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10 July 2018

Dear Mr Siong,

Consultation Paper – Proposed Strategy and Work Plan, 2019-2023

The Financial Reporting Council (FRC) welcomes the opportunity to comment on the IESBA's proposed Strategy and Work Plan.

Generally, we agree with the proposed criteria for including and prioritising projects, in particular taking account of the benefits to the public interest. However, we question the criterion of "the feasibility of undertaking the action within a realistic timeframe", which lacks clarity. If an issue is identified that requires action in the public interest, the IESBA should seek to address it in a timely manner, diverting resources from other projects if necessary where they may be considered to be a lesser priority or seeking additional resources.

With the exception of the issues referred to below, we also are generally supportive of the actions that have been identified, in particular undertaking further research to determine whether there are ethical issues that are not adequately covered by the current ethical principles and, if so, the areas of highest priority. As explained in our answer to question 3, we strongly encourage the IESBA to seek ways to address materiality, and the definitions of PIEs and listed entities, on a more timely basis.

We responded to the IESBA's Strategy Survey in 2017, in which we set out our views on the key issues the IESBA's should address. Of the issues that we identified as the top six priorities, we are pleased that three are included in the proposed work plan:

- Concept of "public interest entity" and "listed entity".
- Materiality.
- Tax planning and related services.

However, we are concerned that three, including two of our highest priorities are not:

- Meaning of the public interest in the global context.
- Definitions and descriptions of terms.
- Breaches to the Code.

We explained in our response to the IESBA's Strategy Survey why these issues should be included. We reiterate in summary below the reasons why we believe the IESBA should include the three issues we highlighted as priorities that have not been included in the actual proposed strategy and work plan.

We set out our responses to the specific questions asked by the IESBA on the proposed Strategy and Work Plan in the attachment to this letter.

Meaning of public interest in the global context

As is noted in the Restructured Code, a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. The IFAC Policy Position issued in June 2012 defines the public interest as "The net benefits derived for, and procedural rigor employed on behalf of, all society in relation to any action, decision or policy." We do not believe this is helpful to understanding what behaviours are appropriate to serving the public interest. The IESBA's Strategy Survey acknowledged the difficulty of defining this concept. However, the Restructured Code, consistent with the extant Code, does not expand upon individual public interest obligations and therefore contains little application material relating to a public accountant's public interest responsibilities.

Given the fundamental importance of the responsibility to act in the public interest, we strongly recommend that the IESBA, together with the IAASB and IAESB, explore developing guidance to clarify what that means and to help professional accountants judge when a matter is of public interest. While the MG Rover case, to which the IESBA has referred, illustrates some issues it is important that this matter is considered widely and further research undertaken on the meaning of 'public interest' in the global context. Given the Monitoring Group's proposals to include a Public Interest framework within its consultation on standard setting reform by the end of the year, we certainly see the merit in IESBA investing time in this in 2019.

Definitions and descriptions of terms

While the IESBA and IAASB are independent standard setting Boards they both fall under the umbrella of IFAC. Members of IFAC are expected to support the adoption of pronouncements issued by both the IESBA and the IAASB. To avoid risks of misunderstanding, the terms used in the pronouncements of the IESBA and IAASB should have the same meaning. This is particularly important for professional accountants undertaking audit and other assurance services.

If this is not added to the IESBA's work plan as a specific project, we strongly recommend that the IESBA and IAASB work together on future projects to identify and address all inconsistencies in the terminology in their pronouncements. The IESBA and IAASB should also improve their liaison and coordination to avoid further inconsistencies, and consequent lack of clarity, arising in the future.

To illustrate the issue, as the IESBA identified in the Strategy Survey, there are certain differences between the definitions of some terms in the Code and the definitions of the same terms in the IAASB's standards. In the Restructured Code, this includes the key difference in how the term "may" is used compared to the IAASB's standards. In the Restructured Code, the term "may" is used, and defined in the Glossary, to "denote permission to take a particular action in certain circumstances, including as an exception to a requirement". The term "might"

is used, and defined in the Glossary, to “denote the possibility of a matter arising, an event occurring or a course of action being taken”. We agree that this reflects some common language usage of those terms. However, this use of "may" in the Code is inconsistent with its use in ISAs where it does not denote “permission” but rather actions auditors might take.

Breaches of the Code

As commented above, a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. The consequences of a breach of the Code can be very significant, giving rise, for example, to an actual or perceived lack of integrity, objectivity and professional behaviour and a consequent loss of confidence in the work of the professional accountant. Accordingly, guidance on how to deal with breaches of the Code is important.

Further, with regard to reporting breaches, a professional accountant should always do so where there is a legal or regulatory requirement. In other circumstances we would expect a professional accountant to report a breach to an appropriate authority when it is in the public interest to do so unless prohibited by law or regulation. The latter point is not sufficiently clear in the Restructured Code which, for example in paragraph R400.80(B)(ii), requires a firm to “Consider reporting the breach [of an independence provision] to a professional or regulatory body or oversight authority if such reporting is common practice or expected in the relevant jurisdiction.” A requirement to “consider” is relatively weak.

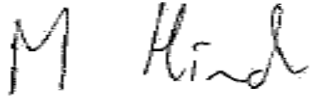
Given the current significant public scrutiny of auditors and professional accountants, including in the UK from Parliamentary Committees, we strongly believe that IESBA should be using the Code to demonstrate that it adheres to the highest possible standards when practitioners address the threats that are created by breaches of the Code, in a way that will clearly underpin justifiable public confidence.

The Chairman’s foreword to the strategy refers to the Monitoring Group’s current work to develop proposals for the reform of international audit-related standard setting. The FRC is strongly supportive of the Monitoring Group’s proposals, particularly in relation to addressing the challenges that IESBA has identified in the strategy.

We strongly endorse the proposal that the focus of standard setting should be more strategic, and outcome focused and less focused on detailed technical drafting. We also support the Monitoring Group’s proposals that standard setting work should be supported by an enlarged technical staff, allowing technical drafting to be carried out by the board’s staff for the board’s approval. It will be important for the expanded staff to have skills appropriate to support the development of standards, and to also have strong project management and stakeholder engagement capabilities to support the work programmes.

If you have any questions on our response or wish to discuss any of our observations in more detail, please contact Mark Babington, Deputy Director of Audit Policy on m.babington@frc.org.uk or +44-20-7492-2323.

Yours sincerely,

A handwritten signature in black ink that reads "M Hind". The letters are cursive and slightly slanted to the right.

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Responses to Specific Questions asked by the IESBA

1. *Do you agree with the proposed criteria for the IESBA to determine its actions and priorities over the strategy period?*

As we comment in the main body of our letter, generally, we agree with the proposed criteria, in particular taking account of the benefits to the public interest. However, we question the criterion of “the feasibility of undertaking the action within a realistic timeframe”, which lacks clarity. If an issue is identified that requires action in the public interest, the IESBA should seek to address it in a timely manner, diverting resources from other projects if necessary where they may be considered to be a lesser priority or seeking additional resources.

2. *Do you support the actions that have been identified with respect to each strategic theme? If not, please explain why?*

With the exception of the issues covered in the main body of our letter, generally, we support the actions that have been identified, in particular undertaking further research to determine whether there are ethical issues that are not adequately covered by the current ethical principles and, if so, the areas of highest priority.

With regard to ‘trends and developments in technology and innovation’ and ‘emerging or newer models of service delivery’, we observe that these are not particularly new but relate to developments over at least 15 to 20 years. However, these changes have inevitably been creating new ethical challenges and dilemmas for professional accountants and other organizations. Whilst new challenges will continue to emerge, much is likely to be capable of being learned from current practice and experience.

As we have discussed in our responses to recent IESBA consultations, we strongly believe that a principles-based approach to ethics, which clearly establishes overarching ethical principles and supporting ethical provisions, supplemented by clearly linked requirements addressing particular circumstances, will result in better ethical and behavioural outcomes. Appropriate principles and clarity of ethical outcomes are capable of application to a wide range of circumstances. Overly detailed requirements should be avoided as they may lack the necessary flexibility to be adaptable to changing circumstances; they may also encourage a rules-based mindset.

We have not, at this time, encountered specific ethical issues related to IT and/or newer models of service delivery that could not be addressed at a high level by the extant ethical principles. However, we recognize that these are developing areas and that it may be helpful to develop a broader consideration and codification of the ethical dilemmas that arise, or that are magnified, for professional accountants due to related developments and how they should be analysed in the context of the fundamental principles.

The challenges that are created by developments and innovation in IT and models of service delivery for professional accountants are not uniquely concerned with ethics and there is likely to be considerable overlap of interests between IESBA, IAASB and IAESB, in developing an understanding of such implications. We support the proposal for the Boards to co-operate in this respect.

Trends and developments in technology and innovation

With respect specifically to developments in IT, we believe that the fundamental principle of confidentiality is particularly important and that challenges arise in securing the confidentiality of data and information that may pose ethical dilemmas – this is an area where the boundaries between what may be unethical and what may be illegal are merging, especially in view of the recent further development of relevant legislation like the EU's General Data Protection Regulation, which came into force in May 2018. The fundamental principle of professional competence and due care is also important as professional accountants may need to obtain new knowledge and skills to ensure and maintain their competence to make relevant professional judgments. The exercise of professional judgment is important in the delivery of services by professional accountants, as well as in evaluating and addressing threats to compliance with the fundamental principles. Such compliance may be more difficult, for example, where the volume and nature of data and information available result in 'data overload' or data whose 'quality' is questionable. There may also be challenges to effective professional judgment when machine learning and artificial intelligence are used to support professional judgments if the 'audit trail' of the machine-based decisions and judgments is not transparent, it iterates in a way that does not require human intervention, which may require re-examination or validation as a result, or requires specialized skills and knowledge.

To address these issues, it may, in part, be helpful to express required ethical outcomes having regard to examples of developments in technology, but we would caution against being too specific, which could result in a lack of adaptability in an area where there is a relatively rapid rate of development.

Emerging or newer models of service delivery

Developments in models of service delivery are constantly evolving and are often related to or go hand in hand with developments in IT as discussed above. For example, we understand how firms of professional accountants may be able to create efficiencies by establishing different functions in parts of the world that are remote from the location of the core engagement team, and which may not be comprised of auditors or professional accountants. However, that remoteness may introduce challenges for the direction, supervision and control of the work, including the need to ensure independence where applicable and maintain the confidentiality of information.

It may be helpful to express the required ethical outcomes having regard to examples of emerging or newer models of service delivery, but we would again caution against being too specific, which could result in a lack of adaptability.

3. *Recognizing that this proposed SWP is ambitious, do you believe the IESBA should accelerate or defer any particular work stream? If so, please explain why.*

With regard to 'materiality' and also the definitions of PIEs and listed entities, the IESBA has indicated that project proposals will not be developed until 2021, with final pronouncements in 2023. The issues related to these projects are pervasive to the Restructured Code and it is important to address them to enable the Restructured Code to be applied and enforced on a consistent basis. Further, the IESBA has stated that "separately, as part of its NAS pre-commitment, the IESBA will consider whether materiality should be a consideration in addressing the question of whether the Code should permit firms to provide NAS to audit clients from an independence perspective." However, the NAS project is planned to be completed in

Q3 of 2021, before the materiality project is undertaken. We strongly encourage the IESBA to seek ways to address materiality, and the definitions of PIEs and listed entities, on a more timely basis.

Materiality

Materiality is a well understood concept in the contexts of preparing financial statements and auditing, but it is less clear how should be taken account of in relation to ethics where qualitative considerations may be particularly important.

For the contexts of preparing financial statements and auditing it is generally recognised that a matter is material if it could reasonably be expected to influence the economic decisions of the users of the financial statements. In the broader context of ethics, we consider that materiality should be judged with regard to the ‘third party test’ - whether an objective, reasonable and informed third party would consider a matter to be material. The third-party test should reflect the anticipated views of the public in whose interests the professional accountant has a responsibility to act, assuming that they are informed about the circumstances (e.g. about the nature of the threats and the nature of any safeguards) and on the assumption that they would be reasonable (i.e. rational, fair and moderate rather than extreme) in forming those views. Being “informed” should be considered in the general sense rather than suggesting a need for specific knowledge and experience.

When applying the third-party test, it is important to recognise that qualitative consideration may lead to something quite small in size being regarded as material and, in some cases, the appropriate response may be that the professional accountant should not be involved at all in the activity that gives rise to the ethical issue.

PIEs and listed entities

We believe the IESBA definitions of “public interest entity” (PIE) and listed entity should be revised and clarified as a priority. However, we recognise that it may be difficult to find a common definition of a PIE that is agreed in all jurisdictions.

The current definition of a PIE establishes only “listed entities” as a common element. This can lead to significant variation across jurisdictions as a result of (1) inconsistency in other types of entity, if any, that are designated as PIEs; and (2) inconsistency in the interpretation of “listed entity”.

As the IESBA recognises, some jurisdictions, including our own, understand “recognised markets” to be broader than “regulated markets”. This can create issues when national laws and regulations may be specific to “regulated markets” (e.g. as a result of EU legislation). For example, in the UK, the Alternative Investment Market (AIM) is considered to be a “recognised market” but it is not a “regulated market” in UK or EU law. Markets that are ‘recognised’ but not classed as ‘regulated’ are generally intended to be subject to ‘lighter touch’ regulation. Including all entities listed on “recognised markets” has led to some stakeholders suggesting that it is disproportionate to subject them to all the requirements applicable to all PIEs.

Proportionality, however, is also an important consideration for entities listed on regulated markets. For smaller listed entities there may be less ‘public interest’ concern that they be subject to the same level of requirements as the largest listed entities. In our Ethical Standard we have exempted ‘SME listed entities’ from a limited number of the more stringent requirements applicable to listed entities. Our definition of a ‘SME listed entity’ is based on that for the purposes of the EU Markets in Financial Instruments Directive (MiFID), the criteria for which include an

average market capitalization of less than Euros 200m. Proportionality will also need to be considered if other classes of entity are designated as PIEs.

Further, some entities are 'listed' on recognised exchanges but their shares, stock or debt are not in substance freely transferable or cannot be traded freely by the public or the entity. We believe that such entities should not be classed as "listed entities" for the purpose of ethical and auditing standards.

Project for documentation.

If the IESBA would struggle to address the projects it has prioritised and those we have suggested adding, we suggest that, in addition to considering obtaining more resources, the project on documentation could be deferred if necessary. We observe there are many instances in the Restructured Code where the professional accountant is "encouraged" rather than required to document matters. This is unhelpful as expectations are not made clear. If there are circumstances where IESBA believes documentation should be produced it should establish a requirement to that effect. If documentation is not essential but could be helpful, the IESBA could better present that and explain why such documentation could be helpful. We believe this could be addressed relatively quickly without a major project.

4. *Do you have comments on any other matters addressed in this consultation paper or any significant matters not covered in this consultation paper that you believe the IESBA should address?*

Promoting global adoption of the Restructured Code and monitoring the extent of adoption of the Code

As part of these activities we strongly recommend the IESBA to obtain an understanding of why the Code is not adopted in some jurisdictions and consider whether there are concerns that can be addressed.

e-Code

The IESBA states that it anticipates the e-Code to contain links to bases for conclusions, IESBA Staff publications and other relevant material outside the Code that provide contextual information or explain the rationale for particular provisions in the Code. We support activities that will aid understanding and application of the Code, but there should be clarity as to the status/authority of any linked material.