

April 2016

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# Feedback Statement and Impact Assessment

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

This document provides a summary of the feedback received by the FRC in response to our September 2015 consultation: Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees. Feedback was provided to the FRC both in the form of written responses which have been published on the FRC website, and through an extensive range of outreach meetings.

This document also sets out the FRC's actions in response to feedback received, and is issued along with: a revised FRC Ethical Standard; revised International Standards on Auditing (UK and Ireland), an amended UK Corporate Governance Code and revised Guidance on Audit Committees. We have also made revisions to the impact assessment published along with the September 2015 consultation document.

The revised standards, Code and guidance are effective for the audit of financial statements for periods beginning on or after 17 June 2016. The FRC will announce, in due course, the withdrawal of existing standards and guidance that will be superseded.

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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## Introduction

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.

## Auditor Ethical Standards

The FRC began a programme of work to review its auditor ethical standard in 2013 seeking to promote standards focussed on principles and to learn from its experience of holding auditors to account to its existing standards.

## European Union (EU) Audit Regulation and Directive

In April 2014, the European Parliament and the Council of the European Union issued Regulation EU/537/2014 covering specific requirements regarding statutory audit of public interest entities<sup>1</sup> (PIEs) (the Regulation), and Directive 2014/56/EU covering the statutory audit of annual accounts and consolidated accounts (the Directive). Both apply with effect from 17 June 2016. The Regulation and Directive taken together require revisions to both the Ethical and Auditing Standards as well as changes to the UK Corporate Governance Code (the Code).

The Directive requires transposition into UK law whereas the Regulation has direct effect in the UK. The Directive includes a number of specific Member State options to derogate from or to extend certain provisions and a general power to add additional provisions. The Regulation builds on the provisions of the Directive and introduces additional or alternative provisions that apply only in the case of audits of PIEs. Unusually for a regulation, it also includes a number of Member State options, which need to be implemented in UK law. The provisions of the Directive, and the options under the Regulation, that relate to the conduct of statutory audits and the independence of statutory auditors are being implemented in the UK through the FRC's auditing and ethical standards, under powers delegated by the UK Government.

The FRC has also taken the opportunity to review the 'Guidance on Audit Committees' (the Guidance), last published in September 2012, in order to align this with the new requirements for audit committees and changes to the ethical standards for auditors.

The FRC issued a public consultation in December 2014<sup>2</sup> to support our work on the measures required to implement the Regulation and Directive, including how Member State options should be addressed. The purpose of that consultation exercise was not to set out an FRC position in respect of any of the questions, but rather openly to seek information from stakeholders to support the development of the FRC's approach to implementation.

The FRC issued a further consultation in September 2015,<sup>3</sup> which reflected the results of the December 2014 consultation in our detailed proposals for implementing the requirements of the Regulation and Directive and included an Impact Assessment. Our rationale for those proposals was set out in the September 2015 consultation. Since then, we have continued to discuss the requirements of the Regulation and Directive with the Government and the European Commission.

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<sup>1</sup> Credit institutions, insurance undertakings, issuers of securities admitted to trading on a regulated market, payment institutions (Paragraph 2 of Regulation 537/2014/EEC).

<sup>2</sup> Consultation: Auditing and Ethical Standards implementation of the EU Audit Directive and Audit Regulation.

<sup>3</sup> Consultation: Enhancing confidence in Audit.

Where we have amended our September 2015 proposals in the final standards, in response to feedback provided by stakeholders, we have set out the reasons for those changes in this Feedback Statement. Where those changes impact on the costs and benefits that arise from regulatory decisions taken by the FRC included in our impact assessment, we have provided updated information as part of this report.

The FRC is a principles-based regulator, and in revising the Ethical and Auditing standards has adopted an approach where we set principles to deliver required outcomes, which are supported by more detailed requirements.

The Department for Business, Innovation and Skills (BIS), the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA) have also consulted on the implementation of certain aspects of the Regulation and Directive and the FRC has worked with them to ensure consistency of approach. The FRC is also undertaking a separate consultation exercise on the new Enforcement Procedure, developed to reflect changes required by European law.

## **International Auditing and Assurance Standards Board**

In addition to implementing the Regulation and Directive, we are also revising our standards to adopt revised auditor reporting standards issued by the IAASB, along with other conforming and consequential changes to its standards. As auditing standards in the UK and Ireland are based on the international standards issued by the IAASB, the FRC is making these revisions to its auditing standards at the same time as making the necessary changes to implement the Regulation and Directive.

## **Competition and Markets Authority**

In September 2014, the Competition and Markets Authority (CMA) published the Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014. This provided the formal orders related to its investigation into the statutory audit market for FTSE 350 companies which began in late 2011. Prior to this, the CMA addressed a number of remedies to the FRC in its 2013 report, 'Statutory audit services for large companies market investigation – A report on the provision of statutory audit services to large companies in the UK'. The FRC also addressed the implications of these in revised versions of the Code and Guidance issued for consultation in September 2015.

## **Ireland**

The Republic of Ireland has not yet passed legislation to bring into Irish law the requirements of the EU Directive. We are discussing with the Irish government the mechanism by which FRC standards might be adapted and adopted in Ireland.

## Responses to the Consultation

The consultation period closed on 11 December 2015, and we received 41 written responses from a diverse range of stakeholders comprising audit firms, professional bodies, investors, corporates, trade and representative bodies, members of the public and others.

In addition to the consultation responses, we undertook a programme of outreach activity, meeting with many stakeholders to discuss their views on or responses to the consultation questions, which we have also used to inform final revisions to the Standards, the Code and the Guidance. A full list of those responses that respondents agreed could be made publicly available is included at Appendix A to this report, and can be found on the FRC website at: <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Enhancing-Confidence-in-Audit/Responses-to-Consultation.aspx>.

Written responses were received from:

- Investors, Corporates and Representative Bodies 14
- Audit Firms 14
- Professional Bodies 8
- Others 5

A number of investors also responded to the consultation in a corporate capacity – each response has, however, only been counted once. In addition to individual investment firms who either responded to the consultation, or met with us to give their views, the Investment Association also provided a response. The Investment Association is the representative body for UK Fund Managers, and its members control over £5 trillion of investment under management.

*One private written response was received and is included in the totals above, but is not listed on the FRC website.*

The FRC also held 29 outreach meetings before the consultation closed, and a further 14 meetings have been held subsequently to inform our detailed responses. Those meetings were held with:

- Investors, Corporates and Representative Bodies 12
- Audit Firms 21
- Professional Bodies 6

Not all respondents responded to all questions included in the consultation. A summary of the main points raised in the responses is set out below, along with our response.

## Ethical Standard

**Q1: Do you agree that the overarching ethical principles and supporting ethical provisions establish an appropriate framework of ethical outcomes to provide a basis for user trust and confidence in the integrity and objectivity of the practitioner, as described in the introduction to the Ethical Standard?**

Respondents who answered this question supported the FRC's proposition that the proposed ethical principles and supporting ethical provisions do establish an appropriate framework of ethical outcomes to support trust and confidence in the integrity and objectivity of auditors.

However, some respondents, mainly audit firms and one professional body, raised concerns about the clarity and complexity of the text of the standard issued for consultation. They also identified a number of areas where they requested additional detail to support the principles and provisions, and cross-referencing to make clearer the links between the principles and the detailed requirements set out later in the text of the standard.

### FRC Response

We have worked to accommodate the feedback received, so as to make the revised standard clearer, less complex and easier to use. We have sought to do this by replacing long phrases in the consultation draft with shorter, defined terms, redrafting long and complex sentences and also improving the cross referencing between specific requirements and the overarching principles to make the relationship between them clearer. As we have worked to finalise the standards, the FRC has also established a separate technical advisory group, to identify those areas where separate additional guidance may be necessary. In developing additional guidance the FRC has sought to balance the need to issue standards and guidance that will achieve the desired ethical outcomes, with the need to avoid undermining the principles and provisions on which the Ethical Standard is based.

**Q2: Do you support the FRC's proposals to restructure the ethical standards, as a single standard for all audit and public interest assurance engagements?**

All of the respondents to this question supported the FRC's proposal to restructure the Ethical Standard. However, a number of firms challenged our proposal to incorporate the Ethical Standard for Reporting Accountants (ESRA) directly into the text of the Standard, and questioned whether the Ethical Standard should apply to work carried out under the ESRA, or to Other Public Interest Assurance Engagements. The main concerns raised in respect of this proposal was that it increased the complexity of the Standard, which those respondents considered would adversely affect clarity.

### FRC Response

The FRC believes that the Ethical Standard should apply to all audit engagements, and other public interest assurance engagements where these are carried out using performance standards issued by the FRC. Application of this requirement to other public interest assurance engagements will only cover work carried out using the Standards for Investment Reporting (SIRs), the standard for Reviews of Interim Financial Information Performed by the Independent Auditor of the Entity (ISRE (UK and Ireland) 2410) and the Client Assets (CASS) Standard. In the case of work carried out using the CASS Standard, auditors are already required by that standard to apply the FRC's Ethical Standard, and therefore this is not an additional requirement resulting from our revision of the Ethical Standard. Similarly, auditors undertaking reviews of interim financial information of entities they audit are already required to comply with the FRC's Ethical Standard.

The ESRA (which is fundamentally based on the text of our Ethical Standards for auditors, with limited adaptations to address the unique circumstances of investment circular reporting engagements) was last updated in October 2006 and, therefore, required significant updating to reflect subsequent changes in our ethical standards for auditors and in the wider ethical framework used by the profession. Drafting a separate revised ESRA would therefore extensively duplicate requirements from the Ethical Standard as in the case of the extant ESRA. The FRC decided, therefore, to provide a single Ethical Standard for auditors and those carrying out other public interest assurance statements. This approach sees a significant reduction in the volume of ethical material in issue, should enable greater consistency in the application of ethical principles across all public interest assurance engagements, and make future changes that may be necessary easier to make and to adopt across these types of engagement on a consistent basis.

In response to concerns and detailed comments about the impact of integrating the ESRA, we have redrafted the text of the Standard to clarify the specific requirements that apply to investment reporting engagements, to better distinguish between those requirements applicable to all engagements (by indicating explicitly that they do, unless specified otherwise), and those that are applicable only to a particular type of engagement. We have also reviewed each of the requirements in the Ethical Standard applicable to an engagement that would previously have been carried out under the ESRA, and clarified where appropriate that they apply in the context of such an engagement. A number of respondents also asked us to consider amending certain auditor independence requirements which were included in the text issued for consultation. We are unable to do this as they are requirements from the Directive.

Please also see the response to question 6.

**Q3: Do you agree with the FRC's proposals for the application of the FRC ES to non-listed PIEs?**

Our proposals were consistent with the feedback we received to our consultation in December 2014 and there was overall support for them, from the respondents to this question. However, two audit firms, two professional bodies and one corporate respondent disagreed, on the grounds that they considered extending the FRC's existing more stringent ethical requirements to non-listed PIEs was unnecessarily going beyond the requirements of the Directive and the Regulation.

A small number of other respondents flagged up the need for additional material to cover the Lloyds of London Insurance Market, and the need for transitional guidance on partner rotation for the auditors of unlisted PIEs.

**FRC Response**

In the responses to our December 2014 consultation, stakeholders broadly supported maintaining the FRC's more stringent requirements. In view of the continuing broad support for these requirements, particularly from investors, and the fact that new arguments were not advanced, we have retained these existing requirements as measures that support user confidence.

In respect of non-listed PIEs, which find themselves subject to the requirements of the Regulation for the first time, the FRC has incorporated guidance (paragraph 3.14 of the ES refers) into the standard to address concerns about the impact caused by partner rotation requirements. This explains those circumstances where an audit committee might be requested to approve the extension of the appointment of an engagement partner or key audit partner from 5 years up to a period not exceeding 7 years.

We are also considering whether to provide additional guidance for the Lloyds Market – given the unique circumstances that apply, this may be through additional material related to our project to revise Practice Note 20 *'The Audit of Insurers in the United Kingdom'*.

**Q4: Do you agree with the FRC's proposal to retain the Ethical Standard – Provisions Available for Smaller Entities (ES-PASE) and to make conforming changes?**

There was strong overall support from those respondents who answered this question, for the retention of the ES-PASE, and making necessary confirming changes. We received a small number of additional comments from respondents suggesting that the FRC consider:

- a) Including the ES PASE within the body of the main Ethical Standard;
- b) Extending the scope to allow more SMEs to take advantage of it; and
- c) Simplifying the provisions.

**FRC Response**

We are retaining the ES-PASE, incorporated as part (Section 6) of the FRC Ethical Standard rather than as a stand-alone document. In bringing the text into the main Ethical Standard, the FRC has identified areas in which the text can be simplified, and these changes have been incorporated.

The FRC is unable to extend the scope of the ES-PASE to apply to other entities, as this would not be compatible with the legal requirements for auditor independence that apply to all statutory audits. However, we note that, since our consultation was issued, the government has announced an increase in the audit exemption threshold, to the maximum permitted by EU law, for periods commencing on or after 1 January 2016. The government estimates that the increase in the threshold will remove the requirement to have an audit from 7,000 companies, but that 4,400 of these may choose to continue to have one. Those entities will be eligible to utilise the provisions in the ES-PASE which offers proportionate provisions for the audit of smaller entities, where the audited entity may benefit from greater support from its auditor.

**Q5: Do you support the FRC's proposal for the group auditor to ensure that any component auditor, whose work they propose to use in the audit and other members of the firm's network, meet the FRC ES or the IESBA Code as set out above?**

A majority of the respondents to this question did not support the FRC's proposal to require the group auditor to ensure that any component auditor drawn from the firm's network, and other members of that network should be independent, as defined by the FRC Ethical Standard rather than the IESBA code. Most of those who did not support this were either audit firms or professional bodies, and suggested maintaining the current requirement that the assessment should be made against the IESBA Code for all audit firms outside the UK and Ireland.

The main reasons stated by those who opposed the proposal were that the FRC proposal would create a complex patchwork of applicable rules internationally, which may limit auditor choice for international group audits. Some also argued that demonstrating compliance with the FRC Ethical Standard may also increase audit cost as a result, and potentially be anti-competitive. Others opposed the proposal on the grounds that the IESBA Code represents a high international standard against which to assess auditor independence that is widely used and understood internationally.

Support for the FRC proposals came from a minority of audit firms, and from almost all corporate and public sector firms, and investors who responded. In our outreach meetings,

investors also strongly expressed the view that, where the audit work on a group component is delivered by a network firm, and where that network firm operates a global methodology, global quality control procedures, and operated under a global brand, their expectation is that the FRC Ethical Standard used by the group auditor should apply to them. A number of investors strongly expressed the view that group auditor should use the FRC Ethical Standard to assess independence for both network and non-network firms used to support a group audit. They considered that this would provide consistency of requirements, at what investors believe to be a higher standard (of independence) that better underpins confidence.

## **FRC Response**

The FRC has carefully considered the feedback provided in response to the consultation. In doing so, we have undertaken a detailed analysis of the respective requirements of the IESBA Code and the FRC Ethical Standard, to identify the additional requirements that a non-UK network firm would be required to apply under the proposal that was issued for consultation. We have also held some further meetings with group auditors and with investors, better to understand some of the responses received.

In the case of some of the group auditors, they expressed the view that they already, under existing requirements, consider all non-audit services provided across the group, against a UK standards benchmark, and therefore, have in place the systems and processes to support compliance with the FRC Ethical Standard. This may not be the case, however, for less formal networks. As noted above, investors strongly advocated that in a global network there is an expectation that an entity is being audited across the network under the standards applicable to the group auditor. Stakeholders responding both to this consultation, and to the December 2014 consultation set great value in the FRC Ethical Standard, as a means of ensuring auditor independence, and thereby underpinning confidence in audit.

Having reviewed the impact of the differences between the FRC Ethical Standard and the IESBA Code on network firms involved in the audit, we sought to identify an approach which would be simple to set out as a requirement in the standard, and would reflect investor concern about the need to ensure high standards of auditor independence, objectivity and integrity. We have amended the consultation draft, therefore, to require the use of the FRC Ethical Standard, where the audited entity the auditor will report on (*entity relevant to the engagement*) is a Public Interest Entity, and for all other entities the IESBA code should be applied, which is the current requirement. We believe that this is a proportionate response to maintain public confidence in audit, and will mitigate compliance costs for the auditors of non-Public Interest Entity groups.

In finalising the text of the Standard (paragraph 4.34R of the ES refers) we have also clarified that when applying the 70% fee cap for non-audit services to an audits firm's network, the requirement applies to the audited entity, its controlled undertakings and the consolidated accounts of that group. However, it does not apply to the parent undertaking of the entity. This is a proportionate approach, and avoids the FRC's application of the cap to network firms having an extraterritorial impact beyond the PIE.

**Q6: Do you support the extension of scope to other public interest assurance engagements, incorporating the requirements of the ESRA into the FRC ES, and do you agree that the restriction of scope of ethical requirements for investment circular work is sufficiently clear in the proposed text?**

A majority of the respondents to this question supported the FRC's proposal to extend the scope of the Ethical Standard, and to incorporate the requirements of the ESRA into the text of the Standard. However, in common with the response to Question 2 (above), a significant minority of respondents raised concerns about the perceived complexity, and a resulting lack

of clarity arising from the incorporation of the ESRA. We engaged with practitioners carrying out engagements under the extant ESRA, who identified a number of practical difficulties, particularly relating to private reporting, arising from the wider range of individuals and types of engagement covered by the Ethical Standard which were not covered by the extant version of the ESRA.

### **FRC Response**

The revision to the Ethical Standard so that it applies to other public interest assurance engagements carried out using performance standards issued by the FRC has not expanded the scope of the Standard. Rather, we have updated the ESRA content in the standard, so that it is based on the newest version of the Ethical Standard, rather than the standards in force in 2006 when the ESRA was last updated, and made the position for CASS audits consistent with the FRC's CASS Standard. We do not propose to expand of the scope of the Standard to cover other engagements that may be in the public interest, but not carried out using a performance standard issued by the FRC which was a concern that was raised in a number of responses to the consultation.

Please also see our response to Question 2.

### **Q7: To provide additional clarity in respect of auditor independence, do you support the FRC's proposal to replace the 'chain of command' definition with the revised wording of the definition of a person in a position to influence the conduct or outcome of an engagement?**

All but one of the respondents to this question supported our proposal to replace the term 'chain of command' with a revised definition of 'person in a position to influence the conduct or outcome of an engagement'. However, several respondents raised concerns that the definition proposed by the FRC was both too detailed and complex and not sufficiently principles-based. Particular concern was raised regarding those individuals in a position to influence the appraisal or remuneration of any member of the engagement team, which respondents felt drew the definition too widely, particularly by including individuals who may only have some minor influence over junior members of the audit team.

A small number of respondents raised concerns about the independence impact on partners acting as non-beneficial trustees, as a result of changes proposed by the FRC to address the self-interest threat that trustees may be exposed to, where they are the auditor of an entity that is a material interest of the trust.

### **FRC Response**

The FRC has reviewed the definition of 'persons in a position to influence' and made some amendments to address concerns raised by respondents. We have also simplified the text of the standard and changed the term to 'covered person' which is a familiar international term, and provided further definition in the glossary. In revising the definition, the FRC has clarified that those who can influence the appraisal or remuneration of any member of the audit team 'management', should only be in respect of those who have a direct influence in that process, rather than being able to 'otherwise influence' it.

However, we are unable to address all of the concerns raised by respondents regarding the expansion in the number of people who now fall within the scope of the revised definition, as some of the requirements objected to have been included to ensure auditor compliance with Article 22 of the Directive, and in particular, the way in which BIS has transposed those requirements into UK law. For instance, personal independence requirements falling on auditors, prevent the audit firm, specified persons and persons closely associated with them

from owning or having an interest in any audited entity within *their area of statutory audit activities*. The FRC is not able, therefore, to provide any exemption or relief in this respect.

The FRC has reviewed paragraphs 2.17-2.19 of the Ethical Standard which sets out the guidance for trustees. After careful consideration, we have retained the requirements on which we consulted, as providing a proportionate way of addressing any self-interest threat that may arise from holding a trusteeship position.

**Q8: Do you support the FRC’s proposal regarding accepting an engagement for an entity employing a former partner or other restricted person, to comply with the requirement set out in the Directive?**

There was overall support for our proposals from those respondents answering this question. However, some respondents, identified this as a complex provision and stressed the importance of providing greater clarity in the drafting of the relevant part of the standard, and its application, for example, by clarifying the acceptance point of an audit engagement in a tender process. Attention was also drawn to the particular circumstances applying to public sector audit in the government sector, where appointments are on a statutory basis.

A small number of respondents raised concerns regarding the impact that this requirement might have on choice of auditor.

**FRC Response**

The FRC has reviewed the text of the standard, and made some clarifications to the text to reflect comments provided by respondents.<sup>4</sup> We have also ensured that these requirements are consistent with those requirements applicable when a partner or responsible individual leaves an audit firm to join a client.

The FRC acknowledges that particular circumstances apply in the case of public sector audits. Audit appointments held by an Auditor General, other than work done under the Companies Act, are continuous, statutory appointments and there is no ability to withdraw from them. At the same time there is no prohibition on the staff of a national audit agency from leaving to join an audit client at any time. This is reflected in paragraph 2.54 of the Ethical Standard.

We note the comments made by a small number of respondents about the possible impact on choice of auditor. However, we believe that this serves to highlight the importance of a matter discussed at the FRC Open Meeting on the Audit Regulation and Directive, about the need for entities to develop a strategy for the procurement of professional services.

**Q9: Do you agree with the FRC’s proposal to mitigate the risk of an auditor’s independence being compromised, by clarifying requirements relating to the provision of non-audit services provided before taking up appointment as auditor?**

There was clear overall support for our proposal from the respondents who answered this question. However, a number of those respondents made recommendations for further guidance in respect of the requirements applying to the provision of non-audit services provided before taking up an appointment as auditor. Many of these concerns were linked, either directly or indirectly to the increased levels of audit tendering activity, and a potential impact on choice of auditor, where firms may not be independent because of non-audit services previously provided.

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<sup>4</sup> This overlaps with Code Provision B.1.1., which is a ‘comply or explain’ requirement.

## **FRC Response**

The FRC has reviewed the text of the Standard, both to clarify and simplify the language, and to identify areas where we have been able to enhance the guidance included, for instance, to clarify when an audit engagement is 'accepted'. Some respondents asked the FRC to consider including an arrangement to 'provide for exceptional circumstances', however, any situation whereby there was a failure to adequately identify a threat that would fail the third party test would not comply with the requirements set out in legislation.

We have also now acknowledged in the text of the standard, that a threat to independence can reduce with the passage of time or because the entity has been subject to audit by another auditor. This is in response to stakeholder feedback, as a means of ensuring that the standard is applied proportionately to address the risk faced.

### **Q10: Do you support the FRC's proposal to make consistent the prohibitions over providing advocacy for an audited entity in relation to tax?**

There was strong opposition to the FRC's proposal from those respondents who answered this question (almost all were audit firms and professional bodies), and a number raised significant concerns. Those supporting the proposals were investor and public sector respondents. The main objections to our proposals made by respondents related to the need to provide greater clarity over what constitutes advocacy, and the concern that the proposed prohibition would adversely affect small and medium-sized entities who may be more reliant on their auditor as a source of advice and support, and also smaller audit firms.

## **FRC Response**

The FRC has carefully considered the feedback from stakeholders. However, it is a requirement of EU law that an audit cannot be undertaken by a firm if there is a threat to that firm's independence posed by advocacy that would fail the objective, reasonable and informed third party test. The FRC is therefore required to ensure that the Ethical Standard contains requirements that address this risk, and we have provided a clearer linkage between the requirement, and the overarching principles which clarify this. For small entities, where an audit is carried out in accordance with the ES PASE, there is a specific exemption from this requirement for qualifying engagements.

In response to the feedback provided, the FRC has revised the text (paragraphs 5.99-5.101) to clarify that the prohibition does not apply to advice provided to an audit client that does not constitute advocacy, and clarified the definitions in the text of the standard itself. We have also made an explicit link between the requirement and the risk that is identified in the ethical provisions. We have also emphasised the materiality consideration, which was already in the draft standard, which permits the provision of a service where it is not material in the context of the engagement. This is consistent with the approach the FRC has taken to the application of the derogation under the ARD in respect of non-audit services where the effect of those services is clearly inconsequential in the context of the engagement.

In doing so, the FRC has sought to consistently apply the principles of the Ethical Standard in a proportionate way to address risks that have been highlighted by the FRC's inspection and enforcement work. In addition, investors have been very clear, that in revising the standard, the FRC should not weaken the independence requirements that apply to auditors of Public Interest Entities and larger quoted companies as these are fundamental to underpinning investor confidence in audit.

**Q11: Do you agree with the prohibition proposed by the FRC in respect of the provision of tax services on a contingent fee basis?**

In common with the response to Question 10, there was strong opposition to the FRC proposal to prohibit contingent fees for tax services, again mainly from audit firms and the professional bodies. They challenged the proposal to prohibit tax services on a contingent fee basis as inconsistent with the approach for other non-audit services, and also questioned the proportionality of the proposal as they contend that some tax services do not give rise to an unacceptable threat to independence, as they are ‘mechanistic’ and do not involve making judgements that will subsequently be subject to audit.

Smaller audit firms also suggested that the proposal would significantly increase costs for smaller audited entities, as they would need to procure a separate provider.

**FRC Response**

The FRC has carefully considered the feedback from stakeholders. Our inspection work has identified a number of instances where auditors have provided tax services on a contingent fee basis, and that fee has been a multiple of the audit fee, sufficient in the FRC’s view to risk compromising auditor independence. As noted in our response to Question 10, investors have been very clear, that in revising the standard, the FRC should not weaken the independence requirements that apply to auditors as these are fundamental to underpinning investor confidence in audit.

However, we acknowledge the need for smaller entities to be able to access appropriate support, and for the FRC’s standards to proportionately address risk. We have, therefore, revised the standard to include a materiality consideration for listed entities below the €200 million MiFID SME capitalisation threshold, whereby the prohibition will not be applicable in situations where a contingent fee for tax services is not material in the context of the audit firm, or the remuneration or profit share of the partner or partners involved in the engagement. We believe that this will address concerns raised in the feedback, however, we reiterate the importance of auditors ensuring that they address the risk posed by a contingent fee engagement that depends on an outcome that is relevant to a future audit judgement relating to a material matter. The absolute prohibition will remain in respect of larger listed entities over the €200 million threshold.

**Q12: Do you agree with the FRC’s proposals to offer targeted reliefs in respect of the audits of smaller listed/smaller quoted entities?**

There was clear overall support from respondents who answered this question, for our proposals to offer some targeted reliefs from certain FRC ethical requirements (relating to the provision of non-audit services), for the audit of smaller listed entities. We developed the proposals in response to calls for the FRC to identify ways for the Ethical Standard to be applied in a proportionate way for the audits of smaller listed entities. Some respondents, however, raised concerns over the additional complexity that might entail from assessing whether or not the reliefs apply to an audited entity, and others raised concerns about the need for greater clarity and simplicity in the terminology used in the text of the Standard.

A small number of respondents requested that the FRC consider extending the proposed reliefs further, and that fewer AIM companies should be subject to the full requirements of the FRC Ethical Standard. Two audit firms disagreed with the provision of reliefs, stating that they consider them to be restrictive on firms that wish to assert compliance with the IESBA code, as the reliefs will mean that in respect of eight requirements, the FRC Ethical Standard will require a less stringent approach with regards to the provision of non-audit services, that that

required by the IESBA Code. Other audit firms have questioned this and advised that they do not see the reliefs as posing a compliance issue.

Two professional bodies opposed the proposal for reliefs, stating that the FRC should withdraw the existing requirements which apply to all entities, so that the reliefs are not necessary.

### **FRC Response**

See response to Question 14.

### **Q13: Do you believe that the FRC's proposals are targeted at the right level, if not what alternative considerations for the application of reliefs would you suggest?**

Most of the respondents to this question supported the proposal to allow reliefs for the audit of entities with a market capitalisation of £100 million or less, a level consistent with the threshold for FRC Audit Quality Review (AQR) inspection. A small number of audit firms, and the response from the Group A firms, suggested that the threshold should be that set out in the MiFID II Directive of €200 million, which would extend the reliefs to a further 90 entities currently on the AIM Market.

Some respondents raised concerns about the FRC's suggested approach to calculating the application of the threshold, in particular where the value of an entity may be subject to significant fluctuation. One audit firm raised concerns that the threshold would mean that the provision of non-audit services to a smaller entity may become unacceptable if the firm fluctuates in value, creating cost and uncertainty for both the audited entity and the audit firm.

### **FRC Response**

See response to Question 14.

### **Q14: Do you agree that the reliefs should continue not to apply, to entities which exceed the threshold and then subsequently fall below the threshold, for a period of two financial years following the financial year in which the reliefs first ceased to apply?**

There was clear support for the FRC's proposal from those respondents who answered this question. However, some respondents challenged the proposal to operate a time lag over the period of eligibility, which was originally included to avoid a situation whereby an audited entity moved in and out of the threshold on an annual basis. Other respondents questioned the need for a time lag at all, or suggested that if one was required it should only be one year in duration. Some respondents requested the FRC consider providing transitional guidance to handle the period over which an entity transitioned through the reliefs' threshold, for example where an audited entity may be eligible for reliefs in one year allowing the provision of certain non-audit services, which may then not be permissible in subsequent years.

### **FRC Response**

The FRC is committed to applying regulation in a proportionate and principles-based way. We have discussed our proposals regarding reliefs with the London Stock Exchange, who supports the FRC Ethical Standard applying to entities that trade on AIM. Retention of the FRC's requirements was also subject to public consultation in December 2014, and received clear support from stakeholders. We do not, therefore, propose to withdraw them as they support stakeholder confidence.

We have carried out a full assessment of those areas where the FRC Ethical Standard will be less stringent than the IESBA Code. For the proposed reliefs, this relates to eight requirements relating to the provision of non-audit services. We consider the reliefs to be proportionate, and based on our outreach work do not adversely affect investor confidence, or that of the AIM market. We therefore propose to retain the reliefs in the final standard.

Although there was broad support for the £100 million threshold proposed in the consultation, it did generate some complexity, when an entity's entitlement to the reliefs needed to be calculated. We discussed this the London Stock Exchange, who supported the Group A firms' proposal for the threshold to be set at €200 million per MiFID II. The attraction of using this threshold is that the Standard can then refer to an existing, and well recognised definition, and that the applicability of the threshold is calculated and monitored under the MiFID II framework on a three year rolling basis. This allows us to simplify the text of the standard, and provide a consistent approach between the standard and the requirements of MiFID II. The final standard has been amended, therefore, to refer to the MiFID II threshold of €200 million. Investors we have discussed this proposal with have been supportive.

In finalising the standard, we have also sought to respond to feedback on complexity, through clarification of language. We have also clarified the applicability of the reliefs to entities that issue debt rather than equities, or a mixture of debt and equity.

We originally consulted on arrangements applicable to those entities which might gain or lose entitlement to the proposed reliefs, to use a qualifying transitional period. This was intended to prevent an entity gaining and then losing entitlement in successive years. As we now propose to adopt the MiFID II definition which calculated the market capitalisation of an entity on a rolling average basis, this should smooth out the impact of short term volatility, and the uncertainty that might arise as a result.

## **Other Issues**

### **Independent Non-Executives**

In the course of revising the Standard, a small number of other issues have been drawn to our attention which we are flagging in this feedback statement, for the sake of transparency. Firstly, we were asked whether there should be an explicit requirement in the Ethical Standard for the Ethics Partner's appointment to be subject to the approval of an audit firm's Independent Non-Executive's (INEs) where they exist. We have not made any adjustment to the Ethical Standard in this respect given the comply or explain nature of that Code and its current limited application.

### **Personal Financial Independence Requirements**

The second issue relates to the personal financial independence requirements for auditors, contained in Section 2 of the Ethical Standard. Paragraph 2.4 of the Standard sets out the requirements contained in Article 22 of the Directive, whereby each key audit partner, and those directly involved in statutory audit cannot hold material direct financial interests in an audited client of the firm. This alone would weaken, in certain respects, the existing prohibition in the Ethical Standard which does not allow any direct financial interest to be held in an audited client by each partner in the firm, each covered person and their closely associated persons. We have, therefore, maintained the existing FRC requirements prohibiting the holding of immaterial direct financial interests, and the wider application beyond those personnel involved directly in statutory audit through paragraph 2.3 of the Standard.

## **Bank Lending Syndicates**

We were also asked about the status of bank lending syndicates, and in particular where a non-audit service is provided by an audit firm to a syndicate which might include entities audited by that audit firm. Where that is the case and the audited entity is a public interest entity, those services will be subject to the requirements of the Audit Regulation in respect of non-audit services. This is because the European Legislation applies to non-audit services provided both directly and *indirectly*. Consequently, firms participating in such engagements will need to apportion any fees, and attribute the appropriate portion to any audit clients so that they can be scored against the non-audit services cap.

## Auditing Standards

### **Q15: Do you agree with the FRC's proposed approach to incorporate the requirements of the Regulation and Directive into the text of the quality control and auditing standards?**

The FRC's approach to the incorporation of the Audit Regulation and Directive requirements into the text of the quality control and auditing standards received overall support from those respondents who answered the question. However, a number of those respondents challenged the text of the standards containing the requirements arising from the Audit Regulation and Directive, instead suggesting that the standards would be clearer if these requirements were maintained in a separate annex, or separate standard.

Others questioned our use of a 'copy out' approach, which imports the text of the legislation into the standards, resulting in inconsistent terminology and uncertainty over those requirements applying to different types of audit engagement. There were also requests to provide within the Standards further guidance on the interpretation of terminology lifted from the EU legislation.

A small number of respondents called for the withdrawal of UK pluses from the existing UK and Ireland standards, which they contend are no longer required, following updates made at the international level by the IAASB.

### **FRC Response**

The FRC continues to believe that the standards should be a single source of requirements and guidance that can be used by all auditors. In response to feedback, we have reviewed the text of the standards, to identify areas where we can better address complex drafting, and improve the clarity of definitions. We have also added additional application material better to support practitioners, and better to clarify and better integrate the requirements of the Audit Regulation and Directive into the text. In response to feedback from the consultation process, the FRC has established a technical advisory group to identify those areas of the standards for which further interpretation would be helpful.

In determining if additional material is necessary, the FRC will look to strike a balance between providing additional guidance to address ambiguity in the language used in the Regulation and Directive, and ensuring the guidance material does not undermine the principles-based nature of our standards – in particular the high level principles set out in the Ethical Standard.

### **Q16: Do you foresee any difficulties if the effective date is for audits of financial statements for periods commencing on or after 17 June 2016?**

A majority of the respondents to this question supported the FRC's proposal to require a single effective date for all of the changes proposed to standards of 17 June 2016. The FRC proposed a single effective date to minimise the cost to audit firms of making two sets of changes to their methodologies, training materials and guidance.

A number of respondents raised concerns that the timetable for the finalisation of standards is very tight, and that revised standards will only be available for a short amount of time before the effective date. Some audit firms operating on a global basis, stated a preference to allow for early adoption of changes to International Standards on Auditing issued by the IAASB to ensure consistency of requirements applicable to their auditors who utilise some global methodological, familiarisation and training material.

## **FRC Response**

The FRC will require a single effective date to apply, and that will be the 17 June 2016 (or the date thereafter that the UK implementing regulations are effective). The FRC is committed to finalising the standards and making them available to users, as soon as they have been approved by the FRC Board and subject to appropriate quality control procedures. This will support the audit firms to provide appropriate update and familiarisation material in time for the main annual update cycle that many of the audit firms operate over the summer period. As the standards will be applicable to audit engagements of periods commencing on or after 17 June 2016, this should provide sufficient time for the roll out of new material.

As the effective date for revised ISAs (UK and Ireland) is later than that used by the IAASB, we propose to permit early adoption of those ISAs amended by the IAASB following the Reporting, Other Information and Disclosures projects, in order to facilitate global audit firms in the update of their materials.

**Q17: Do you agree with the FRC's proposals to:**

**(a) adopt the proposed ISA (UK and Ireland) 700 (Revised) and ISA (UK and Ireland) 701; and**

**(b) extend the application of ISA 701 to (i) those entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code and (ii) PIEs?**

Respondents to this question gave overall support for the FRC's proposals in respect of the adoption of ISA 700 (with one exception on grounds that the respondent believes that this will result in the use of boiler-plate language) and 701; and the extension of the application of ISA 701 to those entities that apply the Code and to PIEs. Some raised concerns about the complexity of the terminology in the standards, and use of long and complex sentences, and there were a number of respondents who requested that existing UK pluses (additional specific requirements) be moved to application material because they are duplicative. Investors that we spoke to, however, strongly supported the retention of the UK pluses.

A number of respondents also flagged complexity arising from the need for differing reporting requirements applying to PIEs, other listed entities and companies applying the Code in one Standard. Some audit firms, mainly large firms, suggested that this could be addressed by adopting a single requirement for all listed companies based on that applicable to PIEs. Smaller audit firms, however, did not support this proposal.

## **FRC Response**

In response to feedback, we have reviewed the language used in the standards relating to the Audit Regulation and Directive, and sought to simplify and clarify it, including the better signposting of which requirements apply in which circumstances. Smaller audit firms and public bodies did not support a proposal to set a single reporting requirement, instead requesting a standard which provides a full range of different reporting requirements based to the type of audited entity concerned. We have decided, therefore, to retain our existing proposal which maximises flexibility for auditors.

Where respondents identified language they considered to be confusing, we have sought to clarify through drafting changes (for instance by removing references to statutory audits derived from the Directive), and in the case of ISA 701, by moving the Key Audit Matters definition contained in a UK plus, to application material. In doing so the FRC hope to encourage auditors to continue to develop relevant and insightful auditor reports.

In ISA 700, the FRC has also simplified the text of the standard, however, noted that there remains ambiguity over the regulation requirement for the auditor to “explain to what extent the audit was considered capable of detecting irregularities, including fraud”, and whether this requirement should be applied in an entity specific way, or generically. The FRC text copies out the ARD language and the FRC continues to work with other European regulators to monitor how this requirement is applied. The FRC’s position is to avoid, wherever possible, boiler-plate reporting unless required to comply with law or regulation.

**Q18: Do you agree with the FRC’s proposals to:**

- (a) adopt the proposed ISA (UK and Ireland) 720 (Revised);**
- (b) include requirements to allow the auditor to provide the required opinions and statements under UK [and Irish] legislation; and**
- (c) withdraw Section B of ISA (UK and Ireland) 720 (Revised)?**

Respondents who answered this question strongly supported the FRC’s proposals to adopt ISA 720, adapted to allow the auditor to provide the required opinions required by UK and Irish legislation. Although two audit firms did challenge the standard as confusing, and recommended that it be re-exposed, and a number of others highlighted complex and confusing language (in particular the use of broadly concurrent) in the text.

A small number of respondents challenged aspects of ISA 720 – in particular noting that the scope of the opinion required by the FRC standard is broader than that required by the Directive, and the definition of other information in the FRC Standard, and the work effort required, is broader than that used in the international standard. There were a small number of responses which raised concerns that the ISA requirement to report on other information may be misinterpreted by users of the auditor’s report, and that any opinion should provide ‘limited’ rather than ‘reasonable’ assurance.

There was also strong support (with two exceptions) for the proposal to withdraw ISA (UK and Ireland) 720 B.

### **FRC Response**

The FRC has carefully considered stakeholder feedback on the complexity of the standard issued for consultation. Many of the responses that raise this question, focus on the fact that the draft standard does not clearly signpost requirements in ISA 720 that are not new requirements, but are existing requirements transferred from ISA (UK and Ireland) 700. We have now done this in a way that is consistent with the international standard issued by the IAASB.

We have also revised the standard to simplify the language, and expanded the application material to better explain the inter-relationship between the requirements of the ISA and the requirements of the Directive.

Given the broad support from respondents, we will withdraw ISA (UK and Ireland) 720 B, and integrate the requirements into a single standard. We also propose to maintain those requirements applicable to other information, which were challenged by a small number of respondents over the scope and definition, as the standard as currently drafted is consistent with the existing UK requirements, and will be less likely to require updating.

**Q19: Do you agree with the FRC’s proposals to enhance auditor reporting in respect of the going concern basis of accounting?**

Investor and corporate respondents supported the FRC’s proposals to enhance auditor reporting in respect of the going concern basis of accounting, as did half of the audit firm respondents and most of the professional bodies. One investor called for the FRC to go further in its proposals. The remaining audit firm respondents and one professional body disagreed with the proposals on the grounds that it added to boiler-plate reporting, and represented gold plating, not being a requirement of EU legislation or international standards. Two audit firms considered the proposal to be anti-competitive, and one audit firm proposed that the FRC should write a UK and Ireland specific ISA which should not be based on the international standard.

**FRC Response**

The FRC considers that the proposal requires no additional auditor’s work-effort, other than addressing reporting requirements that will occur in only a small proportion of audit engagements.

We have, however, reviewed the text of the standard to reduce the current overlap between the requirements in ISA 570 and those in ISA 700, and to clarify the positioning of reporting on material uncertainty within the auditor’s report. As part of our review we have made drafting changes to simplify long and complex sentences, and sought to clarify the requirements that apply to address concerns expressed by some audit firms that our proposals would require significant additional work.

Given the costs associated with our proposals are expected to be negligible, and given that the proposals have been well supported, particularly by investor and corporate respondents, we will maintain this requirement, as amended for the changes noted above.

**Q20: Do you agree with the proposed scope of ISA (UK and Ireland) 250 Section B being limited to PIEs, or do you believe that the requirements of ISA 250B should also apply to non-PIEs in regulated sectors?**

A majority of the respondents to this question supported the FRC’s proposal requiring auditors to report certain material<sup>5</sup> referred to in the consultation to Competent Authorities in regulated sectors, should only apply to Public Interest Entity audit engagements. A small minority of respondents proposed that the FRC should extend this requirement to all entities in regulated sectors.

**FRC Response**

In view of the FRC’s commitment to developing standards and guidance which are proportionate, we are retaining the requirement on which we consulted, which applies only to Public interest Entity audit engagements and financial services entities that are already subject to a regulatory requirement to report information in certain circumstances to the regulator. To clarify the applicability of this standard, we have revised the title to *‘The Auditor’s Statutory Right and Duty to Report to Regulators of Public Interest Entities and Regulators of Other Entities in the Financial Sector’*. Extending the requirements of this standard to other entities is not necessary, as there is no risk to address, the costs resulting from any extension would outweigh the benefits of extending the reporting requirement.

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<sup>5</sup> Relating to breaches of law or regulation, a material threat or doubt over continuous functioning, or a refusal to issue an audit report, or a decision to issue a modified audit opinion.

**Q21: Do you agree with the FRC’s proposals for the minimum retention period for audit working papers for all audit engagements?**

A clear majority of respondents to this question, supported the FRC’s proposal for the minimum retention period for documentation, of six years from the date of the auditor’s report, to apply to all audit engagements. No respondents objected to the proposal.

**FRC Response**

The FRC will require the minimum retention period for documentation, of six years from the date of the auditor’s report, should apply to all audit engagements.

**Q22: Do you agree that the minimum retention period should apply to all audit documentation rather than just those documentation requirements deriving from the Regulation and Directive?**

All of the respondents to this question supported the FRC’s proposal that the minimum retention period, of six years from the date of the auditor’s report, should apply to all audit documentation, and not just those sections referred to in the Regulation and Directive.

**FRC Response**

The FRC will require the retention of all audit documentation, for the minimum retention period of six years from the date of the auditor’s report.

**Q23: Do you agree with the FRC’s proposal to withdraw Bulletin 2008/4 and incorporate additional application material into ISA (UK and Ireland) 210 (Revised)?**

A clear majority of the respondents to this question supported the FRC’s proposals with respect to auditor reporting on the financial statements of micro-entities, by withdrawing Bulletin 2008/4 *The Special Auditor’s Report on abbreviated accounts in the United Kingdom*, and incorporating additional application material into ISA (UK and Ireland) 210 (Revised). A small number of respondents requested that the FRC issue a new bulletin.

**FRC Response**

The FRC will retain the additional application material (paragraph A34-1) in ISA (UK and Ireland) 210 (Revised) in the finalised standard, and will withdraw Bulletin 2008/4 *The Special Auditor’s Report on abbreviated accounts in the United Kingdom*, at the same time. As the application material will support those auditors needing to prepare an auditor’s report for the financial statements of a micro-entity, the FRC does not propose to issue a further Bulletin to cover this issue.

**Other Issues**

**Definition of a Listed Company**

For clarity, we have now aligned the definition of a listed company in the Auditing Standards with that used in the Ethical Standard. As a result, we have clarified that the definition of a listed entity excludes entities whose securities are technically listed but which are not in substance freely transferrable or tradeable are not considered to be listed entities for the purposes of the standards. Accordingly, such entities will not need to comply with the listed entity requirements in the auditing standards, for example: the audit engagement need not be subject to an engagement quality control review; and the auditor will not be required to communicate key audit matters in their auditor’s report.

# UK Corporate Governance Code and Guidance on Audit Committees

## Introduction

Of the 41 consultation responses, 25 addressed changes to the Code or the Guidance. In addition, the FRC also met a number of stakeholders to discuss the consultation.

There was general support for the proposed changes to the Code, except for the proposal to change the words in C.3.1 from 'recent and relevant financial experience' to 'competence in accounting and/or auditing'.

Our proposed revisions to the Guidance were generally well received. Respondents tended to agree with the decision to reduce duplication of the Code, but a few responses noted sections that they would like to see retained for clarity; where these are duplications of the Code we have not chosen to do so. Our further amendments to the Guidance are explained in more detail below.

We also met BIS, the FCA and the PRA as we considered the feedback to coordinate our responses as much as possible.

As Questions 24 and 26 cover many of the same topics the feedback on these questions is considered together.

**Q24: Do you agree with changes to section C.3 of the Code?**

**Q26: Do you agree with changes to the Guidance?**

### ***Recent and relevant financial experience***

In the consultation, we proposed amending Code provision C.3.1 to bring it into line with the wording from the Directive that "at least one member of the audit committee shall have competence in accounting and/or auditing". The current wording of C.3.1 of the Code is "the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience".

### ***Competence relevant to the sector***

We proposed revisions to the Code and Guidance to take account of the Directive's requirements for sectoral competence. The proposed amendment required that the audit committee as a whole should have competence relevant to the sector in which the company operates. The Guidance further provided that "When making appointments to the audit committee the board should consider the overall knowledge and experience of the committee in order to achieve sectoral competence."

### ***Roles and responsibilities of the audit committee***

The consultation did not propose amending the roles and responsibilities of the audit committee in the Code as we were content that the requirements in Article 39 of the Directive were already covered in Code Provision C.3.2.

### ***Competition and Markets Authority Orders and Remedies***

In its report, and subsequent Orders relating to the audit services market, the CMA identified seven remedies. We addressed Remedies 1 (and Parts 3 and 4 of the Order) and 4 in the amendments to the Code and Remedies 1 (and Parts 3 and 4 of the Order); 5 (and Part 5 of the Order); and 6 in the proposed changes to the Guidance.

### *Retendering*

The Code requirement for retendering to take place every ten years was superseded by the Audit Regulation and Directive and CMA Remedies. We proposed amending Code provision C.3.7 to remove this reference.

### *Advance notice*

We proposed amendments to the Code and Guidance to provide for shareholders to be informed about future audit tendering plans. The Guidance further recommended that in instances where the tender is not undertaken in line with the proposed timing this be explained to shareholders.

### *Audit committee oversight of the external audit*

Remedy 5 recommended that the Code be aligned with the Order relating to an audit committee's oversight of the external auditor and the provision of non-audit services. The FRC considered amendments to the Code unnecessary as it already contains provisions that are consistent with the Order, but we included the suggested clarifications in the draft Guidance, a number of which overlap with the amendments suggested by the Regulation and Directive.

### *Increased transparency by audit committees of AQR and CRR work*

Remedy 6 recommended the disclosure of the FRC's Audit Quality Review (AQR) team inspection findings in audit committee reports. In addition, in 2015 the work of the FRC's AQR and the Corporate Reporting Review (CRR) teams was the subject of an externally facilitated review which highlighted stakeholders' interest in hearing more from the FRC generally and engagement specific information from AQR and CRR reviews. The FRC felt that this transparency should be provided by audit committees in the first instance and the Guidance was amended to propose reporting by audit committees of significant AQR and CRR findings.

## **FRC Response**

### ***Recent and relevant financial experience***

Most of those respondents who replied on this point preferred the current formulation, "recent and relevant financial experience", as it was considered broader and more flexible. It has been in the Code for a number of years and was felt to be well understood. In light of the feedback, we are proposing to continue with it.

The committee composition section of the Guidance has been rearranged to provide that a range of skills, experience, professional qualifications and knowledge are important in forming an audit committee and that the requirements for recent and relevant financial experience and sectoral competence (as outlined below) flow from that broader requirement.

We have discussed with the FCA the differences between its Disclosure and Transparency Rules (DTRs) and the Code, many of which have been in place for a number of years (as they have adopted a copy-out approach to EU law). The FCA has confirmed that it continues to regard the DTRs as setting a basic standard and the Code as providing guidance on good practice.

### ***Competence relevant to the sector***

One company respondent did not support the proposed changes, as they considered that a requirement for sectoral competence may unnecessarily narrow the range of suitable candidates. Another respondent felt that more guidance on the interpretation of “as a whole” and “relevant to the sector” is required.

We have decided to proceed with the proposal regarding competence relevant to the sector. Given the amendments to the Guidance to provide that a range of skills, experience, professional qualifications and knowledge are important in meeting the requirements of the Code, we do not consider the formulation overly narrow when the Code and Guidance are read together. We consider that sectoral competence is broader than sectoral executive experience.

We have also included in Section 4 of the Guidance a recommendation that the company disclose “how the audit committee composition requirements have been addressed” in the audit committee section of the annual report, if not provided elsewhere.

### ***Roles and responsibilities of the audit committee***

In general the proposal not to amend the roles and responsibilities as outlined in the Code was supported, but a respondent to the FCA’s consultation questioned whether the Code and the FCA’s copy out of Article 39 were equivalent for the purposes of the DTRs. As outlined above, the FCA has confirmed that the Code continues to provide guidance on best practice.

### ***CMA Orders and Remedies***

In its report, and subsequent Orders, relating to the audit services market for the FTSE350, the CMA identified seven remedies. We addressed Remedies 1 (and Parts 3 and 4 of the Order) and 4 in the amendments to the Code and Remedies 1 (and Parts 3 and 4 of the Order); 5 (and Part 5 of the Order); and 6 in the proposed changes to the Guidance.

### ***Retendering***

There was general support from respondents for the removal of the requirement to retender on a ‘comply or explain’ basis, as this is now redundant. We have also removed such references from the Guidance. One respondent, however, felt that the sentence noting the audit committee’s responsibility for the external auditor should be retained to ensure that the responsibility is clear and aligns with the Guidance, so this reference has not been deleted.

### ***Advance notice***

A number of the responses on this issue were supportive of including an indication of when companies next intend to retender. Some comments referred to the CMA Order which for the FTSE 350 requires disclosure only from five years after the most recent audit tender. The FRC believes that the practice of providing advance notice by all Code companies is of greater value. However, the addition of the word “any” has been made as we wish to ensure that reporting is only undertaken when focused and relevant, to give shareholders and other interested stakeholders details of when the board or audit committee considers it appropriate to retender. An institutional investor response noted that giving sufficient advance notice will provide them with an opportunity, should they wish to do so, to engage with the company on its upcoming tender process. The Guidance has been amended to reflect this revised wording.

### *Increased transparency by audit committees of AQR and CRR work*

Nine responses addressed the proposed reporting by audit committees of AQR and CRR findings. The proposal was generally well received, but some responses raised concerns about reporting expectations, the FRC's Conduct Committee's practices and made minor redrafting suggestions to avoid boilerplate disclosures. One corporate raised strong objections to the increased transparency of AQR reviews, citing concerns about the sensitivity of disclosure, and another respondent proposed some minor redrafting.

In response to feedback the proposal to increase transparency by audit committees of the work of the AQR and CRR has been retained. The FRC has decided to publish, from 2017, the names of those companies or company audits which have been the subject of AQR and CRR review. We note that such transparency is currently outside of the Conduct Committee's operating procedures but we will revise those as necessary to ensure they are aligned with this increased transparency. This will address a number of the concerns expressed by respondents. As a result of the identification of those companies subject to CRR and AQR reviews audit committees are encouraged to report even if there were no significant issues in order to avoid speculation. In any event, the fact that the FRC raised no significant issues is likely to be useful information for investors.

Disclosure of AQR and CRR reviews should be factually accurate, fair and balanced in order for the market to understand and avoid the need for further public clarification. There are specific obligations on the auditor to ensure this is the case. We have been disappointed with some of the early adoption of our current public guidance on reporting of AQR reviews<sup>6</sup>, in particular the lack of detail and specificity regarding findings and the actions taken. A focus of our ongoing monitoring will be how audit committees report the outcomes of AQR and CRR reviews in their annual reports and we will seek to promote clarity of reporting of findings and outcomes.

### **Other changes**

Some respondents suggested areas of the Guidance that would benefit from further clarification. We have addressed these concerns by clarifying the role of the audit committee in relation to the fair, balanced and understandable statement and revised sections of the internal control and risk management sections and those relating to the role of Internal Audit.

The draft Guidance included an appendix that was intended to provide a list of relevant requirements for audit committees, for example, in the FCA's DTRs and the Companies Act. However, some respondents preferred that we distinguish between regulatory requirements and best practice to avoid confusion. The FRC has, therefore, more clearly marked those elements which stem from requirements listed in other statutory or regulatory instruments. Other sections where respondents requested we copy across elements from other documents, for example the Ethical Standard's rules on non-audit services, have instead been referenced by footnote.

One respondent wanted us to incorporate the FRC's Audit Tenders: Notes on Best Practice in the Guidance. The Notes on Best Practice is able to be updated more frequently to address developments in best practice if it is not combined with the Guidance, so we have not incorporated it. Other responses requested more guidance on keeping a range of audit firms

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<sup>6</sup> FRC Statement: Transparency of AQR findings, 20 November 2014, <https://frc.org.uk/Transparency-of-AQR-findings>

independent with a view to future tendering. In our view this is a matter for best practice, and the FRC will include examples in the next revision of the Audit Tenders document.

We received a number of responses on the wording in the Guidance about the policy on non-audit services. Some of these responses may have misunderstood the intention of the Guidance, which is to provide that an audit committee should set a policy for the pre-approval of non-audit services only where these services are considered 'clearly trivial'. Each item above the pre-set limit should be approved by the audit committee. We consider that this requirement aligns with that concerning clearly trivial matters in the Ethical and Auditing Standards.

One response felt that interactions with investors should encompass more than just the reporting included in the annual report. Section 4, addressing communication with shareholders, has been amended to take note of these wider expectations and provide flexibility in the placement of the committee's report. Other respondents raised concerns about the increased reporting required by the revised Section 4. A number of these elements were included in response to investor comment on best practice reporting. As this is considered relevant information for investors we would encourage companies to disclose such information. However, as provided in the Guidance on the Strategic Report, the company may wish to consider whether the information is best placed elsewhere or otherwise referenced.

Schedule B, the Appendix and Footnotes in the Code have been amended to take account of changes to the FCA's DTRs and Listing Rules relating to the Audit Regulation and Directive and the FCA's requirement for reporting on viability. The Preface has also been updated to explain the latest update to the Code, as is usual practice. A summary of the main differences between the 2014 and 2016 editions of the Code can be found in an appendix to this paper.

## **Q25: Is an advisory vote on the audit committee report required?**

### ***Advisory vote on the audit committee report***

The CMA recommended in its report on the audit services market that the FRC introduce into the Code a recommendation that companies propose an advisory vote on the audit committee report.

The CMA considered that the introduction of an advisory vote would increase the audit committee's incentives to discharge their responsibilities in the interests of shareholders, in particular to assess the effectiveness of the external audit process and the approach taken to the appointment and reappointment of auditors. We did not consider such a change necessary, but consulted on whether this recommendation should be included.

### **FRC Response**

Only one response agreed with the introduction of the recommendation, with the large majority saying that investors should decide on the need for a vote. In particular, investors did not support the introduction of an advisory vote on the audit committee report, as they considered there are other avenues through which they may register their concern. We do not, therefore, consider it necessary to include such a recommendation in the Code.

## Impact Assessment

Alongside the consultation issued in September 2015, the FRC issued an impact assessment of the quantifiable costs and benefits arising from regulatory decisions taken by the FRC in proposing revisions to the Ethical and Auditing Standards. None of the respondents commented on the material in the Impact Assessment.

The FRC's estimate of total net costs arising from the proposed revisions of the Ethical and Auditing Standards was £0.253 million. Where we have proposed changes to the final standards, which impact on either the data or underpinning assumptions made in the initial impact assessment, we have set out our best estimate of those changes in the table below, referenced back to the tables in the September 2015 assessment. Where there are changes that are not as a result of decisions taken by the FRC (for instance the government's changes to the audit exemption threshold) they are not included in this assessment.

		<b>Cost/ (Benefit) £ million<sup>7</sup></b>
<b>Net cost arising from FRC proposals reported in the consultation impact assessment</b>		<b>0.253</b>
<i>Section 3A, Table 1 – Implementation changes resulting from FRC decisions – revisions to Ethical and Auditing Standards.</i>	ISA 701 UK Plus moved to Application Material, but this should not impact on the level of auditor's work effort required.	0.000
<i>Section 3A, Table 4 – Changes to Member State Options</i>	No proposed changes	0.000
<i>Section 4, Table 2 – Changes to positions reported subsequent to the December 2014 consultation</i>	Impact of application of MiFID II threshold for reliefs, applicable to 90 medium entities @ 2% of audit fees, based on rates in Appendix 2 of original assessment.	(0.054)
<i>Section 5, Table 3 – FRC proposed augmentations</i>	Inclusion of a materiality threshold for the prohibition of contingent fees for tax services, reduces by 50% our original assessment of cost.	(0.315)
<b>Changes arising from FRC proposed responses to consultation responses</b>		
<i>Question 2</i>	Original assumption was based on costs of expanding requirements to other public interest assurance engagements – costs for CASS work have been included in CASS Standard risk impact assessment. Given requirement is set out in the CASS Standard, and is not additional for the purposes of this consultation, we have discounted the impact (Table 3 Req. 5) by 33%.	(0.528)
<i>Question 7</i>	Wider application of auditor independence regarding persons in a position to influence the conduct or outcome of an engagement - based on 150 hours per large firm (6). 40 in medium (30) and 20 in small (64) – rate split 10% partner, 90% senior manager.	0.982
<i>Question 11</i>	See Section 5, Table 3 above	0.000
<i>Questions 12-14</i>	See Section 4, Table 2 above	0.000
<b>Net total changes</b>		<b>0.085</b>
<b>Net cost arising from FRC proposals</b>		<b>0.338</b>

<sup>7</sup> The values referred to in this assessment are derived from assumptions made by the FRC, and from BIS and FRC data. As the values are small, we have not rounded the numbers, to avoid many of the assumptions being rendered de minimis

The FRC has assessed the impact of the implementation of the Regulation and Directive relating to *regulatory decisions taken by the FRC* to be £0.338 million. Costs arising from complying with legislation are included in the impact assessment prepared by the BIS, and submitted to the Regulatory Policy Committee.

*All figures are stated in £0.000 million, and the references to tables are those in the impact assessment published alongside our 'Confidence in Audit' consultation*  
<https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Enhancing-Confidence-in-Audit/Impact-Assessment.aspx>

## APPENDIX

### Summary of the differences between the 2014 and 2016 editions of the Code

2014 Edition	2016 Edition
Preface	Wording specific to the 2016 edition has been added and minor changes have been made to paragraph 6.
<p>Provision C.3.1:</p> <p>The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.</p>	<p><i>Underlined wording has been added:</i></p> <p>The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. <u>The audit committee as a whole shall have competence relevant to the sector in which the company operates.</u></p>
<p>Principle C.3.7:</p> <p>The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.</p>	<p><i>Deletions shown as strikethroughs:</i></p> <p>The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. <del>FTSE 350 companies should put the external audit contract out to tender at least every ten years.</del> If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.</p>

2014 Edition	2016 Edition
<p>Provision C.3.8:</p> <p>A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:</p> <ul style="list-style-type: none"> <li>• the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;</li> <li>• an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted; and</li> <li>• if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence are safeguarded.</li> </ul>	<p><i>Underlined wording has been added:</i></p> <p>A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:</p> <ul style="list-style-type: none"> <li>• the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;</li> <li>• an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm when a tender was last conducted and <u>advance notice of any retendering plans</u>; and</li> <li>• if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence are safeguarded.</li> </ul>

Schedule B, the Appendix and Footnotes in the Code have been amended to take account of consequential changes to the FCA's DTRs and Listing Rules relating to the Audit Regulation and Directive and the FCA's requirement for reporting on viability.



**Financial Reporting Council**

8th Floor  
125 London Wall  
London  
EC2Y 5AS

+44 (0)20 7492 2300

[www.frc.org.uk](http://www.frc.org.uk)