POST IMPLEMENTATION REVIEW 2016 ETHICAL AND AUDITING STANDARDS CHANGES TO IMPLEMENT THE AUDIT REGULATION AND DIRECTIVE

CALL FOR FEEDBACK

RESPONSE FROM ICAS TO THE FRC

15 February 2019
Background

ICAS is a professional body for more than 21,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK’s and the world’s great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

We welcome the opportunity to respond to the FRC’s call for feedback on the post-implementation review of the 2016 Ethical and Auditing Standards – changes to implement the Audit Regulation and Directive.

Timing – the way ahead

We would question whether now is the best time to consider and review the impact of these changes as we anticipate further changes and updates to the International Standards on Auditing (ISAs) as part of the International Auditing and Assurance Standards Board’s (IAASB) current work plan to revise its quality control standards and ISA 315. That said, we do believe that the 2016 revisions to the FRC’s auditing and ethical standards have had some success in meeting the objectives as summarised in the briefing paper although it is too early to determine whether all of the agreed objectives have been met since these have only been effective since 2016 (indeed, the cap on non-audit services is not yet officially applicable). There would also appear merit in waiting until the Brydon review has concluded to better determine what changes, if any, are required to the respective standards.

Audit Quality

We believe that the concerns around audit quality are more closely linked to issues with the performance of the audit and application of the standards as opposed to deficiencies in the auditing standards per se and therefore amending these standards may not necessarily have the desired impact on audit quality.

The current auditing standards increasingly place more emphasis on compliance and have removed some of the need for, and importance of, auditor judgement. Whilst some of this shift is inevitable given that the focus is on ensuring appropriate consistent application of the standards, we believe there is scope for greater recognition within the FRC’s Audit Quality Review (AQR) scoring process of the auditor’s approach to the more intangible elements of the audit process, such as the application of judgement, professional scepticism and other softer skills.

We would also welcome a more balanced and constructive tone in the (AQR) reports that gives consistent weighting and focus to areas where the audit work has been performed to an acceptable/high standard as well as to shortcomings. Highlighting examples of good performance would provide a helpful source of reference for others and help to improve audit quality. We welcome that this approach is adopted to some extent in the FRC’s thematic papers where examples of good practice are highlighted.
It would also be useful if the FRC was to provide greater insight into their assessment and recognition of any underlying issues or trends that might have contributed to a less than acceptable audit performance. These issues might include things such as volatility within the market or particular sector. Additionally, it would be interesting to understand whether there might be any correlation between the deterioration in audit quality that was noted in the 2017/18 AQR firm reports and the extent of auditor rotation since the implementation of the EU audit reforms.

*Non-assurance services*
We believe many of the independence concerns that are associated with the provision of non-audit services by the audit firm to audit clients may be largely based on perception. That said, as part of our response to the CMA audit market study, ICAS supports a complete prohibition on the provision of non-audit services by audit firms to their PIE clients, (at least the FTSE 350), subject to a small agreed list of permitted assurance-related services.

*FRC Audit Technical Advisory Group – Rolling Record*
In relation to the above we believe there would be merit in considering whether any of the group’s decisions that have not been reflected separately in a Staff Guidance Note could be incorporated into the ISAs (UK) or FRC Ethical Standard at an appropriate place.

*Simplifying the FRC Ethical Standard*
Consideration should be given to following the lead of the International Ethics Standards Board for Accountants (IESBA) to determine whether the Ethical Standard could be restructured and simplified to make its content more readily understandable.

*Proportionality*
We believe that the FRC’s current audit and ethical standards can generally be applied in a proportionate manner. We would emphasise that there is a real need to maintain proportionality to ensure that smaller firms are not unduly burdened.

*E-Standards*
There would be merit in the FRC creating true e-versions of its standards containing hyperlinks to definitions and related standards etc. This would add to the user’s experience and help to digitalise FRC outputs.
Specific Comments

Our answers to the FRC’s specific questions are listed below.

Feedback Questions:

Over-Arching Questions

Question i.
How well do you think the 2016 revisions to auditing and ethical standards have met the objectives set out in our September 2015 consultation ‘Enhancing Confidence in Audit’ and summarised in the objectives section of this briefing paper?

Response i.
We would question whether now is the best time to consider and review the impact of these changes as we anticipate further changes and updates to the ISAs as part of the International Auditing and Assurance Standards Board’s current projects to revise the quality control standards and International Standard on Auditing 315. That said, we do believe that the 2016 revisions to auditing and ethical standards have had some success in meeting the objectives as summarised in the briefing paper although it is too early to determine whether all of the agreed objectives have been met since these have only been effective since 2016 (indeed, the cap on non-audit services is not yet officially applicable). There would also appear merit in waiting until the Brydon review has concluded to better determine what changes, if any, are required to the respective standards.

Question ii.
In carrying out this review of effectiveness, should the FRC consider any additional objectives as being relevant for ethical and auditing standard setting. If so, please state what they are and why?

Response ii.
We would like to highlight that some of the issues and concerns around audit quality are more closely linked to issues with the performance of the audit and application of the standards as opposed to deficiencies in the auditing standards. Therefore, amending these standards may not necessarily have the desired impact on audit quality. Furthermore, as stated in our response to question (i) above, it may be too early to determine whether all of the agreed objectives have been met since these have only been effective since 2016. Our comments above re the Brydon review also apply here.

Question iii.
Do the current ethical and auditing standards drive the auditor to deliver work that meets the expectations of users within the current scope of an audit? If there are expectations that are not being addressed, please state those along with your proposals as to how they can be addressed.

Response iii.
Recent events have highlighted that the user expectation gap still exists and that the purpose and scope of the audit function is not always well understood. That issue is unlikely to be addressed by amending the auditing and ethical standards but rather through a fundamental rethink of the role of audit and how it can evolve to better meet the needs of stakeholders and remain fit for purpose. We believe that this issue will be best addressed as part of the review of the role and purpose of audit being led by Sir Donald Brydon. As stated above, we therefore believe there would be merit in the FRC waiting until the Brydon review has concluded before considering whether any changes are required to its standards.
Question iv.
Are there further steps that the FRC should consider as part of this review to ensure the delivery of high-quality audit? If so, please state what they are and why.

Response iv.
In our opinion, the current auditing standards increasingly place more emphasis on compliance and have removed some of the need for, and importance of, auditor judgement. Whilst some of this shift is inevitable given that the focus is on ensuring appropriate, consistent application of the standards, there is scope for some recognition within the AQR scoring process of the auditor’s approach to the more intangible elements of the audit process, such as the application of judgement, professional scepticism and other softer skills.

We would welcome a more balanced and constructive tone in the FRC AQR reports that gives consistent weighting and focus to both shortcomings and areas where the audit work has been performed to an acceptable/high standard. This would help to increase the transparency on audit quality.

Questions Relating to the Ethical Standard

Question v.
Are the ethical principles and supporting specific requirements sufficiently clear? If not, please explain the issues and how you believe they could be resolved.

Response v.
Consideration should be given to following the lead of the International Ethics Standards Board for Accountants to determine whether the Ethical Standard could be restructured to make its content more readily understandable. We have received a number of comments that the FRC Ethical Standard at places is difficult to understand and interpret. The amalgamation of the old Ethical Standards with the ethical requirements for a Reporting Accountant was partly to blame but is not the sole cause. A commonly cited example is “covered persons” which takes up a sizeable amount of text. Another example is at paragraph 115 where the sentence runs to some considerable length:

“Accordingly, independence not being compromised (which is the test to be applied in evaluating the likely consequences of conditions and relationships that may create threats to integrity and objectivity) is not whether the firm considers that the integrity and objectivity of the firm, its partners and staff and any other covered persons is impaired, but is whether there is freedom from threats to integrity and objectivity, taking into account safeguards applied, at a level where it is probable (more likely than not) that an objective, reasonable and informed third party would not conclude that integrity or objectivity (and therefore independence) is compromised.”

Sentences such as this would benefit from being subject to a simplification process.

Question vi.
Based on experience, do you believe the ethical principles and supporting specific requirements are sufficiently proportionate for PIEs and non-PIEs? If not, please explain your view, including what you would consider the proportionate position to be, having regard to the need to address threats to independence, objectivity and integrity viewed from the perspective of an objective, reasonable and informed third party.

Response vi.
We believe they are currently sufficiently proportionate.

Although not yet actually applicable many companies have proactively applied the 70% cap on non-audit services that was introduced by the EU Audit Regulation.
Question vii.
Do you believe that user confidence would be strengthened if the FRC required the application of the independence requirements of FRC Ethical Standard to all components of a group audit?

Response vii.
In principle, we are supportive of the FRC’s suggested approach which appears conceptually sound. Consideration of course would need to be given as to whether certain practical issues might arise which might cause some issues in relation to applying this approach.

Question viii.
For practitioners, what difficulties, if any, have you encountered in complying with the ethical principles and supporting specific requirements? Is there anything the FRC could do to help alleviate these (e.g. further supporting guidance)?

Response viii.
Please refer to our response to question v.

Question ix.
Do you believe the current restrictions on non-audit services are sufficient to address threats to independence, objectivity, integrity and audit quality, and address stakeholder expectations? If not, please explain why, by providing examples where audit quality has been compromised as a result of non-audit services being provided by the auditor.

Response ix.
We believe many of the independence concerns that are associated with the provision of non-audit services by the audit firm to audit clients may be largely based on perception. That said, as part of our response to the CMA audit market study, ICAS supports a complete prohibition on the provision of non-audit services by audit firms to their PIE clients, (at least the FTSE 350), subject to a small agreed list of permitted assurance-related services.

There are some internal challenges around ensuring the independence of individual members of the audit team and the introduction and use of the software introduced to control this issue. Negative feedback from internal reviews on the basis of independence can impact on staff morale and motivation and if this persists can cause staff to leave the profession.

There may be a need for the Ethical Standard to be sufficiently flexible to support this proposed objective of promoting competition and allow the regulator to grant exemptions from the Ethical Standards in limited circumstances where it is possible for safeguards to be deployed mitigating the threat to independence. For example, providing relief from the “cooling-in” requirements or “in year” appointments where otherwise prohibited non-audit services have been undertaken. This would allow the audit firm to participate in an audit tender. The US SEC has similar powers under their “No-action” letter regime.

Question x.
Do you believe there should be further restrictions, or even an outright prohibition, on non-audit services?
a. Should any further restrictions or prohibitions also apply to “audit related” services, that the auditor is not required to provide? If so, please explain your views.
b. Should any further restrictions or prohibitions also apply to services required by law or regulation (i.e. permitted by the Audit Regulation)? If so, please explain your views.

Response x.
As stated in our response to question ix and in our response to the CMA audit market review we would support a complete prohibition on the provision of non-audit services, subject to a small agreed list of permitted assurance related services, by audit firms to at least their FTSE 350 audit clients. The precise nature of allowable services would need to be the subject of a separate consultation.
Question xi.
There is currently a derogation in the Ethical Standard allowing for the provision of certain non-audit services where these have no direct effect or an inconsequential effect (where indirect) on the financial statements. Should this derogation be maintained in the Ethical Standard, and if so why?

Response xi.
We believe that the scope of this derogation is so limited and relies on the application of judgement, therefore, in order to address any perceived independence issues, it may be more appropriate to remove it entirely from the Ethical Standard.

Question xii.
Do you believe there could be adverse consequences from imposing further restrictions on some or all non-audit services that may outweigh any actual or perceived benefits? If so, please explain your views.

Response xii.
Provided the scope of any further prohibitions is restricted to FTSE 350 entities we believe the perceived benefits would outweigh any related costs/consequences.

Question xiii.
The FRC included reliefs from certain FRC ethical requirements for non-PIE audits for the audit of small and medium-sized entities. Should these reliefs be maintained, and if so why?

Response xiii.
Yes, these should be retained – removing them would add significant time and cost burdens for those entities who turn to their auditor for sufficient ad hoc assistance and guidance in non-audit related matters.

Questions Relating to the Auditing Standards

Question xiv.
Are the relevant auditing requirements of the Regulation and Directive as integrated into the revised ISAs (UK) sufficiently clear? If not, please explain the issues that are currently of concern and how you believe they could be resolved.

Response xiv.
We believe that the relevant auditing requirements of the Regulation and Directive as integrated into the revised ISAs (UK) are sufficiently clear.

Question xv.
For practitioners, what other difficulties, if any, have you encountered in complying with the revised ISAs (UK)? Is there anything the FRC could do to help alleviate these (e.g. further supporting guidance)?

Response xv.
Any difficulties encountered in complying with the revised ISAs (UK) relate mainly to the internal challenges associated with the development of firm wide policies and practices. Therefore, we do not believe that any further supporting guidance from the FRC would be necessary.
Question xvi.
Is the work required of an auditor on an entity’s compliance with laws and regulations, and those procedures to identify irregularity, including fraud, sufficient to meet the needs and legitimate expectations of users? If not, what additional work would you require and why?

Response xvi.
There is no disputing that Society’s expectation of audit is changing, and we believe the public interest test is changing with it. As a result, there is a need for the profession to consider whether it meets user expectations and whether the scope of audit needs to evolve. One consideration would be to introduce a UK version of the US requirements on the effectiveness of an entity’s internal control over financial reporting (and the integrated audit approach). Greater oversight of controls might give more confidence over the absence of management bias and incentives. Anything that gives greater insight into the reliability of financial reporting would be helpful.

However, we believe this is a matter that should be left to the Brydon review to consider.

Question xvii.
Should the FRC take further steps to increase the value of extended auditor reporting to users of financial statements? If you agree, what material would you like to see included in auditor’s reports?

Response xvii.
The revisions and improvements in auditor reporting have undoubtedly been beneficial and welcomed by investors, particularly the inclusion of key audit matters in the auditor’s report thereby improving market confidence. This has provided investors and other key stakeholders with increased visibility into the audit process.

The experimentation within one of the Big 4 audit firms with a ‘graduated findings’ approach to the audit opinion, signaling a shift from the binary opinion, has been cited as most insightful and useful for investors and therefore the availability of this approach as an option for inclusion within the auditor’s report could be given greater prominence in the revised reporting standards.

Consideration could also be given to including some commentary or indication of the number and quantification of the effect of the audit adjustments on the profit or loss. Perhaps the most appropriate location for this information would be in the audit committee report with the auditor making reference to it in the auditor’s report.

Question xviii.
ISA (UK) 720 sets out the auditor’s responsibilities in respect of other information – do you believe the current requirements are sufficiently responsive to the needs of users of financial statements? If you disagree, please set out what additional work you would like to see auditors undertake.

Response xviii.
There is anecdotal evidence to suggest that investors increasingly use information outside of the financial statements to inform their decisions. Therefore, consideration should be given to whether the scope of audit should be extended to other information such as KPIs, Non-GAAP measures and ESG information. The nature of any assurance on such information would need to be explored but the firms are already undertaking such work outside of the financial statement audit.

It is not clear whether the market would be willing to pay for this additional assurance but if it can be linked to audit quality, and agreed as providing greater value to stakeholders, there is nothing to suggest that the market would not be willing to pay for this service. Again, we envisage that this is a subject that the Brydon review will consider.
Question xix.
For going concern, auditors are required to assess whether management’s use of the going concern basis of accounting as required by IFRS or UK GAAP is appropriate. How could auditors make their assessment of greater value to users of financial statements? Please set out what steps you believe should be required to better underpin confidence in audit and audited.

Response xix.
There is an argument that the going concern requirements should be made clearer. It is sometimes overlooked by certain stakeholders that it is management who are responsible for the appropriate application of the going concern basis and this needs to be re-emphasised. Consideration should also be given to whether guidance is required in relation to the auditor’s role in relation to assessing cybersecurity risk in a financial statement audit and the vulnerability of the organisation to possible cyber-attack and the implications for the going concern status thereafter.