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Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees

Annex 5: Provisions available for Small Entities (2016)

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ETHICAL STANDARD
PROVISIONS AVAILABLE FOR SMALL ENTITIES (2016)

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PREFACE

The FRC's Ethical Standards apply in the audit of financial statements and other public interest assurance engagements. They are read in the context of the Statement "The Financial Reporting Council – Scope and Authority of Audit and Assurance Pronouncements" which sets out the application and authority of the FRC's Ethical Standards.

The Ethical Standard – Provisions Available for Small Entities (ES- PASE) applies specifically to audits that fall within its scope.

The terms used in the FRC's Ethical Standards are explained in the Glossary.

INTRODUCTION

This standard does not apply for the audit of '*public interest entities*'.

- 1 The FRC issues an Ethical Standard which sets out the overarching principles, supporting ethical provisions and specific requirements, that auditors are required to comply with in order to discharge their responsibilities in respect of their integrity, objectivity and independence. The FRC Ethical Standard addresses such matters as:
 - How audit firms set policies and procedures to ensure that, in relation to each audit, the audit firm and all those who are in a position to influence the conduct and outcome of an audit act with integrity, objectivity and independence;
 - Financial, business, employment and personal relationships;
 - Long association with the audit engagement;
 - Fees, remuneration and evaluation policies, litigation, gifts and hospitality;
 - Non-audit services provided to audited entities.

That Ethical Standard applies to all audit firms and to all audits and must be read in order to understand the alternative provisions and exemptions contained in this Standard.

- 2 The FRC is aware that a limited number of the requirements in the FRC Ethical Standard are difficult for certain audit firms to comply with, particularly when auditing a small entity. Whilst the FRC is clear that that standard is appropriate in the interests of establishing the integrity, objectivity and independence of auditors, it accepts that certain dispensations, as set out in this Standard, are appropriate to facilitate the cost effective audit of the financial statements of Small Entities (as defined below) that are not '*public interest entities*'.

- 3 This Standard provides alternative provisions for auditors of Small Entities, that are not '*public interest entities*', to apply in respect of the threats arising from economic dependence and where tax or accounting services are provided and allows the option of taking advantage of exemptions from certain of the requirements in the FRC Ethical Standard for a Small Entity audit engagement. Where an audit firm takes advantage of the exemptions within this Standard, it is required to:
- (a) take the steps described in this Standard; and
 - (b) disclose in the audit report the fact that the firm has applied the FRC's Ethical Standard – Provisions Available for Small Entities.
- 4 (i) In this Standard, for the UK a 'Small Entity' is:
- (a) any company, which is not a UK listed company or an affiliate thereof, that qualifies as a small company under Section 382 of the Companies Act 2006;
 - (b) where group accounts are produced, any group that qualifies as small under Section 383 of the Companies Act 2006;
 - (c) any charity with an income of less than the turnover threshold applicable to small companies as identified in Section 382 of the Companies Act 2006;
 - (d) any pension fund with less than 100 members (including active, deferred and pensioner members)¹;
 - (e) any firm regulated by the FCA, which is not required to appoint an auditor in accordance with rule SUP 3.3.2R of the FCA Handbook;
 - (f) any credit union which is a mutually owned financial co-operative established under the Credit Unions Act 1979 and the Industrial and Provident Societies Act 1965 (or equivalent legislation), which meets the criteria set out in (a) above;
 - (g) any entity registered under the Industrial and Provident Societies Act 1965, incorporated under the Friendly Societies Act 1992 or

¹ In cases where a scheme with more than 100 members has been in wind-up over a number of years, such a scheme does not qualify as a Small Entity, even where the remaining number of members falls below 100.

registered under the Friendly Societies Act 1974 (or equivalent legislation), which meets the criteria set out in (a) above;

- (h) any registered social landlord with less than 250 units; and
- (i) any other entity, such as a club, which would be a Small Entity if it were a company.

(ii) In this Standard, for the Republic of Ireland a 'Small Entity' is:

- (a) [companies] to be determined when draft legislation is confirmed;
- (b) [charities] to be determined when draft legislation is confirmed;
- (c) any pension fund with less than 1,000 members (including active, deferred and pensioner members)²; and
- (d) any other entity, such as a club or credit union, which would be a Small Entity if it were a company.

Where an entity falls into more than one of the above categories, it is only regarded as a 'Small Entity' if it meets the criteria of all relevant categories.

ALTERNATIVE PROVISIONS

ECONOMIC DEPENDENCE

- 5 When auditing the financial statements of a Small Entity an audit firm is not required to comply with the requirement in Section 4 of Part B of the FRC Ethical Standard, paragraph 4.44, that an external independent quality control review is performed.**

² In cases where a scheme with more than 1,000 members has been in wind-up over a number of years, such a scheme does not qualify as a Small Entity, even where the remaining number of members falls below 1,000.

- 6 Section 4 of Part B of the FRC Ethical Standard, paragraph 4.44 provides in effect that, where it is expected that the total fees for both audit and non-audit services receivable from a non-listed audited entity, that is not a *public interest entity*, and its subsidiaries audited by the audit firm will regularly exceed 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 15% the firm shall arrange an external independent quality control review of the audit engagement to be undertaken before the auditors' report is finalised. Although an external independent quality control review is not required, nevertheless the audit engagement partner discloses the expectation that fees will amount to between 10% and 15% of the firm's annual fee income to the Ethics Partner and to those charged with governance of the audited entity.

SELF-REVIEW THREAT – NON-AUDIT SERVICES

- 7 **When undertaking non-audit services for a Small Entity audited entity, the audit firm is not required to apply safeguards to address a self-review threat provided:**
- (a) the audited entity has 'informed management'; and**
 - (b) the audit firm extends the cyclical inspection of completed engagements that is performed for quality control purposes.**
- 8 Section 5 of Part B the of the FRC Ethical Standard requires that, when an audit firm provides non-audit services to an audited entity, appropriate safeguards are applied in order to reduce any self-review threat to a level where independence is not compromised. Section 5 of Part B of the FRC Ethical Standard provides examples of safeguards that may be appropriate when non-audit services are provided to an audited entity (for example in paragraphs 5.103 for tax services and 5.181 for accounting services). In the case of an audit of a Small Entity, alternative procedures involve discussions with 'informed management',

supplemented by an extension of the firm's cyclical inspection of completed engagements that is performed for quality control purposes.

- 9 The audit firm extends the number of engagements inspected under the requirements of ISQC (UK and Ireland) 1 *'Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements'*³ to include a random selection of audit engagements where non-audit services have been provided. Particular attention is given to ensuring that there is documentary evidence that 'informed management' has made such judgments and decisions that are needed in relation to the presentation and disclosure of information in the financial statements.
- 10 Those inspecting the engagements are not involved in performing the engagement. Small audit firms may wish to use a suitably qualified external person or another firm to carry out engagement inspections.
- 11 In addition to the documentation requirements of ISQC (UK and Ireland) 1, those inspecting the engagements document their evaluation of whether the documentary evidence that 'informed management' made such judgments and decisions that were needed in relation to the presentation and disclosure of information in the financial statements.

EXEMPTIONS

MANAGEMENT THREAT - NON-AUDIT SERVICES

- 12 **When undertaking non-audit services for Small Entity audited entities, the audit firm is not required to adhere to the prohibitions**

³ ISQC (UK and Ireland) 1 requires audit firms to establish policies and procedures which include a periodic inspection of a selection of completed engagements. Engagements selected for inspection include at least one engagement for each engagement partner over the inspection cycle, which ordinarily spans no more than three years.

in Section 5 of Part B of the FRC Ethical Standard, relating to providing non-audit services that involve the audit firm undertaking part of the role of management, provided that:

- (a) it discusses objectivity and independence issues related to the provision of non-audit services with those charged with governance, confirming that management accept responsibility for any decisions taken; and**
- (b) it discloses the fact that it has applied this Standard in accordance with paragraph 25.**

13 Section 5 of Part B of the FRC Ethical Standard, paragraph 5.36, provides that where an audit firm provides non-audit services to an audited entity where there is no 'informed management', it is unlikely that any other safeguards can eliminate a management threat or reduce it to an acceptable level, with the consequence that such non-audit services may not be provided to that audited entity. This is because the absence of a member of management, who has the authority and capability to:

- receive the results of the non-audit services provided by the audit firm; and
- make any judgments and decisions that are needed, on the basis of the information provided,

means that there is an increased management threat since the audit firm will be closer to those decisions and judgments which are properly the responsibility of management and more aligned with the views and interests of management.

14 An audit firm auditing a Small Entity is exempted from the requirements of Section 5 of Part B of the FRC Ethical Standard, paragraphs 5.73(b) (internal audit services), 5.84(b) (information technology services), 5.106 (tax services), 5.141(c) (corporate finance services), 5.153(b) (transaction related services), 5.159(a) (restructuring services) and 5.174(b) (accounting services) in circumstances when there is no 'informed management' as envisioned by Section 5 of Part B of the FRC

Ethical Standard, provided it discusses objectivity and independence issues related to the provision of non-audit services with those charged with governance, confirming that management accept responsibility for any decisions taken and discloses the fact that it has applied this Standard in accordance with paragraph 25.

ADVOCACY THREAT – NON-AUDIT SERVICES

15 **The audit firm of a Small Entity is not required to comply with Section 5 of Part B of the FRC Ethical Standard, paragraphs 5.113 and 5.159(b) provided that it discloses the fact that it has applied this Standard in accordance with paragraph 25.**

16 Section 5 of Part B of the FRC Ethical Standard, paragraph 5.113 provides that the audit firm shall not undertake an engagement to provide tax services to an audited entity where this would involve acting as an advocate for the audited entity in the resolution of an issue:

- (a) that is material to the financial statements; or
- (b) where the outcome of the tax issue is dependent on a future or contemporary audit judgment.

Such circumstances may create an advocacy threat which it is unlikely any safeguards can eliminate or reduce to an acceptable level.

17 Section 5 of Part B of the FRC Ethical Standard, paragraph 5.159(b) provides that the audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity where the engagement would require the auditor to act as an advocate for the entity in relation to matters that are material to the financial statements.

18 Such circumstances may create an advocacy threat which it is unlikely any safeguards can eliminate or reduce to an acceptable level.

- 19 Where an audit firm auditing a Small Entity takes advantage of the dispensation in paragraph 15, it discloses the fact that it has applied this Standard in accordance with paragraph 25.

PARTNERS JOINING AN AUDITED ENTITY

- 20 **The audit firm of a Small Entity is not required to comply with Section 2 of Part B the FRC Ethical Standard, paragraphs 2.49 and 2.53 provided that:**
- (a) it takes appropriate steps to determine that there is no significant threat to the audit team’s integrity, objectivity and independence; and**
 - (b) it discloses the fact that it has applied this Standard in accordance with paragraph 25.**

- 21 Section 2 of Part B of the FRC Ethical Standard, paragraph 2.49 provides that where a former partner, or another person who is personally approved as a statutory auditor, is appointed as a director (including as a non-executive director), a member of the audit committee or body performing equivalent functions, or to a key management position with an audited entity, having previously been a person in a position to influence the conduct or outcome of the audit:

- (a) in the case of a partner, at any time during the two years prior to such appointment; or
- (b) in the case of another person, at any time during the year prior to such appointment;

the firm shall resign from the engagement where possible under applicable law or regulation.⁴ The firm shall not accept an audit for the entity until:

- (i) in the case of a partner, a two-year period; or

⁴ The timing of the audit firm’s resignation as auditor is determined in accordance with paragraph 1.50 of Section 1 of Part B the FRC Ethical Standard.

(ii) in the case of another person, a one year period;

commencing when the person ceased to be a person in a position to influence the conduct or outcome of the audit for the entity, has elapsed or until the person ceases employment with the entity, whichever is the sooner. Such circumstances may create self-interest, familiarity and intimidation threats.

22 Section 2 of Part B of the FRC Ethical Standard, paragraph 2.53 provides that where a former partner, or another person who is personally approved as a statutory auditor formerly employed by or at the disposal of or under the control of the firm, has joined an entity as a director (including as a non-executive director), a member of the audit committee or body performing equivalent functions, or to a key management position the firm shall not accept an audit where the person had, prior to leaving the firm and:

(a) in the case of a partner, within two years before acceptance of the engagement; or

(b) in the case of another person personally, within one year before acceptance of the engagement;

been a person in a position to influence the conduct or outcome of any audit involving any partner of the firm who would be a member of the engagement team, or would be the engagement quality control reviewer, for the audit were it to be accepted.

23 An audit firm takes appropriate steps to determine that there is no significant threat to the audit team's integrity, objectivity and independence as a result of the former partner's employment by an audited entity that is a Small Entity by:

(a) assessing the significance of the self-interest, familiarity or intimidation threats, having regard to the following factors:

- the position the individual has taken at the audited entity;
- the nature and amount of any involvement the individual will have with the audit team or the audit process;

- the length of time that has passed since the individual was a member of the audit team or firm; and
 - the former position of the individual within the audit team or firm, and
- (b) if the threat is other than clearly insignificant, applying alternative procedures such as:
- considering the appropriateness or necessity of modifying the audit plan for the audit engagement;
 - assigning an audit team to the subsequent audit engagement that is of sufficient experience in relation to the individual who has joined the audited entity;
 - involving an audit partner or senior staff member with appropriate expertise, who, where the firm already audits the entity, was not a member of the audit team, to review the work done or otherwise advise as necessary; or
 - undertaking an engagement quality control review of the audit engagement.

24 When an audit firm auditing a Small Entity takes advantage of paragraph 20 it discloses the fact that it has applied this Standard in accordance with paragraph 25 and documents the steps that it has taken to comply with this Standard.

DISCLOSURE REQUIREMENTS

- 25 **Where the audit firm has taken advantage of an exemption provided in paragraphs 12, 15 or 20 of this Standard, the audit engagement partner shall ensure that:**
- (a) the auditors' report discloses this fact, and**
 - (b) either the financial statements, or the auditors' report, discloses the type of non-audit services provided to the**

audited entity or the fact that a former audit engagement partner, or other person personally approved as a statutory auditor, has joined the audited entity.

- 26 The fact that an audit firm has taken advantage of an exemption provided by the Ethical Standard – Provisions Available for Small Entities is set out in a separate paragraph of the audit report. It does not affect the Opinion paragraph. An illustrative example of such disclosure is set out in the Appendix.
- 27 The audit engagement partner ensures that within the financial statements reference is made to the type of non-audit services provided to the audited entity or the fact that a former partner or other person personally approved as a statutory auditor has joined the audited entity. An illustration of possible disclosures is set out in the Appendix. Where such a disclosure is not made within the financial statements it is included in the auditors' report.

EFFECTIVE DATE

- 28 This revised Ethical Standard becomes effective on xxxxxxxx.

APPENDIX: Illustrative disclosures

These examples will be further updated as necessary before the revision of this standard is finalised to reflect proposed changes to ISA (UK and Ireland) 700.

(a) *Illustrative disclosure of the fact that the audit firm has taken advantage of an exemption within the auditor's report*

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement [set out [on page ...]], the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Ethical Standards issued by the Financial Reporting Council (FRC), including "Ethical Standard – Provisions Available for Small Entities", in the circumstances set out in note [x] to the financial statements.

Scope of the audit of the financial statements

Either:

A description of the scope of an audit of financial statements is [provided on the FRC's website at ...] / [set out [on page ...] of the Annual Report].

Or:

An audit involves obtaining evidence about the amounts and disclosures in the financial statements ...

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at ...and of its profit [loss] for the year then ended; ...

[Date of the auditor's report, *auditor's signature and address*]

(b) *Illustrative disclosure of relevant circumstances within the financial statements*

Note [x] In common with many other businesses of our size and nature we use our auditors to prepare and submit returns to the tax authorities and assist with the preparation of the financial statements⁵.

Note [x] In common with many other businesses of our size and nature we use our auditors to provide tax advice and to represent us, as necessary, at tax tribunals⁶.

Note [x] XYZ, a former partner of [audit firm] joined [audited entity] as [a director] on [date]⁷.

⁵ Where exemption in paragraph 12 (Management threat in relation non-audit services) is applied.

⁶ Where exemption in paragraph 15 (Advocacy threat – tax services) is applied.

⁷ Where exemption in paragraph 20 (Partners joining an audited entity) is applied.



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