

July 2019

FEEDBACK STATEMENT AND IMPACT ASSESSMENT

Post Implementation Review of the 2016 Auditing and Ethical Standards

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Executive Summary

1. This paper sets out the Financial Reporting Council's proposed revisions to the 2016 UK Auditing and Ethical standards. These revisions are the result of our Post Implementation Review of the efficacy of these standards, a process which included a Call for Feedback in November 2018, and a position paper in March 2019.¹ In addition to the formal submissions received from our Call for Feedback, we have engaged in a process of ongoing outreach to a wide range of stakeholders, including investor representatives.
2. Our key objectives are to enhance confidence in audit, ensure that consideration of the public interest is placed at the core of UK audit firm culture, and strengthen auditor independence. We are seeking to meet these objectives within the current legal, regulatory and financial reporting frameworks in the UK. At the same time, we will continue to liaise with the other regulatory reviews looking at the health and competitiveness of the UK audit market, regulation and the scope of audit.
3. The audit sector is under unprecedented scrutiny – two independent reviews have been completed by Sir John Kingman (on the FRC) and by the Competition and Markets Authority (on competition in the market for statutory audit services). The Business, Energy and Industrial Strategy Select Committee has held a series of evidence sessions and reported on the Future of Audit. Currently, Sir Donald Brydon is carrying out a wide-ranging independent review into the quality and effectiveness of audit.
4. It would not be appropriate, in this consultation to cut across the scope of Sir Donald's review, or to anticipate Ministers' consideration of the independent reviews and subsequent public consultations, which may ultimately require legislation to address. Where we have identified audit weaknesses or failings as a result of the FRC's own inspection and enforcement work, however, we have proposed some revisions to address these urgently. It would be irresponsible not to take action to address recurring issues which drive poor quality audit, undermine stakeholder confidence in audit or, in more extreme cases, lead to audit failure.
5. Some of the matters that we outlined in the Position Paper issued in March 2019 are being considered as part of Sir Donald's independent review and were covered in the Call for Views which he issued in April. Where this is the case, we will defer making any changes until Sir Donald has reported and his recommendations have been considered by government, to ensure that all of the current work to strengthen audit in the public interest is effectively co-ordinated. This includes matters such as: the scope of the auditor's responsibilities in respect of fraud, laws and regulations and other information in the Annual Report and possible enhancements to auditor reporting. We have, therefore delayed a proposal to consult of whether the auditor should include in their report adjusted and unadjusted differences.
6. Key changes we are proposing include:
 - Simplifying and restructuring the Ethical standard in order to achieve higher levels of understanding and compliance;
 - Re-defining the 'objective, reasonable and informed third party' test which is a core element of the Ethical Standard;

¹ <https://www.frc.org.uk/consultation-list/2018/post-implementation-review-2016-ethical-and-auditi>

- The introduction of a list of permitted services that auditors of Public Interest Entities (PIEs) can provide, limiting these to those which are closely related to the audit and/or required by law and regulation. This reflects the commitments made by some of the largest audit firms in their evidence to the BEIS Select Committee. This existing list of prohibited services continues to be enshrined in law;
- Expanding the scope of certain ethical requirements to cover entities which may not be formally designated as PIEs, but are clearly of significant public interest (drawing on lessons learned from the BHS enforcement case);
- Strengthening certain ethical prohibitions and requirements which relate to auditor independence, including the provision of non-audit services, for the auditors of all listed entities;
- Clarifying and enhancing requirements in the auditing standards including:
 - Group audit procedures;
 - Auditor reporting;
 - Enhanced work effort in respect of irregularities in law and regulation, including fraud;
 - Greater clarity over the auditor's work effort on 'other information' included within annual financial reports.

Introduction

7. The FRC is committed to acting as a proportionate and principles-based regulator and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work to maintain investor and wider stakeholder confidence in audit.
8. In a Call for Feedback in November 2018, the FRC sought views from stakeholders as to the effectiveness with which the FRC's Auditing and Ethical standards had achieved the objectives we had set in 2016, which were reported in our consultation paper 'Enhancing Confidence in Audit'.² However, since those original objectives were set out, the UK audit landscape has changed significantly, which requires further steps to be taken if users are to feel that audit meets their legitimate expectations. These changes include:
 - increased public, press and Parliamentary interest in audit;
 - changing expectations of users of financial information following a number of audit and corporate failures;
 - the decline in the quality of audit in several firms inspected by the FRC; and
 - perceptions about the lack of independence of the profession arising from statutory audit being a comparatively small component of large multi-service firms, and concerns that those firms are driven by commercial considerations which support the sale of additional services, rather than challenging management as part of a high-quality audit.
9. In addition to the proposals included in this paper, we have consulted separately on a revised ISA (UK) 570 covering Going Concern. The standards included within this consultation therefore include conforming amendments to align them with our proposed changes to ISA (UK) 570.
10. In the Ethical Standard, we have also taken account of revisions to the IESBA International Code of Ethics, which come into effect on 15 June 2019. Our long-standing approach is that the FRC Ethical Standard remains no less stringent than the Code. Some of the changes we are proposing reflect the continuation of that policy.
11. Within this consultation we analyse the feedback we have received and set out our proposed revisions to the standards. We welcome further feedback on any aspect of these proposals but have also included specific questions which it would be helpful for respondents to address.
12. Our intention is that revised standards will apply to the audit of financial periods commencing on or after 15 December 2019. The proposed revisions include text which reflects the legislation that has been passed by Parliament in support of EU Exit. However, in finalising the standards before the end of this year, we will update the text as necessary to reflect the applicable legal position.

² <https://www.frc.org.uk/consultation-list/2015/consultation-enhancing-confidence-in-audit>

Request for Comments

Comments are invited in writing on all aspects of the Exposure Drafts of the revised Ethical Standard and ISAs (UK). In particular, comments are sought in relation to questions 1–14 below:

Question 1: Do you agree with the revised definition of an ‘objective, reasonable and informed third party’ and with the additional guidance on the application of the test?

Question 2: Do you agree with our proposed measures to enhance the authority of Ethics Partners, and do you believe this will lead to more ethical outcomes in the public interest?

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

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

Question 5: Do you agree with the additional prohibitions we are proposing to introduce – in learning from the experience of enforcement cases like BHS, if the more stringent PIE provisions are to have a wider application to non-PIE entities, which entities should be subject to those requirements?

Question 6: Do you agree with the removal of the reliefs for SMEs in Section 5 of the Standard, and the retention of reliefs for ‘small’ entities (in Section 6 of the Standard)?

Question 7: Do you agree with the proposed removal of the derogation in the 2016 Ethical standard which allowed for the provision of certain non-audit services where these have no direct or inconsequential effect on the financial statements?

Question 8: Do you agree with the inclusion of FRC staff guidance within the application material, and has this improved clarity of the requirements?

Question 9: Do you agree with the inclusion of FRC staff guidance within the application material of the auditing standards, and has this improved clarity of the requirements?

Question 10: Do you agree with the changes we have made to ISAs (UK) 700, 250 A and 250 B, including the extension of the requirement for auditors to report on the extent to which their audits are capable of detecting irregularities, including fraud.

Question 11: Do you agree with the proposed additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit Matters and increased disclosure around materiality?

Question 12: Do you agree with the revisions we have made to ISA (UK) 720, including the enhanced material setting out expectations of the auditor’s work effort in respect of other information?

Question 13: We are proposing changes to the standards to be effective for the audit of periods commencing on or after 15 December 2019. Do you agree this is appropriate, or would you propose another effective date, and if so, why?

Responses should be sent to AAT@frc.org.uk and marked for the attention of James Ferris. Responses should be received by 5pm on Friday 27 September 2019. Respondents should feel free to cover any other matters relevant to the consultation which are not the subject of specific questions.

Impact Assessment

The FRC is a principles-based regulator and is committed to issuing proportionate Standards and Guidance that support the provision of high-quality, independent audit. The requirements proposed in these Exposure Drafts have been developed in response to particular issues and concerns in respect of auditor independence, reporting and the adequacy of audit work effort.

In making these revisions we have had regard to the FRC's 'Principles for the development of Codes, Standards and Guidance which include:

- there is a clearly defined issue relevant to the FRC's mission and responsibilities;
- the change is the most appropriate way to address the issue;
- 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 legislation or 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;
- the anticipated benefits of the change outweigh the costs.

With reference to these Principles, the FRC concluded that these revisions are necessary as the risks to the public interest of not acting are significant. In these circumstances, and given the risk posed to investors and other stakeholders by decreased confidence in audit (including concerns over auditor independence and audit quality), the FRC has concluded that it is appropriate to strengthen ethical requirements, particularly in respect of auditor independence, and to require additional work effort to be applied. The revised standards have been simplified and clarified to help increase compliance, which will have a tangible but unquantifiable benefit. Likewise, strengthening of stakeholder confidence as a result of the changes we have proposed will deliver significant, but unquantifiable benefits.

The cost as a result of these proposals is estimated to be as set out in the following table. Where there are changes that are not as a result of decisions taken by the FRC (for example in respect of EU Exit or other statutory requirements) they are not included in this assessment. However, the FRC welcomes views from stakeholders if they believe that we should consider other factors.

Impact	Assumptions	Cost Impacts	Estimated Cost (£000)	Recurring (Y/N)
Familiarisation and Training with revised standards (ethical and auditing).	Updating guidance by technical managers/partners (90%/10%) 500 hours for 6 large firms; 50 hours for 30 medium firms; 10 hours for 64 small firms. A discount of 25% applied to reflect the fact that audit firms update technical/methodology material on an annual basis.	Audit firm	1,044	N
Familiarisation and Training with revised standards (ethical and auditing).	Familiarisation of audit practitioners with standards estimated at 2 hours per practitioner. Other assumptions consistent with Impact 1, but a discount of 40% applied since practitioners are required to maintain CPD, and an aspect of familiarisation with standards would have taken place anyway.	Audit firm	2,965	N
Introduction of a permitted non-audit services list for PIE auditors.	We do not believe that there will be significant incremental costs as a result of this proposal. Although there is the potential for some additional tendering costs for previously allowable services, the feedback we have received has indicated that the market was already moving towards this outcome. Loss of revenue from the provision of such services cannot be considered a qualifying cost, since the likely outcome of changes in the market is a redistribution of this revenue rather than a significant decrease. We also note that greater clarity about what services may or may not be provided is likely to reduce internal procedures - including for example ethical consultations within the firms.	N/A	0	N/A
Removal of SME reliefs from the Ethical standard.	The feedback we received in our Call for Feedback indicated that very little practical use was being made of these reliefs. Changes to the IESBA Code, also made it difficult to maintain certain reliefs. We estimate that some costs will arise for audit firms in terms of refreshing processes and procedures, however, only to the extent of the benefit used in the 2016 impact assessment.	Audit firm/ audited entity	54	Y
Enhanced auditor reporting requirements. Additional reporting requirements in respect of materiality, KAMs and misstatements apply to all entities who are required to comply with ISA (UK) 701.	Based on 2,800 engagements (PIE audits and other listed), with an additional requirement of 2 hours of partner time and 2 hours of manager time (based on estimated hourly rates)	Audit firm	6,160	Y
As a clarification of the auditor's responsibilities on other information - and at a more granular level - we believe this will drive more consistent practice across the firms and therefore likely increase work effort.	The FRC's 2018 thematic review of the work carried out by auditors on 'other information' identified significant inconsistencies in work effort and methodology. Some will need to significantly increase the work they do in this area. For PIEs we have assumed additional hourly costs of 1 manager & 3 team member hours; for listed entities 1 manager and 2 team member hours; for other entities 0.5 manager and 1 team member hour, with 50% of engagements requiring additional work effort based on our thematic review.	Audit firm	1,432	Y

Enhanced work effort: law and regulation, including fraud. The most significant impact is likely to be our extension of the requirement to report on the extent to which an audit is capable of detecting material irregularities relating to non-compliance with regulation, including	This is an additional reporting requirement which requires auditors to provide disclosure in their auditor's reports and ensure that their work effort is consistent with those disclosures. The incremental cost will be for non-PIE audits only since PIE auditors are already required to comply. We have assumed 1 additional manager hour per affected engagement.	Audit firm	2,152	Y
Benefits to auditors from having standards and guidance in a single place, with the incorporation of TAG material and relevant staff guidance.	Benefit scaled at 20% of relevant familiarisation costs.	Audit firm	(802)	N
		Total	13,005	
One off costs (£000):	3,207			
Recurring costs (£000):	9,744			

Analysis of Call for Feedback responses and detail of proposed revisions to the standards.

November 2018 Call for Feedback:

How well do you think the 2016 revisions to Ethical and Auditing standards have met the objectives set out in our September 2015 consultation 'Enhancing Confidence in Audit' and summarised in this consultation document?

Perspectives on the effectiveness of the 2016 revisions to the Ethical and Auditing standards which implemented the requirements of the Audit Regulation and Directive differ, according to their source. On balance, we found that investors and the groups which represent them tend to be more sceptical, particularly in respect of perceptions of auditor independence. There was also significant and understandable concern about the reported decline in audit quality exacerbated by a number of high-profile corporate failures, which has the effect of undermining stakeholder confidence. Some respondents commented that in some respects the changes had not 'gone far enough' to strengthen auditor independence and enhance quality.

However, those changes were made at a time when the appetite for regulatory intervention was very different. Legal requirements were 'copied out' from EU law into UK law without amendment, and the prevailing view at the time was that the UK should not go further than required by law.

Audit firms recognise that confidence in the quality of audit has declined, whilst the expectations on auditors have continued to grow. Public and wider societal expectations of audit have changed, and this is reflected in the government's decision to commission Sir Donald Brydon to carry out an independent review of audit. This follows on from the Kingman review of the FRC which recommends the creation of a new statutory regulator, and the Market Study by the Competition and Markets Authority.

The Brydon Review is considering the current scope of audit, and whether that is sufficient to meet the expectations and needs of stakeholders. However, our own audit inspection work, and a number of recent enforcement cases have identified examples of significant differences between what is expected of auditors delivering high-quality audit under the current framework, and how well in practice this is being delivered. Where our work has identified problems, which lead to audit weakness or even failure, it is imperative that we take actions to address those failings. In doing so we have considered only the remedies we can implement within the current framework of law, regulation and financial reporting.

November 2018 Call for Feedback: In carrying out this review of effectiveness, should the FRC consider any additional objectives as being relevant for Ethical and Auditing standard setting. If so, please state what they are and why?

A common theme running through the responses to this question was the need to restore confidence in audit through strengthening auditor independence and reducing conflicts of interest. This has been a critical aspect of our revisions to the Ethical standard, which are set out in more detail in the rest of the consultation paper below, including our proposed re-definition of the 'objective and informed third party test'.

Alongside this was a call for enhanced clarity and a simplification of the text of the standard to make it more user friendly. Once again, we have set this as a key objective in the way we have reorganised and shortened the standard including, for example, separating out requirements specific to reporting accountants. In terms of the scalability of the requirements we have tried to help readers more easily identify those requirements which impact on different types of audited entity.

There was also a call for us to be cognisant of the other regulatory reviews which are either underway, or subject to public consultation. We have taken care not to pre-empt the outcome of those reviews, or the consideration of their findings by government. We believe that the changes we are proposing to the Ethical standard – in respect of the provision of non-audit services for example – provide urgently needed clarity which will serve to increase confidence that auditors and those carrying out other public interest assurance engagements, are independent of the entities on whose financial information they are giving assurance.

November 2018 Call for Feedback: *Do the current Ethical and Auditing standards drive the auditor to deliver work that meets the expectations of users within the current scope of an audit? If there are expectations that are not being addressed, please state those along with your proposals as to how they can be addressed.*

November 2018 Call for Feedback: *Are the ethical principles and supporting specific requirements sufficiently clear? If not, please explain the issues and how you believe they could be resolved.*

Many of the responses to this question covered similar ground to that which asked practitioners to identify barriers to compliance: namely the perceived complexity of the standard, and the use of terminology from European Law which is ambiguous. We set out below how we have attempted to address those concerns.

We also propose to strengthen the key test included within the Ethical standard when practitioners consider the application of the ethical principles – the ‘objective, reasonable and informed third party’ test. Our proposal is to replace the extant definition with one which has greater focus on the perspective of stakeholders who are the ultimate beneficiaries of assurance, and also to provide more application guidance that firms should use when making an assessment:

“Such a person is informed about the respective roles and responsibilities of an auditor, those charged with governance and management of an entity, and is not another practitioner. The perspective offered by an informed investor, shareholder or other public interest stakeholder³ best supports an effective evaluation required by the third-party test, with diversity of thought being an important consideration.”

Question 1: Do you agree with the revised definition of an ‘objective, reasonable and informed third party’ and with the additional guidance on the application of the test?

November 2018 Call for Feedback: *Are there further steps that the FRC should consider as part of this review to ensure the delivery of high-quality audit? If so, please state what they are and why.*

³ Such parties will include those considered to be the stakeholders of a company for the purposes of meeting directors’ obligations under s172 of the Companies Act 2006.

Respondents to this question stressed the importance of the FRC aligning closely with proposals being put forward by other independent reviews. Our response is set out in the detailed commentary on the changes we are proposing to the standards. Where we are convinced, based on the findings from our inspection and enforcement work, that action needs to be taken now to strengthen requirements in standards then we have done so. We have also applied this principle to our separate consultation setting out proposals to strengthen the auditor's work effort in respect of going concern, which was one issue of particular focus in feedback. We also propose to enhance the authority of the Ethics Partner function, in order to ensure firm wide focus on ethical matters and the public interest, and to require reporting to those charged with governance, where an audit firm does not follow the Ethical Partner's advice.

Question 2: Do you agree with our proposed measures to enhance the authority of Ethics Partners, and do you believe this will lead to more ethical outcomes in the public interest?

We considered whether it was appropriate to revise at this stage ISA (UK) 240 which deals with an auditor's responsibilities in respect of fraud, which has been subject to recent scrutiny by the Business, Energy and Industrial Strategy Select Committee. We consider that the current requirements are clear – and that auditors are required to design their audit in a way that will identify and risks of material misstatement (including from fraud). However, it is apparent that the application of those requirements is not always given sufficient focus. Rather than revise the standard at this stage, we will not propose any significant changes until Sir Donald Bryson has concluded his review, and his recommendations have been considered by the Government.

November 2018 Call for Feedback: *Based on experience, do you believe the ethical principles and supporting specific requirements are sufficiently proportionate for PIEs and non-PIEs? If not, please explain your view, including what you would consider the proportionate position to be, having regard to the need to address threats to independence, objectivity and integrity viewed from the perspective of an objective, reasonable and informed third party.*

In aggregate, there is broad agreement that PIE audits should be subject to a more stringent set of ethical principles and supporting requirements than non-PIEs. However, recent enforcement cases, including the BHS case makes a strong case that we should consult on whether the more stringent requirements should be applied to additional entities which are of significant public interest (without those entities themselves being designated as additional PIEs). The revised Glossary of Terms definition of this term is:

“An entity which does not meet the definition of a Public Interest Entity, but nevertheless is of significant public interest to stakeholders. Entities included within the scope of the FRC's Audit Quality Review, which are not public interest entities, are other entities of public interest.”

These include some larger privately owned companies. The additional ethical requirements which we propose to apply to this category of audits is set out in detail below, particularly in respect of the provisions of non-audit services.

November 2018 Call for Feedback: *Do you believe that user confidence would be strengthened if the FRC required the application of the independence requirements of FRC Ethical standard to all components of a group audit?*

Some respondents identified a number of practical difficulties with a proposal to require all component auditors of a group audit to comply with the UK Ethical standard, regardless of jurisdiction. However, no arguments were presented which disagreed with the principle that the same independence requirements should apply to all auditors in the group.

There were two aspects to the extant rules which require revision. Both relate to the territorial application of the FRC's independence requirements to the auditors of a UK PIE group. The components of such a group may be based in a number of different countries, including those outside of the European Union. The work may also be carried out by an audit firm, a member of its network or a third-party firm.

Under the current rules, for a group audit of a UK PIE, when the engagement partner assesses the independence of component auditor, they use the FRC Ethical Standard regardless of the territory where the component is based. For non-PIE group audits, the requirements of the extant version of the IESBA Code apply instead, when assessing the independence of component auditors outside of the UK.

In order to ensure greater consistent, and as a result of changes to UK legislation, that have been made to support UK withdrawal from the European Union, the independence requirements of the FRC Ethical standard will now apply to the auditors of all components, regardless of where those components are based. The following revisions have therefore been made to the ES:

- Part A paragraph 2.4 has been amended to clarify that the FRC's independence requirements apply to all firms whose work has been used in the conduct of a PIE audit engagement.
- Paragraph 5.167R [now 5.41] has been amended to remove the restriction on the territorial application of prohibitions on the non-audit services which can be provided by a PIE auditor.

November 2018 Call for Feedback: *For practitioners, what difficulties, if any, have you encountered in complying with the ethical principles and supporting specific requirements? Is there anything the FRC could do to help alleviate these (e.g. further supporting guidance)?*

Respondents identified difficulties in complying with the Ethical standard which related to the structure of the text, including the clarity with which requirements affecting different types of engagement and entity were set out, as well as sometime ambiguous language which required further explanation and interpretation, which the FRC provided through the development of guidance supported by our multi-stakeholder Technical Advisory Group.

Without moving away from our principles based approach, but in order to address these concerns we propose to:

- Place all material specific to reporting accountants in one section of the standard. This allows for a simplification of the structure of the standard throughout, and removes significant duplication; and
- Incorporate FRC guidance within the body of standards to address areas of ambiguity or interpretation.

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

November 2018 Call for Feedback: Do you believe the current restrictions on non-audit services are sufficient to address threats to independence, objectivity, integrity and audit quality, and address stakeholder expectations? If not, please explain why, by providing examples where audit quality has been compromised as a result of non-audit services being provided by the auditor.

November 2018 Call for Feedback: Do you believe there should be further restrictions, or even an outright prohibition, on non-audit services?

a. Should any further restrictions or prohibitions also apply to "audit related" services, that the auditor is not required to provide? If so, please explain your views.

b. Should any further restrictions or prohibitions also apply to services required by law or regulation (i.e. permitted by the Audit Regulation)? If so, please explain your views.

The provision of non-audit services by audit firms to audited entities has been the subject of significant public and parliamentary debate. The provision of such services creates a widely held perception that the fees generated through the sale of non-audit services makes auditors less independent, as their judgment may be affected by commercial considerations rather than focusing on providing a robust challenge of management. The regime that was introduced in 2016 extended the prohibitions for auditors of public interest entities and introduced a 70% cap on the fees that audit firms (and their networks) can earn from non-audit services relative to audit fees. This has led to a decline in fees from those services and the independent scrutiny and approval of these services by audit committees has significantly reduced their use. More recently, the largest UK audit firms have begun to change their own policies, committing to the BEIS Select Committee that they will not provide 'non-essential' services to entities they audit in the FTSE 350.

The feedback we received in answer to our Call for Feedback was very mixed. Many audit firms and professional bodies who responded felt that insufficient time has passed to fully assess the impact of the 2016 reforms, including the 70% fee cap. Whilst supportive of some further restrictions, some of the firms felt that these should be market led rather than built into the Ethical Standard itself. More generally the firms asked for a simplification of the text of the standard, greater clarity of the requirements that impact different types of engagement, and a more definitive list of prohibited services. Concerns were also raised about proportionality, particularly how prohibitions might be extended or applied to non-PIE entities.

Nevertheless, we received consistent feedback from stakeholders who rely on audited financial information that the fees earned by the firms by providing non-audit services to entities they audit has resulted in declining confidence in the ability of those firms to provide truly independent and rigorous assurance.

The FRC remains committed to a principles-based regime for the provision of non-audit/additional services. Many of those who responded to our Call for feedback (whether formally in writing or through subsequent outreach) thought that there was a strong case for certain 'audit related' services to be provided by auditors. However, restoring public

confidence in the independence of auditors is of paramount importance, and these services create a risk (both real and perceived) which we believe warrants further restrictions. In addition to the changes outlined elsewhere (for example in respect of the informed, reasonable and objective third-party test) we therefore propose the following specific changes to the Ethical Standard in respect of non-audit services:

- Moving from a list of prohibited services, to a shorter list of permitted non-audit/additional services for auditors of Public Interest Entities. These services are closely related to the audit (for example review of interim information) and/or required by UK law or regulation (for example reporting on client assets or Solvency II). The permitted services list clearly identifies those services which are or are not subject to the 70% fee cap.
- Prohibiting audit firms from accepting any non-audit/additional service engagement where that would require the firm or a covered person playing any part in the management decision-taking.
- Prohibiting the use of contingent fees for such services. We believe the self-interest threat where a fee is contingent on a particular outcome is too great to be mitigated.
- Removing the derogation that existed over prohibited services, which allowed them to be provided in certain circumstances, and which has led to unhelpful interpretations being made.
- The application of the permitted services list and the prohibitions have been extended to include an audit firm undertaking the statutory audit of an 'other entity of public interest'.
- Where prohibitions apply to services provided to a listed audit client, we have removed the reliefs which previously applied to SME listed entities. We received feedback that these were not widely used as they conflicted with IFAC membership obligations for Forum of Firms members.
- Absolute prohibitions have been introduced on the provision of internal audit services, and recruitment services to an audited entity by the auditor of that entity.
- The prohibitions in respect of the provision of Information Technology Systems have been simplified and clarified.

Further, we propose:

- To consult on the application of the more stringent PIE requirements in the standard to other non-PIE entities which are still of significant public interest. We have asked for stakeholder views about which types of entity should be subject to any new requirement.
- A new requirement for firms to establish policies and procedures in respect of gifts and hospitality offered by or received from entities which may become relevant to a public assurance engagement in the future.

- Clarifying requirements in cases where audit firms are associated with litigation (for example as administrators) and act as an agent in a way that threatens their independence.

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

Question 5: Do you agree with the additional prohibitions we are proposing to introduce – in learning from the experience of enforcement cases like BHS, if the more stringent PIE provisions are to have a wider application to non-PIE entities, which entities should be subject to those requirements?

Question 6: Do you agree with the removal of the reliefs for SMEs in Section 5 of the Standard, and the retention of reliefs for ‘small’ entities (in Section 6 of the Standard)?

Question 7: Do you agree with the proposed removal of the derogation in the 2016 Ethical standard which allowed for the provision of certain non-audit services where these have no direct or inconsequential effect on the financial statements?

November 2018 Call for Feedback: Are the relevant auditing requirements of the Regulation and Directive as integrated into the revised ISAs (UK) sufficiently clear? If not, please explain the issues that are currently of concern and how you believe they could be resolved.

Respondents identified a number of areas within the ISAs (UK) where the integration of the requirements of the Audit Regulation and Directive had led to some confusion, principally because of ambiguous terms in the legislation. To address this additional FRC staff guidance was developed. Which we propose to integrate into the text of the standards, to the extent that it is still needed. In addition to the specific changes described elsewhere within this consultation document, these changes include:

- Including a definition of the term ‘material subsidiaries’ within ISA (UK) 220;
- Enhanced application guidance in ISA (UK) 220 in respect of the conduct of an EQCR for a PIE audit;
- Enhanced application guidance in ISA (UK) 600 on the evaluation of the work of a component auditor in a group audit; and
- Additional application material in ISA (UK) 620 explaining how the FRC’s ethical requirements apply to an auditor’s expert.

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

Question 9: Do you agree with the inclusion of FRC staff guidance within the application material, and has this improved clarity of the requirements?

November 2018 Call for Feedback: For practitioners, what other difficulties, if any, have you encountered in complying with the revised ISAs (UK)? Is there anything the FRC could do to help alleviate these (e.g. further supporting guidance)?

The most significant issues reported to us about the difficulties practitioners have faced in applying the revised ISAs (UK) has been the relationship between supplementary guidance developed through engaging with the multi-stakeholder Technical Advisory Group and the Ethical and Auditing Standards themselves. The guidance was developed to provide and FRC interpretation of certain requirements contained with the Audit Regulation and Directive. We have, therefore, taken this opportunity to incorporate that material directly into the standards, primarily within application guidance. We believe this provides enhanced clarity about those requirements, and how they should be applied, in a 'one stop shop' approach.

We note some specific issues identified which relate to the nature of the underlying international auditing standards on which UK ISAs are based (for example in respect of the relationship between emerging technology tools and the requirements of standards). The FRC continues to work closely with the IAASB and other audit regulators in the development of these international standards and will utilise this feedback as part of that process.

We further note certain issues of interpretation and application which may need to be revised once legislation is finalised and made effective following the UK's exit from the European Union.

November 2018 Call for Feedback: *Is the work required of an auditor on an entity's compliance with laws and regulations, and those procedures to identify irregularity, including fraud, sufficient to meet the needs and legitimate expectations of users? If not, what additional work would you require and why?*

Whilst the majority of the audit practitioners who responded to our question felt that current requirements were sufficient, other feedback has highlighted a lack of understanding by some non-practitioners about what the responsibilities of auditors are in respect of the detection of irregularities, including fraud. Auditors themselves recognise that this has created an 'expectation gap'. We therefore believe that auditors should do more to explain what it is they do, and how effective that can be in detecting irregularity and fraud.

We propose to extend the existing ISA (UK) 700 requirement for auditors of public interest entities to report on the extent to which their audits are considered capable of detecting irregularities, including fraud, to all audits. We have further clarified the requirement by including relevant FRC staff guidance into the application material of the standard.

We have also revised ISA (UK) 250 A *Consideration of Laws and Regulations in an Audit of Financial Statements* and ISA (UK) 250B *The Auditor's Statutory Right and Duty to Report to Regulators of Public Interest and Regulators of Other Entities in the Financial Sector* in order to achieve the following:

- A clearer articulation of the auditor's responsibilities in respect of non-compliance with laws and regulations, and how these responsibilities should be discharged. This includes more explicit links to the requirements of related standards including ISAs (UK) 240, 265 and 315.
- Adding to application material in ISA (UK) 250 B to include FRC staff guidance material in respect of the reporting requirements to regulators for PIEs.

With regard to the auditor's responsibilities relating to fraud, and potential revisions to ISA (UK) 240, as noted earlier in this paper, we note that the remit of Sir Donald Brydon's Independent Review of audit and the matters included in his *Call for Views* of April 2019.⁴ The Brydon review is considering broader questions about what the expectations of auditors are, or should be, in respect of fraud, and the legal and regulatory framework which is required to deliver on those expectations. We believe that auditors already have a clearly articulated responsibility in ISA (UK) 240, "for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error".⁵ If further changes to ISA (UK) 240 are required as a result of Sir Donald's recommendations, we will consider those in due course.

Question 10: Do you agree with the changes we have made to ISAs (UK) 700, 250 A and 250 B, including the extension of the requirement for auditors to report on the extent to which their audits are capable of detecting irregularities, including fraud.

November 2018 Call for Feedback: *Should the FRC take further steps to increase the value of extended auditor reporting to users of financial statements? If you agree, what material would you like to see included in auditor's reports?*

Our Call for Feedback found some support for further enhancements to requirements around auditor reporting, with many respondents recognising the positive impact of the FRC's previous innovations in this area. Our original approach to changing the auditor's report was to set high level principles and expectations, and limit the degree of prescription. Some respondents argued that market lead innovation continues to be a more appropriate driver for further enhancements rather than additional requirements in the standards.

However, we believe that the pace of innovation has slowed in recent years and therefore propose to include the following additional requirements in ISA (UK) 701:

Respondents to our Call for Feedback have asked us to prescribe certain areas of good practice within our standards. We note that auditors were already free to include this good practice in their reports. However, we have concluded that additional information requirements should be included within the auditing standards in order to ensure greater consistency and transparency in the market. In order to address this, we propose to consult on the following revisions:

- Requiring auditors to describe the significant judgements made in respect of how Key Audit Matters were addressed in the course of the audit;
- Clarifying what is meant by the term 'where relevant' as applied to the auditors of PIE entities when describing key observations arising in respect of significant risks of material misstatement; and
- Enhanced disclosures in respect of materiality, including the specification of performance materiality, which shows the auditor's assessment as to the effectiveness of internal control in the entity.

⁴https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/794244/brydon-review-call-for-views.pdf

⁵ ISA (UK) 240 (Revised June 2016), para 5

Sir John Kingman has recommended that a form of 'graduated findings' be introduced, where the auditor would be additionally required to give a view on management's decisions in areas that are key audit matters, including for example whether they were considered 'optimistic' or 'cautious'. We note that nothing in the current or revised ISAs (UK) would prevent auditors from adopting 'graduated findings' on a voluntary basis. We further note that the Brydon review will be giving further consideration to this idea, and will revisit ISA (UK) 701 requirements in the light of the findings of his review.

Question 11: Do you agree with the proposed additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit Matters, increased disclosure around materiality and disclosure of misstatements?

November 2018 Call for Feedback: *ISA (UK) 720 sets out the auditor's responsibilities in respect of other information – do you believe the current requirements are sufficiently responsive to the needs of users of financial statements? If you disagree, please set out what additional work you would like to see auditors undertake.*

The responses to this question were almost unanimous that an 'expectation gap' exists in respect to the work auditors carry out on 'Other Information' within the annual report, and that there is also a lack of clarity about the extent of assurance users want and are prepared to pay for. The FRC's recent thematic review of how the firms currently approach this work identified clear inconsistencies, and as a result we propose to revise the standard to make it simpler to apply, and to also address the weaknesses identified with the following measures:

- Simplifying the text of the standard by moving material relating to UK specific requirements for 'statutory other information' to application guidance;
- Clarifying the FRC's expectations about the work effort required from auditors in respect of other information by: (i) incorporating FRC staff guidance into the application guidance of the standards (ii) enhancing the application guidance dealing with work effort;
- Aligning the standard with proposed revisions to ISA (UK) 570 on *Going Concern*, which will now be the primary source of reporting requirements in respect of going concern and viability.

We will consider and implement any further changes to standards which are required as a result of the Brydon review.

Question 12: *Do you agree with the revisions we have made to ISA (UK) 720, including the enhanced material setting out expectations of the auditor's work effort in respect of other information?*

November 2018 Call for Feedback: *For going concern, auditors are required to assess whether management's use of the going concern basis of accounting as required by IFRS or UK GAAP is appropriate. How could auditors make their assessment of greater value to users of financial statements? Please set out what steps you believe should be required to better underpin confidence in audit and audited financial statements.*

Subsequent to our original Call for Feedback we launched a separate consultation on Going Concern with proposed revisions to ISA (UK) 570, recognising the significance of the concerns

raised in that area.⁶ That consultation closed for comment on 14th June 2019. The exposure drafts included within this consultation include conforming amendments to align with the proposed changes to ISA (UK) 570.

Question 13: We are proposing changes to the standards to be effective for the audit of periods commencing on or after 15 December 2019. Do you agree this is appropriate, or would you propose another effective date, and if so, why?

Financial Reporting Council

15 July 2019

⁶ [https://www.frc.org.uk/consultation-list/2019/exposure-draft-proposed-isa-\(uk\)-570-\(revised\)](https://www.frc.org.uk/consultation-list/2019/exposure-draft-proposed-isa-(uk)-570-(revised))



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