ICAEW REPRESENTATION
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Enhancing Confidence in Audit

ICAEW welcomes the opportunity to comment on the *Enhancing Confidence in Audit* published by FRC on 26 October 2015, a copy of which is available from this link.

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1. In this response we initially include our major points. Then for the each of the categories draft ethical standards and draft auditing standards we include general comments, followed by responses to specific questions and then detailed points. Finally we include our responses to specific questions on the draft corporate governance code and guidance.

MAJOR POINTS

2. We welcome the opportunity to comment on this extensive consultation on the application of complex technical requirements to already complex standards and codes. We are pleased that the focus of change has largely been on implementing the EU Audit Regulation and Directive (ARD), rather than some of the less evidence-based suggestions in the December 2014 consultation.

3. The scale of the proposed changes will have undoubtedly required much effort and co-ordination. However, to be fit for purpose, standards need to be robust, proportional, understandable and workable. We do not believe that all of these attributes have been achieved. The approach of reproducing clauses from the EU Regulation verbatim and en-bloc, with either no explanation, or explanations which are located away from the requirement, and/or do not actually explain the EU-derived wording, is likely to result in requirements being forgotten or misunderstood. The direct transposition has also not been completed on a consistent basis. Some responsibility for interpretation of EU requirements must fall with the FRC as the standard setter. Many users (particularly smaller practitioners) will not have the time and resource to distil the labyrinthine document that the Ethical Standard (ES) in particular has become, into directly applicable requirements. A ‘track changes’ comparison to the existing standards might have been useful.

4. We understand that the FRC has been advised that a copy-out approach to the ARD is the only acceptable approach. While having directly applicable law also included in the standards is useful, we do not believe that anyone can have intended that the combination of these requirements with existing standards should result in there being three definitions of Key Audit Matters in ISAs, for example. By maintaining all three the FRC has generated a layer of complexity without corresponding value for investors. Similarly, by copying out the requirements from the Regulation relating to PIEs without further explanation, the level of complexity introduced is indefensible on any grounds, least of all audit quality.

5. We argued in our response to the December 2014 FRC consultation paper that as AIM companies were not PIEs within the ARD definition, and given the different nature of AIM entities, it was unnecessary to apply requirements to them over and above those for other non-PIE audits. While we welcome FRC’s efforts to allow relief for smaller AIM entities, the application of additional rules is ‘gold plating’, and unnecessary given the robustness of the principles-based approach with appropriate monitoring and discipline. If adherence to the principles over and above the rules is truly intended, as is stated in the revised standard, then it is important to fully commit to that approach. However, we note that some respondents to the December 2014 consultation did not favour removing additional rules for AIM audits. That notwithstanding, having additional rules for ‘AIM over £100m market cap’ companies adds to the complication, especially for those businesses with market values around the £100m cap. We cannot see that this added complexity will achieve anything for any stakeholder, other than extra costs.

6. We note that there are some areas where the changes proposed have gone beyond those specified by the ARD. In particular, removing the words ‘before an appeals tribunal or court’ in paragraph 5.113 when discussing tax advocacy. We understand that it was intended to clarify a misconception that more general advocacy is acceptable, while trying to make the requirement more principles based. However, the feedback we have received from members suggests that the remaining wording is being read to indicate a greater degree of absolute prohibition than is intended. If there is an issue with understanding a requirement, there must be better ways to explain it than to appear to change it fundamentally. A strict interpretation

will also lead to increased cost to businesses who need to engage a second firm of accountants to deal with its tax affairs resulting in duplication of effort as they will have to gain a understanding of the clients business and accounts. The audited entity's staff will also duplicate time spent with each firm. Additional costs to business could easily exceed £100m (we comment in more detail below). We do not see that there will be any quantifiable benefits and there is no evidence of this issue damaging audit quality in the past.

7. We also fail to see the evidence to support the complete prohibition of contingency fees on tax services for all audits. We understand that the move may have been based on a review of inspections that highlighted the tendency to adopt a rules based approach. If this is the case, then that raises questions around enforcement of the existing requirement rather than suggesting a need to change it. As noted above, there are costs associated with engaging a different firm, for those businesses that are attracted by contingent fee arrangements.

8. Including the Ethical Standard for Reporting Accountants (ESRA) within the ES will overcomplicate the standard for most readers. Many users will find the ESRA requirement irrelevant for their purposes. It is also notable and conspicuous that PASE has not been included with the revised standard, being more relevant to a greater number of expected users than ESRA. This suggests that the primary focus of the ES is large entities and does not fully consider the needs of small entities. It would be useful to create an electronic version of the standard which allows a user to filter the sections most relevant to them, in a similar vein to that which we understand is currently being worked on by IESBA.

9. Given the likelihood that users will find the interpretation and practical application of this standard challenging due consideration should be given to the establishment of a confidential FRC advice helpline. If FRC fails to implement this, ICAEW and the professional bodies will inevitably need to have to give our own interpretations via our advisory service helplines and regulatory mechanisms. It would be helpful to restore the interaction that we used to have with the APB on queries raised to avoid multiple interpretations: professional bodies issuing interpretations that the standard setter itself may not agree with is not a desirable outcome.

GENERAL POINTS ON DRAFT ETHICAL STANDARDS

10. Overall we support a presumption of minimum regulation, with strong evidence being required to engage in 'gold plating'. It is not clear to us from the consultation document that this is the case however we do welcome the retention of a 'black list' approach.

11. In amending the existing guidance FRC has taken the approach of reproducing clauses from the EU Regulation verbatim and en-bloc with either no explanation, or explanations which are located away from the requirement (see paragraph 40 below on Non Audit Services (NAS) for example), and/or do not actually explain the EU-derived wording. This is likely to result in requirements being forgotten or misunderstood. Two examples of the problem are:

    - paragraph 4.49 of the Ethical Standard, which seems to imply a need for positive quality performance incentives in remuneration policy, rather than simply not being incentivised on selling NAS, which is what the explanatory paragraphs still discuss;

    - paragraph 5.33 (making judgements and taking decisions that are properly the responsibility of management), which appears inconsistent with paragraph 5.56(b) (playing any part in management or decision making).

12. The approach to transposing the Directive is not always consistent and there does not always appear to be a clear rationale distinguishing situations of verbatim reproduction and those where the approach appears to be adopt and modify. For example, in paragraph 5.57 'immaterial' has been struck out and replaced by 'clearly inconsequential' and it is unclear why FRC feel that the use of immaterial is inappropriate, or how these terms are supposed to interact, both with each other, and a third judgemental concept of triviality. Materiality is a

useful concept as it has quantitative and qualitative characteristics and there should be a good reason for deviation from tried, tested and widely understood concepts.

13. Furthermore, some sections are very long (for example Part B paragraphs 1.1 to 1.26) – if they cannot be reduced, more subheadings would be useful to assist navigation. Para 1.26 is particularly broad with an unhelpful and unexplained use of 'and the like'. The numbering convention is not always helpful.

14. The introduction section is very long and it is not always clear how it interacts with the rest of the standard: what prevails in the event of a conflict? There also appears to be surplus/repetitive text, for example, we are not convinced that paragraphs I5-I9 require quite so much content to adequately convey the points that FRC are trying to make. As an overall point we think it would be useful to apply the principle espoused in FRCs Cutting Clutter report, being that 'clutter undermines … usefulness …by obscuring important information and inhibiting a clear understanding'.

RESPONSES TO SPECIFIC QUESTIONS

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?

15. Paragraph I3 implies that, in the context of an assurance engagement, the user and the client will be different parties. FRC explain that by 'client' they mean the entity however in certain assurance engagements the user may also be the entity by virtue of the collective decision making of the board. The distinction should be between management and user rather than client and user.

16. We note that the revised explanation of integrity appears to lend more prominence to candour and fairness as an integral part of the principle rather than a related quality. It would be more sensible to use the IESBA definitions as a basis with some expansion into related qualities as additional discussion. This would help avoid confusion associated with differing definitions of the fundamental principles.

17. Paragraph I17 states that compliance with specific requirements may not be sufficient to meet requirements of overarching principles. The interaction between the two is unclear. We are supportive of a principles based approach to ethical decision making. However, the intention here is that the overarching principles can exist as a standalone section taking precedence over the rest of the Ethical Standard. If so then presumably an override would be required if the detailed requirements were to conflict with overarching principles. It is also difficult to find examples in the draft standard where principles are given prevalence over rules.

18. Part A paragraph 2.3 is not clear. It seems to suggest that the independence of those 'persons in a position to influence the conduct or outcome of the engagement' could be affected by the interests and relationships of, for example, employees who have nothing to do with the audit. This seems unnecessary and undermines the whole approach to personal independence. It also states that a firm should not accept an engagement where there is any threat at all. We would suggest that there are always threats however residual but it is important to accept when they are sufficiently insignificant or mitigated by effective safeguards to have no adverse effect. The wording of this also becomes muddled on transition from (i) b to (ii). There seems to be a continuity problem with the text.

19. The text suggests that 'it is probable that a reasonable and informed third party would conclude' is a more stringent test than 'an objective, reasonable and informed third party would not conclude'. This raises questions as to FRC's interpretation of probable which we believe should be 'more likely than not'. Does FRC believe that probable is a lower than 50% hurdle?

Also the chosen test phraseology is not used consistently as many times there is no reference to probable. We also note the removal of the reasonable and informed third party test in determining whether a relationship is clearly inconsequential (paragraph 2.33). It is therefore unclear whose doubts or what test we should be considering in making such an assessment.

20. In paragraph 1.14, the text ‘Save where the circumstances contemplated in paragraph 1.21 apply’ should be in paragraph 1.13, not paragraph 1.14, as paragraph 1.21 relates to the appointment of an ethics partner.

21. Paragraph 1.73 is an example where directly reproducing the text from the Directive is less than helpful. There is no obvious guidance on how an assurance provider is to assess the integrity of the members of the supervisory, administrative and management bodies (or indeed what is meant by these terms). If paragraph 1.75 is intended to be a list of what a user should do to comply with paragraph 1.73 then that intention should be clearly communicated.

22. In Section 3 the mixed use of existing definitions and EU definitions leaves significant room for confusion. The proposed text suggests that ‘key audit partners responsible for the audit’ are different from ‘key partners involved in the engagement’. The current rotation period for engagement partners is more stringent than the ARD and the IESBA requirements. It is reasonable to retain these but the introduction of ‘key audit partners responsible for the audit’ into the requirement now applies more stringent requirements to partners in charge of key subsidiaries. This appears to be ‘gold plating’ without evidence supporting a need for change. It is therefore interesting (and perhaps inconsistent) that the ARD requires all key partners involved in the engagement, which would presumably include key audit partners, to have at least a three year ‘off’ period, whereas the proposed UK text specifies two years.

23. The role of the Ethics Partner requires further consideration. We note the additional guidance for firms with three partners or less but consideration should also be given to situations where the firm is large enough to have an Ethics Partner but small enough for it to be impractical to entirely separate such a role from others with which a conflict might arise.

24. In considering loan staff assignments, the timeframe of ‘no more than a period of weeks or possibly a small number of months’ (Para 2.39) is too imprecise to be of much value.

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?

25. We support combining Ethical Standards 1-5 into one document in particular giving preference to the content traditionally contained within Ethical Standard 1. However, including the Ethical Standard for Reporting Accountants (ESRA) will overcomplicate the standard for most readers. Many users will find the ESRA requirement irrelevant for their purposes. It is also notable and conspicuous that PASE has not been included with the revised standard, being more relevant to a greater number of expected users than ESRA. We would favour a ‘think small’ approach.

26. However, the reference to non-audit engagements within scope as ‘other public interest assurance engagements’ risks confusion with the requirements for PIE audits and suggests a wider scope than then definition states. We also note that certain FRC reporting standards proposed to be covered by this new standard contain elements where an engagement may result in a report, but crucially no assurance opinion, being given. A number of ‘public interest assurance engagements’ will be carried out by auditors, in which case the audit restrictions would apply. Where this is not the case we are not convinced that it is appropriate to apply the full suite of audit restrictions to non-audit engagements.

27. It would be useful to create an electronic version of the standard which allows a user to filter the sections most relevant to them, in a similar vein to that which we understand is currently being worked on by IESBA.

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

28. The Directive includes a number of entities as PIEs: we believe a similar treatment should be adopted for all PIEs, whether unlisted or otherwise.

29. Equally, we do not believe that the FRC should apply requirements that go beyond the Regulation, or indeed the PIE requirements in the Regulation, to those listed entities that are not PIEs within the EU definition of a PIE. They have a significant impact on cost, ability to assist smaller entities, and a deterrent effect on competition at the smaller end of the listed audit market. Our more detailed views on this can be found in our response to the 2014 discussion paper. That given, we note the FRC's comments that a number of respondents were uncomfortable with removing existing requirements, unnecessary as they are in a principles-based environment. At the very least the requirements should be understandable and clear. We do not think the added complexity in having additional requirements for companies in this category with a market cap of over £100m results in any clear benefit to any stakeholder.

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

30. We agree: this is a proportional approach. However, it is unclear to us why the PASE, which applies potentially to many audits, is not included in the consolidated ES, when the less frequently applied ESRA is.

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?

31. It seems illogical to extend the assessment of a non-EU network firm's compliance to be on the basis of the ES, rather than the IESBA code. We concede the need for a different approach within the EU as the IESBA code is not fully compliant with the detailed prohibitions in Regulation. However we do not believe that unnecessarily extending the reach of the ES and thereby complicating matters for international audits is the answer. Our more detailed views on this can be found in our response to the 2014 discussion paper.

32. This 'dual standard' for overseas firms engaged on a group audit depending on whether they are part of the network or not, also raises interesting questions. Should the Group auditor apply a different assessment of objectivity and potentially carry out more work in the case of a non-network firm to compensate even if they believe the audit is technically adequate? If not, should investors have less confidence in the audit? In addition, it could have the side effect of clients engaging non-network firms to audit overseas subsidiaries to preserve flexibility on non-audit engagements. With different rules in different jurisdictions the FRC cannot ensure consistency to enhance UK financial statements?

33. This section also removes reference to a review of independence in this context being the specific responsibility of the audit engagement partner. The intention behind this is unclear.

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?

34. The definition of public interest assurance engagement requires clarification. As noted above, this implies a wider range of engagements than the definition states. In addition, does the FRC have any immediate plans to issue new, additional suites of performance standards. See also our response to Q2: as noted above, we think the inclusion of ESRA will over-complicate the standard for most readers.

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?

35. We agree with the intention to add clarity here, however the impact of the definition needs to be considered. A 'person in a position to influence the conduct or outcome of the engagement' is defined very broadly and will need careful consideration. It states 'including for example any individual who is, or whose services are provided by, any external expert of the firm'. This would seem to imply that external experts need to be independent. By comparison paragraph 2.70 seems to take a more measured but perhaps inconsistent approach to external consultants/experts (not requiring independence as such but an assessment of objectivity and integrity).

36. The requirements around financial interests and the interaction between Part B paragraphs 2.3 and 2.4 are questionable. Paragraph 2.3 seems to add two additional elements to paragraph 2.4 - firstly it covers 'each partner' in the firm and secondly says that they and the firm cannot 'engage in any transaction in a financial instrument' of the entity. Direct reproduction of the Directive here produces an absurd result in that an audited entity would not be able to have outstanding trade payables of any amount for any services owed to the firm, nor could a partner employed by the firm have, say, a BT landline when that firm audits BT. Financial instruments includes trade payables, trade receivables, loans, mortgages, and insurance arrangements to name but a few examples and there is no suggestion of a materiality threshold here. If an absolute ban on any involvement in this context (commercial or otherwise) is intended then that should be clearly stated. Aside from an exception for bank accounts on normal commercial terms, the purpose of paragraphs 2.21 and 2.22 is unclear given the breadth of 2.3.

37. The requirements around trusteeships have always been convoluted and confusing as they are written 'back to front' - in particular paragraph 2.7. This would be an ideal opportunity to re-write it to enhance clarity.

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?

38. Yes we agree that this is necessary to comply with the Directive.

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?

39. Paragraph 5.56 is an example of unhelpful layout and interaction, being a reproduction of the Regulation on NAS but not located adjacent to the discussions on the individual NAS themselves. PIE requirements appear to be detached from specific sections, meaning that, for a listed PIE (most PIEs), reference would have to be made to both sections. Paragraph 5.64 merely states that the Regulation shall prevail if it is more stringent. There is no explanation of the EU PIE requirements. When reading the general non-audit services sections, such as on internal audit, it would be easy to forget that the provisions (black list) in 5.56 still apply. The

PIE requirements should be merged into the relevant section. At the very least, better cross referencing is needed. The discussion on NAS fees exceeding audit fees (paragraph 5.26) is better located near the fee cap discussion.

40. Paragraph 4.31: we accept that the Directive as drafted narrowly defines the scope of the audit/NAS fee ratio calculation. However we believe that there is no need to go beyond the Directive as NAS fees are transparent within the accounts and investors are therefore able to make informed decisions if they have specific concerns.

41. In terms of the initial three year period before the cap starts, we understand from comments at the FRC roundtable on the consultation on 2 November that it is intended that the initial assessment would be made in 2020 considering the need to calculate three years average fees, starting from the transposed legislation coming into force. If this is the case, then the text could be clearer, as it is not mentioned anywhere. Also, as it is based on the last three years average fees, it does not appear to provide for situations where there is a new auditor, unless the outgoing auditor's fees are to be used.

42. Furthermore, the ES refers to fees for services over a consecutive three year period, but there is no aggregation period applied to those total fees. Is it simply to be assumed therefore that since the comparative is an annual amount that this is the fees paid over a 12 month period and if so one that equates to the financial year? What happens if there are substantial changes to the Group - for example, can one aggregate fees for two merging groups or do you just look at the 'continuing' holding company? How might the latter scenario apply in the case of reverse acquisitions?

43. We believe that establishing an effective date (paragraph 1.76) needs to consider, for example, Part A paragraph 2.1, which establishes an element of being independent before the audit starts.

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

44. Removing the words 'before an appeals tribunal or court' in paragraph 5.113 when discussing advocacy is intended to clarify a misconception that more general advocacy is acceptable, whilst trying to make the requirement more principles based. Whilst caveats remain, there must be better ways to explain a requirement than to remove words which are seen to actually change the requirement and suggest a greater degree of prohibition than perhaps was intended. A strict interpretation will also lead to increased cost to businesses who need to engage a second firm of accountants to deal with its tax affairs resulting in duplication of effort as they will have to gain a understanding of the clients business and accounts. The business will also duplicate time spent with each firm. An additional cost of £2,000 a company for simple tax affairs would not be unreasonable estimate, increasing significantly for more complicated cases. As the number of companies subject to audit and not eligible for PASE is circa 150,000[1], it would only need one third of them to have minor tax issues that their auditors would feel constrained not to advise on, for the cost to reach £100m. There will be no quantifiable benefits and there is no evidence of this issue damaging audit quality in the past. We are concerned that this may undermine the profession's role as trusted adviser in the non-PIE market. This has become a very significant point with smaller practitioner auditors and we would welcome a reconsideration of how to deal with the perceived problem. We also note that paragraph 5.116 becomes irrelevant if the above amendment is made.

[1] Companies House Company Register Activities 2013-14, table F': 151,000 companies not dormant or audit exempt in 2013-14.

45. We also note that the definition of advocacy threat in paragraph 1.30 is now inconsistent with that in 5.37. Is there a specific reason for the introduction of ‘undertaking an active responsibility for the marketing of an entity’s shares’? Is this intended to bar all M&A activity?

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

46. We do not see evidence to support the complete prohibition of contingency fees on tax services for all audits. We understand that the move may have been based on a review of inspections that highlighted the tendency to adopt a rules based approach. If this is the case, then that raises questions around enforcement of the existing requirement rather than suggesting a need to change it. We repeat our point above regarding the costs associated with engaging a different firm, for those businesses that are attracted by contingent fee arrangements.

47. In adopting the EU definition of contingent fees we note the inclusion of ‘or other event’ which is not only inconsistent with the IESBA code but also potentially with paragraph 4.13(d). The phrase could be widely interpreted to include audit cost overruns caused by events at the audited entity, for example. We believe and hope that it is unlikely that it is intended to prohibit such items.

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

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?

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?

48. We argued in our response to the December 2014 consultation paper that as AIM companies were not PIEs within the ARD definitions, and given the different nature of AIM entities, it was unnecessary to apply requirements to them over and above those for other non-PIE audits. While we recognise FRC’s efforts to allow relief for smaller AIM entities, the application of additional rules is ‘gold plating’, and unnecessary given the robustness of the principles-based approach, with appropriate monitoring and discipline. If adherence to the principles over and above the rules is truly intended, as is stated in the revised standard, then it is important to fully commit to that approach.

49. However, we note that some respondents to the December 2014 consultation did not favour removing additional rules for AIM audits. That notwithstanding, having additional rules for ‘AIM over £100m market cap’ companies adds to the complication, especially for those businesses with market values around the £100m cap. We cannot see that this added complexity will achieve anything for any stakeholder, other than extra costs.

50. Additionally, should such additional requirements be retained, there needs to be a significant lead in. In paragraph 5.66 we believe the lead in wording should be ‘the first and last day of the <u>most recent</u> year ended <u>at least</u> six months prior to…’ Year ends will typically not be six months prior to the start of the current period.

51. We support the relaxation for entities with securities that are listed but not, in substance, traded: this seems to reflect the substance of the requirements.

OTHER POINTS ON DRAFT ETHICAL STANDARDS

52. Paragraph I9 implies that an impairment of objectivity will always give rise to an impairment in independence. Objectivity is a state of mind whereas independence is often an outcome or state of being. The language here implies they are one and the same whereas a professional can be free from conditions and relationships but remain biased. Again this may create confusion for anyone trying to gain an understanding of fundamental principles.

53. The first sentence of paragraph I7 appears incomplete.

54. The formatting in the fifth line of paragraph I16 appears to be incorrect.

55. Is FRC comfortable that the use of the word recusal in paragraph 2.62 is the best word from a plain English perspective?

56. What is meant by reducing ‘the threat a level’ at the end of paragraph 5.160? Is this a typographical error?

GENERAL POINTS ON DRAFT AUDITING STANDARDS

57. We welcome this extensive consultation and congratulate the FRC on its efforts in a difficult technical area. In particular, we welcome the FRC’s continued commitment to ISAs as issued by the IAASB.

RESPONSES TO SPECIFIC QUESTIONS ON DRAFT AUDTING 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?

58. We agree in principle with the proposal to incorporate the requirements of the Regulation and Directive into the text of the quality control and auditing standards but we have significant concerns about the manner in which this objective has been achieved.

59. The FRC should consider the effects of the complexity it is proposing to introduce on auditors, companies and ultimately, investors. The ISAs as drafted already address many EU requirements: unnecessary copy-out leading to inconsistencies, clutter and a lack of clarity can and should be eliminated.

60. We support the FRC’s objective of having all related requirements in one place. We also understand how the FRC has arrived at its proposals and the fact that it has very little time in which to make any significant changes. Nevertheless, we strongly urge the FRC to consider further changes to avoid the potentially significant adverse consequences of its proposed approach. There is unlikely to be another opportunity in the near future and this approach sets a precedent.

61. The way in which the FRC has sought to bring all of the relevant requirements together has resulted in a level of complexity, duplication and overlap that will have a significant impact on the internal consistency and integrity of ISAs. The proposed ISAs, as they stand, are barely comprehensible to anyone other than a technical specialist. This cannot be a desirable state of affairs and there are alternatives.

62. The ISAs as drafted already address many of the EU Directive and Regulation requirements but we understand that the FRC has been advised by BIS that only a copy-out approach is acceptable. A copy-out approach is clearly unavoidable in implementing the Regulation but that is not the case for the Directive. Having three slightly different requirements covering the

same area generates a layer of complexity that is out of all proportion to any corresponding value to investors.

63. With regard to the Regulation, one solution might be to include the exact wording of the Regulation in application material or a footnote, making it clear that in the FRC's view, complying with the extant ISA requirement will achieve compliance with the legal requirement. Another alternative is the approach taken by the Financial Conduct Authority (FCA) in the listing and transparency rules. This involves keeping the required copy-out but stating elsewhere that in the view of the FCA, compliance with other extant requirements will result in compliance with the copied out legal requirement.

64. With regard to the Directive, a small amount of interpretation could have a disproportionately beneficial effect by reducing or eliminating a lot of complexity. For example, we believe that it is both possible and right to engineer more clarity and a simpler approach to the various different categories of company covered by the changes. At present, different requirements apply to PIEs, listed entities and UK Code Companies, among others, which will inevitably lead to confusion and error. We believe that reducing this by adding a limited number of requirements above and beyond those required by the Regulation and Directive in order to consolidate them would be a better approach. For example, we can see no compelling reason why an unlisted PIE should not report in the same way as a listed PIE and why a listed entity that is not an EU PIE should report any differently to an EU PIE. It is hard to imagine any substantive rationale for a requirement to consider whether 'other information' is materially misstated applying to UK Corporate Governance Code reporters but not PIEs or listed entities.

65. Similarly, is it not clear why some requirements apply to statutory but not non-statutory audits. We acknowledge that different requirements might be justifiable for different categories of PIEs and listed entities because of their different characteristics but the rationale for distinguishing between statutory and non-statutory audits is less clear.

66. The FRC has displayed courage in the recent past in leading the way internationally and it is, as it points out in the consultation document, entitled to make the necessary changes to make the ISAs workable in the UK, in the interests of audit quality. It might therefore consider the following:

    - some key changes, such as the definition of KAM, appear in several places in the standards, slightly differently. We do not believe that this is necessary or desirable, or that there should be slight differences in wording where there is no clearly different meaning;

    - ISA 230 refers to 'finalising the audit file', but proposed amendments refer to 'closing the file'. We do not believe that there is any difference, nor do we believe that the FRC is uncertain about this issue, and it should therefore use the same terms;

    - in ISA 220, it is simply unclear whether the proposed requirements regarding the engagement quality control review are the same as the existing requirements. It would have been better had the EU requirements in paragraphs 21R-1 and R-2 been properly integrated into the existing paragraphs 19-21 rather than added as a separate paragraph.

67. We accept that firms performing PIE audits should understand the requirements of ISAs and legal requirements. However, complexity is increasingly a competition issue and we believe that the FRC should do what it can to make its standards understandable. Smaller firms considering whether to tender for listed entity/PIE audits will be deterred by excessive and unnecessary complexity. Complexity and proportionality are not mutually exclusive where complexity is necessary but we believe that some of it, in this case, is unnecessary.[2] The

[2] For example, 32D-1 in ISQC 1 applies to 'statutory audits of financial statements'. 37-1 applies to 'audits of financial statements or other public-interest assurance engagements'. 38R-1 applies to 'statutory audits of financial statements of

requirement for proportionality in standard-setting derives from and applies to legal requirements as well as other areas and we challenge the FRC to show how its approach in any way demonstrates proportionality, as required by S26 (5) of the consolidated Directive. Auditors of smaller entities are always disproportionately affected by complexity and they will become even more reliant on the commercial publishers to strip out material to produce a useable edition of ISAs for the vast majority of audits, which are still unlisted entities that do not apply UK Corporate Governance Code and that are not PIEs.

68. One particular aspect of complexity that will be problematic for auditors of smaller entities is the definition of 'statutory audit'. It does not appear to mean 'all audits required by statute' and clarification will needed if errors are to be avoided. A statutory audit is defined as one required by the Accounting Directive. It applies to some but not all entities and there is a potential for too much work to be performed on pension funds, credit unions and, in particular, unincorporated charities under the Charities Act 2011, none of which are 'statutory' audits under this definition. However, such entities often require an audit under other legislation and it is not clear whether these are therefore statutory audits for these or other purposes.

69. Paragraph 12 of the Directive states that additional non-legal national requirements are permitted if they 'add to the credibility and quality of annual financial statements'. This is hard to reconcile to the statement on page 14 of the consultation which states that the FRC has added '…additional guidance that is appropriate in the UK and Irish National legislative, cultural and business context.' It is equally not clear how this latter statement relates to the statement in the FRC's impact assessment that FRC pluses should only be added where they 'will enhance the quality of audit and maintain requirements already subject to public consultation'. The impact assessment also notes that the FRC has 'looked to minimise any additional requirements and identify off-setting benefits to cover additional costs'. It is not clear that any of this has even been attempted, still less achieved.

70. We have noted recent responses to the FRC that we believe it *should* be able to reserve to itself the power to add to additional requirements to achieve credibility and quality, and to deal with specific national issues. In all cases, we have also noted that the power should only be in exceptional situations, that we have confidence in the due process of the IAASB and that the FRC's first route to argue for change should be through those channels.

71. It is vital that the UK maintains consistency with the internationally accepted ISAs issued by the IAASB and keeps the UK discretionary pluses to an absolute minimum to avoid putting the UK at a competitive disadvantage. It is therefore important that there is absolute clarity regarding the provenance of pluses. Those marked as deriving from the revised ISAs or the EU legislation are clear enough but there are many unmarked pluses Some of these appear have been imported from extant ISAs, and there are many conforming amendments that are difficult to trace. What concerns us most is the lack of clarity regarding which are the new, entirely discretionary (quality) pluses, i.e. what the FRC has added on this occasion that is not derived in any way from extant standards or legislation. These could and should have been highlighted.

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?

72. Subject to the final standard being available on a timely basis, we do not foresee any exceptional difficulties if the effective date is for audits of financial statements for periods commencing on or after 17 June 2016. Early adoption is helpful for large firms with global methodologies based on IAASB's standards which have an earlier implementation date.

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public-interest entities'. None if this is inappropriate but the level of complexity is arguably unnecessary and begs some attempt at simplification.

73. However, the timing of publication of the final standards by the FRC is critical. Most firms' businesses revolve around a December year-end cycle so the relevant training would be early to mid-summer 2016 to deal with an effective implementation date of 1 July 2017. It is important that the final standards are available before then to avoid a second round of training in early 2017. While many of the changes will be made by international network firms to be able to assert compliance with ISAs for December 2016, many firms would struggle if the timetable was brought forward given the extent of training and software upgrades that will be needed.

74. We understand that the FRC has to wait until BIS changes the law in April before it can make the changes and we urge both BIS and the FRC to ensure that this timetable does not slip. We also strongly suggest that the FRC publishes a near-final web version of the text as soon as possible, as do the FCA and IASB.

75. It is also important that there is also absolute clarity regarding the implementation date of any revised ES, not least for the benefit of financial statements users.

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?

76. We agree in principle with the adoption of ISAs 700 and 701 in the UK but we have significant concerns about the manner in which this objective has been achieved.

77. We strongly support continued convergence with ISAs in the important area of audit reporting and we are pleased that the FRC has moved in this direction. The FRC has done what it can to influence the IAASB and EC but cannot now change their requirements. The FRC's own impact assessment notes that 'FRC pluses should be removed where the issues that they relate to have been addressed in the revised IAASB standards'. In the context of KAM, we understand that technical exercises have been conducted using real audit reports to try and determine whether any reported risks would be excluded under paragraphs 11 or 11-1. We understand that no examples could be found. The distinction is going to make no difference to what is reported by auditors and is therefore redundant. For these reasons, we urge the FRC to change its own requirements in this case and we suggest that it:

- uses the IAASB's definition of KAM in the requirements;
- retains the extant UK requirements for reporting on materiality and scoping in paragraph 16;
- includes as application material any of the remaining extant UK material not covered by the IAASB's ISA.

78. Our rationale for this suggestion is to remove unnecessary complexity that potentially compromise audit quality. We urge the FRC recognise the importance of this issue and not to treat wording as if it were written in stone, simply because it has been through due process. The FRC is going to have to be more innovative than this going forward if it is to maintain its standing in the long run. We are not suggesting that any such material be removed. Investors will be far more concerned about the complexity of proposals and the potential inconsistencies arising from that, than they will be about differences in definitions and whether something is a requirement or included in application material.

79. We understand that there have been suggestions that material on fraud copied out from Article 10 of the Regulation to paragraph 45R-1(d) in ISA 700 (explaining the extent to which the audit

was considered capable of detecting fraud) should be tailored for each client. This will not be a widespread interpretation of the requirement and will be difficult to implement. Some FRC guidance may be needed. We also understand that efforts have been made to communicate the impracticability of this to the European Commission.

80. We agree with the extension of the application of ISA 701 to those entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code as this is consistent with the existing UK regime. We do not believe that a further extension to other PIEs is either necessary or helpful. We note above in paragraph 7 our belief that the proposed differentiation of requirements applied to listed entities, EU and non-EU PIEs and entities reporting on compliance with the UK Corporate Governance Code is unnecessarily complex, and that simplification is possible. How does this requirement apply for entities which comply with their own sector Code in lieu of the UK Corporate Governance Code, eg Further Education Colleges, Higher Education institutions?

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)?

81. We have concerns about paragraph 14D-1 which states that auditors 'shall consider whether there is a material inconsistency between the statutory other information and the requirements of the applicable other information reporting framework'. Article 34(1)(a)(ii) of Directive 2013/34 requires auditors to express an opinion on whether the management report has been *prepared in accordance with* the applicable legal requirements. Material differences between the statutory other information disclosed and the requirements of the applicable reporting framework are generally understood as being *non-compliance* with the framework, rather than *material inconsistencies* between the two and the proposed wording is confusing. The related application material (which extends beyond paragraph A36-1, as noted, to paragraph A36-4) more accurately articulates the relevant considerations.

82. Furthermore, the addition of the words '….shall perform such procedures as are necessary….to identify any material inconsistencies' in paragraph 14-2 can be read as implying an audit level work effort over the other information, and going beyond the requirements and intention of IAASB, which limited the scope of the required consideration to the auditor's knowledge obtained during the audit. We suggest that the FRC consider deleting these words to avoid raising expectations.

83. Subject to this these observations, we agree with the FRC's proposals.

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

84. The FRC has made some substantial additions to ISA 570, the purpose and value of which are not clear. 21-2 is a lengthy paragraph on auditor responsibilities to be included in the audit report when auditors concur with the use of the going concern basis of accounting and there are no material uncertainties ('conclusions relating to going concern'). We are not convinced of the value of this paragraph or understand how it fits with other reporting responsibilities because parts (b) and (c) are new requirements that apply to September 2015 year-ends, but all they do is direct the auditor to report in accordance with ISA 700, and because we do not see the point of (a). Similar considerations apply to paragraph 21-1 which merely repeats material already included in ISA 701 and we do not understand why the FRC considers clarification necessary. We suggest that both paragraphs are deleted.

85. Paragraph A8-1 adds a reference to 'all available information about the future', a phrase both unexplained and worrying. If this is included, it should be more specific and quote the relevant requirement or source.

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?

86. We do not believe that the requirements of ISA 250B should also apply to non-PIEs in regulated sectors. There are clear benefits in public interest reporting to regulators, but for non-PIEs it would be preferable for the nature of reporting to be specified by the regulators concerned, rather than setting it out in auditing standards.

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

87. The FRC has not explained why this proposal is necessary. We have no objections to it.

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?

88. The minimum retention period should apply to all audit documentation rather than just those documentation requirements deriving from the Regulation and Directive. There is no reason to have differing requirements for documentation retention depending on the source of the requirement. It would cause practical difficulties and the differential might, as a result, be ignored.

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)?

89. Bulletin 2008/4 should be withdrawn as it is out of date but we strongly suggest that the FRC should give further consideration to producing a new Bulletin, to avoid inconsistencies in practice.

DETAILED POINTS ON DRAFT AUDITING STANDARDS

(page references below are to the pdf)

90. **ISQC 1**

    1-1. Change of scope to cover *other public interest assurance engagements*: to the extent that this change refers to the public interest, this restriction to engagements falling within FRC's standards is welcome although it does represent a narrowing of the current application of ISQC 1.

    P8. The definition of staff does not make sense in plain English and the purpose is unclear. Is there a bracket in the wrong place? Is the intention to catch staff who do not consider themselves to be professionals?

    P9. The definition of statutory audit includes one voluntarily carried out at the request of small undertakings which meets legal requirements that are equivalent to those for an audit under point (b), where national legislation defines such audits as statutory audits. Is this a drafting

error? What was point (b) in the Directive has been re-labelled by the FRC as point (ii) in this draft.

58R-1. Long lists such as these might be relegated to an appendix.

91. **ISA 210**

A15-1. Some guidance regarding what happens when a client refuses to make the additional disclosures might eventually be needed. We are unclear as to how this section interacts with S393 of the Companies Act 2006.

A19a**.** This may be a direct lift from ISA 720 but the paragraph should make it clear that this cannot happen in the UK The reference should be to 6biii not biiib. This point also applies to some changes in ISA 560 (A10a and A16a) but there may be others. When ISA 720 applies, many of the paragraphs will be renumbered. This paragraph will become A20, for example, and all the other paragraphs renumbered accordingly.

A36-1. This paragraph is excessively lengthy and confusing. Some thought should be given to how to make it less so. Some suggested wording for the other matter paragraph would also be helpful.

92. **ISA 220**

24R-2. This paragraph would benefit from some interpretation. As drafted it requires the EQC Reviewer to keep a record of the review, as well as there being a record of the results of the review on the audit file. Should not all of the records of the EQCR be in one place, on the audit file?

93. **ISA 230**

8D-1 and 14D-1. These require the auditor to ‘retain any other data and documents in audit documentation…’.It is not clear what ‘data’ means in this context. The Directive does not elucidate and also refers to ‘records’. Some guidance may ultimately be needed.

94. **ISA 240**

43R-1. This requires auditors to inform authorities where they have reported a fraud to their client and the client has not investigated it. Does this conflict with current UK money laundering guidance? There is no suggestion of any *de minimis* limit.

95. **ISA 260**

16-1 is very long. Is there any scope for splitting it out? 16R-2 exacerbates this problem – especially as many of the requirements are similar to existing requirements.

A18-1. This paragraph may be true, but it is no more than a statement of the obvious, repeated elsewhere.

96. **ISA 330**

19R-1 is vague. It is included under substantive procedures, and requires auditors to ‘assess’ valuation methods. It is derived from AR 112 (l) which requires auditors to report to the audit committee to ‘report and assess the valuation methods’, and is out of context in ISA 330.

97. **ISA 540**

21D-1. The repetition of the point in this paragraph about going concern and scepticism when reviewing cash flows from ISA 570 para 12D-1 is unnecessary. A simple cross reference would suffice, or the paragraph could be split. Going concern is not an estimate.

98. **ISA 570**

21-1. We note above our belief that this adds nothing of substance and we do not understand why the FRC considered clarification was necessary if the IAASB did not think it so. The paragraph is arguably irrelevant. ISA 701 is the applicable standard and the determination process is outlined there. This paragraph adds nothing of substance.

21-2. We question the value of the additional extensive paragraph on auditor responsibilities to be included in the audit report ('conclusions relating to going concern') when the auditor concurs with the use of the going concern basis of accounting and there are no material uncertainties. Could it be cross referenced? Could it be application material? Parts (b) and (c) are new requirements that apply for September 2015 year-ends, but all they do is direct the auditor to report in accordance with SA 700. We do not see the point of (a).

21-1 and 21-2 are both hard to follow. They are discretionary pluses, we do not see why they are being included and we suggest that they are deleted.

A8-1. An addition referring to 'all available information about the future' is both unexplained and worrying. If this is included at all, it should be more specific and quote the exact requirement or source.

99. **ISA 580**

Footnote 12 is an apparently discretionary plus whose purpose is opaque.

100. **ISA 700**

A65-1 and A72-1 - is this the right place for assertions regarding compliance with ISAs?

P579 addition, and on P583 and elsewhere – while this does no harm, it seems unnecessary.

101. **ISA 701**

We note above our concerns about three definitions of KAM. We suggest that the FRC:

- uses the IAASB's definition of KAM in the requirements;
- retains the extant UK requirements for reporting on materiality and scoping in paragraph 16;
- includes as application material any of the remaining extant UK material not covered by the IAASB's ISA.

11-1 states that in the UK and Ireland, the introductory language in paragraph 11(a) *shall be amended…* which gives the impression that something may have been taken away, which is not the case.

13.2. A discretionary plus which is a substantive change, the sense of which is not entirely clear, nor is the need for it. 10-1(b) already requires that PIE KAMs include fraud so this is an unnecessary discretionary plus.

A33-1-5. We understand that the addition on group and parent KAM is taken from a clarification note prepared when the issue was queried. We are not sure that it needs 5 paragraphs to make the point.

102. **ISA 706**

A2-1. IAASB saw no need for a paragraph dealing with law or regulation requiring an emphasis of matter well as a KAM, it is not prohibited, the FRC has given no specific example and it appears to be an unnecessary statement of the obvious.

103. **ISA 720**

Definitions – paragraph c. This appears to be an extension of the definition of 'other information'. Could it be moved to the application material? We are unclear as to how 'broadly concurrent' is likely to be interpreted. We cannot see that paragraph d adds anything of substance, either.

A36-1. This appears to be a substantive and substantial addition, in application material, essentially unrelated to 14D to which it is attached. How are auditors supposed to go about it?

14-2 appears to be an augmentation IAASB requirements. Why is it needed? We note above that 14D-1 is also flawed. It states that auditors 'shall consider whether there is a material inconsistency between the statutory other information and the requirements of the applicable other information reporting framework'. Can 'information' be materially inconsistent with a legal requirement? The same applies to 14-2(c).

22D-1 and 22D-2 refer to 'applicable legal requirements'. The FRC has gone to the trouble of defining 'applicable other information reporting framework'. Having done so, the definition should be used.

We believe that the time is now right for the FRC to consider whether the extensive and wearying use of 'In the UK & Ireland…..' throughout the ISAs is still necessary. It would be better for a general reference to be made. The risk of confusion is small.

DETAILED POINTS ON DRAFT CORPORATE GOVERNANCE CODE AND GUIDANCE

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

104. We concur with the FRC's view that the existing responsibilities in section C.3 of the UK Code of Corporate Governance (the Code) largely address the requirements of the ARD in this area. Apart from the matter addressed below, we agree with the minimal changes proposed to the Code, given the requirement to implement the ARD and align with CMA recommendations.

105. We note that the proposals continue to suggest reporting of advance notice of tendering plans. The draft guidance (otherwise commented on below) expands on this, indicating that where a tender is nit undertaken in accordance with proposed timing, this be explained. In our response to the BIS discussion paper in December 2014, we expressed concern about the then-BIS proposal to incorporate advance notice of tendering in to the legislative reporting requirements. Our concern was that Companies would be nervous of specifying earlier dates than those mandated, as this would reduce the flexibility available should there be, for example, a takeover bid or other event that might make a change of auditor unhelpful at a particular date. We note that BIS has withdrawn their proposals.

106. While the FRC proposals do not include any disclosed date becoming binding, as the BIS proposals did, directors will not relish having to explain changes to plans in detail so we are again concerned that there will either be a tendency not to consider earlier tendering, or to make such a bland boiler-plate statement that it will be of no use to readers at all. Any

requirement in this area should allow maximum flexibility for reporting to focus on key matters that shareholders and prospective shareholders really need to know.

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

107. We note the CMA recommendation in this area. Building CMA recommendations into existing codes and guidance usefully reduces the number of sources that need to be referred to. We believe effective corporate governance depends on useful engagement with shareholders, and on the face of it, an advisory vote assist engagement. That said, we note the comments that investors are not convinced of the usefulness of this and believe FRC should be steered by their views, provided they are representative of all investors.

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

108. On the whole we agree with the changes to the Guidance. Two areas that we do believe merit review are: a) the guidance on advance notice of tendering (see above); and b) the guidance on audit committee experience. In our response to the BIS discussion paper in December 2014, we commented that the phrase ‘the committee members as a whole will need to have competence in the sector...’ can be interpreted in a number of ways. Does competence mean qualification or experience? Does experience mean ‘executive’ experience? Does ‘as a whole’ mean a majority of the individuals or collectively? While the proposed guidance addresses the first of these, additional guidance could be added to address the remaining questions.