

November 2018

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# Post Implementation Review

## 2016 Ethical and Auditing Standards Changes to Implement the Audit Regulation and Directive

### Call for Feedback

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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1. In June 2016, the FRC issued a revised FRC Ethical Standard, and a suite of revised International Standards on Auditing (ISAs) (UK). The revised Ethical Standard contained new material to support the implementation of the Audit Regulation and Directive, and also changes required following a review of Ethical Material that the FRC had carried out. The ISAs (UK) were revised to reflect new material to support the implementation of the Audit Regulation and Directive, and changes made by the IAASB to the suite of international standards on auditor reporting (ISAs 700, 701, 705, 706 and 720). This included new requirements to support enhanced reporting on Going Concern. When the standards were adopted, the FRC made a commitment to carry out a post implementation review of how well the standards had secured the objectives identified at the time of their adoption within three years.
2. This post implementation review is one element of a wider programme of FRC audit-related work. We already have a separate project considering revisions to ISA (UK) 570 – *Going Concern*, to address concerns about the quality of work undertaken based on our enforcement work, and to better respond to user expectations. This work will also align closely with the support that the FRC is providing to the Competition and Markets Authority Market Study of the UK audit market, Sir John Kingman’s consideration of the way in which audits are procured, and over the medium term with work to look at the future scope of audit. Work on the future scope of audit will focus on those issues that can not be addressed through changes to standards alone, and will also align with the FRC’s project on the future of corporate reporting.
3. The objectives for the changes to standards were to:
  - Strengthen auditor independence by reducing conflicts of interest arising from the provision of non-audit services to audited entities (through the prohibition of certain types of services and through the application of a 70 per cent fee cap for Public Interest Entity audits);
  - Strengthen auditor independence by requiring stricter rules to safeguard personal financial independence and limiting the fee income that an auditor can earn from any one entity;
  - Make clearer that independence requirements apply to all those individuals in a position to influence the outcome of an audit engagement, rather than just those individuals in a hierarchical chain of command;
  - Strengthen requirements preventing an auditor from offering services (e.g. tax services) which relate to areas of judgment in the financial statements of an entity that the auditor will subsequently need to audit, and preventing the use of contingent fees in a number of areas, where this would pose a threat to auditor independence;
  - Strengthen reporting and communication requirements for statutory auditors to allow the results of the audit to be better understood by users of the financial statements and audit committees in particular; and
  - Enhance procedures to support quality control of audits including engagement quality control reviews (EQCR) and require enhanced documentation and work effort for group audits to buttress the integrity of the group audit file as a stand-alone record of the audit work done by the group auditor, based on a more granular assessment of the work of component auditors.

4. The Audit Regulation and Directive were together part of the European Commission's response to the financial crisis, and the weaknesses with some audits that had been identified during that period. The response sought to strengthen auditor independence, reduce conflicts, strengthen quality and preserve trust in independent audit. Measures were also implemented to improve co-operation between audit regulators. The full package of changes to Standards, Corporate Governance and Enforcement, including the development of a new Audit Enforcement Procedure were consulted on publicly by the FRC<sup>1,2</sup>.
5. The Audit Regulation and Directive came into force on 17 June 2016. The standards that the FRC issues ahead of that date came into effect for the audit of financial periods commencing on or after that date. Since the revised standards were adopted, two cycles of audits have been completed. The FRC also has sought to learn lessons from our enforcement work and our programme of audit inspections to gather feedback on whether the changes made to standards have had the desired impact on auditor independence and on audit quality.
6. Since the revision of the auditing and ethical standards in 2016, expectations on auditors have clearly developed, with a number of high-profile audit failures, coupled with deteriorating quality results from our inspection work. This shows that it is appropriate to consider whether further measures are needed to address weaknesses, and ensure that audit better meets the expectations of those who rely on it.
7. The Audit Regulation brought into law<sup>3</sup> the need for PIE audits to be tendered every ten years, and for an auditor to rotate after twenty years. Whilst we have been fortunate in the UK that tendering has been driven by quality rather than price (feedback from investors is that they are not averse to a high-quality audit costing more), for the largest and most complex audits, particularly in financial services it can be difficult for an audit committee to receive sufficient tenders to run a qualifying competition. This may be because audit firms are ineligible to bid because they are the incumbent, or it may be because firms are conflicted because they already provide non-audit services to that entity. Given that tendering was to address independence concerns caused by very longstanding relationships between entities and audit firms, it is important that tenders receive a range of different proposals to provide audit committees with a greater degree of choice. Whether this can be supported through standards is a question to address as part of this review.
8. In taking forward this Post Implementation Review, the FRC's principal concern is that the standards used in the UK support the delivery of high-quality audit, by demonstrably independent auditors who act in the public interest. We believe that this will best serve the needs of users and also allow audit to respond to better meet the expectations of those who rely on it to support decision making, or because they have an interest as another public stakeholder.
9. To support the Post Implementation Review, the FRC seeks feedback in respect of the questions set out in **Appendix 1**. Feedback should be sent by email to [AAT@frc.org.uk](mailto:AAT@frc.org.uk) and marked for the attention of **James Ferris**. Feedback should be received by **5pm on Friday, 15 February 2019**.

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<sup>1</sup> <https://www.frc.org.uk/consultation-list/2015/consultation-enhancing-confidence-in-audit>

<sup>2</sup> <https://www.frc.org.uk/consultation-list/2016/consultation-enhancing-confidence-in-audit-the>

<sup>3</sup> The requirement previously existed in the UK in the Corporate Governance Code, on a comply or explain basis.

## **Appendix 1**

### **Feedback Questions:**

#### **Over-Arching Questions**

- i. How well do you think the 2016 revisions to auditing and ethical standards have met the objectives set out in our September 2015 consultation 'Enhancing Confidence in Audit'<sup>4</sup> and summarised in paragraph 3 of this consultation document?
- ii. 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?
- iii. 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.
- iv. 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.

#### **Questions Relating to the Ethical Standard**

- v. Are the ethical principles and supporting specific requirements sufficiently clear? If not, please explain the issues and how you believe they could be resolved.
- vi. 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.
- vii. 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?
- viii. 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)?
- ix. 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.
- x. 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.

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<sup>4</sup> <https://www.frc.org.uk/getattachment/e7841adf-ca5b-44e9-af1b-aa83cafeb5b9/./:aspx>

- xi. There is currently a derogation in the Ethical Standard allowing for the provision of certain non-audit services where these have no direct effect or an inconsequential effect (where indirect) on the financial statements. Should this derogation be maintained in the Ethical Standard, and if so why?
- xii. Do you believe there could be adverse consequences from imposing further restrictions on some or all non-audit services that may outweigh any actual or perceived benefits? If so, please explain your views.
- xiii. The FRC included reliefs from certain FRC ethical requirements for non-PIE audits for the audit of small and medium-sized entities. Should these reliefs be maintained, and if so why?

#### **Questions Relating to the Auditing Standards**

- xiv. 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.
- xv. 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)?
- xvi. 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?
- xvii. 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?
- xviii. 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.
- xix. 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.

Respondents to this request for feedback do not need to respond to all of the questions.

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