document, relate to:
- Imposing additional requirements in auditing standards that may be adopted by the European Commission (see Section 1);
  - Providing for proportionate application of standards and some simplified requirements (see Section 2);

---

<sup>4</sup> <https://www.frc.org.uk/FRC-Documents/FRC/About-the-FRC/Principles-for-the-development-of-Codes.pdf>

- Extending more stringent requirements to other entities in addition to those designated in law as ‘public interest entities’ (see Section 3);
  - Prohibited non-audit services for public interest entities (see Section 4);
  - Restrictions on fees for non-audit services for audited public interest entities and the proportion of total fees that can come from one audited entity (see Section 5);
  - Retention periods for audit records (see Section 6); and
  - Audit firm and key audit partner rotation periods for public interest entities (see Section 7).
- (x) The Audit Directive and Audit Regulation also introduce some new requirements for which there are no options (the BIS Discussion Document gives more details of these). The FRC will consult in 2015 on proposed specific revisions to the audit and ethical standards to implement those requirements. That consultation will also address the implementation of Member State options, taking into consideration the responses received to this consultation, if it has been confirmed that the FRC will have the discretion to exercise them.
- (xi) The impact assessment presented in this consultation identifies possible impacts and benefits related to the relevant Member State options but does not attempt to quantify them. The FRC would welcome stakeholders’ views on the possible impacts and benefits.
- (xii) In April 2014, the FRC set out its work to enhance justifiable confidence in the quality of audit<sup>5</sup>. A key element of that work is a review of the ethical framework for auditors, including the ethical standards. Further revisions to the ethical standards that may be proposed as a result of that review will be consulted on in 2015 at the same time as the proposed detailed revisions to implement the Audit Directive and Audit Regulation.
- (xiii) The International Auditing and Assurance Standards Board (IAASB) is finalising revisions to some International Standards on Auditing (ISAs) that are expected to come into effect over the next couple of years (including the auditor reporting standards). The ISAs provide the basis for the FRC’s auditing standards. Where appropriate and practicable, the FRC will seek to ensure that revisions to the standards for the Audit Directive and Audit Regulation, the wider review of the ethical framework for auditors and the IAASB revisions are made at the same time to avoid multiple revisions to standards over a relatively short period of time.

---

<sup>5</sup> <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/April/FRCs-work-to-enhance-justifiable-confidence-in-au.aspx>

## Invitation to comment

1. The FRC is requesting comments on this Consultation Document by 20 March 2015. The FRC is committed to developing standards based on evidence from consultation with users, preparers and others. Comments are invited in writing on all aspects of the Consultation Document. In particular, comments are sought in relation to the questions asked in the individual Sections. Those questions are reproduced below with cross references to the pages where the context for each question is presented. Please give reasons for your answers. The questions are premised on the basis that the FRC is given the power to exercise the relevant Member State options through its audit and ethical standards (which is addressed by BIS in its Discussion Document).

### **Section 1 – Auditing Standards**

#### **Question 1** (see pages 11 – 13)

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)?

### **Section 2 – Proportionate Application and Simplified Requirements**

#### **Question 2** (see pages 14 – 15)

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.

#### **Question 3** (see pages 15 – 17)

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.

### **Section 3 - Extending the More Stringent Requirements for Public Interest Entities to Other Entities**

#### **Question 4** (see pages 18 – 25)

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?



**Question 5** (see pages 18 – 25)

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?

**Question 6** (see pages 18 – 25)

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?

**Section 4 – Prohibited Non-audit services**

***Prohibition of additional non-audit services*** (see pages 29 – 35)

**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?

**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?

**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?

***Derogations in respect of certain prohibited non-audit services*** (see pages 35 – 36)

**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?

**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?

***Audit Committee's role in connection with allowed non-audit services*** (see page 36)

**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?

***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*** (see pages 37 – 39)

**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?

***Applying restrictions to other group auditors that are not part of the group auditor's network*** (see pages 39 – 40)

**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?

**Section 5 – Audit and Non-audit Services Fees**

***Fees for non-audit services*** (see pages 42 – 46)

**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?

**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?

**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,?

**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?

**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)?

**Total fees for audit and non-audit services** (see pages 46 - 48)

**Question 20**

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

**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?

**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".

**Section 6 – Record Keeping**

**Question 23** (see page 49)

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?

**Section 7 – Audit Firm and Key Audit Partner Rotation**

**Audit firms** (see page 50)

**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?

**Key audit partners** (see pages 50 - 51)

**Question 25**

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

**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?

**Consultation Stage Impact Assessment****Question 27** (see pages 52 – 60)

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

2. Information on how to submit comments and the FRC's policy in relation to responses is set out on page 62.

# 1 Auditing Standards

- 1.1 Article 26 of the Audit Directive requires auditors to carry out statutory audits in compliance with “international auditing standards” adopted by the Commission. “International auditing standards” are defined in the Directive as “International Standards on Auditing, International Standard on Quality Control (ISQC 1) and other related Standards issued by the International Federation of Accountants (IFAC) through the IAASB, in so far as they are relevant to the statutory audit.”
- 1.2 The Commission has not yet adopted any international auditing standards. The timetable for when it may do so is not clear, but it is not expected that it will have adopted any auditing standards by the date the Audit Directive and Audit Regulation come into effect – 17 June 2016.
- 1.3 The FRC’s auditing standards - the ISAs (UK and Ireland) and ISQC (UK and Ireland) 1 - are based on the corresponding international standards issued by the IAASB. Where necessary, the international standards have been augmented with a small number of additional requirements to address specific UK and Irish legal and regulatory requirements; and additional guidance that is appropriate in the UK and Irish national legislative, cultural and business context.
- 1.4 The FRC has not at this time adopted ISA 700, *Forming an Opinion and Reporting on Financial Statements*. The FRC has instead issued ISA (UK and Ireland) 700, *The Independent Auditor’s Report on Financial Statements*. The main effect of this is that the form of auditor’s reports may not be exactly aligned with the precise format required by ISA 700 issued by the IAASB. However, ISA (UK and Ireland) 700 has been drafted such that compliance with it will not preclude the auditor from being able to assert compliance with the ISAs issued by the IAASB.
- 1.5 The FRC’s standards also include two complete additional standards that address responsibilities of auditors relating to specific national legal and regulatory requirements:
  - ISA (UK and Ireland) 250 Section B – The Auditor’s Right and Duty to Report to Regulators in the Financial Sector
  - ISA (UK and Ireland) 720 Section B – The Auditor’s Statutory Reporting Responsibility in Relation to Directors’ Reports
- 1.6 Article 26 presents Member State options in relation to supplementing international auditing standards adopted by the Commission.

- (i) Member States may apply national auditing standards, procedures or requirements as long as the Commission has not adopted an international auditing standard covering the same subject-matter. (paragraph 1 of Article 26)
- (ii) Member States may impose audit procedures or requirements in addition to the international auditing standards adopted by the Commission, only:
  - (a) if these those audit procedures or requirements stem from or are necessary to give effect to specific national legal requirements relating to the scope of statutory audits; or
  - (b) to the extent necessary to add to the credibility and quality of financial statements. (paragraph 4 of Article 26)

- 1.7 The FRC believes it should have the ability to exercise these options. The FRC's current additional requirements and standards are intended to address national legal and regulatory requirements and/or add to the credibility and quality of financial statements (for example by assisting Boards and audit committees fulfil their responsibilities under the UK Corporate Governance Code and giving greater transparency of the auditor's considerations in the audit). These existing requirements have been consulted on previously and supported by stakeholders who may be concerned if they were lost in the future. Without this ability to add requirements, it would also be more difficult for the FRC to continue to be innovative in seeking ways to support confidence in audit (as it has done recently with enhanced auditor reporting, which was well received by stakeholders) and to better contribute to the development of international standards. Any future proposed new additional requirements would be subject to the criteria in Article 26, consideration under the FRC's 'Principles for the development of Codes, Standards and Guidance' (see paragraph (viii) of the Introduction to this consultation document, and appropriate consultation.

### **Content of the auditor's report**

- 1.8 Article 28 of the Audit Directive stipulates required content for all auditor reports in relation to statutory audits. Article 10 of the Audit Regulation stipulates additional content for auditor reports in relation to statutory audits of PIEs. Both Article 28 of the Directive and Article 10 of the Regulation provide that Member States "may lay down additional requirements in relation to the content of the audit report".
- 1.9 The FRC's requirements for the content of auditor reports on financial statements are set out in ISA (UK and Ireland) 700. This will be revised in due course to reflect the additional requirements of the Audit Directive and Audit Regulation.
- 1.10 ISA (UK and Ireland) 700 currently lays down requirements that are not included in the Audit Directive and Regulation. For example, it requires, in the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, that the auditor's report shall provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit.
- 1.11 If given the ability to do so, the FRC therefore proposes to exercise the provisions to lay down additional requirements in relation to the content of the audit report, subject to appropriate consultation and due process.

### **Additional report to the audit committee**

- 1.12 Article 11 of the Audit Regulation requires the auditor of a PIE to submit an additional report to the audit committee of the audited entity (or, if there is no audit committee, the body performing equivalent functions) not later than the date of the submission of the auditor's report on the financial statements. Article 11 stipulates required content of the report but also provides that Member States "may lay down additional requirements in relation to the content of the additional report to the audit committee".
- 1.13 The FRC requirements for communications by the auditor to audit committees are set out in ISA (UK and Ireland) 260, *Communication With Those Charged With Governance*. Subject to consultation and due process, the FRC proposes to revise this in due course to reflect the additional requirements of the Audit Regulation.
- 1.14 ISA (UK and Ireland) 260 currently lays down requirements for matters to be communicated that are not included in Article 11 of the Audit Regulation. For example,

it requires, in the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, that the auditor communicate to the audit committee information that the auditor believes will be relevant to the audit committee in fulfilling its responsibilities under the UK Corporate Governance Code, including, for example, the auditor's views on matters such as the robustness of the directors' assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity and its outcome.

- 1.15 If given the ability to do so, the FRC therefore proposes to exercise the provisions to lay down additional requirements in relation to the content of the additional report to the audit committee, subject to consultation and due process

**Question 1**

Do you agree that the FRC should, subject to continuing to have the power to 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, add to the credibility and quality of financial statements)?

## 2 Proportionate Application and Simplified Requirements

### Proportionate application of auditing standards to small undertakings

- 2.1 The Audit Directive establishes rules concerning all statutory audits of annual and consolidated financial statements. Article 26 of the Audit Directive requires auditors to carry out statutory audits in compliance with “international auditing standards” adopted by the Commission. Member States may apply national auditing standards, procedures or requirements if the Commission has not adopted an international auditing standard covering the same subject-matter. Member States may also impose additional audit procedures or requirements where necessary to give effect to national legal requirements relating to the scope of statutory audits or to the extent necessary to add to the credibility and quality of financial statements (see Section 1).
- 2.2 If a Member State requires the statutory audit of ‘small undertakings’, Article 26 provides that the Member State may provide that application of the auditing standards is to be proportionate to the scale and complexity of the activities of such undertakings. Member States may also take measures in order to ensure the proportionate application of the auditing standards to the statutory audits of small undertakings. ‘Small undertakings’ are defined in the Audit Directive to mean small undertakings as measured by the criteria established in the Accounting Directive (Directive 2013/34/EU).
- 2.3 As explained in Section 1 of this consultation the Commission has not yet adopted any international auditing standards. The timetable for when it may do so is not clear, but it is not expected that it will have adopted any auditing standards by the date the Audit Directive and Audit Regulation come into effect – 17 June 2016. The FRC’s auditing standards are based on the corresponding ISAs and ISQC 1 issued by the IAASB.
- 2.4 The IAASB has designed the ISAs and the ISQC to enable them to be applied in a manner proportionate with the size and complexity of an entity<sup>6</sup>. Many of the standards include specific application material identifying ‘considerations specific to smaller entities’. The IAASB continues to recognise that, in order to achieve effective implementation globally, its standards need to be, and be seen to be, capable of being proportionately applied in an audit based on the size and complexity of the entity and is expected to continue to take this into consideration when revising its standards in the future.
- 2.5 All the FRC’s auditing standards were updated in 2009 for the IAASB’s revised ISAs which had, inter alia, been revised to improve their clarity. 17 out of 18 respondents to the consultation on that update supported the view that that same standards should apply to audits of entities of all sizes. A post implementation review of the ‘clarity standards’ identified areas where improvements could be considered but did not identify major issues concerning the ability to apply the standards proportionately.
- 2.6 In light of the above, the FRC does not believe that it needs to take further specific action at this time to provide that application of the auditing standards is proportionate

---

<sup>6</sup> An IAASB staff paper “Applying ISAs Proportionately with the Size and Complexity of an a Entity” can be obtained at:

<http://www.ifac.org/sites/default/files/publications/files/applying-isas-proportionate.pdf>

An IAASB staff paper on “Applying ISQC 1 Proportionately with the Nature and Size of a Firm” can be obtained at:

[http://www.ifac.org/sites/default/files/publications/files/Staff%20QA%20ISQC%201%20Proportionality\\_FINAL.pdf](http://www.ifac.org/sites/default/files/publications/files/Staff%20QA%20ISQC%201%20Proportionality_FINAL.pdf)



to the scale and complexity of the activities of such undertakings, and would welcome views on this.

### Provision for simplified requirements

2.7 Some of the Articles in the Directive establish that Member States may provide simplified requirements for statutory audits that are:

- required by national law as regards small undertakings; or
- voluntarily conducted by small undertakings which meet national legal requirements that are equivalent to those for an audit under the point above, where national legislation defines such audits as statutory audits

2.8 These Articles and the particular requirements are:

Article	Requirements that may be simplified
<p>22b</p> <p><b>Preparation for the statutory audit and assessment of threats to independence</b></p>	<p>Matters that must be assessed and documented before accepting or continuing an engagement, including:</p> <ul style="list-style-type: none"> <li>• Compliance with Article 22 (independence)</li> <li>• Identifying threats to independence and safeguards</li> <li>• Having the competent employees, time and resources to carry out the audit in an appropriate manner</li> <li>• Whether the key audit partner is approved as a statutory auditor</li> </ul>
<p>24a</p> <p><b>Internal organisation of statutory auditors and audit firms</b></p>	<p>Organisational requirements for auditors, including that statutory auditors or firms:</p> <ul style="list-style-type: none"> <li>• Establish policies and procedures to ensure owners and other parties do not intervene in a way that would jeopardise independence and objectivity</li> <li>• Have sound administrative and accounting procedures, internal quality control, effective risk assessment, and effective controls for information processing</li> <li>• Establish policies and procedures to ensure employees, and any other natural persons who are directly involved in the statutory audit activities, have appropriate knowledge and experience</li> <li>• Establish policies and procedures to ensure outsourcing of important audit functions does not impair the auditor's quality control or the ability of the competent authority to supervise the auditor</li> <li>• Establish effective arrangements to prevent, identify, eliminate or manage and disclose threats to independence</li> </ul>

	<ul style="list-style-type: none"> <li>• Establish adequate policies and procedures for carrying out audits, coaching, supervising and reviewing employees and organising the structure of the audit file</li> <li>• Establish an internal quality control system to ensure the quality of the audit</li> <li>• Use appropriate systems, resources and procedures to ensure continuity and regularity in the carrying out of statutory audit activities</li> <li>• Establish appropriate and effective arrangements for dealing with and recording incidents which have, or may have, serious consequences for the integrity of audit activities</li> <li>• Have adequate remuneration and performance policies, providing sufficient incentives to secure audit quality. The amount of revenue derived from providing non-audit services to the audited entity shall not form part of the performance evaluation and remuneration of any person involved in, or able to influence the conduct of, the audit</li> <li>• Monitor and evaluate the adequacy and effectiveness of systems, internal quality control and arrangements established in accordance with the Directive and, where applicable, the Audit Regulation, and take appropriate measures to address deficiencies.</li> </ul>
<p>24b</p> <p><b>Organisation of the work</b></p>	<p>Requirements for the auditor to keep records of:</p> <ul style="list-style-type: none"> <li>• Any breaches of the provisions of the Directive and, where applicable, of the Audit Regulation. Member States may exempt all auditors from this obligation with regard to minor breaches.</li> <li>• Any consequence of any breach, including the measures taken to address such breach and to modify their internal quality control system. They shall prepare an annual report containing an overview of any such measures taken and shall communicate that report internally.</li> <li>• Any complaints made in writing about the performance of the statutory audits carried out.</li> </ul>

2.9 When developing the Ethical Standards for Auditors (ESs), the former Auditing Practices Board (APB) of the FRC considered (a) the implications to all audit firms, irrespective of size and (b) the effect on audits of whatever nature and size, irrespective of whether the entity is publicly traded or privately owned. It confirmed through consultation, that it should prepare the ESs to apply to all audits regardless of the size of the entity, and that those ESs should be supplemented, where appropriate, by additional requirements to address the position of listed companies.

2.10 However, to address particular concerns about the impact on small entities that had been identified in the consultation process, the APB decided to allow the option of taking advantage of relief from a small number of the requirements in the ESs for a

Small Entity audit engagement. Such relief is provided in the form of an additional standard setting out the 'Provisions Available for Small Entities' (the ES PASE). Taking advantage of a relief in the ES PASE requires the auditor's report to disclose this fact to ensure that users of the accounts are kept informed about the situation. With the exception of the ES PASE, the FRC has not established 'simplified' requirements for auditors of small undertakings.

- 2.11 Quality control requirements for audit firms, which include organisational requirements, are established in the FRC's (ISQC (UK and Ireland) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*. Quality control requirements at the audit engagement level are established in ISA (UK and Ireland) 220, *Quality Control for an Audit of Financial Statements*. As explained above, the audit and ethical standards are designed to be able to be applied in a manner that is proportionate with the size and complexity of an entity. Responses received to previous consultations have generally supported the view that the same standards and requirements should apply to all audits.
- 2.12 The FRC will consult in 2015 on the detailed specific revisions to the audit and ethical standards needed to reflect the requirements of the Audit Directive and Audit Regulation. In developing those proposed revisions we will consider whether simplified requirements for the matters identified above in the Directive are appropriate and, if we are able to do so, how they could be implemented. To help our considerations, the FRC would welcome views on this beforehand.

### **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.

### **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 to Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

### 3 Extending the More Stringent Requirements for Public Interest Entities to Other Entities

- 3.1 The Audit Regulation lays down requirements for the carrying out of the statutory audit of annual and consolidated financial statements of “public-interest entities” (PIEs). It also establishes rules on the organisation and selection of statutory auditors and audit firms by public interest entities to promote their independence and the avoidance of conflicts of interest, and rules on the supervision of compliance by statutory auditors and audit firms with those requirements.
- 3.2 The requirements set out in the Audit Regulation are more stringent than those Member States are required to establish more generally for all statutory audits under the Audit Directive. The definition of PIEs is therefore relevant to ensuring that the regulatory impact of the more stringent requirements of the Audit Regulation falls on all appropriate entities and is not higher than is necessary to serve the public interest.
- 3.3 The EU definition of PIEs for the purpose of the Audit Regulation is set out in Article 2 of the Audit Directive.

‘Public interest entities’ means:

- (a) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC;
- (b) credit institutions as defined in point 1 of Article 3(1) of Directive 2013/36/EU of the European Parliament and of the Council<sup>1</sup>, other than those referred to in Article 2 of that Directive;
- (c) insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC; or
- (d) entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.

- 3.4 The cross references to various other Directives (which themselves have further references to other Directives) in essence result in PIEs defined as:
- Entities with securities admitted to trading on a regulated market in a Member State (‘EU listed entities’);
  - Credit institutions (includes banks);
  - Insurance undertakings;
  - Other entities designated by Member States as public interest entities.
- 3.5 The Audit Regulation provides a Member State option to exclude certain cooperatives and savings banks (covered by the above definition) that are required or permitted to be a member of a non-profit making auditing entity to be excluded from all or some of the provisions of the Audit Regulation. The rationale for this is that the statutory audit of these cooperatives and savings banks is characterised in some Member States by a system that does not allow them to choose their statutory auditor or audit firm freely.

The audit association to which the cooperative or savings bank belongs as a member is obliged by law to carry out the statutory audit. Such audit associations act on a non-profit-making basis without pursuing commercial interests, as results from their legal nature. In addition, the organisational units of these associations are not associated with a common economic interest, which could jeopardise their independence. However, this circumstance does not arise in the UK and this option is therefore not relevant.

- 3.6 BIS is seeking views on the Member State option to widen the EU definition of PIEs (see paragraph 3.3(d) above). As explained in chapter 6.1 of its Discussion Document, BIS does not (subject to confirmation from that consultation) propose to widen the EU definition of PIEs for statutory purposes and accordingly will not designate other entities as such. PIEs as defined for the purpose of the Audit Directive and Regulation are subject, without exception, to all the legal provisions applicable to PIEs – Member States cannot establish sub-categories of PIEs in law and, for example, apply only certain provisions of the Audit Regulation to them. As a result, including additional categories of entity to the statutory definition of PIEs would not allow for selective application of certain more stringent statutory requirements to those entities.
- 3.7 Whilst we agree with the BIS proposal, we believe it is relevant also to consider whether there are entities that do not automatically fall under the definition of PIEs in accordance with the Audit Regulation but are nonetheless of sufficient public interest to warrant applying to them some but not all of the more stringent requirements applicable to PIEs.
- 3.8 Currently, the FRC's audit and ethical standards include more stringent requirements in a number of areas for 'listed entities' and more communication requirements for 'entities that are required, or choose voluntarily, to report on how they have applied the UK Corporate Governance Code', rather than defining a wider category of PIEs for this purpose. However, audit firms are also required to establish policies and procedures which set out the circumstances in which those requirements that apply to listed companies are applied to other audit engagements. The more stringent requirements in the FRC's auditing and ethical standards relate primarily to:
- Engagement quality control review (EQCR), including:
    - Requiring that the review provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.
    - Specifying particular matters to be covered by the review including, discussing significant matters with the engagement partner, reviewing the financial statements, reviewing audit documentation relating to significant judgments and conclusions, and evaluating the conclusions reached in formulating the auditor's report and whether it is appropriate.
  - Communications to those charged with governance and the audit committee about the audit and audit findings, including:
    - Confirming compliance with relevant ethical requirements regarding independence, and giving details of relationships and other matters between the auditor, and its network firms, and the audited entity that may bear on independence.

- For entities that report on application of the UK Corporate Governance Code, communicating to the audit committee information the auditor believes will be relevant to the Board and the audit committee in the context of fulfilling particular responsibilities of the Board and audit committee under the Code. This includes the auditor's views on matters such as business risks relevant to financial reporting, significant accounting policies, management's valuations, the entity's system of internal control, the robustness of the directors' assessment of the principal risks facing the entity, and the directors' explanation in the annual report as to how they have assessed the prospects of the entity.
- Additional information to include in the auditor's report, including:
  - For entities that report on application of the UK Corporate Governance Code:
    - Describing those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;
    - Providing an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole; and
    - Providing an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement and was influenced by the auditor's application of materiality.
- More stringent limits on the proportion of total audit and non-audit fees that can be earned from a particular audited entity/group (see Section 5, paragraph 5.20).
- Rotation periods for key audit partners (see Section 7, paragraph 7.7). Rotation periods are not mandated for entities that are not listed, but auditors are required to assess the threats arising from long association and apply safeguards or, if appropriate safeguards cannot be applied, not undertake the audit.
- More stringent restrictions on non-audit services that can be provided to a listed audited entity (see Section 4). Lesser restrictions apply for particular services provided to other entities (providing, inter alia, they do not have material effect on the financial statements and the auditor does not take decisions that are the responsibility of management), including valuation services, tax calculations, litigation support, some recruitment services, restructuring services, and accounting services.

3.9 The meaning of 'listed entity' is defined by the FRC for the purpose of the auditing and ethical standards.

*Listed entity* - An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body. (This is consistent with the definition established by the IAASB for the purpose of the ISAs, on which the FRC's auditing standards are based.)

For the purpose of APB Ethical Standards, listed company includes any company in which the public can trade shares on the open market, such as those listed on the London Stock Exchange (including those admitted to trade on the Alternative Investments Market), PLUS Markets and the Irish Stock Exchange (including those admitted to trade on the Irish Enterprise Exchange).

3.10 It can be seen that the FRC's definition of 'listed entity' includes, but is wider than, the scope of 'EU listed entities' that are covered by the Audit Directive definition of a PIE. However, the FRC's audit and ethical standards do not currently include more stringent requirements for credit institutions and insurance undertakings that are not listed entities. There are four possible categories of entity that may be considered to be of some public interest:

- PIE and also 'Listed' as currently defined by the FRC – for example, a company listed on the London Stock Exchange
- PIE but non-Listed – for example, a non-Listed bank or insurance company
- Non-PIE but 'Listed' as currently defined by the FRC – for example, an AIM-listed company
- Non-PIE and non-Listed – for example, certain public sector entities without any listing.

3.11 The FRC's audit and ethical standards will need to be revised to be at least consistent with the relevant provisions of the Audit Regulation for PIEs. There are a number of alternative options for doing so by applying some or all of the more stringent requirements of the Regulation or some or all of the current more stringent requirements applicable to Listed entities (as currently defined by the FRC) to categories of entity other than PIEs. These options would reflect different public interest expectations and would give rise to differing degrees of complexity in the FRC's standards. Such complexity may make the expectations of auditors less clear to investors and other stakeholders and could therefore reduce their confidence in the independence of auditors.

3.12 One alternative would be to revise the standards to reflect the minimum requirements necessary to comply with the Audit Regulation - deleting the existing requirements for Listed entities as currently defined in the FRC standards and simply adding the requirements for PIEs set out in the Audit Regulation. This would require only two categories of entity to be distinguished – PIE and non-PIE. It would also be deregulatory for some entities:

- (a) Listed entities as defined by the FRC that are not PIEs (such as an AIM-Listed entity), because this would disapply the current FRC requirements applicable to them; and
- (b) Listed entities as defined by the FRC that are also PIEs (such as a company listed on the London Stock Exchange) because this would disapply the current

more stringent FRC requirements applicable to them that are not also required by the Audit Regulation.

3.13 A second alternative, that would maintain the status quo in terms of the current FRC requirements but would also be consistent with the Audit Regulation, would be to keep the existing requirements for Listed entities, as defined by the FRC, but to add requirements for PIEs that would be necessary to implement the Audit Regulation. There would be different requirements applicable to each of the four categories of entity referred to in paragraph 3.10:

- (a) PIE and also Listed – The more stringent requirements of the Audit Regulation as well as any incremental ones required under the current FRC requirements would apply;
- (b) PIE but non-Listed – The more stringent requirements of the Audit Regulation would apply;
- (c) Non-PIE but Listed – The more stringent requirements under the current FRC requirements would apply; and
- (d) Non-PIE and non-Listed – Neither class of more stringent requirements would apply.

3.14 A third approach, that would have fewer levels of differing requirements than the approach outlined in paragraph 3.13, would be retaining but amending the existing requirements for Listed entities to be requirements only for PIEs as well as adding requirements for PIEs that would be necessary to implement the Audit Regulation. As compared with the first alternative, this would be similarly deregulatory for Listed entities that are not PIEs (such as an AIM-Listed entity), but would not be deregulatory as compared to the status quo for Listed entities that are also PIEs. For entities that are PIEs but non-Listed (such as an unlisted bank or insurance company) this approach would add to the requirements of the Audit Regulation any more stringent requirements of the current FRC standards.

3.15 There are other alternatives that would arise from applying some or all of the more stringent requirements in the FRC's current standards, and/or some or all of the requirements of the Audit Regulation applicable to PIEs, selectively to some non-PIEs. In this regard, relevant considerations would include whether any, and if so which, entities that are PIEs but non-Listed, Listed but not PIEs or not PIEs and non-Listed should be made subject to some or all of those more stringent requirements. This could be achieved without making such entities subject to the other provisions in the Audit Regulation, that are not directly included in the audit and ethical standards, and to other UK law and regulations specific to PIEs. If so, it would also be relevant to consider which of those more stringent requirements should apply in each case. These considerations are discussed further below.

### **Listed entities**

3.16 As explained above, the FRC's definition of a listed entity is broader than 'EU listed entities' included in the Audit Directive definition of a PIE (essentially those entities admitted to trading on an EU regulated market), extending the definition to include entities whose securities are traded publicly on an equivalent market outside the EU or on a non-EU regulated market within the EU. The FRC wishes to understand stakeholders views as to whether there are reasonable grounds for applying more stringent audit and ethical requirements in the audit and ethical standards, to an entity if it is an EU listed entity but not if it otherwise meets the definition of a listed entity.



Accordingly, the FRC wishes to understand whether stakeholders believe that there are reasonable grounds why the more stringent audit and ethical requirements should not be applicable to some or all types of entities other than EU listed entities that are listed entities as currently defined for the purposes of the FRC's audit and ethical standards.

### ***Other entities***

3.17 As noted above, the EU Directive provides that Member States can designate other entities as PIEs. BIS does not propose to do so for statutory purposes. Nevertheless, it is possible that stakeholders will expect the more stringent requirements established in the FRC's audit and ethical standards for PIEs to apply to other entities that are not PIEs as defined in the Audit Directive and are also not listed entities as currently defined by the FRC.

#### *Arguments for applying the more stringent audit and ethical standards requirements to more entities*

3.18 The primary argument is that stakeholders may perceive there are other entities that are 'clearly' of sufficient public interest and expect audits of them to be subject to the same, more stringent, requirements as PIEs. This could help maintain confidence in audit.

3.19 While audit firms are required by FRC's standards to establish policies and procedures which set out the circumstances in which those requirements that apply to listed companies are applied to other audit engagements, there is a lack of consistency in how different firms do this and the types of entity that are so covered. Applying the more stringent audit and ethical standards requirements to more specified entities would improve consistency of application of the requirements and ensure that audits of entities that are generally perceived to be of sufficient public interest are subject to those requirements.

#### *Arguments for not applying the more stringent audit and ethical standards requirements to more entities*

3.20 An argument against is that this would unnecessarily go beyond the EU requirements. However, the EU Audit Directive and Regulation have been developed in a manner that establishes the minimum scope of application and clearly recognises that Member States should, where appropriate, be able to categorise more entities as PIEs and has specifically provided for this possibility. Applying only some of those requirements (those directly included in the audit and ethical standards) more widely would therefore be consistent with what is envisaged in the Audit Regulation and Directive. The FRC believes the issue is whether, given the relative complexity and sophistication of our capital markets compared with many other parts of Europe, other types of publicly traded entity should be treated in an analogous manner to entities whose securities are traded on an EU market and believes this can be distinguished from what might normally be considered to unnecessarily go beyond the EU requirements.

3.21 An argument against widening the application of the more stringent requirements to entities that are not currently subject to those requirements is that this has not previously been raised as a significant concern by stakeholders. This could be because stakeholders believe appropriate additional entities are subject to those more stringent requirements because they believe auditors designate them for that purpose in accordance with the audit and ethical standards requirements.

*If the more stringent audit and ethical standards requirements are to be applied to more entities, to which ones?*

3.22 The FRC has previously explored and consulted on (through the former Auditing Practices Board when the Ethical Standards for Auditors were being developed) whether it was possible to develop a generic definition of a PIE that could ensure consistency in designation of entities for audit purposes, and concluded that it was not possible. However, the more stringent requirements for PIEs as defined in the Audit Directive could be applied to other types of entity if considered appropriate to meet stakeholder expectations. The FRC's Audit Quality Review (AQR) team currently monitors the quality of the audits of listed and other entities in whose financial condition there is a major public interest.

<b>Entities whose audits fall with the scope of the AQR for 2014/15<sup>7</sup></b>	<b>EU PIE</b>	<b>FRC 'listed entity'</b>
<ul style="list-style-type: none"> <li>All UK incorporated companies with listed equity and / or listed debt.</li> </ul>	<p style="text-align: center;">✓</p> <p>(when listed on a regulated market of a Member State)</p>	✓
<ul style="list-style-type: none"> <li>All non-EEA incorporated companies with listed equity and / or listed debt audited by a UK Registered Auditor.</li> </ul>	✗	✓
<ul style="list-style-type: none"> <li>AIM or ISDX-quoted companies incorporated in the UK with a market capitalisation in excess of £100 million.</li> </ul>	If a credit institution or insurance undertaking	✓
<ul style="list-style-type: none"> <li>UK unquoted companies, groups of companies, limited liability partnerships or industrial and provident societies with Group turnover in excess of £500million.</li> </ul>	If a credit institution or insurance undertaking	✗
<ul style="list-style-type: none"> <li>UK incorporated banks not already included in any other category.</li> </ul>	✓	✗
<ul style="list-style-type: none"> <li>UK Building Societies.</li> </ul>	✓	✗
<ul style="list-style-type: none"> <li>Private sector pension schemes with either more than £1,000 million of assets or more than 20,000 members.</li> </ul>	✗	✗
<ul style="list-style-type: none"> <li>Charities with incoming resources exceeding £100 million.</li> </ul>	✗	✗

<sup>7</sup> More specific details of entities within the scope of the AQR can be found at: <https://www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx>

<ul style="list-style-type: none"> <li>• Friendly Societies with total net assets in excess of £1,000 million.</li> </ul>	<p style="text-align: center;">✓ (insurance undertakings)</p>	✘
<ul style="list-style-type: none"> <li>• UK Open-Ended Investment Companies and UK Unit Trusts managed by a fund manager with more than £1,000 million of UK funds under management.</li> </ul>	✘	✘
<ul style="list-style-type: none"> <li>• Mutual Life Offices whose “With-Profits” fund exceeds £1,000 million.</li> </ul>	<p style="text-align: center;">✓ (insurance undertakings)</p>	✘

3.23 The AQR categories are not intended to be a definitive list of the types of entities in which there may be a public interest; the categories focus on the larger of certain types of entities and the list is subject to review and change each year. However, it helps to illustrate the types of other entity that could be considered appropriate to fall under the more stringent requirements in the audit and ethical standards. In addition, other entities that may be considered to be of sufficient public interest for this purpose could include, for example, certain public sector bodies in which there is a clear public interest.

#### 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?

#### 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 stringent requirements should apply to which types of other listed entities?

#### 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?

## 4 Prohibited Non-audit Services

4.1 Article 5 of the Audit Regulation stipulates that a statutory auditor or an audit firm carrying out the statutory audit of a public-interest entity, or any member of the network to which the statutory auditor or the audit firm belongs, shall not directly or indirectly provide to the audited entity, to its parent undertaking or to its controlled undertakings within the Union any prohibited non-audit services in:

- (a) the period between the beginning of the period audited and the issuing of the audit report; and
- (b) the financial year immediately preceding the period referred to in point (a) in relation to the services listed in point (e) of the second subparagraph. (see below)

The prohibited non-audit services specified in Article 5 are:

- (a) tax services relating to:
  - (i) preparation of tax forms;
  - (ii) payroll tax;
  - (iii) customs duties;
  - (iv) identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law;
  - (v) support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspections is required by law;
  - (vi) calculation of direct and indirect tax and deferred tax;
  - (vii) provision of tax advice;
- (b) services that involve playing any part in the management or decision-making of the audited entity;
- (c) bookkeeping and preparing accounting records and financial statements;
- (d) payroll services;
- (e) designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems;
- (f) valuation services, including valuations performed in connection with actuarial services or litigation support services;
- (g) legal services, with respect to:
  - (i) the provision of general counsel;

- (ii) negotiating on behalf of the audited entity; and
- (iii) acting in an advocacy role in the resolution of litigation;
- (h) services related to the audited entity's internal audit function;
- (i) services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity;
- (j) promoting, dealing in, or underwriting shares in the audited entity;
- (k) human resources services, with respect to:
  - (i) management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:
    - searching for or seeking out candidates for such position; or
    - undertaking reference checks of candidates for such positions;
  - (ii) structuring the organisation design; and
  - (iii) cost control.

4.2 Article 5 provides that a statutory auditor or an audit firm carrying out statutory audits of public-interest entities may provide to the audited entity, to its parent undertaking or to its controlled undertakings non-audit services other than the specified prohibited non-audit services. This is subject to the approval of the audit committee after it has properly assessed threats to independence and the safeguards applied. Where the statutory auditor or the audit firm belongs to a network, these provisions also apply to any member of the network.

4.3 There are three Member State options to consider:

- (i) Member States may prohibit services in addition to those listed in Article 5 where they consider that those services represent a threat to independence.
- (ii) By way of derogation, Member States may allow the provision of the services referred to in points (a) (i), (a) (iv) to (a) (vii) and (f), provided certain that the following requirements are complied with:
  - (a) they have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements;
  - (b) the estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee referred to in Article 11; and
  - (c) the principles of independence laid down in [the Audit Directive] are complied with by the statutory auditor or the audit firm.

- (iii) Member States may establish stricter rules setting out the conditions under which a statutory auditor, an audit firm or a member of a network to which the statutory auditor or audit firm belongs may provide to the audited entity, to its parent undertaking or to its controlled undertakings non-audit services other than the prohibited non-audit services.

4.4 The approach to independence for auditors of PIEs under the Audit Directive and Regulation is to:

- Prohibit the auditor from providing any non-audit services that would involve the auditor in auditing their own work or from playing any part in the management of the entity;
- Require the auditor to assess the threats to independence arising from any proposed non-audit services and to establish appropriate safeguards to address them;
- Require audit committee consideration of the adequacy of the proposed safeguards to address threats to the auditor's independence and to approve such services only if they are satisfied the safeguards will be adequate.

4.5 Actual and perceived threats to auditor independence that arise from the provision of non-audit services to PIEs are additionally addressed by the establishment of a cap on the fees that can be earned from the provision of non-audit services that are not prohibited (see Section 5 of this consultation document). There are some differences between the scope of the prohibitions and the cap, in particular regarding the extent to which network firms are included and the application to audited entities outside the EU (see paragraph 5.11):

- In the case of the prohibitions, whilst these apply to the auditor and its network firms wherever they are based, they only apply to services provided to the audited entity and entities controlled by it that are based within the EU; and
- In the case of the cap, this does not encompass services provided by the auditor's network firms.

Accordingly, it would be possible for the auditor and its network firms to provide non-audit services through a non-EU based network firm to a component of the group based outside the EU.

### **The status quo under the FRC's ethical standards**

4.6 Currently, the FRC's ethical standards adopt, as a base line, a threats and safeguards approach to non-audit services. Overlaid on this, there are non-audit services that are prohibited in certain circumstances (where it has been determined based on consultation that no safeguards could address the threats to the auditor's independence to the satisfaction of a reasonable and informed third party). In some respects, these prohibitions go beyond those in the Audit Regulation but in some other respects they are less stringent. The auditor is required to identify and evaluate threats and apply appropriate safeguards if they are to accept the engagement. For listed entities, there are further safeguards as follows:

- A requirement in the ethical standards that "In the case of listed companies where the fees for non-audit services for a financial year are expected to be greater than the annual audit fees, the audit engagement partner shall provide

details of the circumstances to the Ethics Partner and discuss them with him or her. Where the audit firm provides audit services to a group, the obligation to provide information to the Ethics Partner shall be on a group basis for all services provided by the audit firm and its network firms to all entities in the group.”

- For companies that comply with the UK Corporate Governance Code, responsibilities of the audit committee, specified in the Code, include developing and implementing a policy on the engagement of the external auditor to supply non-audit services. If the external auditor provides non-audit services, the section of the annual report that describes the work of the audit committee should include an explanation of how auditor objectivity and independence are safeguarded.
- Details of fees paid for audit and non-audit services to the auditor and the auditor’s associates have to be disclosed by companies in their annual accounts, ensuring there is transparency.

### **Implications of moving from the FRC’s status quo to the requirements of the Audit Directive and Regulation**

- 4.7 Notwithstanding the current FRC requirements and the safeguards applied, concerns continue to be expressed by some stakeholders about non-audit services provided to audited entities. It is not clear whether these concerns would be completely addressed by implementing the requirements established by the Audit Directive and Regulation. We believe, therefore, that it is important to consider whether and, if so how, appropriate exercise of the Member State options in this area may be appropriate in the public interest to further address these concerns.
- 4.8 The exercise of such Member State options could be considered appropriate, for example, to maintain the status quo in the FRC’s current ethical requirements. It could also be considered appropriate to go further than the current requirements, depending on whether the benefits of doing so would outweigh the impact of doing so. In consulting on a range of possible options which could be considered, we are seeking stakeholder feedback on the impact of those options as well as on their perceived benefits. Stakeholder impact will assist the FRC in developing any specific proposals that may be considered appropriate to consult upon further in due course, having regard to the principles for the development of standards referred to in paragraph (viii) of the Introduction to this consultation document.

### ***Prohibition of additional non-audit services***

- 4.9 The categories of prohibited non-audit services specified in the Audit Regulation are broadly consistent with those for listed entities in ES 5. However, the scope of the restrictions in the Audit Regulation are more extensive both in relation to the types of entity covered (PIEs vs listed entities) and the types of service (for example, ES 5 does not prohibit all forms of tax advice). Also, the Regulation generally establishes outright prohibitions for the categories (subject to a few possible exceptions – see below), while in ES 5 some services are allowed if not material to the financial statements. ES 5 also allows some otherwise prohibited services to be provided to listed entities in ‘emergency situations’, which the Audit Regulation does not. ES 5 is also more restrictive regarding human resources services; and is more detailed in its description of prohibited corporate finance, transaction related and restructuring services, and accounting services.

4.10 The FRC is considering whether it is necessary or appropriate to exercise the Member State option to prohibit additional non-audit services to address concerns about the threats to auditor independence and, if so, the mechanisms for doing so. One way of doing so, if considered appropriate, would be to add additional services to the 'black list' of prohibited services in the Audit Regulation. An alternative would be to establish, a 'white list' of permitted services with auditors prohibited from providing all other services to audit clients.

4.11 Currently, ES 5 establishes a category of 'audit related services'.

Audit Related Services specified in ES 5 are:

- Reporting required by law or regulation to be provided by the auditor;
- Reviews of interim financial information;
- Reporting on regulatory returns;
- Reporting to a regulator on client assets;
- Reporting on government grants;
- Reporting on internal financial controls when required by law or regulation;
- Extended audit work that is authorised by those charged with governance performed on financial information<sup>8</sup> and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions.

4.12 'Audit related services' are defined as "those non-audit services specified in [ES 5] that are largely carried out by members of the engagement team and where the work involved is closely related to the work performed in the audit and the threats to auditor independence are clearly insignificant and, as a consequence, safeguards need not be applied."

4.13 If the FRC were to revise ES 5 to allow only specified non-audit services to be provided by the auditor of a PIE, it could establish a 'white list' based on the current 'audit related services' plus any such other services identified for which it would be evident to stakeholders that the auditor of the entity is clearly an appropriate provider and an objective, reasonable and informed third party would not conclude that the auditor's independence is compromised by providing these services. For example, these may be considered to include, in addition to the audit related services above:

- Reports required by the competent authorities / regulators supervising the audited entity, where the authority / regulator has either specified the auditor to provide the service or identified to the entity that the auditor would be an appropriate choice for service provider. These might include, for example:
  - in relation to entities regulated under the Financial Services and Markets Act 2000 (FSMA), reports under s166 and s340 of FSMA; and

---

<sup>8</sup> This does not include accounting services.



- other reports provided for under the rules of the competent authority / regulator.
- Audit and other services provided as auditor of the entity, or as ‘reporting accountant’, in relation to information of the audited entity for which a reasonable and informed third party would conclude that the understanding of the entity obtained by the auditor for the audit of the financial statements is relevant to the service, and the nature of the service would not compromise the auditor’s independence and objectivity. These might include, for example:
  - audit and other services relating to public reporting as reporting accountant on financial or other information of the audited entity in a prospectus or circular (including reports that may be required by the Prospectus Rules, the Listing Rules and the Take Over Code);
  - services, including private reporting, that are customarily performed by the reporting accountant to support statements made by the directors, disclosures in a prospectus or circular or, in the case of premium listed issuers, to support confirmations provided by the sponsor to the FCA;
  - audit and other assurance services relating to public reporting on other information issued by the entity, such as reports on information in the front of annual reports not covered by the auditor’s report on the financial statements.

4.14 However, it may also be appropriate to add other services to this list if this approach were adopted, and we are seeking stakeholder feedback on which services should be included in such a ‘white list’ to enable us to consider the feasibility of doing so. If established, the white list of specified allowed non-audit services would also need to be reviewed at intervals to ensure it continued to reflect the expectations of stakeholders without unnecessarily inhibiting audited entities from obtaining non-audit services from their auditor where considered appropriate.

4.15 The Audit Directive and Regulation clearly recognise that Member States may wish to impose further restrictions to address threats to auditor independence and has specifically provided for this possibility because there was a range of views on the matter across Europe. The FRC has identified a number of arguments both against and for the prohibition of further non-audit services for PIEs (either through adding to the ‘black list’ or establishing a ‘white list’) and is seeking stakeholder feedback as to the extent to which these and other arguments are persuasive to them and should be taken into consideration.

Arguments against introducing further restrictions

4.16 Arguments include:

**Responsibility for determining whether the auditor should provide particular additional services should remain a consideration for audit committees.**

4.17 Existing provisions in the UK Corporate Governance Code (which would apply to some PIEs) require audit committees to take auditor independence into account when considering whether they should be engaged to perform non-audit services, and this will in effect be established in law through the Audit Regulation. Imposing further prohibitions through law or standards, on services that auditor can undertake, reduces

the responsibility of audit committees to make decisions in the best interest of the entity.

**Acceptable non-audit services could be unnecessarily prohibited giving rise to an unnecessary, and potentially costly, reduction in choice for audited entities.**

- 4.18 A risk of introducing a white list of specified permitted non-audit services is that with hindsight it becomes evident that certain services have been omitted, and therefore effectively prohibited, that could have been included. Also, new services could arise that might be considered appropriate for the auditor to undertake, but are not on the list. Having to obtain a non-audit service from another provider other than the auditor could increase costs for the audited entity if that other provider had to obtain knowledge of the entity that the auditor of the entity already possessed. Also, a lack of familiarity with the entity could, depending on the nature of the service, result in a non-audit service provided by a provider other than the auditor being of lower quality, as the other provider might not recognise issues that would be evident to the auditor with its knowledge of the entity. As indicated above, if a white list is established, the FRC would need to periodically review it, but it would inevitably take a period of time to update.
- 4.19 It would be helpful if respondents could indicate whether or not provisions could be made to adequately mitigate the risk that adopting a 'white list' approach might inappropriately prevent an auditor from providing services not specifically prohibited, and not specifically considered in developing the white list. For example, it might be considered appropriate to allow the audit committee to approve services not on a white list in exceptional circumstances and, where so, to require disclosure in the audit committee report and/or in the auditor's report of the service provided and the reason why it was appropriate?

**A resulting increase in non-audit services provided to non-audit clients may reduce the number of firms willing or able to tender for particular audits.**

- 4.20 Depending on the nature of the non-audit service and how far forward it may impact the financial statements, firms that provide them may in effect rule themselves out of future tenders for particular audits. For example, if a firm provides advice to a non-audited entity on systems that affect the amounts in the financial statements they would be precluded (as is currently the case) from accepting appointment as auditor of that entity for at least as long as the effect on the financial statements is material (as there would be a significant 'self-review' threat). If on average firms provide more of such services to each non-audited entity (e.g. to make up for lost income from non-audit services provided to audited entities) there could be a reduction in the number of firms able to tender for particular audits. The restrictions on providing non-audit services to an audited entity may also make it less attractive for an audit firm to perform audit services for some or all PIEs and could also reduce their incentive to invest in audit innovation.

**Providing non-audit services is important for audit firms to enable their staff to obtain a broader knowledge and understanding of companies and industry sectors and to provide interesting variety in their work to help attract and retain the best people.**

- 4.21 It has been argued that providing non-audit services to audit clients is a significant benefit in developing staff and providing them with a variety of fulfilling experience. The FRC will welcome respondents' views when answering the consultation questions as to why, if they believe it to be the case, such benefits to staff may be greater if they are

provided to audit clients rather than to non-audit clients. Audit firms would still be able to provide such services to non-audit clients so such benefits should still be achievable.

**Further prohibitions would unnecessarily go beyond the Audit Regulation.**

- 4.22 Further prohibitions, in addition to restricting the choice of service provider available to entities may also restrict the commercial activities of audit firms. Such restrictions should not, therefore, be imposed unless there is an appropriate public interest argument to do so.

**Arguments for introducing a “white list”**

- 4.23 The primary argument identified is that:

**The benefits to the perception of the auditor’s independence may be considerable because there would be much greater clarity as to what is permissible and why and therefore eliminate the perception of the underlying threat to the auditor’s independence.**

- 4.24 The primary issue with non-audit services is that, even when approved by the audit committee, they are perceived to align the audit firm’s commercial interests in winning such assignments with the interests of management. They are therefore perceived to compromise auditor independence, and reduce confidence in the value of the audit.
- 4.25 The Audit Regulation also recognises this broader ‘alignment of interests’ issue because it imposes a limit on the value of non-audit services that are not prohibited, and not specifically required by law, that can be provided by the auditor to a PIE (see Section 5).
- 4.26 The current approach in the ESs – prohibiting certain services that are deemed material to the financial statements and / or present an insurmountable threat to auditor independence, whilst allowing other services if safeguards are put in place – does not fully address this perception. A common safeguard that auditors apply is to put a separate team in place to perform the engagement. However, this may not be seen as being effective against a threat which could operate through unseen and perhaps subtle influences within the audit firm partnership – these influences may, for example, simply come from the auditor knowing that the non-audit relationship is important to the firm.
- 4.27 A clearer approach, that may avoid uncertainties as to the appropriateness of particular services and should enhance confidence in audit, would be to allow only specified audit related services for PIEs (for which it is generally evident to all stakeholders that such work would be likely to be assigned to the auditor) and prohibit the auditor from providing all other non-audit services to those entities. Development of such an approach would be subject to consultation and have regard to the principles for developing standards referred to in paragraph (viii) of the Introduction to this consultation document.
- 4.28 This perception issue about the auditor’s independence does not appear to be as significant in relation to entities which are not generally regarded as public interest entities and, therefore, the FRC believes it does not seem necessary to consider such an approach for them. This would be in accordance with the spirit of the Audit Regulation which states in its preamble text that “These strict requirements should be

applicable to statutory auditors and audit firms only insofar as they carry out statutory audits of public-interest entities.”

For many companies, the supplemental impact of such further prohibition on audit committee choice and commercial flexibility for auditors may not be extensive

4.29 The range of non-audit services prohibited by the Audit Regulation is quite broad. As a result, the FRC believes there may be relatively few services currently provided, other than audit related services, that would be permitted under the Audit Regulation. The FRC has reviewed the annual reports of the FTSE 100 for 2013 and identified that non-audit services provided to them comprised:

	£m	% of audit fees	Status under Audit Regulation
Audit Related	94	16%	Likely permitted
Other Assurance Services	33	6%	May be permitted
Tax Compliance Services	34	6%	Likely prohibited
Tax Advisory Services	44	8%	Likely prohibited
Corporate Finance Services	16	3%	Likely prohibited
Pension Scheme Services	7	1%	May be permitted
Other Non-audit Services	61	10%	Need further detail to assess
Total	289	50%	

4.30 Based on the table above, audit related services (as currently defined) in 2013 represented approximately 16% of audit fees; and it seems unlikely that other non-audit services currently being provided representing more than a further 10-15% could be eligible to consider in relation to an extended definition of audit related services. It is not possible to consider this in much further detail just from our analysis of the nature of non-audit services disclosed in annual reports, because the disclosures (required and provided) are insufficiently granular. However, some voluntary disclosures reveal that ‘other assurance services’ and ‘other non-audit services’ include services such as:

- Sustainability assurance;
- Independent project assurance;

- IT services; and
- Training support for IFRS.

4.31 It should be noted that while the total of non-audit service fees of £289 million is approximately 50% of the audit fees charged of £576 million, we identified that a significant number of individual entities still spend more than the equivalent of 70% of the audit fee on non-audit services (see Section 5 which addresses the cap on fees for non-audit services).

The possible impact on the ability of audit firms to tender for particular audits

4.32 Paragraph 4.20 identifies that establishing further prohibitions on non-audit services could reduce the number of audit firms able to tender for particular audits. However, in a market where the timing of tenders will likely become fairly predictable for individual companies, audit committees have the ability to determine that non-audit services should not be obtained from firms that they may wish to keep 'clean' for possible tenders. It is also possible for audit firms to consider whether they are prepared to reduce their ability to tender for particular audits.

4.33 Further consideration could be given also as to whether, if there is an ongoing (but immaterial) effect on the financial statements of a past service, which was completed when a firm was not the auditor (but that would have been prohibited for the auditor), the firm could nonetheless subsequently accept appointment as auditor. Although this may appear at odds with prohibiting a non-audit service that has an immaterial effect on the financial statements when holding office as auditor, an important difference is, in this case, that the firm would not be looking for new work or earning fees in relation to the past service when acting as auditor. Hence, there would not be a self-interest threat.

***Derogations in respect of certain prohibited non-audit services***

4.34 The prohibited services which may be allowed by derogation, subject to the conditions set out in paragraph 4.3(ii) above (including that they have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements) are:

- Tax services relating to:
  - preparation of tax forms
  - identification of public subsidies and tax incentives
  - support regarding tax inspections by tax authorities
  - calculation of direct and indirect tax and deferred tax
  - provision of tax advice
- valuation services, including valuations performed in connection with actuarial services or litigation support services

4.35 Auditors cannot be permitted to provide to an audited entity the other prohibited non-audit services specified in the Audit Regulation in any circumstances. However, if prohibited non-audit services were widened beyond those set out in the Audit

Regulation we believe this derogation could also be applied to those additional prohibited services.

#### Arguments for taking up the derogations

4.36 The derogations are deregulatory and also broadly consistent with the current approach in ES 5 which often allows non-audit services that are not important / material to the financial statements. It may also be argued that if such services are not material to the financial statements, prohibiting them would be a disproportionate regulatory action. This may also be a particular consideration for groups that may have components in locations for which the auditor of that component is identified as the only practicable provider of a particular non-audit service.

#### Arguments for not taking up the derogations

4.37 One of the conditions for taking up the derogations is that the services should have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements. This helps to address the self-review threat faced by the auditor. However, it does not address the self-interest threat where the auditor may be perceived to align the audit firm's commercial interests in winning such assignments with the interests of management.

4.38 If the FRC, following consultation, extended restrictions as discussed above to allow only specified non-audit services to be provided, a series of exceptions based on materiality to the financial statements would make the requirements less hard edged and, therefore, less likely to have the intended aim of reducing perception issues.

4.39 No exceptions would also avoid perception issues arising related to judgments about materiality.

#### ***Audit committee's role in connection with allowed non-audit services***

4.40 As identified above, the Audit Regulation requires that the provision of non-audit services that are not prohibited must be approved by the audit committee after it has properly assessed threats to independence and the safeguards applied. This is consistent with existing provisions in the UK Corporate Governance Code and we are not aware of a demand or need for further, stricter, rules to be established.

#### ***Prohibition of other 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?

##### **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?

#### **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?

#### ***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?

#### **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?

#### ***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?

#### **Other considerations**

#### ***Application of the prohibitions outside the EU***

***Should the prohibitions on the provision of non-audit services, by the audit firm and all members of its network, apply only when the services are provided to related group components of the audited entity based in the EU (as required by the Audit Regulation) or also when provided to related group components based outside the EU?***

- 4.41 Article 5 of the Audit Regulation stipulates that "A statutory auditor or an audit firm carrying out the statutory audit of a public-interest entity, **or any member of the network** to which the statutory auditor or the audit firm belongs, shall not directly or indirectly provide to the audited entity, to its parent undertaking or to its **controlled undertakings within the Union** any prohibited non-audit services ..." (emphasis added).

- 4.42 Services provided to entities outside the EU are not completely ignored, the Audit Regulation also stipulates that “When a member of a network to which the statutory auditor or the audit firm carrying out a statutory audit of a public-interest entity belongs provides any of the non-audit services, ..., to an undertaking incorporated in a third country which is controlled by the audited public-interest entity, the statutory auditor or the audit firm concerned shall assess whether his, her or its independence would be compromised by such provision of services by the member of the network.” However, this provision does not extend to requiring consideration of services provided to a parent entity based outside the EU.
- 4.43 Restrictions imposed by ES 5 currently are generally expressed as requirements of ‘the audit firm’. For the purposes of the Ethical Standards, ‘audit firm’ is defined to include ‘network firms in the UK and Ireland which are controlled by the audit firm or its partners’. The Audit Regulation will broaden the requirements to any member firm of a network, but only in so far as they provide services to components of the audited entity based in the EU. It will not prohibit the provision of non-audit services to components of the audited entity based in other countries such as the US. Under ES 1, group audit partners have to be satisfied that other auditors who are not subject to the FRC’s Ethical Standards are objective; and audit firms have to establish that network firms not involved in the audit are required to comply with the international Code of Ethics issued by the International Ethics Standards Board for Accountants; this would not, however, necessarily require such other firms to comply with the specific prohibitions in ES 5 regarding non-audit services.
- 4.44 When the FRC revises the Ethical Standards to implement the provisions of the Audit Directive and Regulation, and to address other matters identified in the wider review of the ethical framework for auditors (see paragraph (xii) of the Introduction), a key objective will be to ensure that the ethical principles are clearly identified and that any supporting provisions are designed to assist auditors comply, and be seen to comply, with those principles. Accordingly, the FRC believes it is appropriate to consider other possible revisions to the ethical standards that can support the changes introduced by the Audit Regulation in respect of prohibited non-audit services, and contribute to the clarity of the ethical principles and the perception of stakeholders that they have been complied with.

*Arguments for applying restrictions to network firms in respect of services provided to any component of the audited entity*

- 4.45 The strict prohibitions established by the Audit Regulation are only mandated for application within the EU. However, many PIEs will have components based outside the EU and allowing weaker requirements for parts of a group audit is contrary to ensuring that the principle of independence is achieved both in practice and perception. The limitations in the Audit Regulation may reflect the limits to which the EU believes it can reasonably go in establishing restrictions in law. While the Audit Regulation does not specifically provide for extending these restrictions outside the EU, neither does it prohibit that. To ensure that auditors do, and are perceived to, comply with ethical principles the supporting provisions should apply in relation to all components of the audited entity and all members of the auditor’s network regardless of geographical location.

*Arguments for not widening the restrictions on network firms*

- 4.46 While the FRC cannot directly impose its standards on auditors in other jurisdictions it could require lead group auditors who are subject to its standards to ensure the principles of independence set out in those standards are complied with by all



members of the network whose work they decide to use in performing the audit of the group. However, it may be argued that this results in unreasonable extraterritorial application of the prohibition, beyond what is required in law and that the FRC should not indirectly impose its standards on auditors in other jurisdictions.

***For the purposes of group audits, should the restrictions apply just to the group auditor and members of its network or also to other auditors, if any, whose work the group auditor may be using for the purpose of the group audit?***

- 4.47 The Audit Regulation establishes requirements for audit firms and members of their network. The FRC does not currently seek to impose its Ethical Standards on 'other auditors' (including network firms). As noted above, under ES 1 group audit partners have to be satisfied that other auditors who are not subject to the FRC's Ethical Standards are objective. The supporting guidance in ES 1 indicates that this includes obtaining appropriate evidence that the other auditors have a sufficient understanding of and have complied with the current international Code of Ethics, including the independence requirements, and that, in the case of a listed company, the group audit engagement partner establishes that the company has communicated its policy on the engagement of the external auditor to supply non-audit services to its affiliates and obtains confirmation that the other auditors will comply with this policy.

*Arguments for applying restrictions to all other auditors in a group audit*

- 4.48 As indicated above, on a principles basis it is difficult to argue that it is satisfactory for different restrictions to apply to different auditors whose work is used by a group auditor. This risks services being provided to a group component that would, if covered by the FRC's standards, be deemed to compromise auditor independence and, thereby, reduce confidence in the audit. The current position, under which compliance with the international Code of Ethics can be accepted as sufficient, reflects that that Code is not considered significantly weaker than the FRC's current Ethical Standards in this area. However, following revision of the FRC's Ethical Standards to implement the provisions of the Audit Directive and Regulation, and to address other matters identified in the wider review of the ethical framework for auditors are, that may not continue to be the case.

*Arguments for not applying restrictions to all other auditors in a group audit*

- 4.49 The current position in the FRC's Ethical Standards was adopted in light of the perceived difficulty in seeking to mandate the application of standards in jurisdictions where they do not directly apply, and a pragmatic decision that accepting that compliance with the international Code of Ethics should be sufficient to compensate for this. Although there is a risk that compliance with the international Code may in the future no longer be considered sufficient to achieve compliance in substance with the FRC's revised standards, there may still be difficulties in seeking to mandate application of the FRC's standards in other jurisdictions – some of these may be overcome by group engagement auditors including appropriate terms of engagement for the group audit and through their directions to other auditors whose work they will use. However, there could be other difficulties if, for example, an auditor in another jurisdiction was required by law or regulation to perform services that would be prohibited under the FRC's standards (i.e. where there would be a difference in substance in 'audit related' services in the jurisdictions). This could be addressed by including an exception where services are requirements to be performed by the auditor under law or regulation in another jurisdiction, or by revising the definition of audit related services to achieve the same effect.

4.50 In audits of large global groups there is also an increased risk of an inadvertent breach of a prohibition that does not apply directly in a particular location (e.g. where an overseas auditor not directly subject to the FRC's ethical standards or the EU Directive and Regulation accepts an engagement to provide a non-audit service that is acceptable locally but prohibited for the purpose of the group audit). This raises the question of the potential consequences of the breach for the group audit. The Audit Directive provides that sanctions for breaches should be proportionate; it would not necessarily therefore lead to a conclusion that such a breach renders the entire group audit invalid. The FRC's ethical standards already provide guidance for inadvertent breaches – see paragraph 4.51 below.

***Geographical scope of 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?

***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?

***Breaches of the requirements***

4.51 The FRC is aware that inadvertent breaches of ethical requirements can occur and as such it is necessary to clarify the possible consequences for an audit if, for example, a prohibited service was inadvertently provided to an audited entity (or in a group audit to a group component) by the auditor or a network firm. Currently, the FRC's ethical standard on non-audit services states that:

“Whenever a possible or actual breach of an Ethical Standard is identified, the audit engagement partner, in the first instance, and the Ethics Partner, where appropriate, assess the implications of the breach, determine whether there are safeguards that can be put in place or other actions that can be taken to address any potential adverse consequences and consider whether there is a need to resign from the audit engagement.

An inadvertent violation of this Standard does not necessarily call into question the audit firm's ability to give an audit opinion provided that:

- (a) the audit firm has established policies and procedures that require all partners and staff to report any breach promptly to the audit engagement partner or to the Ethics Partner, as appropriate;
- (b) the audit engagement partner promptly notifies the partner or member of staff that any matter which has given rise to a breach is to be addressed as soon as possible and ensures that such action is taken;
- (c) safeguards, if appropriate, are applied (for example, by having another partner review the work done by the relevant partner or member of staff or by removing him or her from the engagement team); and
- (d) the actions taken and the rationale for them are documented.”

However, it is important to be aware that breaches of standards can lay the auditor open to disciplinary proceedings and possible sanctions, the severity of which will depend on the circumstances.

4.52 Article 30a of the Audit Directive addresses sanctioning powers of competent authorities. Possible sanctions for breaches of the Audit Directive or the Audit Regulation include, inter alia:

- a temporary prohibition, of up to three years’ duration, banning the statutory auditor, the audit firm or the key audit partner from carrying out statutory audits and/or signing audit reports;
- a declaration that the audit report does not meet the requirements of Article 28 of the Audit Directive or, where applicable, Article 10 of the Audit Regulation;
- the imposition of administrative pecuniary sanctions on natural and legal persons.

## 5 Audit and Non-audit Services Fees

5.1 Article 4 of the Audit Regulation establishes provisions applicable to the fees for statutory audit and non-audit services provided to PIEs. The Article specifically provides that Member States may apply more stringent requirements.

### Fees for non-audit services

5.2 Paragraph 2 of Article 4 establishes a cap on fees for non-audit services provided to an audited PIE.

When the statutory auditor or the audit firm provides to the audited entity, its parent undertaking or its controlled undertakings, for a period of three or more consecutive financial years, non-audit services other than those referred to in Article 5(1) of this Regulation, the total fees for such services shall be limited to no more than 70 % of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertaking, of its controlled undertakings and of the consolidated financial statements of that group of undertakings.

For the purposes of the limits specified in the first subparagraph, non-audit services, other than those referred to in Article 5(1), required by Union or national legislation shall be excluded.

Member States may provide that a competent authority may, upon a request by the statutory auditor or the audit firm, on an exceptional basis, allow that statutory auditor or audit firm to be exempt from the requirements in the first sub-paragraph in respect of an audited entity for a period not exceeding two financial years.

5.3 Particular points of note in relation to our current understanding of the calculation of the cap are:

- The cap only applies to fees for non-audit services provided by the appointed statutory auditor/audit firm – fees for non-audit services provided by members of the auditor's network are not included in the numerator for the purpose of testing compliance with the cap.
- If the PIE is a member of a group, the fees for non-audit services provided by the given auditor to any other member of the group are included in the numerator for the purpose of testing compliance with the cap.
- The auditor has to have been providing audit and non-audit services to the audited PIE for a period of three or more consecutive years before the cap applies – i.e. it applies in the fourth and subsequent consecutive years of the provision of such services. BIS has also indicated that they do not intend that the cap should be applicable until the accounting year beginning on or after 17 June 2019 (i.e. the 4<sup>th</sup> accounting year beginning after the application of the Regulation).
- If there is an interruption in the provision of relevant non-audit services, or in being the statutory auditor, then the cap will not be applied until non-audit services have been provided again for three or more consecutive years.

- For the cap to apply, the audited entity has to have been a PIE for each of the years concerned.
  - Any non-audit services that are ‘required by law’ are excluded from consideration in testing compliance with the cap. This applies even if the law does not specifically require the entity’s auditor to be the provider of the service that is required by law.
- 5.4 The cap is intended to provide a safeguard against the self-interest threat that arises when an auditor has financial or other interests (in obtaining additional non-audit work and related fees from the audited entity) which might cause the auditor to be reluctant to take actions in relation to the audit that would be adverse to those interests of the audit firm. In particular, concerns are often identified that large fees for the provision of non-audit services, compared to the audit fee, threaten an auditor’s independence, objectivity and integrity.
- 5.5 As indicated above, Article 4 specifically provides that Member States may apply more stringent requirements. A number of ways in which more stringent requirements could be applied, if considered appropriate, include the following, which are discussed further below:
- Applying a lower cap than 70%.
  - Including non-audit services provided by network firms in the numerator for purposes of testing compliance with the cap.
  - Requiring a modified cap formula to be applied sooner than after three consecutive years after becoming a PIE or after an interruption, either in the provision of non-audit services or in being the statutory auditor.

***Applying a lower cap than 70%***

- 5.6 The FRC’s ethical standards restrict the types of non-audit service that can be provided (and these restrictions will need to be increased to at least include all the specifically prohibited non-audit services specified in the Audit Regulation for PIEs as discussed in Section 4) but do not currently impose a cap on fees for allowed non-audit services. Instead other safeguards are applied, including those set out in paragraph 4.6 above.
- 5.7 The statutory disclosure requirements for fees paid to auditors for audit and non-audit services cover fees paid to the auditor and their “associates”. For practical purposes “associates” includes network firms. As identified in Section 4 of this consultation, measured on this basis, a significant number of individual FTSE 100 entities still spend more than the equivalent of 70% of the audit fee on non-audit services from the auditor and the auditor’s associates in a particular year. However, these required published disclosures of fees for audit and non-audit services do not enable an analysis of fees excluding those provided by associates and excluding services required by law, i.e. on a basis comparable to the cap formula under Article 4. As a result, it is not possible to assess whether there are a significant number of PIEs for which the fees for non-audit services have historically exceeded 70% of the audit fee calculated in accordance with the formula for the cap in Article 4.
- 5.8 Section 4 also identifies non-audit services that are not prohibited under the Regulation, in relation to which the FRC is consulting on whether they should be on a ‘white list’ of permitted non-audit services considered appropriate for a PIE auditor to

provide (with all other non-audit services prohibited in the case of PIEs). Not all of the potential white list non-audit services may be 'services required by legislation' and, to the extent they are not, they would not be excluded from the cap. The fees for some of these services could in some circumstances be very significant compared to, or even greater than, the audit fee (e.g. fees for the services provided by the auditor as 'reporting accountant' in relation to information in circulars and prospectuses that require a publicly reported opinion thereon and other, generally private, reporting customarily performed by the reporting accountant to support statements made by the directors, disclosures in the prospectus or circular or, in the case of premium listed issuers, to support confirmations provided by the sponsor to the FCA). Accordingly, companies that are PIEs could be limited in some circumstances in their ability to obtain such services from their auditor, by virtue of the operation of the cap. This could be mitigated in exceptional circumstances, for a period not exceeding two years, if the competent authority were able to grant exemptions from the cap.

- 5.9 In light of this, the FRC does not believe that it would be appropriate to establish a lower cap than 70%, to the extent that this would further limit the ability of companies to obtain non-audit services that it is considered appropriate for the auditor to provide. However, there may be other circumstances where more restrictive arrangements than the Audit Regulation cap may be appropriate (see for example "Services provided by network firms" below) and the FRC believes that if made the competent authority for this purpose it should introduce a more restrictive cap if necessary to maintain confidence in the independence and objectivity of PIE auditors, subject to appropriate consultation and due process. There is no provision in the Audit Regulation for Member States to set a higher (less restrictive) cap.
- 5.10 The FRC believes that, if made the competent authority for this purpose, it should also have the ability to grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years, as provided for in Article 4. This could help mitigate those circumstances where an audited entity wishes to obtain non-audit services for which stakeholders would agree the auditor of the entity is clearly the most appropriate provider, but which would cause the cap to be exceeded.

### ***Services provided by network firms***

- 5.11 As discussed in Section 4, the specific non-audit service prohibitions established by the Audit Regulation apply to both the auditor and network firms, but only in so far as those services are provided to group entities based in Europe. However, the cap on fees for allowed non-audit services applies to the auditor of the audited entity - but not also to network firms - on a global basis for services provided to all group entities, not just to those entities based in Europe. The rationale for this difference in scope is not clear from the requirements and it could be confusing to some stakeholders. Section 4 discusses how in principle the scope of prohibited non-audit services might be changed from that set out in the Audit Regulation. We consider below how the scope of the cap might, in principle, be made more consistent with the scope of the prohibitions and to meet stakeholder expectations, explore possible reasons for doing so and seek respondents' views.
- 5.12 Currently, restrictions imposed by the FRC's ethical standards on the types of non-audit service that can be provided (ES 5) are imposed to the extent they are provided by "the audit firm". This is defined to include "network firms in the UK and Ireland which are controlled by the audit firm or its partners", but does not include other network firms. In relation to group audits, any such other network firm that performs work on financial information related to a component of the group at the request of the group engagement team, is effectively required, as a minimum, to comply with the (less

restrictive) requirements of the IESBA Code. As described in Section 4 of the consultation, the FRC is exploring whether, for group audits, a network firm (whether or not controlled by the group audit firm or its partners) that performs work on financial information related to a component of the group at the request of the group engagement team, should perform such work in compliance with the same ethical principles as apply to the group audit firm.

- 5.13 Although networks of audit firms typically comprise a number of legally separate partnerships and other bodies, these separate entities are generally perceived by stakeholders as indistinguishable from each other from an independence perspective because they are either controlled by the audit firm, are under common control, ownership or management, are part of a larger structure aimed at profit or cost sharing, or are otherwise affiliated or associated with the audit firm through common quality control policies and procedures, common business strategy, the use of a common name or through the sharing of significant common professional resources. Further, the close relationships and mutuality of interests of network firms may give rise to a self-interest threat for the audit firm, where other members of the network are providing significant amounts of non-audit services to an entity audited by the audit firm.
- 5.14 In light of this, the FRC believes that, if a white list approach is not adopted and/or if non-UK network firms and network firms that are not controlled by the audit firm or its partners are not required to comply with the same ethical standards as the group audit firm, consideration should be given as to whether fees for non-audit services provided by all of the auditor's network firms should be included in the numerator for purposes of testing compliance with the 70% cap. If this were the case, where the PIE is the parent company of a group, the audit and non-audit fees for the purpose of calculating the cap would be the total respective group fees paid to the auditor and the auditor's network firms. This would result in a consistent numerator and denominator in testing compliance with the cap, and would be a more restrictive approach than under the Audit Regulation.

#### ***Applying a modified cap formula in certain circumstances***

- 5.15 As indicated above, the cap does not apply in any year if the auditor has not been providing audit and non-audit services to the audited PIE for a period of three or more consecutive previous years during which the audited entity has been a PIE. The cap would not therefore apply in the early years of being a PIE or if there is an interruption in the provision of relevant non-audit services, or in being the statutory auditor. It would be possible to apply a more stringent requirement by applying a modified cap formula that uses an alternative denominator than the three year average of audit fees used in the cap formula specified under the Regulation.
- 5.16 It would not be practicable to apply a modified cap denominator based on the actual audit fees for the same year, because there may not be certainty as to what the audit fees would be when the fees for non-audit services fees would need to be established. Establishing a cap denominator based on the audit fee(s) for one or more previous years may also present practical difficulties where, for example, there is a significant increase in audit fees resulting from exceptional circumstances, such as the entity becoming a PIE for the first time. It would, however, be possible to require a cap to be calculated based on, say, the audit fee estimate provided to the audited entity for the same year and a modified numerator that excludes some or all white list services, if such an approach were to be adopted.

5.17 The FRC believes that the other safeguards described above, and in Section 4 of the consultation, particularly if a white list approach were to be adopted, would be sufficient to maintain confidence in the objectivity and independence of PIE auditors (with respect to non-audit services) for periods when in practice the EU Regulation cap would not apply.

5.18 If responses to this consultation indicate that a modified cap formula may be appropriate in certain circumstances, the FRC will develop and consult on specific proposals in 2015 when it consults on proposed detailed revisions to the ethical standards.

#### **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?

#### **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?

#### **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?

#### **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 any non-audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?

#### **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)?

#### **Total fees for audit and non-audit services**

5.19 Paragraph 3 of Article 4 establishes requirements where more than 15% of an audit firm's total fee income is received from a single PIE.

When the total fees received from a public-interest entity in each of the last three consecutive financial years are more than 15 % of the total fees received by the statutory auditor or the audit firm or, where applicable, by the group auditor carrying out the statutory audit, in each of those financial years, such a statutory auditor or audit firm or, as the case may be, group auditor, shall disclose that fact to the audit committee and discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats. The audit committee shall consider



whether the audit engagement should be subject to an engagement quality control review by another statutory auditor or audit firm prior to the issuance of the audit report.

Where the fees received from such a public-interest entity continue to exceed 15 % of the total fees received by such a statutory auditor or audit firm or, as the case may be, by a group auditor carrying out the statutory audit, the audit committee shall decide on the basis of objective grounds whether the statutory auditor or the audit firm or the group auditor, of such an entity or group of entities may continue to carry out the statutory audit for an additional period which shall not, in any case, exceed two years.

5.20 The FRC's Ethical Standard 4, *Fees, remuneration and evaluation policies, litigation, gifts and hospitality*, currently establishes more restrictive requirements in relation to audit and non-audit services fees received from entities.

#### ES 4

31. Where it is expected that the total fees for both audit and non-audit services receivable from a listed audited entity and its subsidiaries audited by the audit firm<sup>9</sup> will regularly exceed 10% of the annual fee income of the audit firm<sup>10</sup> or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm shall not act as the auditor of that entity and shall either resign as auditor or not stand for reappointment, as appropriate.<sup>11</sup>
32. Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audited entity and its subsidiaries audited by the audit firm will regularly exceed 15% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm shall not act as the auditor of that entity and shall either resign as auditor or not stand for reappointment, as appropriate.
35. Where it is expected that the total fees for both audit and non-audit services receivable from a listed audited entity and its subsidiaries audited by the audit firm will regularly exceed 5% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 10%, the audit engagement partner shall disclose that expectation to the Ethics Partner and to those charged with governance of the audited entity and consider whether appropriate safeguards need to be applied to eliminate or reduce to an acceptable level the threat to the auditor's objectivity and independence.
39. Where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audited entity and its subsidiaries audited by the audit firm will regularly exceed 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit

<sup>9</sup> Total fees will include those billed by others where the audit firm is entitled to the fees, but will not include fees billed by the audit firm where it is acting as agent for another party.

<sup>10</sup> In the case of a sole practitioner, annual fee income of the audit firm includes all earned income received by the individual.

<sup>11</sup> Paragraphs 31 to 40 [of ES 4] do not apply to the audits of those public sector bodies where the responsibility for the audit is assigned by legislation. In such cases, the auditor cannot resign from the audit engagement, irrespective of considerations of economic dependence.

share is calculated, but will not regularly exceed 15%, the audit engagement partner shall disclose that expectation to the Ethics Partner and to those charged with governance of the audited entity and the firm shall arrange an external independent quality control review of the audit engagement to be undertaken before the auditor's report is finalised.

5.21 The FRC believes that it is appropriate to maintain the long standing more restrictive requirements in ES 4. The FRC is not aware that these more restrictive requirements are giving rise to practical difficulties for audited entities or their auditors. In relation to this, and considering the specific requirements established in the Audit Regulation, the FRC believes that an expectation that fees will exceed the specified percentages for at least 3 consecutive years should be considered to constitute an expectation of "regularly" exceeding those limits.

5.22 As discussed in Section 3 of this consultation, the FRC is considering whether the more stringent requirements in its ethical standards that apply in relation to audits of listed entities should apply to audits of PIEs when the standards are revised to reflect the requirements of the Audit Directive and Audit Regulation. If that approach were to be adopted the more restrictive requirements in ES 4 will apply for all audits of PIEs.

**Question 20**

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

**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 other entities that may be deemed of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply

**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"

## 6 Record Keeping

- 6.1 Article 15 of the Audit Regulation requires that auditors keep specified documents and information for a period of at least five years following the creation of such documents or information. Member States may require auditors to keep the documents and information for a longer period in accordance with their rules on personal data protection and administrative and judicial proceedings.
- 6.2 The UK and Ireland professional bodies of which auditors are members require audit working papers to be kept for more than five years.

The 'Audit Regulations and Guidance' of the Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants of Scotland, and the Institute of Chartered Accountants in Ireland require that "A Registered Auditor must keep all audit working papers which auditing standards require for an audit for a period of at least six years. The period starts with the end of the accounting period to which the papers relate."

The Rulebook of the Association of Chartered Certified Accountants requires professional accountants to keep audit working papers for seven years.

- 6.3 The FRC does not itself currently specify a minimum period for which audit documentation must be retained. However, ISQC (UK and Ireland) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, requires that "The [audit] firm shall establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation." For this purpose the minimum retention period would be as specified in the regulations and rules of the professional bodies, as identified above.

### 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?

## 7 Audit Firm and Key Audit Partner Rotation

7.1 Article 17 of the Audit Regulation establishes limits on the maximum continuous periods of time audit firms can be engaged as auditor by an audited entity and the time for which an audit engagement partner can serve in that role. There are also specified minimum amounts of 'time-off' before a firm can be reappointed as auditor or a partner can resume the role of engagement partner. A number of Member State options are provided for in relation to these periods.

### Audit firms

7.2 The provisions of the Audit Regulation relating to the rotation of audit firms are imposed on the audited entity because it is the entity that has responsibility for appointing the auditor. Accordingly, how these provisions and the Member State options pertaining to them will be implemented in UK law and are being consulted on by BIS (see Chapter 6.4 of the BIS Discussion Document).

7.3 However, the FRC believes that auditors should also have a responsibility to ensure that they do not act as auditor when they are effectively barred by law from doing so. Accordingly, the FRC proposes to reflect these provisions, as finalised by BIS, in the audit and/or ethical standards when those standards are revised to implement the Audit Directive and Audit Regulation.

### 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?

### Key audit partners

7.4 Paragraph 7 of Article 17 stipulates that "The key audit partners responsible for carrying out a statutory audit shall cease their participation in the statutory audit of the audited entity not later than seven years from the date of their appointment. They shall not participate again in the statutory audit of the audited entity before three years have elapsed following that cessation."

7.5 By way of derogation, Member States "may require that key audit partners responsible for carrying out a statutory audit cease their participation in the statutory audit of the audited entity earlier than seven years from the date of their respective appointment."

7.6 A definition of "key audit partner" is given in the Audit Directive.

'key audit partner(s)' mean(s):

- (a) the statutory auditor(s) designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on behalf of the audit firm; or
- (b) in the case of a group audit, at least the statutory auditor(s) designated by an audit firm as being primarily responsible for carrying out the statutory audit at the level of the group and the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries; or

(c) the statutory auditor(s) who sign(s) the audit report.

- 7.7 The FRC's Ethical Standard 3, *Long association with the audit engagement*, currently establishes more restrictive requirements, in relation to audits of listed entities, for engagement partners, engagement quality control reviewers and other key partners<sup>12</sup> involved in an audit. These include in particular in relation to the engagement partner:

In the case of listed companies, ... the audit firm shall establish policies and procedures to ensure that:

- (a) no one shall act as audit engagement partner for more than five years; and
- (b) anyone who has acted as the audit engagement partner for a particular audited entity for a period of five years, shall not subsequently participate in the audit engagement until a further period of five years has elapsed.

- 7.8 The FRC believes that it is appropriate to maintain the long standing more restrictive requirements in ES 3. The FRC is not aware that these more restrictive requirements are giving rise to practical difficulties for audited entities or their auditors.

- 7.9 As discussed in Section 3 of this consultation, the FRC is considering whether the more stringent requirements in its ethical standards that apply in relation to audits of listed entities should apply to audits of PIEs when the standards are revised to reflect the requirements of the Audit Directive and Audit Regulation. If that that approach were to be taken, the more restrictive requirements in ES 3 would apply for all audits of PIEs (see also the discussion of the definition of PIEs and the application of the ethical standards to PIEs and other entities in Section 3).

#### **Question 25**

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

#### **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?

---

<sup>12</sup> For the purpose of the FRC's ethical standards a 'key partner' is defined as "A partner, or other person in the engagement team (other than the audit engagement partner or engagement quality control reviewer) who either:

- is involved at the group level and is responsible for key decisions or judgments on significant matters or risk factors that relate to the audit of that audited entity, or
- is primarily responsible for the audit of a 'significant affiliate or division'."

## Consultation Stage Impact Assessment

1. The Financial Reporting Council (FRC) sets high quality audit standards and guidance for listed and other entities for the aim of supporting investor, market and public confidence in financial and governance stewardship. As published in its Regulatory Approach, the FRC has regard to the need for its standards to be applied in a proportionate manner in different circumstances. It carries out and publishes impact assessments and adopts, where possible, principles that can be applied appropriately and at reasonable cost. Any decisions about whether to propose new additional requirements in the future, by exercising any Member State options within the FRC's remit, would be made with regard to the FRC's 'Principles for the development of Codes, Standards and Guidance'<sup>13</sup> (see paragraph (viii) of the Introduction to this consultation).
2. This consultation considers approaches to improve auditing and ethical standards through appropriate exercise of the relevant Member State options as part of the implementation of the amendments to the EU Audit Directive and the new EU Audit Regulation. BIS, in its Discussion Document, is seeking views on a range of reforms to the audit regime, including whether, in a revised statutory framework, the FRC should be given the specific responsibility to deal with the subject matter of the Articles of the Audit Directive and Regulation that affect matters addressed in auditing and ethical standards, including the ability to exercise all the associated Member State options, in accordance with the FRC's usual processes for setting such standards.
3. The Audit Directive and Regulation will also require other amendments to auditing and ethical standards for which there are no options. This consultation does not address those amendments and therefore the FRC is not consulting on their impact at this time – the detail of the proposed revisions to the standards to implement them will be consulted on in 2015, and the possible impacts will be highlighted (however, respondents will be asked to recognise that those particular revisions will implement legal requirements). The detailed changes to the standards to implement the Member State options will also be covered in that consultation and will have regard to the responses received to this consultation.

### **Imposing additional requirements in auditing standards adopted by the European Commission**

4. As explained in Section 1, the FRC's auditing standards are based on the ISAs issued by the IAASB, which are the standards the Commission will be considering for EU adoption under the Directive in due course. The FRC already supplements the ISAs with a small number of additional requirements, primarily related to national legal and regulatory requirements and to enhance audit quality, for example by requiring auditors to provide information to assist Boards and Audit Committees fulfil their responsibilities under the UK Corporate Governance Code and by requiring enhanced auditor reports.
5. The FRC believes it is important to have the ability to add requirements that stakeholders agree add to the credibility and quality of financial statements and serve the public interest. As identified above and in the Introduction, any decisions about whether to propose new additional requirements in the future would be made with regard to the FRC's 'Principles for the development of Codes, Standards and Guidance', which include that anticipated benefits outweigh costs, and would be

---

<sup>13</sup> <https://www.frc.org.uk/FRC-Documents/FRC/About-the-FRC/Principles-for-the-development-of-Codes.pdf>

consulted on following the FRC's due process, including assessing the impact of implementing any such proposals.

### **Providing for proportionate application of standards and simplified requirements**

6. As explained in Section 2, the FRC's auditing and ethical standards are designed to be capable of being applied proportionately to the size and complexity of an entity. However, the FRC is asking in this consultation whether respondents believe that they are capable of being so applied and, if not, what action they believe the FRC could take.
7. The requirements in the Directive that may be simplified are those that relate primarily to particular aspects of ethics and quality control. This consultation asks whether the specified requirements in the Directive should be simplified for auditors of small entities and, if so, how.
8. Conditional exemptions from some of the requirements in the FRC's ethical standards are currently available to auditors of small entities to provide that their impact is proportionate to the concerns of stakeholders in those entities. The Directive establishes independence requirements for auditors, and the FRC will review the available exemptions from its standards in 2015 to ensure the requirements of the Directive are not breached. The independence requirements in the Directive include:
  - Member States shall ensure that when carrying out a statutory audit, a statutory auditor or an audit firm, and any natural person in a position to directly or indirectly influence the outcome of the statutory audit, is independent of the audited entity and is not involved in the decision-taking of the audited entity; and
  - The statutory auditor or an audit firm shall not carry out a statutory audit if there is any threat of self-review, self-interest, advocacy, familiarity or intimidation created by financial, business, employment or other relationships between:
    - (i) the statutory auditor, audit firm, its network, and any natural person in a position to influence the outcome of the statutory audit; and
    - (ii) the audited entity;

As a result of which an objective, reasonable and informed third party, taking into account the safeguards applied, would conclude that the statutory auditor's or audit firm's independence is compromised.
9. Providing for proportionate application of standards and simplifying some specific requirements for auditors of small entities has the potential to lower the costs of auditing those entities, and the FRC believes it should have the ability to do this. However, there is a risk that audit quality may also be reduced either in actuality or perception. If respondents believe that the FRC could take action to further simplify or allow for proportionate application of the standards, we are also asking them to indicate their views as to the impact of such actions on the actuality and perception of audit quality. These are matters the FRC will need to take into consideration when considering the responses to this consultation and whether changes to the auditing and/or ethical standards should be proposed if the power to exercise these particular Member State options through its standards were to be delegated to the FRC.

## **Extending the more stringent requirements for Public Interest Entities to other entities**

10. As explained in Section 3, BIS is minded to establish a statutory definition of a Public Interest Entity (PIE) reflecting the minimum definition in the Audit Directive, and does not propose to designate any other entities as PIEs for the purpose of implementing the Directive and Regulation in the UK. The BIS discussion document seeks views on this.
11. Currently the FRC's auditing and ethical standards establish more stringent requirements only for 'Listed entities' (the definition of which is wider than the listed entities included in the proposed statutory definition of a PIE ('EU listed entities'), but does not include all credit institutions and insurance undertakings that will fall within the minimum definition of a PIE under the Directive). Section 3 presents some alternative options for the FRC in light of this, in particular which categories of entity should be subject to which more stringent requirements in the public interest, and seeks views on them (see paragraphs 3.10 - 3.23 and questions 4 – 6).
12. As identified in Section 3, the more stringent requirements in the FRC's standards currently relate primarily to:
  - Engagement quality control review;
  - Communications to those charged with governance and the audit committee about the audit and audit findings
  - Additional information to include in the auditor's report
  - Rotation periods for key audit partners;
  - More stringent limits on the proportion of total audit and non-audit fees that can be earned from a particular audited entity/group; and
  - More stringent restrictions on non-audit services that can be provided to an audited entity.

There are overlapping, but not identical, requirements established by the Audit Regulation that apply to PIEs.

13. Applying these requirements to other entities would have a number of procedural impacts on the audit of those entities, the principal of which would result from requiring an engagement quality control review if the audit had not previously been designated by the audit firm to be subject to such review. The direct costs would include the time spent by the reviewer and incremental time spent by the engagement team in relation to the review. The other principal impact, which may be significant to some such entities, would be the tighter restrictions on the types of non-audit services that could be provided by their auditor (including the increased restrictions that will arise from implementing the Audit Regulation as discussed in Section 4 and below).
14. The perceived benefits, of applying the more stringent requirements would be that they would provide additional safeguards against risks to audit quality and auditor independence and would enhance confidence in the audits of the entities amongst their public stakeholders. In considering which entities would be of sufficient public interest to warrant doing so, the FRC will consider whether the perceived benefits would outweigh the costs.



15. In considering the impact of retaining and, where applicable extending, the more stringent requirements currently applicable to 'Listed entities' under the auditing and ethical standards to entities other than PIEs, the FRC will also consider whether the differential impacts of particular more stringent requirements, relative to their perceived benefits, would justify different levels of restrictions in particular areas being applied to different categories of such entities.

#### **Prohibited non-audit services**

16. Section 4 identifies that the Audit Regulation specifies particular non-audit services that an auditor is prohibited from providing to an audited entity that is a PIE. These restrictions must be applied for all entities that meet the statutory definition of a PIE, but, as discussed in Section 3, there is a possibility that different restrictions could be applied to other entities that may be determined to be of sufficient public interest. Derogations are possible to enable some, but not all, of the services that the auditor of a PIE is prohibited from providing under the Audit Regulation if, inter alia, the effect of those services on the financial statements of the entity is not material. The Audit Regulation also specifically provides that Member States can prohibit other non-audit services and establish stricter rules for allowed non-audit services.
17. Section 4 sets out arguments both against and for introducing further restrictions on non-audit services that can be provided. A perennial perception issue for stakeholders is concern that the independence of an auditor may be compromised when the auditor earns large fees from non-audit services provided to an audited entity and the auditor has a self-interest in not losing that income stream. One of the options the FRC has set out to address this is, rather than specifying prohibited non-audit services, specifying a 'white list' of non-audit services that an auditor would be allowed to provide to an audited entity that is a PIE (and other entities that may be deemed of sufficient public interest as discussed in Section 3). These would be limited to non-audit services for which it was generally accepted that the auditor of the entity is an appropriate provider (subject to falling within the cap on fees for services that are not required by legislation) and greater clarity as to what is acceptable could be obtained. The list would be subject to periodic review. An illustrative list for consideration is given in paragraph 4.13.
18. However, the FRC is not committed to this course of action and the consultation asks for views on which approach respondents believe is most appropriate to eliminate perceptions of threats to the auditor's independence arising from the provision of non-audit services - 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, or a 'white list' of allowed services with all others prohibited.
19. The main impact of introducing further restrictions would be to limit the types of non-audit services PIEs could commission from their auditor and, therefore, they would have to use another service provider. Having to obtain a non-audit service from another provider could increase costs if that other provider had to obtain knowledge of the entity that the auditor already possessed. However, it also possible that greater competition to provide such services could reduce prices for them. The perceived benefit of imposing more stringent restrictions is that this would enhance the confidence of public stakeholders in PIEs that the independence of the auditor is not compromised.
20. The consultation also asks whether the derogation to allow particular prohibited non-audit services should be taken up where they have an immaterial effect on the financial statements. The main impact of this would be to mitigate the impact of the

underlying prohibitions, in so far as that impact would result from the services subject to derogation. However, doing so could create uncertainty because there could be different views as to whether the impact of particular services on the financial statements was immaterial or not. This uncertainty could possibly be addressed by limiting the derogation to those services where the effect on the financial statements is clearly less than material, for example where it is clearly trivial<sup>14</sup>. Derogations would also make the arrangements for what is and is not prohibited less clear, and the complexity and uncertainty could impair stakeholders' perception of the auditor's independence.

21. The Audit Regulation stipulates that audit services not prohibited under the Audit Regulation that are provided by the auditor for PIEs require the approval of the audit committee, after the audit committee properly assesses threats to independence and the safeguards applied. The cap on fees from such non-audit services is intended to be a further safeguard against threats to the auditor's independence and objectivity in connection with such services. However the consultation asks whether respondents consider that further conditions should be applied in connection with the provision of such services by the auditor and whether those views would be different depending on whether or not a white list approach was adopted.
22. The FRC will take responses to the consultation into account when considering whether more stringent requirements should be proposed and/or whether the derogations should be provided for and, if it is considered that they should, those proposed requirements will be consulted on, and their impact further assessed, as part of the consultation on the proposed detailed amendments to the standards in 2015.

#### ***Application of prohibitions outside the EU***

23. The prohibitions in the Audit Regulation apply "extraterritorially", i.e. they apply to the audit firm and all of its network firms wherever they are based, within or outside the EU. However, as regards members of the audited entity's group, the prohibitions in the Audit Regulation only apply to the provision of non-audit services to members of the audited entity's group based in the EU. Accordingly, such prohibitions do not apply to the provision of non-audit services by the auditor or its network firms to components of the audited entity's group (whether controlled by the audited entity or that are fellow subsidiaries or a parent entity) that are based outside the EU. Rather, under the Audit Regulation, the auditor is required to consider the threats to their independence from the provision of such services to such group entities, and to apply appropriate safeguards. The Audit Regulation stipulates that the auditor may continue to carry out the audit of the PIE only if the auditor can justify that the provision of such services does not affect the auditor's professional judgment and the audit report.
24. A key element of the threats and safeguards approach is that, if an objective, reasonable and informed third party, taking into account the safeguards applied, would conclude that the auditor's independence is compromised, the auditor should not carry out the audit. Accordingly, where a non-audit service provided by the auditor or a network firm would give rise to threats that that cannot be sufficiently mitigated by

---

<sup>14</sup> The concept of 'clearly trivial' is established in the FRC's auditing standards, which explain that "clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with [auditing standards], and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

applied safeguards, either the auditor or its network firm should not provide the non-audit service or the auditor should withdraw from the audit engagement.

25. From an ethical principles perspective, the most appropriate position would be that the same requirements should apply regardless of where an audited entity is situated geographically. If the threats arising from a non-audit service provided to an audited entity in the EU by the auditor or a network firm are deemed to be such that no safeguards are sufficient, and accordingly the service is prohibited, it is hard to rationalise that appropriate safeguards can be established if the service is provided to an entity outside the EU.
26. The consultation therefore explores whether the prohibitions in the Audit Regulation (and any extension thereof under the Member State options) on the provision of non-audit services to a PIE by its auditor and its network firms should be extended to components of the audited entity based outside the EU. It also explores whether, for the purpose of group audits, the restrictions should apply to all auditors whose work the group auditor may decide to use for the purpose of the group audit and not just to the auditor's network firms. Arguments for and against these extended restrictions are set out in Section 4.
27. The main impact if restrictions are extended may be a difficulty for some group components to obtain particular non-audit services if they are based in locations where there are no suitable alternative service providers. The perceived benefit of imposing more stringent restrictions is that this would enhance the confidence of public stakeholders in PIEs that the independence of the auditor is not compromised.
28. The FRC will take responses to the consultation into account when considering whether more stringent requirements should be proposed and, if it is considered that they should, those proposed requirements and their impact will be consulted on as part of the consultation on the proposed detailed amendments to the standards in 2015.

## **Audit and non-audit services fees**

### ***Fees for non-audit services***

29. Section 5 identifies that the Audit Regulation imposes a cap on the fees that can be earned for allowed non-audit services provided by the auditor to an audited entity that is a PIE (services required by law are excluded from the cap). The Audit Regulation provides that Member States could opt to establish more stringent restrictions but does not allow lesser restrictions.
30. The provision that only those services which are required by EU or national legislation can be excluded from consideration when testing for compliance with the cap could have important consequences for services currently performed by auditors for which stakeholders may agree the auditor is the most appropriate provider. These may include, for example, services provided by 'reporting accountants', who are also auditors to the entity, acting for premium and standard listed issuers producing prospectuses or circulars under the UK Listing Regime.
31. At present, the services provided by these reporting accountants can be split into two categories; those that require a public reporting opinion from the reporting accountant and those that are customarily performed by the reporting accountant to support statements made by the directors, disclosures in the prospectus or circular or, in the case of premium listed issuers, to support confirmations provided by the sponsor to the FCA.

32. Those services that require a public output under the Prospectus or Listing Rules broadly relate to the requirement to report on the track record of the issuer or target, profit forecasts or estimates (prospectus only) and pro forma information. As these are required by EU or national legislation, they are likely to be excluded from the calculation of the cap. However, we are aware that the vast majority of listed issuers producing a prospectus or circular, currently select their existing auditor to perform the role of reporting accountant for services that are not directly required by law, and as such, may need to be included within the cap (subject to clarifying the legal position in relation to those services).
33. As discussed in Section 4, the FRC is considering an approach which would identify those services which an auditor should be limited to providing if the audited entity is a PIE (or other entity that may be deemed of sufficient public interest as discussed in Section 3) - a 'white list' approach. An illustrative list is given in paragraph 4.13. If respondents identify that the white list approach is appropriate, the FRC will further consult in due course, having regard to the responses to this consultation, on which services stakeholders would agree the auditor is clearly an appropriate provider and an objective, reasonable and informed third party would not conclude that the auditor's independence is compromised by providing those services (however, services not required by EU or national law would still be subject to the cap).
34. Section 5 discusses considerations in relation to the option to establish more stringent requirements and seeks respondents' views on them. This may be particularly relevant, for example, if a white list approach to permitted non-audit services is not adopted. The FRC will take responses to the consultation into account when considering whether more stringent requirements should be proposed and, if it is considered that they should, those proposed requirements will be consulted on as part of the consultation on the proposed detailed amendments to the standards in 2015.
35. The main impact of imposing more stringent restrictions on fees for non-audit services would be to reduce the ability of audit firms to provide allowed non-audit services to PIEs (and other entities that may be deemed of sufficient public interest as discussed in Section 3). Consequences of this could include, for example:
  - An audited entity not being able to obtain a non-audit service from its auditor in a particular year, or at all, even though it considers the audit firm to be the most appropriate service provider; and
  - The audited entity having to obtain a non-audit service from a provider other than its auditor.
36. Having to obtain a non-audit service from another provider could increase costs if that other provider had to obtain knowledge of the entity that the auditor already possessed. However, it is also possible that greater competition to provide such services could reduce prices for them.
37. The impact of imposing more stringent requirements would depend on the extent to which the Member State option to further restrict the categories of non-audit services that may be provided to the entity, beyond those categories strictly prohibited by the Audit Regulation, was exercised. If the 'white list' approach discussed in Section 4 is considered appropriate, that would restrict the provision of all other non-audit services to a PIE (and other entities that may be deemed of sufficient public interest as discussed in Section 3), subject to ongoing monitoring and review of the white list.

38. The perceived benefit of imposing more stringent restrictions on fees for non-audit services is that this would enhance the confidence of public stakeholders in the audited entities that the independence of the auditor is not compromised.

#### ***Total fees for audit and non-audit services***

39. Section 5 identifies that the Audit Regulation establishes requirements where more than 15% of an audit firm's total fee income is received from a single PIE. The FRC's ethical standards currently impose more restrictive requirements for Listed entities as currently defined by the FRC. The FRC is not aware that its long standing more restrictive requirements are giving rise to practical difficulties for audited entities or their auditors and accordingly believes they should be maintained (and apply to all PIEs, and other entities that may be deemed of sufficient public interest as discussed in Section 3, if that is agreed by respondents to the consultation).
40. Imposing restrictions on the proportion of fees that an auditor can earn from a single entity that is a PIE (and other entities that may be deemed of sufficient public interest) is not expected to have a significant impact on the costs of audit for such entities. It is possible that it could limit the ability of some audit firms to offer audit services to particular entities, but the FRC believes that for entities of sufficient public interest, limits on the proportion of the auditor's total fees that can be earned from that entity are important to stakeholder confidence that the auditor's independence is not compromised by a self-interest threat.

#### **Record keeping**

41. Section 6 identifies that the Audit Regulation requires auditors to keep specified documentation for at least five years or a longer period in accordance with rules on personal data protection and administrative and judicial proceedings. As explained in Section 6, longer retention periods are currently specified for auditors in the UK and Ireland. It is proposed that these longer periods are maintained and the consultation asks where the requirements should be established by the FRC, for example in the auditing standards and, if so, what the specified retention period should be. If the retention period is maintained in line with current requirements in the UK and Ireland there should not be a significant impact. Also, if the retention periods were reduced that may reduce costs if the auditor decides to not retain the documentation for a longer period, but there is a risk that documentation is not retained during the period for taking legal action against an auditor.

#### **Audit firm and key audit partner rotation**

42. As explained in Section 7, the Audit Regulation establishes limits on the maximum continuous periods of time audit firms can be engaged as auditor by an audited entity that is a PIE and the time for which a key audit partners can serve in that role. There are also specified minimum amounts of 'time-off' before a firm can be reappointed as auditor or a partner can resume the role of a key audit partner.

#### ***The audit firm***

43. The provisions of the Audit Regulation relating to the rotation of audit firms are imposed on the audited entity because it is the entity that has responsibility for appointing the auditor. However, the FRC believes that auditors should also have a responsibility to ensure that they do not act as auditor when they are effectively barred by law from doing so, so that they may be held appropriately accountable under professional standards if they were to do so. Accordingly, the FRC is consulting on

whether the FRC's audit and/or ethical standards should establish this responsibility for auditors.

44. Establishing this responsibility for auditors should help reduce the risk of an auditor accepting reappointment when they are time barred and the potential consequences, both for the auditor and the audited entity. The FRC does not believe that there would be any significant cost implications of establishing such a responsibility.

***Key audit partners***

45. The FRC's ethical standards currently establish more restrictive requirements than the Audit Regulation, in relation to audits of listed entities, for engagement partners, engagement quality control reviewers and other key partners involved in an audit. The FRC is not aware that these more restrictive requirements are giving rise to practical difficulties for audited entities or their auditors and believes that it is appropriate to maintain them. The arguments relating to possible negative impacts on audit quality for shorter periods served, and those relating to the possible impairment of stakeholders' perception of the auditor's objectivity if longer periods are served have been explored in the previous consultations leading to the current FRC requirements.
46. This consultation asks whether respondents' believe the more restrictive requirements in the ethical standards should be maintained and also whether those more restrictive requirements should be applied to all PIEs (and other entities that may be deemed of sufficient public interest as discussed in Section 3) when the standards are revised to implement the Audit Directive and Regulation. Responses will be taken into account when proposing the revisions to the standards that will be consulted on in 2015.

**Question 27**

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

## **Glossary**

Audit Directive – EU Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, as amended by Directive 2014/56/EU

Audit Regulation – EU Regulation 537/2014 on specific requirements regarding statutory audit of public-interest entities

BIS – Department for Business Innovation and Skills

EC – European Commission

ES – Ethical Standard for Auditors as issued by the FRC

ES PASE – Ethical Standard for Auditors – Provisions Available for Small Entities

EU – European Union

FRC – Financial Reporting Council

IAASB – International Auditing and Assurance Standards Board

ISA – International Standard on Auditing as issued by the IAASB

ISA (UK and Ireland) – International Standard on Auditing (UK and Ireland) as issued by the FRC

Listed entity – listed entity as defined by the FRC (see paragraph 3.9 of this consultation document)

Non-audit services – services other than statutory audit provided to audited entities

PIE – public interest entity as defined in the Audit Directive (see paragraph 3.3 of this consultation document)

This consultation document is issued by the Financial Reporting Council for comment.

For ease of handling, we prefer comments to be sent by e-mail to:

[k.billing@frc.org.uk](mailto:k.billing@frc.org.uk)

Comments may also be sent in hard copy to:

Keith Billing  
Financial Reporting Council  
8<sup>th</sup> Floor  
125 London Wall  
London  
EC2Y 5AS

Comments should be despatched so as to be received no later than 20 March 2015.

The FRC's policy is to publish on its website all responses to formal consultations issued by the FRC unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or postal or e-mail addresses) from submissions; therefore, only information that you wish to be published should be submitted.

The FRC aims to publish responses within 10 working days of receipt.

The FRC will publish a summary of the consultation responses, either as part of, or alongside, its final decision.







**Financial Reporting Council**

8th Floor  
125 London Wall  
London  
EC2Y 5AS

+44 (0)20 7492 2300

[www.frc.org.uk](http://www.frc.org.uk)