



AUDIT NEWS

Introduction

Welcome to Audit News 56, your regulatory update containing the latest technical guidance and best practice advice. Please share this issue with colleagues involved in audit work.

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Reports under the Solicitors Regulation Authority (SRA) Accounts Rules

We have published interim guidance for members, [Technical Release 16/15AAF](#), dealing with recent changes to the Accountant's Report requirements under the SRA Accounts Rules. The guidance has been prepared following an announcement by the SRA of changes to the form of the Accountant's Report and the background under which reporting accountants are undertaking their role. These changes affect Accountant's Reports being prepared for law firms whose accounting period ends on or after 1 November 2015.

Consultation on guidance on aspects of ICAEW's Code of Ethics

The collapse of the MG Rover car company in 2005 led to an enquiry by the Financial Reporting Council (FRC) into the actions of the company's auditors and accounting advisors. This resulted ultimately in a disciplinary charge being levied by the FRC against an ICAEW member firm in respect of certain corporate finance transactions in 2001. The charges involved failure to consider the public interest; and failure to safeguard against threats to ethical behaviour resulting from conflicts of interest and the fees charged.

Although the appeal process, completed in early 2015, resulted in many of the charges being overturned, the FRC tribunal reports raised questions about the clarity of some aspects of what is now ICAEW's Code of Ethics.

ICAEW's Ethics Standards Committee has issued for consultation three draft guidance notes. These are prepared on the basis that the issues raised by the MG Rover case do not require changes to the Code of Ethics itself, but that there are a number of aspects where guidance on the requirements of the Code could usefully be given for the avoidance of doubt.

The draft guidance notes do not necessarily reflect the formal position of ICAEW. ICAEW's view will be finalised once the committee has considered responses to the consultation.

The [consultation](#) is open until 23 March 2016 and all comments, whether positive or negative, are welcome. Please send your responses and any questions to ethicspolicy@icaew.com

EU audit regulatory reform: where are we?

The European Union Audit **Directive** and **Regulation** (collectively ARD) passed in 2014 have an effective date of 16 June 2016. The UK government (through the Department of Business, Innovation and Skills – BIS), the FRC, ICAEW and the other recognised supervisory bodies (RSBs) have been working towards this implementation. It will fundamentally change the audit regulatory environment and the codes and standards that auditors have to follow, especially those relating to the audits of public interest entities (PIEs). Draft legislation and re-drafted codes and standards have been consulted on by **BIS** and **FRC**, however, they are not yet finalised. More will emerge on all these matters when finalised but, in the meantime, where are we on the key points?

Who regulates what?

The FRC will be designated as the competent authority with ultimate responsibility for audit regulation. The ARD requires it to monitor and undertake certain investigation and disciplinary activities in respect of the audits of PIEs (see below). The government will issue a ministerial direction requiring other activities to be delegated back to the RSBs (albeit with a power to reclaim activities if we are not doing our job properly, and to take on other work directly in the public interest) so, for most audits, there will be little regulatory change.

What is a PIE?

The ARD define a PIE as:

- an entity listed on an EU-recognised stock exchange (so, in essence, all UK-listed companies except those on the AIM and ISDX growth markets); and
- most unlisted banks, building societies and insurance companies.

This definition will require the FRC to take on more direct activity (see above) than at present. In addition, the FRC proposes to take on the direct monitoring of a number of further audits of companies they believe are of an economically systemic nature, particularly large AIM-listed companies (those with a market capitalisation over £100m). However, the major audit category that the FRC currently uses to determine which audits it monitors directly will be wound down, so there will be two-way traffic between the FRC and the RSBs on some audits. We are working with the FRC to ensure any handover is achieved smoothly.

Audit firm tendering and rotation

This is only required for PIE audits (as defined by the ARD, see above). In essence, a PIE will have to put its audit out to public tender at least every 10 years and change to a different audit firm at least every 20 years. There are some complex transitional arrangements which mean this won't all need to happen on 16 June. PIEs which last changed their audit firm before 16 June 2003 have the longest time to change – between four and seven years. In addition, tenders in the 10 years before 16 June 2016 will generally count for transitional purposes. BIS published some **useful supplementary information** addressing most of this last March, however, it is being updated.

Reporting to supervisors

Auditors of PIEs will be required to report:

- information regarding legal breaches or breaches of the administrative rules;
- doubts over going concern; and
- the issue of a qualified audit report.

BIS is finalising which of these should be reported to the FRC and which to the FCA.

Codes and standards

The FRC **consultation** set out draft revised ethical standards on auditor independence (ES), draft revised auditing standards (ISAs), and a draft revised UK Corporate Governance Code. Comments below are based on the published drafts which may change. The final drafts are expected to apply for audits of accounting periods where those periods commence on or after 17 June 2016.

The ES – the FRC has substantially reworked the draft ES, which were last amended in 2010. It is proposed that the existing ES 1-5 and the Ethical Standard for Reporting Accountants (which applied to engagements in accordance with the FRC Standards for Investment Reporting (SIRS)) be incorporated into one document; this also features a new introduction section and a section setting out an overarching principle and supporting ethical principles. The existing Provisions Available for Smaller Entities (PASE), which applies to smaller audits below the legal threshold for a statutory audit, continues as a separate document, and is not set to change substantially.

The biggest change in the independence requirements relates to PIE audits (see definition above). A new set of requirements from the ARD are included verbatim. These particularly affect:

- partner rotation;
- the provision of non-audit services to audited entities (NAS); and
- the introduction of a fee cap requiring NAS fees not to exceed 70% of audit fees, over a three-year period.

For listed non-PIE audits (primarily AIM companies), the current requirements for listed entities continue broadly to apply. There are some relaxations for entities with a market capitalisation of under £100m.

For other audits, the main change relates to the provision of tax NAS. The requirements on contingency fees and advocacy work are tightened up.

One issue for international audits is that network firms involved in the audit of a UK group will now be expected to apply the ES requirements. At present they apply the International Ethics Standards Board for Accountants Code.

The ISAs – the FRC has included amendments reflecting the ARD requirements, together with changes made internationally to ISAs since the last UK amendment, and a number of additional points. These are summarised in an [appendix](#) to the main FRC consultation document and tracked changed versions of the ISAs affected are also included as a separate [document](#).

Most ISAs have been updated, including ISA 700 on the audit report which has been changed substantially. Changes have also been made, among other things, to ISA 570 to enhance reporting on going concern.

Corporate governance – the UK Corporate Governance Code for listed entities includes relatively minor ARD-initiated changes to the requirements for audit committees. However, the FRC has taken the opportunity to completely rewrite the 2012 document, *Guidance for Audit Committees*. This incorporates and tidies up the additional ARD requirements and those imposed by the Competition and Markets Authority [Orders](#) in 2014.

International Education Standard 8

On 1 July, a new International Education Standard (IES) issued by IFAC's IAESB comes into force. [IES 8](#) sets new professional competence requirements for audit engagement partners.

The new standard builds on the existing focus on professional competence that is already a requirement of legislation, professional body licensing requirements and registered auditors' internal due diligence. IES 8 will therefore be complementary to firms' current procedures and practices. Nevertheless, it is important to be aware of the change and to take appropriate steps.

We will amend the application process for responsible individuals (RIs) in the coming months. It will become necessary for applicants and their firms to confirm that those proposed as RIs have achieved the competencies listed in IES 8 through their work experience and CPD. The application form will require examples. Similarly, in their review work from 1 July, the QAD team will look to see that:

- firms have appropriate procedures in place to meet the requirements of IES 8; and
- selected engagement partners and other RIs are using a planned programme of CPD to ensure they are maintaining the competencies required by IES 8.

[IES 8 may be downloaded from the IFAC website.](#)

Auditor insights into the retail and insurance sectors

One of the impacts of the current price deflation in the retail sector is that more companies are reporting declining sales year on year. This shows how important it is not to look at like-for-like sales in isolation. A new report, **Audit insights: retail**, highlights how the focus on like-for-likes could be masking financial problems that retailers face, particularly the rising costs of online investment; the extra bill from increases in the living wage and the volatility of currency fluctuations. The most important information - which is sometimes overlooked - is how profitable retailers' like-for-like sales are. The ones who are going to survive are those who are able to manage their costs more effectively as their profits are squeezed in these areas.

The introduction of the national living wage for employees aged 25 and over in April will be top of the agenda for many retailers because of the significant impact it will have on their costs. To give you an idea of the scale of challenge facing retailers, staff currently on the national minimum wage will see their pay grow by more than 10%. By 2020, this will have risen by nearly 40% compared to their 2015 minimum wage. Retailers will need to identify how they can increase productivity to offset these costs, and how much they will be able to pass on to the consumer in the current climate. In addition to the cost of compliance, there will also be an important knock-on effect that retailers may have to plan for: the amount by which they will have to increase the pay of other staff to maintain pay differentials if they are to retain their best employees.

Julie Carlyle, Chair of ICAEW's Audit insights: retail working group and Head of Retail at EY UK & Ireland, said 'Like-for-like is no longer the only indicator and cannot be looked at in isolation. Investors need to focus on profit and companies need to ask how they can react to and plan for the new retail environment. Retailers are certainly under a lot of pressure but, by considering how they can best respond to the new normal, they will put themselves in a better position to be successful.'

Our latest **Audit insights: Insurance** report suggests that the increasing use of personal data could make some people uninsurable. This is the result of smartphones, wearables like fitbits or apps, search engines and social media generating so much data about our individual risk factors (from fitness to where you live, or whether you need to drive at night). What this means is that, rather than shared paying for shared risks, we have to be able to afford as individuals the risks we represent individually. This will be higher for some than others.

Philippa Kelly, ICAEW Financial Services Assurance Manager said 'Insurance protects us against risks we face in everyday life but can't necessarily bear the cost alone. It depends on groups of people being exposed to similar risks and seeking similar cover. Increasingly, technology means there is so much data about our own individual risk factors that it no longer makes sense for companies to group us together. But this means some people may be so high risk that they're priced out of insurance altogether leading to 'uninsurables'. This could easily be due to factors people can't control such as where they live, genetic conditions or new developments like cyber risk. Society needs to decide what we do about that.'

Both reports are based on the insights of auditors with specialist knowledge of both sectors.