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Transcript: Enhancing Justifiable Confidence in Audit

Financial Reporting Council

Welcome and Opening Remarks

Stephen Haddrill

Chief Executive Officer, Financial Reporting Council

I. Preamble

Welcome, ladies and gentlemen. I am Stephen Haddrill, Chief Executive of the FRC, which you probably already know. I am very pleased to see a good turnout this afternoon and I hope we can do justice to you by explaining some of the things that are going on in relation to the implementation of this piece of European legislation – and a rather complicated piece of European regulation in many respects. I am pleased that, working with the Department for Business, Innovation and Skills (BIS), we are getting through it and I hope that we can elucidate a bit further this afternoon where we have got to.

II. FRC Strategy

1. *Corporate Reporting*

It is my job to give you a little bit of background and then to hand over to those people who are dip-dyed in this subject and have been for the last year or so. Last week, the FRC published – and I do not know if many of you saw it – our strategy for the next three years. If I can just describe it briefly, in a nutshell, it comes down to three core pillars.

The first is to make sure that corporate reporting in the UK is absolutely world-class and takes advantage of all the changes to the corporate reporting framework that has been implemented in the UK over the last three to four years. They are really quite considerable, ranging from the introduction by the Government of the Strategic Review; European legislation in terms of non-financial reporting; and then our own work, through the Corporate Governance Code, on extended audit-committee reporting and the introduction of the longer-term viability statement etc, and, of course, the changes to the Auditing Standards as well. I am very conscious that there is a lot that people have had to digest, and I think companies have risen to that challenge fairly successfully. What we want to make sure is that they continue to do so and that, as a regulator, we help in that regard, rather than hinder. We are not here to catch you out but to help drive continuous improvement in achieving that goal.

2. *Quality of Audit*

The second pillar is very much around the quality of audit. Audit quality has definitely improved over the last few years in the UK, and I am particularly pleased by the way the firms have responded to some of the challenges that they have been set, particularly in relation to retendering. We are always a bit worried that that could lead to a race to the bottom, cutting prices and cutting quality at the same time. The evidence suggests that, at least in relation to the top end of the FTSE, that has not been happening, which is very good news. At the same time, we wanted to see the firms innovate, and I think the firms have innovated, particularly around their response to the new audit reporting standards. I am very pleased that investors have, themselves, felt that that is the case, and that it is not just my view – it is the investor view as well. That is good news because I think it calms all of us to think that we are on the track, and the right track is the one that investors want.

However, the journey is not at an end and we still, in our audit-monitoring work, find too many audits to be below the bar in terms of their quality, and we are setting ourselves, in the next strategy period, a goal of reducing the figure by which our audit inspections show audits to be not meeting the requirements of the standards. At the moment, for the FTSE 350, that is about 30% of the audits done, and we want to see that, by the end of our strategy period, down to

about 10%. We will address that, again, by working very closely with the firms, helping them understand our concerns and encouraging them to address the real causes of the problems – not tackling them on an audit-by-audit basis but tackling them across the firm and addressing some overall management issues in doing so.

III. Implementation of the Audit Regulation and Directive (ARD)

1. *Confidence in Audit*

As well as doing that, we will be implementing the ARD, and I think that speaks to the work around enhancing justifiable confidence in audit. We want to make sure that the steps that are taken really do command confidence amongst investors and the public at large. In many respects, I think the EU legislation gives us an opportunity to do that; particularly the work that the EU has done and we will be implementing around the standards. We will be hearing a bit more about that shortly, because a lot of the standards concern the independence of the auditor, and the auditor's freedom from influence from the company that they are auditing. That is very important to us, and we have the opportunity to implement those standards in such a way that that is reinforced in the UK, and certainly not weakened.

2. *Confidence in the Regulatory Regime*

Second, the legislation also gives us the opportunity to make sure that the public can have confidence in the regulatory regime as a whole. The FRC is the independent regulator, and the professional bodies have a very important role as regulators in their own right. The legislation asks us to separate out the responsibilities that we and the professional bodies have. In doing so, I think we achieve clarity about who does what. Presently, arrangements between us and the professional bodies are really quite convoluted, and I think we will emerge from the change with a greater sense that the word 'independent' in 'independent regulation' really means what it says, and that the professional bodies, themselves, in their territory, if you like, are also committed to raising standards in their membership.

3. *Dividing Lines*

What, then, is the dividing line between the two of us? It is, basically, the EU's definition of what a public-interest entity (PIE) is. A PIE is, basically, a listed company or one of quite a long list of companies in the financial services sector, including some relatively small insurance companies. We will be taking on responsibility for audit inspection across the totality of that list and will also be responsible for other matters in that area, including disciplinary matters. The professional bodies will be responsible for inspection and discipline etc outside that public interest area. I say 'outside' the public interest area, but that includes some really quite significant private companies, so it is a pretty serious business as well. I think we will, however, end up with a brighter line between our responsibility and that of the professional bodies, and also the clarity that the Government has created the FRC as the single competent authority, which will be delegating its powers wherever and whenever it can to the professional bodies and looking to them to raise standards [inaudible].

IV. Conclusion

I will now hand over to Marek Grabowski, who will summarise the main changes, particularly in the audit standards area, and then we will move on to a panel discussion. I hope that that has given you a bit of an introduction, and I will hand over to Marek.

Summary of Main Changes: What ARD Means for Audit and the UK

Marek Grabowski

Director, Audit Policy, FRC

I. Preamble

Good afternoon, everybody. I think maybe we should start by looking at what the drivers for change in this area are. Stephen has talked a bit about the ARD, which, of course, is a primary driver of the changes we are making. There are a number of others, however, and it is worth mentioning those.

II. Summary of Changes

1. *Review of Ethical Framework*

First of all, over a couple of years leading up to this point, the FRC had already begun a review of the ethical framework that applied, looking at feedback from the inspection and disciplinary processes that we go through, to see whether or not there were issues that we needed to address. Perhaps I can summarise our objective as being to modify the way in which the Ethical Standards were applied, so that they were seen more as a set of principles, the outcomes of which should be met, rather than a set of rules that one had to, if you like, dance between in order to get to the right place.

2. *Client Assets Standard*

In terms of the range of public interest assurance engagements that we cover, we already cover the Standards for Investment Reporting (SIRs). We cover other things, like reviews, and we have proposed a client assets standard, which has just been finalised. In relation to that, we have proposed that our Ethical Standards for auditors should cover that. We have, then, a range of public interest engagements for which we also provide the Ethical Standards, so we wanted to bring those together, make them more integrated and, in the process, reduce quite a large number of pages of standards-setting which was duplicated.

3. *International Standards*

Third, there has also been a significant amount of change introduced by the International Standards set by the International Auditing and Assurance Standards Board (IAASB). Much of that is, in truth, very similar to things that we have already introduced in the UK, so I think we will see the changes there, on the whole, as being slightly less significant. I am not saying in all cases, but the issue there has been to try to integrate what the IAASB has done with the ARD changes, which often touch the same places and are now touching our own existing requirements.

III. Ethical Standards

1. *Audit Regulation*

a. *Non-audit services for PIE audits*

I am going to start with the Ethical Standards, if I may, and to recognise that the Audit Regulation, as many of you will know already, covers PIEs, while the Audit Directive really covers the whole range of audits, including PIEs.

In terms of the Audit Regulation, probably the most significant changes are those relating to non-audit services for PIE audits. We are not proposing to mandate applying the restrictions on non-audit services from the Regulation to other companies. I will come on to talk about that further but that is the high-level message that I would like to pick up at this point.

Rather like a blacklist, what the Audit Regulation does, essentially, is to set out certain types of non-audit services that certain types of firm are not allowed to provide to audited entities or to parts of an audited entity's group. These are legal prohibitions; it is illegal, in that sense, and has a legal consequence if one was to do that. It is a very particular type of prohibition. The FRC is not extending that specific blacklist to other entities, but, as you will see, we are looking at other ways in which we have tried to bring together the thinking, so that we are on a principles basis.

There are some Member State options in the Regulation. Particularly around the blacklisted services, there are some possible derogations where some of those services do not have a material impact. On the whole, we think that is a good option. We are, therefore, proposing to take up those derogations, but using a very particular wording that makes it clear that what we see as immaterial in the context of ethics is not necessarily the same as quantitative thresholds for materiality for the financial statements. We have, therefore, avoided using 'immateriality' and are proposing to use 'clearly inconsequential' in this area.

b. Cap on fees for non-audit services

The other area in relation to non-audit services addressed by the Regulation is the cap on fees for non-audit services. You will know that there is a 70% cap worked out on a rolling-three-year average of the audit fee. We are not proposing to make that any more stringent in the UK. We have no option to make it less stringent. However, there are some less principle-based aspects of the cap mechanism. Whether intended or not, for example, if you follow exactly what the Regulation says technically, there would be a cessation of the measurement of the cap if you hit a year when the audit firm, for some reason, did not provide any non-audit services. We felt that there should be a more principle-based approach here, so we are proposing that a gap year will not 'reset the clock'.

The other less principle-based aspect of the cap is that it really only applies to the audit firm itself. Most stakeholders do not see a difference between an audit firm and its network firms; put differently, it is hard for them to see the distinction, in ethical terms, between something that a significant network firm does and what the individual audit firm does. Again, we believe that, to make the cap more principle-based, it should be applied on a network-wide basis.

The last point perhaps worth making here is not one that is in our power but, nonetheless, we are delighted that there is some clarification on what is not included in the cap measurement. There was a lot of concern early on that services that are required, effectively, to be provided to support regulators would not meet the definition of those things that are left out, which could be problematic because some of those services can be for very large amounts of fees relative to the audit fee, in some circumstances. There is, however, clarity now that those things that are required by a regulator who has delegated power of the Government to make those regulations would fall within the exemption for services required by law. Perhaps, finally, as a reminder, the reference to 'required by law' does not mean that it is specifically the statutory auditor that is required by law to perform the service; it is the service that is required by law.

2. Audit Directive

a. Independence requirements

Moving on to the Directive, we are now into the territory of looking at things that apply more generally in the context of audits. There are a number of changes. Some may or may not seem very significant in the UK context, but I would like to draw out a few points.

First, the independence requirements are not restricted to people employed by the audit firm, but are extended to all natural persons whose services are placed at the disposal or under the control of the firm, and who are involved in the audit. This would, then, include all secondees from the network firm, or other people perhaps seconded in from an external expert to perform the services, or provided by contract to provide those services. It seems, therefore, that, in

some areas, there are going to be some new people who are involved in audits that audit firms will need to think about in terms of those who have to comply with the ethical requirements.

b. Time limits around mergers

There are some specific provisions now dealing with a situation where audit firms merge and the ethical issues have to be addressed within a specific time limit. We would like to think that those time limits are not seen as the period in which one aims to complete these changeovers, but rather that there is haste to get there as soon as possible with the time limit seen as a backstop of a three month period. However, the more complex the merger the more complex these arrangements might be to address, and the more time may be needed to address them.

c. Restrictions on gifts and hospitality

These have been tied down to the point where only those things which an objective, reasonable and informed third party would consider them to be trivial or inconsequential are allowed.

d. Related individuals

Fourth, there are some detailed changes around the individuals whose position, or whose conditions or relationships, need to be taken into account as they might be seen to affect the independence of a firm. There is a slight increase in the reach of those requirements to additional types of individual family members. I do not necessarily need to go into detail, but some family members are now caught that would not have been caught by our existing rules. For example, some family members that live in the same home as an auditor, but who are not dependent on the auditor would, nonetheless, now be caught by the independence considerations. This is really the EU harmonising with some other legislation in other areas.

IV. Requirements for Listed Entities

1. Relief for Companies with Market Capitalisation of Less than £100 Million

One of the issues we had to address was one where we already have, in the UK, more stringent requirements for listed entities. The feedback we had on our earlier consultation suggested that, on the whole, there is support for keeping those and there would be some concern if they were lost in this process. We have, then, on the whole, proposed to continue them, although there are a couple of points perhaps worth mentioning here.

First, we are proposing some reliefs in relation to those requirements where the listed company itself has a market capitalisation below £100 million. The choice of that level of market capitalisation was intended to align with where we were expecting to do reviews of the audits of e.g. AIM companies. That, then, is a deregulatory proposal compared to where we are today.

2. Definition of 'Listed Companies'

We have also had representations that there are some circumstances where the definition of 'listed companies' – and our definition is really based on the International Standards definitions for ethics and auditing standards – can catch companies who have a technical listing but whose shares are not, in substance, listed or traded on a stock exchange and not freely exchangeable. They get caught up in a lot of regulations, when, in fact, for example, they might be structured purely for tax compliance reasons or some other good purpose. We have, then, clarified that where, in substance, there is no listing in terms of what the international definition would say, the more stringent requirements would not apply.

3. Other Requirements

There are, however, some other aspects of our more stringent requirements in the areas of reporting to those charged with governance, limits on the proportion of total fees from a single

client, and the rotation of partners, where we felt that not only should they be continued but that they could and probably should be applied to all PIEs. Generally speaking, we have not applied the other, more stringent requirements to other entities not already caught by them, but, in these three areas, consistency of approach seems to be the right answer.

V. Summary of Changes

1. *Provision of Tax Services on a Contingent Basis*

One driver of change is that there were a few other things that we have been learning from the ethics process as we have gone along. Some of you who have been watching the Ethical Standards for a while will remember that, back in 2010 originally, and again in 2011, we put out rules which were designed, effectively, to move away from a position where the auditor was providing tax services on a contingent basis. We have continued to see some rules-based mind-set in this area, because we linked those requirements or that prohibition to particular circumstances, and we have seen a number of people argue that they are not strictly within that scenario. We are, then, now proposing to make it absolutely clear and very principle-based. What we are trying to say is that, if you were to provide tax services on a contingent-fee basis, stakeholders applying the third party test, on the whole, would regard that as not consistent with the auditor's role.

2. *Chain of Command*

Another area where we have had a lot of difficulty in terms of interpretation is application of the concept of the 'chain of command', so, again, we have removed that. It is problematic in terms of people determining who is in the chain of command. Of course, the relevance of that term was that, if you were in the chain of command, certain of the ethical and independence requirements would apply to you. We have tried here to link this to the EU concept of a person in a position to influence the conduct or outcome of the audit. Instead, we have tried to give some clearer definitions including those individuals who are directly involved in the audit and those involved in supervisory, management or other oversight roles within the audit firm, in positions above the individuals who are directly involved in the audit. We hope that this will be easier to apply. There were a range of other possibilities considered, including whether we should simply say 'all partners in the firm', for example, but we felt that that was disproportionate.

3. *Group Audit Engagements*

The other point I would like to touch on here is how we dealt with group audit engagements and the application of prohibitions in the blacklist items. As I said earlier, we did not extend the blacklist beyond those that it directly applies to; however, we do think that, when you consider the independence of the individual audit firm, you should think about the independence of that firm as a stakeholder would, thinking about what the other network firms are doing and, indeed, what other third party firms who are involved in the audit are doing. With a view to being proportionate, we have proposed that the independence of a network firm involved in the audit should be judged by the auditor on the same basis as the firm – ie on the basis of our Ethical Standards. For other network firms not involved in the audit and for third party firms, we would expect the audit team to look to the current version at the time of the International Ethics Standards Board for Accountants (IESBA) Code – the international code in this area.

4. *Engagement of Former Partners*

Continuing with the other changes, there are also some new requirements in the Directive around accepting an engagement for an entity, or keeping an engagement, where a partner of a firm leaves and goes to join that entity. One of the things that we have introduced is a requirement parallel to that in relation to former partners – where, in effect, there is acceptance

of a new engagement when a former partner has already joined the (to be) audited entity. That is trying to be even-handed in terms of a principles-based approach.

5. *Advocacy*

There are some changes to the wording that we gave in an example around advocacy. I know that some people have raised that question with us. We are not, fundamentally, trying to change the game in this area; what we are trying to do is to keep to a more principled and judgmental approach. The example that had been given in relation to advocacy made it sound like that was the only circumstance in which you could be an advocate. We want people to look at the actual circumstances and make an appropriate judgment. For that reason, most of the guidance that was there is still very similar. We may get questions on that, but I wanted to touch on that.

6. *Structure and Scope of the Ethical Standard*

I touched on this earlier in that I said we wanted to ensure that we had as few pages of Ethical Standards as we possibly could. We now have a proposed single Ethical Standard, with the overarching principles. We have tried to make it clear that, where safeguards are needed to reduce the threat, this really is about meeting a reasonable and informed third party test. You should be thinking about it from the point of view of the user, in effect.

Ethical Standard – Provisions Available for Small Entities (ES-PASE)

The last point is the ES-PASE, which we are proposing to retain. We have not integrated it into the ES in the material that we have published, but it is our intention to integrate it into the one standard. Nonetheless, we are interested in your views on the way in which we are approaching it. You will probably tell us what you think the impact on firms and on the responsibilities of audit committees, etc, is.

7. *Auditing Standards*

There are three particular IAASB standards projects that have all come to fruition around the same time: Auditor Reporting, Other Information, and Disclosures. We have tried to wrap all of those up together and to provide a single implementation date that addresses those changes with the changes coming through the ARD. There is a lot of overlap in the topics touched upon.

I would say that, in summary, most of the changes that are coming through the ARD or through the IAASB standards are things that we have at least broadly introduced in the UK. Where there are differences, they tend to be differences in an element of scope of those items and so on. Here, I think the job was mostly to bring these together in a way that could be worked effectively but, on the other hand, did not lose anything that we already had. We had strong support in the earlier consultation that we should keep the things that we had already achieved in the UK; for example, the extended reporting that we had introduced in the auditor's report in the UK included scope and materiality of the audit. While those have not come through in the international standards or EU requirements, we have retained them and have tried to build them in, in a way that works.

We have introduced one additional item, which is reporting by exception on going concern related matters. This is a topic that you will know the FRC has been quite active on, following the Sharman inquiry, and a number of requirements were introduced last year for the Code companies sector. The introduction here of a reporting requirement, therefore, does not go beyond what we did for those companies but, for other companies' audits, we are asking the auditor to report by exception on their findings in relation to the appropriateness of the going concern basis of accounting and whether there were material uncertainties, without changing the scope of their work in any way.

8. *Other Information*

There are some differences in terms of what we have and what the International Standards have; in essence, however, we have already introduced the work effort that the auditor has to do that came through the International Standards. What the International Standards have done further is to introduce a reporting requirement which we had only applied, in essence, to Code companies, but the International Standard brings it in for all audits. It is also slightly different in wording. But that is in essence what is happening differently in this area.

There are, also, some legal requirements that come through in terms of the auditor reporting on consistency with the financial statements and, indeed, with the legal framework for the preparation of that non-financial information.

Reporting to those charged with governance and regulators is not something that we can change or have interfered with, but there are significant new requirements for PIE audits in terms of reporting to those charged with governance and to the appropriate regulators, whether in the financial sector or in the listed sector.

VI. Conclusion

That is all I had to say and I would now like to hand over to Ray King, who chairs our Audit and Assurance Council and who is going to chair the panel for us.

Panel Discussion

Ray King, Chair, Audit and Assurance Council, FRC

Thank you, Marek. Good afternoon, everybody, and I add my own welcome. This is a very important part of the outreach for the consultation process on the ARD and the related changes, so we are very keen to get your input this afternoon. I am a non-executive director of the FRC but I also chair a number of audit committees in corporates, so I see both sides of the fence, as it were.

In terms of the panel this afternoon, we want to have a period of discussion to get our thoughts going, and then we will open up the discussion to the audience and allow you to make your own individual contributions. If I could introduce the panel first of all, you have met Marek, who is the Director of Audit Policy. Beside him, we have Melanie McLaren, who is the Executive Director of Codes and Standards on the FRC Board. We then have Hywel Ball, who is Head of Assurance at Ernst & Young (EY) in the UK and who has also been chairman of Scotland for EY in the past. Then we have Rodger Hughes, who was a partner at PWC for 37 years and, like me, is now a serial non-exec.

We want to help get the discussion going, but what I think would be useful, just to get our grey matter working, is to get some thoughts from a couple of practitioners. I will invite Hywel first to comment on his initial thoughts on the ARD and the related changes of ethics – not going too deeply but just key, top-of-head thoughts. I will then invite Rodger to comment, from an audit committee chair perspective, and we will move on from there.

Hywel Ball, Managing Partner, Assurance, UK & Ireland, EY

Thank you. I have two headline thoughts covering what Marek has covered today, and then a few words on the audit market in general. There is lots of detail in the guidance and consultation that has come out, although I cannot confess to have read everything. Our guys are working through it, so what I am going to say are probably quite personal reflections. We welcome the fact that the FRC is not going further than the EU in terms of non-audit services, but there is still a lot of ambiguity. I understand that that is the EU rule and I am not professing to say that that was written with that amount of clarity, but there are still a number of areas there that I think will cause audit committees issues as we go through that debate.

One in particular is what is required by law, because I think that hits some of the classic areas that auditors in the past have thought about doing; for example, the SIRs when you are looking at working capital, and a lot of Class 1 actions, which is traditionally an area that companies have found of value when the auditor has done that.

The other area that we were a little concerned about is whether that also included regulation in third party countries. A big area there could be the US with Sarbanes-Oxley (SOX) and whether that gets caught by the cap. In terms of the 70% cap, audit committees will have to think about how they monitor and measure that. I recognise there is a responsibility on the audit firms to share that information, but I think the audit committees will also need to think about how they do that on the independence side.

The other aspect which comes out when you look more at the non-audit services is that this will start impacting accounts fairly shortly, from 1 July next year [inaudible], so companies need to start thinking now about their professional services procurement strategy, especially if they have not already done their audit tender, and they have to think about the timing of all those issues coming together. There is a layer in there of non-audit restrictions on top of the time they will have to do to tender to the market.

That is a nice segue into the market itself. This year alone, we expect to see about a quarter of the FTSE 100 to have tendered. Since the regulation was agreed, that means that we are about halfway through the game for the FTSE 100. Independence has been a practical issue, and there are a couple of more practical issues than that. For a lot of companies, the audit firms have found it a lot trickier than they originally thought to make sure that independence comes through in time in advance of the tender. I think clarity is needed on when independence needs to be established before appointment, and what that means. It is quite a grey area in reality in terms of when you need to be clean before you start your work. That has been quite a difficult practical issue for firms. The FTSE 350 is behind, generally speaking, because of the volume of tenders. We are doing some survey work at the moment and will issue after Christmas, which has definitely a flavour that a lot of the 350 have yet to really think through their strategy in terms of tendering and in terms of how they select and procure their non-audit services. Hopefully, this is a very timely wake-up call for those businesses that have yet to think their way through what they are going to do over the next period.

Ray King

Rodger, as a serial audit committee chair, what are your thoughts?

Rodger Hughes

Speaking on behalf of audit committee chairmen, the general attitude of audit committee members and, indeed, non-executive directors will be, 'We are perfectly capable of making our own judgments. We do not need bureaucrats in Brussels to tell us what to do.' That is the basic starting premise.

Having said that, their next question would be: 'We understand Brussels has rules, so what does it mean for us?' I think they will look at two things: first, 'What does it mean in terms of any constraints in terms of what we do?' They will be concerned about approval of non-audit services and what that means in terms of what they do, either for the specific services or the overall fees and appointment of auditors and pre-appointment work: 'Does this constrain our choice because the finance director will be using this other firm for that and we cannot use them.' They will be concerned about that.

Then they will be concerned about: 'We have to report all this stuff now. If we commission a significant piece of non-audit work, we have to write to our shareholders and explain ourselves.' There will be that element of it.

I am intrigued as to what sectorial competence is in terms of composition of the audit committee. There is an interesting definitional thing there.

I have an issue with one very specific point, which is that I do not think that audit committees should negotiate fees. I think we are stuck with it, but it is wrong because it is an executive function that you are asking non-executive directors to perform, so it mitigates against what you are trying to achieve. In terms of the interpretation of how, in practice, audit committees can deal with that, what I think they will do is seek to delegate the actual negotiation and say it is being done on their behalf

Ray King

Is this an element of too much being expected of audit committees generally

Rodger Hughes

No, I do wonder if it is a mistake though. I would be interested to go back to see if it was written in French and wrongly translated. In a subsequent paragraph, it refers to 'approval' rather than 'negotiation.' You can negotiate but you can approve around negotiation, so the wording needs editing in the document. .

I would make two comments: first, as a professional of many years, I find it depressing that it needs 123 pages of Ethical Standards to tell a professional accountant how they should behave. I just find that a bit long and repetitive, and my challenge to the FRC is: can you get it down to 99 pages without reducing the essence.

My final comment, having said all of that – and the FRC had no idea of my views when I came here – is that I think the FRC has done an excellent job on this. I really do. I think it has been principles-based and proportionate, but, most important of all, it has listened. There was a proper consultation process back in December to March, and I think it has resisted a temptation that many other regulators would have seized – let me put it that way.

Ray King

I have a lot of personal admiration for the amount of FRC effort. I took over chairing the Audit and Assurance Council in September and, at my first meeting, there was something like 1,100 pages of work, so it does reflect the outcome of a really long process of extensive consultation.

Hywel, coming back to you for a moment, if I may, in terms of the requirements on PIEs, this now goes into non-listed companies in the shape of insurance companies and banks. In terms of the implications for those companies and their auditors, there are going to be things coming at them that they have not seen before.

Hywel Ball

I think that is going to be one of the most difficult areas for us to navigate under the current scenario, because some of those guys are relatively small beasts and it will be a big shock to the system for all concerned in terms of how –

Ray King

Auditors and auditee.

Hywel Ball

Yes, and how we go into these guys, as well as the extent of rigour that they will now need to apply when making appointments. I think it also has interesting implications where they are subsidiaries of larger overseas financial services companies and the rotation of auditors around. While it is not affecting group audit, it will start challenging the efficacy and efficiency of the overall audit too. On many layers, that extension is going to be significant.

Ray King

Melanie, from an FRC perspective, how do you expect the world to change within the FRC in terms of how we manage regulations as a single competent authority and the fact that we have a lot more audit firms involved in the Audit Quality Review (AQR) process? What are the big changes for the FRC as a result of all of this?

Melanie McLaren

As you have already touched on, as the single competent authority there are certain PIE-related tasks that we will not be able to delegate and which we currently rely on professional bodies to deal with, so we are still working it through. It does mean, however, that, in terms of doing a quality review, for example, there will be something between 50 and 60 firms that we will need to inspect, whereas, currently, we inspect and report on about 10. That does have quite a significant impact and we need to make sure that we do that in a proper and proportionate way. The result is that we are currently reviewing eight or nine firms that we report on at least tri-annually and there will be some work here that we are not going to want to report on reviews on 50 firms, where we are just looking at potentially one PIE audit. That said, we very much want to maintain competition and quality in that PIE audit space, so we do not want to drive firms out just by virtue of the fact that they are going to be subject to FRC inspection and monitoring. We have quite a lot of change, potentially, in that monitoring regime.

Perhaps I should add that this is still a consultation. Although we did an in-principle consultation, there is still an opportunity and we would very much like feedback about whether or not we have got it right. We want to make sure that we have a regime that is as clear as we can make it. We cannot interpret European law, as much as I, in particular, would like to interpret some of the rules. With that caveat, we do want to try to make sure that we have a clear regime that particularly investors, who are the key customers here, understand and can have confidence in. We would like to make it clear and understandable, so we have put quite a lot of emphasis, as Marek said, on trying to reiterate what the principles are, and then, having set out the principles, explain that, in some areas, there are matters of law and, therefore, rule, that fill the principle in. We have been particularly welcoming feedback on whether we have got those principles right.

The other thing I would add is that the FRC must also highlight potentially one of the best tools that we have in our codes and standards toolbox, which is the Corporate Governance Code. Marek's has placed square emphasis on the Auditing Standards, but, as Rodger has said, we also have a long tradition of audit committees exercising judgment, and we want to retain as much of that as we can, which is why we are seeking to make minimum changes to the Corporate Governance Code.

Ray King

As an audit committee chair, it is near and dear to one's heart, because I am sure that not everybody will recognise that there has been significant layering of regulation in one form or another over the years, and we are now aiming to try to pause. I think our word now is 'improvement' going forward. We have done a lot of stuff and we want to be able to do is to try to make sure that time and effort is put into getting the best out of what has already been done.

Melanie McLaren

Yes, it is about embedding and guiding through these changes and the recent changes.

Ray King

Do you think we will be able to keep a no change commitment afloat?

Melanie McLaren

Never say 'never', but it is, in part, about mind-set, and we do already have a rebuttable presumption that we do not make a change unless we need to make a change. I think it is about recognising that any change incurs time, effort and, therefore, cost on business. As Marek has highlighted, however, we have tried to be very thoughtful about the way we are making these changes. When it is a matter of law, we have no option, when it is a matter of retaining existing confidence and not turning back the clock, the feedback we had from the in-principle consultation was that we should hold fast and not change. Therefore, we just need to be very thoughtful about anything in addition.

Ray King

You mentioned cost of the FRC. We have had a good impact assessment and maybe an auditor's assessment of cost from your neck of the woods.

Hywel Ball

There are two things that have impacted us: first, price. We have talked about price. Price is a visible component because you can see what the market is saying. Broadly, I would agree that the market has held its nerve in the FTSE 100, to a degree, and pricing is flat or maybe going up if you have particular angle about an issue that that company is facing and that you can drive purely from a sales perspective which is great compared to the history in the Netherlands, where they have forced rotation on a much shorter timescale and I would say that, on average, the price went down about 20-25%. On the one side, then, we have price, which I think is a good news story, to a degree. The slight unknown that we have at the moment and which we are walking into is the change for the audit firms in terms of their business model. The business model change comes across as the cost of pitching and, generally speaking, we have not really industrialised pitching as much as our clients might think. They are quite bespoke and, especially if you want to win that audit, you have to make it bespoke; otherwise, the client sees it. They are, then, quite expensive activities to tender.

Then you have the slightly unknown, which is the transition cost, and that has yet to be really planned through. We had the FRC meeting at the end of last week and, to date, the view from the inspections of first year audits has been okay, but we are at the very start. We are only now going in. If you think of all these tenders happening now, they will not get done for another 18 months or two years. That whole wrapping up of transition costs, on top of tendering costs, is something that we will try to mitigate through efficiencies. We have to recognise the quality challenge but, ultimately, it is going to be shared across the market, and that is the price point we have yet to see coming through commercially.

Ray King

Regulation, of course, is a reality here. It is important and we will implement thoroughly, but what about the tone from the top? At the end of the day, in terms of how audit firms are run and how corporates operate, the tone from the top seems to be the essential first building block, really, to make sure that the whole system works properly.

Hywel Ball

The tone from the top in the audit firm is absolutely vital in terms of quality, in terms of messaging to all departments if we have these conflicting demands of maintaining business versus maintaining the quality versus the total potential cost recovery. That is a difficult leadership challenge in terms of making sure that you still maintain that tone at the top. The most important thing, however, is quality.

The other interesting point, if I can go slightly off at a tangent, is that the culture question is one that is coming up all the time when you go into a tendering audit: how can you, as auditors – because you are around the organisation and seeing a lot more – help us with the tone that

the top of the board is setting for reputation and culture? Increasingly, that is a challenge that you, as audit-committee chairs, are getting what is a real benefit from the tender activity is the extent of innovation that the competition is driving. Not only that: it is making it crystal-clear to us in the profession that demands are broadening, which is changing some of the challenges that we need to look forward to the future in the audit profession and how we define the audit and accounting professions in the 21st century.

Ray King

Marek, I have left you alone so far. . We did this initial consultation at the end of last year or thereabouts. Has anything changed significantly in terms of perception? Have significant things been revisited and has the view on the outcome of that changed significantly, or is it very much a carry-through with further stuff added from the end of last year? That first stage was very valuable, was it not?

Marek Grabowski

It was. I would say it is probably the latter: a carry-through. Not much changed, and the reason is that we had a very open consultation – or at least we tried to make it a very open consultation. We laid out a number of options – the blacklist, for example. We laid out an alternative at the other end of the spectrum in terms of a whitelist. We explained how those would work, in effect, and what the pluses and minuses would be. We have listened to responses but we were not starting from a place where we were anchored on a major change in some areas that we have now moved away from.

Ray King

In terms of the international scene, which is very much your responsibility in the FRC, where are we now with regard to auditing standards in the international context for changes that are coming through now? Where does this place us in terms of the UK's position?

Marek Grabowski

I said a number of times that, largely, many of the things that have been changed, at least in principle, have already been changed in the UK. You could think of that as the international side catching up. What it has enabled us to do, however, is to lead the way, for some of the more difficult things, like the Auditor Reporting, which has probably helped the international scene to move forward more quickly. It has, however, also put us in a position where we can get to where we would really like to be, which is that we can align more fully with the International Standards. In this proposal, we are aligning the one remaining standard from the old suite – 700, the Auditor Reporting standard – with the international standard, and we are adopting a new standard – ISA 701 – which deals with extended auditing. I would say that it puts us in a position where we are more aligned internationally.

Ray King

I think we will now open things up for the audience to make some comments and ask some questions. We have the intelligentsia here from the FRC, and everybody else will chip in as appropriate.

Cathryn Cearns

This may be pleading dreadful ignorance, particularly as I have not had a chance to go through the BIS consultation that has now come out, but I did wonder whether the Ethical Standards are the only place where the prohibition on non-audit services and the cap ought to be, in the sense that the regulation applies to auditors, of course, but it also applies to the companies themselves. Therefore, if there was a breach – for example, if a service was provided that should not have been provided, or the cap was breached – and a sanction fell on the company

or its directors, as well as the auditors, should the audit committee be able to access the rules around these in a different place and be able to see them slightly more transparently? It is a slightly off-target question for the FRC, in a way, because you have been asked to deal with what auditors should do, but I do wonder whether audit committees ought to have more direct guidance about rules and requirements, they would be sanctioned if nothing went wrong with them.

Melanie McLaren

Last week, BIS issued their consultation dealing with the legal aspects; the change in the law in connection with the ARD. We, as you would expect, have been working quite closely with them, and with the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), so there are four consultations that are available in this space currently. It will be for BIS to deal with the directors and the relevant rules there. We do expect that, as the single competent authority, they would write into some of their regulation that we would have a role to play in terms of exercising some of the key judgments.

There are some aspects of the rules – for example, judging whether you are a PIE and when you become a PIE for the FRC, not just in engaging with auditors, but also engaging with the companies in some of those aspects. The legal implementation, however, is going to require a lot of detailed work. BIS have given some insight last week on some of the key regulations, but they do recognise that they have quite a lot of work to do between now and March time, when they have to lay regulations in Parliament.

Ray King

From a FRC point of view, what is our timescale now marching forward from 11 or 12 December, when the consultation period ends?

Marek Grabowski

Our plan is to publish our final material in April time, which would enable a small run-in to the implementation date of 16 June. These rules will apply to audits for periods commencing after that date. If you are a calendar year-end company, 2017 is your first year. If you happen to be a June year-end, it is going to be the period beginning 1 July 2016. Nonetheless, in all of those cases, our rules would be in place, and we fully expect BIS's rules will be in place too before those dates.

Melanie McLaren

It is perhaps rather more than a legal nicety to say that we do need Government to pass the regulations that we are standard setting in this space, before we can turn the standards on. We are aiming for about the time.

Andrew Carpenter, Association of British Insurers

I am asking about PIEs and the extension beyond listed companies. I understood that you say that some requirements of the ARD are quite stronger for listed, because that preserves the apparatus we currently have. Perhaps that is a separate matter, but that is not what I had in mind in the question. You said that there were three respects to the extension of those to other PIEs and I wondered if you could expand on that. From the perspective of looking down from a large listed company whose essence is external financing to a mutual, which has no external financing and is heavily regulated through the PRA and through Solvency II?, this seems a surprising move to that further burden, and I wondered if you could expand on that.

Marek Grabowski

I will go first and try to give you an explanation. The three areas that we are looking at are ones that support the independence of the auditor, and that will be very important to those

regulators that you mentioned. Those areas should not really put much additional burden upon the entity. Let me just run through them very briefly in each case.

Perhaps the one that has some potential to have a real change is the partner rotation requirements. For listed companies, we have a five-year rotation period. If you went purely by the regulation, it would be a seven-year rotation period so it is a little shorter. On the other hand, the requirements that we have for five years already have an allowance to move up to seven years in exceptional circumstances. From the point of view of transition, there may be exceptional circumstances in some cases, and maybe those rules would not kick on. On the other hand, consistency with the expectations of what is good for a PIE audit would be to have the same rules across the PIE audits area.

The other requirements are really internal reporting requirements, which ensure that, effectively, the audit committee is well informed about the activities and the independence of the auditor. Those things are not putting an additional burden in terms of oversight – that oversight responsibility was really created by the regulation – but enabling the entity's audit committee, for example, to do a better job. That is the way I would explain our rationale, at least.

Richard Gillin, Deloitte

I was just wondering about the effective date of one or two of the requirements; in particular, the thing that is causing us and audit committees a lot of thought is the application of the 70% cap. You asked a question in your consultation paper which, broadly speaking, if you take calendar years, means 'Do we apply it to 2017, averaging '16, '15 and '14 or do we wait and apply it to 2020, averaging '17, '18 and '19?' Unless I missed it, I could not see an effective date in the transition section in the standard, so I was a little confused. Some certainty would help a lot in the market.

Marek Grabowski

I will comment briefly. The BIS consultation that has just been referred to talks about the cap not coming into play until three years down the line, so that is, as I understand it now, where we will be. That is, essentially, what I think will happen across Europe, unless individual member states choose to do something more stringent. In terms of the basic interpretation of the way the cap works, because there will not be three years' average date until three years after the transition date, it is, effectively, a transition period.

Ray King

If you take the case of a December year-end company, it would be the averaging of '17, '18 and '19 to apply to 2020.

Henry Irving, ICAEW

Some of the new rules and legislation which is coming in could be seen as being pro-competition and choice – for example, mandatory rotation and the non-audit services cap – and some could be seen to be perhaps, in its overall effect, more concentrated on the market – for example, the extended inspection of PIEs etc. What does improved competition and choice look like, and what could the FRC be doing to make sure that that is achieved?

Melanie McLaren

First and foremost, I would say that the FRC were focused on audit quality. We do believe that competition helps build and drive innovation, and it also helps support quality, but we are not approaching this from a competition mandate per se. That said, we do not want to drive good-quality auditors out of the market, which is why we need to be very thoughtful and quite proportionate in the way that we do tackle the smaller PIEs and make sure that we do develop together a proportionate but effective regulatory regime.

Ray King

Are these the regulated non-listed PIEs?

Melanie McLaren

Yes, those in particular. It is the case that in the Code requirement for re-tendering by FTSE 350s, we have not really seen much outside of the current big four, but that does not mean that that has to be the case. We move to an extended group of PIEs. I think the experience of the FTSE 350 will not necessarily hold across the rest of the market.

Ray King

Hywel, do you have any views from a market perspective?

Hywel Ball

Even within the large firms that are already regulated, we have to make sure that being an auditor remains an attractive job. We were talking earlier about the pressure that results when there is retendering and I think the increased public disclosure that is in the consultation is going to increase the Bunsen burner feeling for those audit partners. I am, then, somewhat concerned about losing good auditors who just do not want to do this.

The second point on competition is really interesting, because there is an aspect in the market that some clients are deciding that they want XYZ to be the tax provider. If you look at the top end of the market, they might decide that they are not going to ask that firm to do the tender, but to ask the other two firms. You might be down to a choice of two. If you layer on a potential independence issue cropping up, unforeseen for one of those, you are potentially left with a sole choice. That is an exaggeration to make the point, but certainly the first thing that the company needs to do is to work out its professional-services strategy and where it wants to procure.

In reality, for us as service providers, our commercial intent as a multiservice practice does not really help. I think it is very difficult for us to say to the company, 'We do not want to do the audit because we would rather do this more lucrative work.' Our public interest and our role to society is overarching those commercial intents and, as a rule, we are not having those conversations. We might say to a company, especially recently, 'You are running the tender right in the middle of our busy season, and I am not going to do it because you are asking for the tender to be done in January, February and March. It is just putting too much pressure on things.' We are trying to negotiate and to talk to the audit committee chairs, especially to be realistic about when they run the tenders and to think about other challenges that the firm might have.

Ray King

May I pick up that AQR point, if I may? Rodger, going forward now, there is an expectation that audit committees and, therefore, companies will disclose matters relating to the outcome of the AQR process or the Corporate Reporting Review (CRR) process in their annual report. Do you have any perspectives on that?

Rodger Hughes

I think audit committees are much more engaged in terms of the quality of the audit. I think that everything going on to date has done that. Having to comment on the effectiveness of the audit has made people think, 'How do you sort out the effectiveness of the audit?' It is quite difficult for the audit committee to do this but the requirement has had a good impact but that has had a good impact. People understand: 'It is nice and cosy but we are going to have to think about putting it out to tender at some point. What should our policy be?' That is already there. It is part of my duties to, every now and then, make sure that this is tested in

the market. It is part of my duties to try, as best as I can, to work out whether these guys and gals are doing an effective audit or not. We just see the surface of their work.

There is pressure, and Hywel alluded earlier to pressure to improve the quality of audit. I think a lot of the work that is being done on data analytics is very good at the moment. I have seen that on two audit committees now coming through in terms of stuff, so audit committees are picking up on that and saying, 'We kind of like this stuff – we will have some more of that, please.' I think there is some good stuff going on there, and that knocks on into competition, because the more audit committees – and they are – are getting engaged in terms of, 'What is this audit all about?' the more they are open to, 'How do these guys do it compared to those guys?' There is, actually, a very welcome pressure in terms of the quality of the audit. I agree with Hywel that I think fees will go up eventually, because there is an extra cost being put in. It is no longer the case that as a recurring stream of income you can accept lower margins. I chaired committees at PWC 10 years ago deciding whether or not we wanted an audit, so I am fully aware of what goes on in terms of the economics. You have to accept the reality that extra cost is being put in the system. At some point, it will come out somewhere I'm afraid.

Hywel Ball

Just picking up on the analytics point, one of the benefits of competition in the market has been to drive innovation, and analytics has been an area that all the firms have really grasped and said, 'This is something we can really do.' Then there is a dialogue to have with the regulators to ensure that we optimise the standards in a way that we can maximise the efficiency and effectiveness of using these new analytics.

Ray King

Do you mean the Auditing Standards?

Hywel Ball

Yes, so that we can sit back and ask, 'what would a standard look like that would increase quality, improve efficiency and deliver more insight?' That is a debate that –

Ray King

That recognises a topic area –

Melanie McLaren

In our '16-'19 strategy period, very early on we expect to be having a dialogue about the use of technological innovation and the impacts on standards, so that we can ensure that, in the UK, we drive them forward in a sensible and proportionate way. It may, yet again, be one of those areas where we have to play another pathfinder role.

Hywel Ball

I genuinely believe that the UK can be a leader for the global auditing and accounting profession because there are some structural issues that the Americans are doing because of SOX. Also, because we are going through this innovation in advance of most of the other major European pieces, driven by the speed of competition, we are really well placed to drive that transformation.

Rodger Hughes

Ray, I am conscious that I didn't answer your question about AQRs. In terms of AQRs audit committees are very happy to report "we had an AQR". As I understand it, the reporting is more a concern for the audit firms.

Marian Williams, FRC

I am not being strident, Ray, but a question, maybe, for Melanie and Hywel, if I can: how will this affect confidence in audit? Essentially, that is what we are trying to build on here. How do you think the ARD will affect that?

Hywel Ball

I think that, over the last 10 years or so, audit committees have really got on top of non-audit services and have self-regulated and self-managed that. The previous largesse, where the ratios were 2:1 or 3:1, has gone, and the average now is about 31% for the FTSE 100. That regulation is probably not needed, because audit committees have dealt with that, so I do not think that that will fundamentally change confidence in the market.

I do think changing the auditor will increase the confidence, and I say that because the other side of the coin that we experienced is that, when one tenders the audit, one of the things that the company is very worried about is, 'What are you going to say about accounting policies? Are you going to be happy with the state of the accounting quality that you have?' That is one of the areas that they really challenge everyone on. I would not say it is an opinion shop but it is a good hard look at where you are going with your accounting qualities.

The reverse of that coin is that, when you come out and have another firm of auditors sign off on your accounting quality, that is going to increase confidence in the market, in that that organisation has a sound basis and has had two separate firms look at its accounting quality in detail.' I think that will help confidence, certainly from the investor community.

Melanie McLaren

From an FRC point of view, it comes back to what Stephen said about the strategy. It is about time we focused on embedding change, having that 'Let's have an improvement philosophy', so that we rebalance the conversation and that we are talking with more confidence and a greater degree of boldness about the quality that we see in the UK market from a position of strength, underpinned by some quite hard-edged principles and standards that tackle some of the perception of independence, and then driving forward continuous improvement under an expectation that we see that coming through in the quality of the audits that we monitor. We have some aspirations for the whole of the market in that regard.

Julia Penny, SWAT UK and ICAEW

As has already been said, the ethics goes to some considerable number of pages, and it is not done as a straightforward 'mark up the changes because of the nature of those changes.' I am sure that the large firms will have no difficulty in working through, in detail, and seeing what those changes are and how to implement them from a systems point of view, but Melanie has already said that 50-60 firms are going to be covered by the PIE side of things, when only 10 were previously. There are two sides to this: first, how do you think those firms – and, if you are incorporating them into that as well – are going to cope with reading the complexity and picking out the changes? The challenge to the FRC in the final drafting is, when doing those things, to build up from the simple 'Think small first', so that firms can easily see how to implement the changes, have you thought about that style and how you are going to end up with a final presentation?

Melanie McLaren

It is a point well made. Perhaps I should just say that we are doing a series of roadshows which we are organising largely through the professional bodies to get to some of those smaller practitioners to make sure that they understand the nature of this change, and to engage, because this is a consultation. If you have particular views or perspectives about that, we would love to hear about them.

That said, the Ethical Standard starts with hard-edged principles, so we think that that is the right way to go. Then it moves to, 'These are the matters of law that you need to look at to

support those hard-edged principles.’ It is, then, a matter of fact that, if you are auditing even one PIE, you need to have read what the law says. As a professional, there is no shirking from that. It is those overarching, hard-edged principles that we hope will help land some of the messages, so if there are particular views about how we can make those harder and sharper, we would love to hear them.

Marek Grabowski

To add one other very practical point, we have tried very hard to cross-refer exactly where each paragraph came from in the old system or from the new material. If you look at each paragraph, you will see a source reference, which should at least be some help. I appreciate it is a lot of material and, as you say, a lot of change.

Ray King

If there are no further questions, could I thank you for coming today? It has been great to have such a big audience. This is an important part of our consultation process. We hope that the team has explained the background to the changes in a way that you have found helpful. We very much look forward to your input. If you want to send us written input in response to the consultation by early December, that would be taken very seriously. Thank you very much for coming.