

# **INVESTOR BRIEFING NOTE ON THE FRC'S IMPLEMENTATION OF THE AUDIT REGULATION AND DIRECTIVE**

## **Introduction**

The FRC consulted on revisions to the UK Corporate Governance Code, Guidance on Audit Committees and the Ethical and Auditing Standards. These changes were necessary to implement the requirements of the EU Audit Regulation and Directive (ARD), changes to international auditing standards, and a review of ethical matters commissioned by the FRC.

We received 41 written responses from a diverse range of stakeholders and carried out an extensive range of outreach meetings, including a number of investor-only discussions. This briefing note sets out our final position in respect of topics that we believe are likely to be of most interest to investors. The revised Standards, Code and Guidance are expected to be effective for the audit of financial statements for periods beginning on or after 17 June 2016 once confirmed by UK legislation.

The FRC is also developing its implementation as the proposed competent authority for audit in respect of audit inspection, enforcement and oversight. The FRC will carry out inspection and enforcement for Public Interest Entities (PIE). The PIE definition covers entities listed on a regulated market, banks and other credit institutions and insurance undertakings. The FRC will delegate other regulatory tasks to the audit professional bodies.

## **Changes to the Corporate Governance Code and Guidance on Audit Committees**

The Code consultation proposed minimal changes, incorporating only those amendments required by the ARD. Revisions to the Guidance reflected not only ARD amendments but also recent reviews into best practice and information gathered from other areas of the FRC's work.

In response to consultation feedback, audit committee composition requirements have been amended. We have retained the requirement for at least one member of the committee to have 'recent and relevant financial experience', noting that under the ARD also need (as now) there is a need to have at least one member with 'competence in accounting and/or auditing'. The audit committee as a whole is also required to have competence relevant to the sector in which the company operates. The Guidance clarifies that the board should ensure a range of skills, experience, knowledge and professional qualifications in addressing the composition requirements.

Committees should also inform their investors in advance of any audit retendering plans.

The Guidance was revised to clarify the committee's role in respect of risk and internal audit. There is now an expectation that the committee will report on the significant findings of reviews undertaken by the FRC's Corporate Reporting Review and Audit Quality Review teams.

The consultation asked whether an advisory vote on the audit committee report should be required, as recommended by the CMA. The vast majority of investors considered it unnecessary, as there are other avenues through which they may register concern.

## **Changes to Standards**

Changes at the European level have brought in new requirements for all statutory audits, and set additional requirements for the audit of

### Ethical Standards

Changes to the Ethical Standard have been focused on measures to enhance auditor independence, including underpinning in standards policy decisions to be reflected in UK legislation (such as retendering and rotation of the audit). In the case of a PIE, the standards prohibit the provision of certain types of non-audit services, and subject others to a fee cap of no more than 70 per cent of the audit fee calculated on a rolling three-year basis.

In some areas the UK standard retains existing UK ethical requirements, and goes beyond the ARD, in line with feedback from earlier FRC consultations. In particular for PIEs the standard requires that those auditors from a network firm auditing a component of a PIE should be held to the more stringent UK ethical requirements. In other circumstances the recognized international code will apply (as now)

Auditors now need to consider their independence from the perspective of an objective, reasonable and informed third party. If such a party would conclude that an action would compromise the auditor's independence, the auditor will need to ensure that action is not taken or they would no longer be able to undertake the audit engagement.

The revised standard makes clearer the risks to independence posed by situations where the auditor acts as an advocate, and emphasises the prohibition which applies in all but immaterial situations.

The FRC has reflected investor feedback on the significance of large AIM companies which are not included in the PIE definition. Accordingly the more stringent requirements that apply to PIEs have been applied to AIM companies which are above the MiFID SME threshold of Euro 200m.

The standard prohibits contingent fees for tax services provided to larger listed entities with a market capitalisation of more than €200 million, to address the risk that contingent fees can grow to a level that they pose a threat to auditor independence.

### Auditing Standards

Auditing Standards have been revised to accommodate the requirements of the ARD, and also changes at the international level made by the International Auditing and Assurance Standards Board (IAASB). These changes derive from three projects completed by the IAASB covering: auditor reporting; other information and the audit of disclosures in financial statements, and include:

- Revisions to reporting standards have incorporated existing UK Extended Auditor's Reporting requirements;
- A requirement for auditors to provide within their audit report a separate opinion, covering the statutory other information<sup>1</sup> published alongside the financial statements stating whether that information is: consistent with the financial statements; prepared in accordance with legal requirements; and that it does not contain material inconsistencies;

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<sup>1</sup> The strategic report, the director's report and the separate corporate governance statement

- Enhanced reporting to audit committees covering key audit matters; and
- By-exception reporting on going concern.

#### Audit Inspection

UK audit firms involved in the audit of UK PIEs and large AIM companies will be subject to direct inspection and oversight by the FRC, and will also be required to publish an annual transparency report. As now, the UK will rely on the audit inspection regimes in the EU and other countries considered equivalent. The FRC will continue to inspect in other countries where possible.

#### Audit Enforcement

The FRC is currently [consulting](#) on the audit enforcement procedure to be applied from 17 June and the closing date for responses is Wednesday 4 May.