



**CONSULTATION: AUDITING AND ETHICAL STANDARDS
IMPLEMENTATION OF THE EU AUDIT DIRECTIVE AND
AUDIT REGULATION**

RESPONSE FROM ICAS TO THE FRC

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Background

1. ICAS welcomes the opportunity to comment on the FRC Consultation: Auditing and ethical standards - Implementation of the EU Audit Directive and Audit Regulation. Our CA qualification is internationally recognised and respected. We are a professional body for over 20,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK's and the world's great companies.
2. Our Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key Points

Detailed responses to the individual questions are included below, but we would like to highlight the following key matters:

- We believe that requirements from the EU audit legislation which relate to Public Interest Entities (PIEs) as defined in the EU Audit Directive, should only be applied to entities which are within the scope of this definition in the UK.
- The FRC's more stringent requirements should be applicable to 'Listed entities' only. However, we believe that the FRC should specifically scope out from its more stringent requirements, those entities listed on non-regulated markets in the EU, where the entity's market capitalisation is not more than £100 million. In this respect, we believe that in terms of the growth agenda it would be appropriate to reduce the regulatory burden on such entities.
- To potentially avoid any 'gold plating' of the EU legislation we would favour applying the legislation as is i.e. introducing a 'black list' of prohibited non-audit services with other services allowed, subject to the evaluation of threats and safeguards by the auditor and/or audit committee. That said, we are aware that given the scope of the services that are being prohibited, it might be more practical to use a mixed approach of including in the FRC's ethical standards for auditors, the blacklist of services which are prohibited as per the EU legislation, whilst also including a white list indicating services which are definitely allowable. Services which do not fall into either category would then be allowable, subject to approval of the audit committee (as well as satisfying the related cap on non-audit services). Guidance would also be required for audit committees in this respect, which could be included in the FRC's 'Guidance on audit committees'.

Question 1

Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

We agree. Our only caveat is that any additional requirements should only be added where there is a clear demonstrable case for doing so and appropriate due process is followed.

Question 2

Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

We believe that the FRC's current audit and ethical standards can generally be applied in a proportionate manner. In relation to the ethical standards, we would be supportive of drafting these in a more principles-based manner to better facilitate greater consistency in their application. Additionally, we are supportive of retaining the FRC's Ethical Standard 'Provisions available for small entities'.

Question 3

When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles 22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available for Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

We believe that the same requirements should generally apply. As we note in our response to question 2 above, however, we do favour retention of the PASE ethical standard in relation to the audits of smaller entities.

Question 4

With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:

(a) should they apply to PIEs as defined in the Audit Directive?

(b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

- (a) No. These more stringent requirements should only apply to those Public Interest Entities (PIE) which also come within the scope of the FRC's 'Listed entities' definition. We see no need to extend the application of these additional more stringent requirements to all PIEs.
- (b) On the premise of seeking to reduce the regulatory burden on smaller listed entities and to promote the Government's growth agenda, we believe the opportunity should be taken to relieve certain listed entities from the FRC's more stringent requirements. We propose an approach that would scope out from the FRC's more stringent requirements, those entities listed on the AIM, ISDX Growth or other non regulated EU markets, which have a market capitalisation of less than £100 million.

Rationale

ICAS is supportive of the UK Government's stance that there should be no expansion of the PIE definition beyond the minimum requirement. This will allow the focus to remain on key, higher profile and higher risk audits and will ensure that resources are appropriately employed to address the public interest risk. ICAS is also of the view that as the EU scope has already been expanded to include non-listed insurers and some unlisted banks, no further entities are required to be designated as PIEs.

We also believe that there is need to take stock and consider the appropriateness of the current framework in the UK. The definition of a PIE in the Directive includes an entity “that issues transferable securities that are admitted ... on a regulated market”. We consider that this definition captures entities listed on the London Stock Exchange and on the ISDX Main Board but not those listed on AIM or ISDX Growth markets.

In the view of ICAS, the objective of the AIM and ISDX Growth markets is to encourage growth and ready access to capital markets for small and medium entities. We believe it is in the interests of the public to exclude these markets from the PIE definition (as BIS is proposing by not planning to extend the scope of the EU PIE definition) in order to encourage growth without adding the additional regulatory burden, costs and challenges associated with being a PIE. That said, entities on AIM and the ISDX Growth market currently come within the scope of the FRC’s ‘Listed entity’ definition and are therefore subject to the FRC’s more stringent requirements. This contrasts with the FRC’s ‘major audit’ scope criteria, which only applies to entities on AIM or ISDX which have a market capitalisation in excess of £100 million. There would appear merit in the FRC adopting a more consistent approach in this respect, and therefore, we believe that the FRC’s more stringent requirements should only apply to those entities listed on AIM, ISDX Growth, or other non-regulated EU markets which have a market capitalisation of more than £100 million. With respect to AIM, this would relieve approximately 82% of its constituents from having to comply with the FRC’s more stringent requirements.

Question 5

Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

They should only be applied to those entities caught by the definition of a PIE as per the EU audit legislation. Therefore, the only listed entities that will be impacted are those which are listed on an EU regulated market.

Question 6

Should some or all of the more stringent requirements in the FRC’s audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?

We see no reason to extend the scope of such requirements. There has not been a major issue to date with this approach. We, therefore, see no need to burden such entities with additional regulatory requirements.

Question 7

What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

To potentially avoid any ‘gold plating’ of the EU legislation, we would favour applying the legislation as is i.e. introducing a ‘black list’ of prohibited non-audit services with other services allowed, subject to the evaluation of threats and safeguards by the auditor and/or audit committee.

That said, we are aware that, given the scope of the services that are being prohibited, it might be more practical to use a mixed approach of including in the FRC's ethical standards for auditors, the black list of services which are prohibited as per the EU legislation, whilst also including a white list indicating services which are definitely allowable. Services which do not fall into either category would then be allowable subject to approval of the audit committee (as well as satisfying the related cap on non-audit services). Guidance would also be required for audit committees in this respect, which could be included in the FRC's 'Guidance on audit committees'. Additionally, there would be a need to review the white list on a regular basis.

Question 8

If a 'white list' approach is deemed appropriate to consider further:

(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?

(b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?

- (a) We believe further, more detailed consideration needs to be given to the proposed white list.
- (b) Any such list cannot be exhaustive. If a service was not listed on the white list, then provided it is not prohibited by article 5 of the EU Regulation, it should be allowable, subject to approval of the audit committee (as well as satisfying the related cap on non-audit services). Guidance would also be required for audit committees in this respect, which could be included in the FRC's 'Guidance on audit committees'.

Question 9

Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

We see no reason to specifically prohibit any additional non-audit services.

Question 10

Should the derogations that Member States may adopt under the Audit Regulation – to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

On balance, if any such services have no direct effect, or have an immaterial effect on the audited financial statements, then it may be beneficial from a business perspective to allow entities to procure services of this nature from their auditor. That said, we do accept that there may be some difficulties in determining whether certain of these services do in fact have an immaterial effect on the audited financial statements.

Question 11

If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be 'immaterial' sufficient? If not, is there another condition that would be appropriate?

This should be sufficient, coupled with the additional requirements contained in article 5 (3) of the EU Audit Regulation, which includes that an estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report from the auditor to the audit committee.

Question 12

For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?

We believe that the required approval of the audit committee, and having to satisfy the cap requirements, are sufficient safeguards. Our response applies, regardless of whether a black list or white list approach is adopted.

Question 13

When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based? If not, what other standards should apply in which other circumstances

In principle, we are supportive of the FRC's suggested approach which appears conceptually sound. However, this might be viewed as seeking to 'gold-plate' the EU requirements which might be at odds with UK Government policy. Additionally, we question whether certain practical issues might arise which might cause some issues in relation to applying this approach.

Question 14

When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all other auditors whose work they decide to use in performing the audit of the group? If not, what other standards should apply in those circumstances?

We are supportive of the substance of what is being proposed i.e. that the same rules should apply to all audit firms involved in the audit of group entities. However, as per our response to question 13, such an approach may be viewed as 'gold-plating' the EU requirements. Additionally, we question whether certain practical issues might arise which might cause some issues in relation to applying this approach.

Question 15

Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

We believe that the 70% cap on non-audit fees is sufficient.

Question 16

If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

It should have the power to grant exemptions and exercise discretion as to whether it does so. In our view, the audit committee should have a key role in any criteria that are developed.

Question 17

Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms?

The cap should apply as established in the legislation. We see no reason to gold-plate the EU requirement.

Question 18

If your answer to question 17 is yes, for a group audit where the parent company is a PIE, should the audit and non-audit fees for the group as a whole be taken into consideration in calculating a modified alternative cap? If so, should there be an exception for any non-audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?

Not applicable, in light of our response to question 17.

Question 19

Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances (see paragraphs 5.3 and 5.15)?

Yes, this is what was agreed in the EU legislation. We see no reason for the UK to deviate from what was agreed.

Question 20

Do you believe that the requirements in ES 4 should be maintained?

Yes, to 'Listed entities', subject to our proposal to scope out certain entities as per our response to Question 4 above.

Question 21

When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

We see no reason to be more restrictive than is required by the EU legislation. Therefore, the more restrictive requirements should only apply to those PIEs which are caught by the FRC's definition of a 'Listed entity' (subject to our proposal to scope out certain entities as per our response to Question 4 above).

Question 22

Do you believe that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute an expectation of "regularly" exceeding those limits? If not, please explain what you think would constitute "regular".

We believe this to be a reasonable means of assessing this requirement.

Question 23

Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?

We do not believe this to be necessary. All of the relevant bodies already have requirements which are more stringent in this respect than the EU Audit Regulation. However, if the FRC decides to do so, then it should stipulate a period of ‘at least six years’.

Question 24

Do you believe that the FRC’s audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?

We are not convinced that this is strictly necessary but we have no objections to the FRC’s proposed approach of reflecting the finalised provisions in the audit and/or ethical standards when those standards are revised to implement the Audit Directive and Audit Regulation. We would also highlight that companies also continue to have a responsibility for ensuring that this requirement is not breached.

Question 25

Do you believe that the requirements in ES 3 should be maintained?

Whilst we would welcome a level global playing field in this area, there do not appear to be any real concerns being expressed at the existing UK requirements. Additionally, there is logic in having the ‘cooling off’ period aligned with the partner’s time on period. This also helps to address the real and perceived familiarity threat. Therefore, we are supportive of retaining the existing requirements in ES 3, subject to our proposal to scope out certain entities as per our response to Question 4 above.

Question 26

When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

We believe that the more restrictive requirements should only apply to those entities which are currently caught by the scope of the FRC’s definition of a ‘Listed entity’ (subject to our proposal to scope out certain entities as per our response to Question 4 above). These more restrictive requirements should not be applied to other PIEs.

Question 27

Are there any other possible significant impacts that the FRC should take into consideration?

Where possible, there is a need to avoid being overly prescriptive in implementing the EU legislation. The audit committee has a key role and performs an important governance function, so there is a need to seek to empower them. Ultimately, if the shareholders are unhappy with its performance, they can seek to change the committee chairman and other members of the committee as appropriate.