

September 2015

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

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

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**Annexes in respect of Sections 2-5 of this consultation document are published separately on the FRC's website: <https://frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Enhancing-Confidence-in-Audit.aspx>**

## SECTION 1: INTRODUCTION

The FRC is committed to acting as a proportionate and principles-based regulator, and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work, to maintain investor and wider stakeholder confidence in audit.

In developing the proposals which are the subject of this consultation, the FRC has continued to seek to:

- develop a clear and sustainable framework and clear lines of accountability (so that companies and audit firms know the exact role of all UK regulatory bodies);
- maintain market confidence in the independence of regulation (so that investors and potential investors remain confident in the quality of financial statements);
- apply the rule of proportionality, and deliver implementation that can be justified and defended; and
- serve the public interest.

### European Union (EU) Audit Regulation and Directive

In April 2014, the European Parliament and the Council of the European Union issued Regulation EU/537/2014 covering specific requirements regarding statutory audit of public interest entities<sup>1</sup> (PIEs) (the Regulation), and Directive 2014/56/EU covering the statutory audit of annual accounts and consolidated accounts (the Directive). Both apply with effect from 17 June 2016. The Regulation and Directive taken together require revisions to both the Ethical and Auditing Standards as well as changes to the UK Corporate Governance Code (the Code). The FRC has also taken the opportunity to review the 'Guidance on Audit Committees' (the Guidance), last published in September 2012, in order to align this with the new requirements for audit committees and changes to the ethical standards for auditors.

The Directive requires minimum harmonisation of requirements at the European level and these are being transposed into UK law. The Directive also gives the opportunity for Member States to exercise derogations and options. The Regulation has a direct effect in law and requires maximum harmonisation at the European level. Unusually for a regulation, it also includes some Member State options. The FRC has considered the issues raised by the interaction between the Regulation and the Directive.

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

The FRC has reflected the results of the December 2014 consultation in its proposals for implementing the requirements of the Regulation and Directive. We are also continuing to discuss the requirements of the Regulation and Directive with the Government and the European Commission. Areas where the FRC proposes to implement additional requirements that go beyond those proposed by the European Union or the International Audit and Assurance Standards Board (IAASB) are set out later in this consultation paper, along with the rationale for that proposal, and in the accompanying impact assessment.

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

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

The FRC is a principles-based regulator, and in revising the Ethical and Auditing standards has developed an approach where principles are supported by more detailed requirements. As set out later in the consultation document, this is intended to mitigate the risk that auditors treat standards (and the Ethical Standard in particular) as a rule book where behaviour is driven by a series of prohibitions rather than an assessment of what behaviours or actions are appropriate. The requirements in the Regulation have a direct effect in law, and therefore, cannot be subject to interpretation by the FRC in drafting the standards. Therefore, these requirements are copied largely verbatim into the text of the standards and are identified for the purposes of this exposure draft with shading. The requirements of the Directive do not have direct effect in law and can be interpreted. The requirements are set out in detail in the text of the Directive, and because they need to be complied with, the FRC has copied in the text and identified it within the text of the standards. This has been done to provide auditors with a single source covering all requirements.

The Department for Business, Innovation and Skills (BIS), the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA) are also consulting on the Regulation and Directive and the FRC has worked with them to ensure consistency of approach.<sup>3</sup>

### **International Audit and Assurance Standards Board**

In addition to implementing the Regulation and Directive, the IAASB has recently issued revised auditor reporting standards,<sup>4</sup> a revised Standard on 'The Auditor's Responsibility Relating to Other Information' (ISA 720), and revised standards on 'Communication with Those Charged with Governance' (ISA 260) and 'Going Concern' (ISA 570). The IAASB has also issued the results of its project on 'Addressing Disclosures in the Audit of Financial Statements'. As auditing standards in the UK and Ireland are based on international standards issued by the IAASB, the FRC is taking the opportunity to include necessary revisions to the auditing standards at the same time as making the necessary changes to implement the Regulation and Directive.

### **Competition and Markets Authority**

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

Following the decision of the CMA to delay finalising its proposed Orders to assess the implications of the Regulation and Directive, the FRC deferred consideration of whether to make any changes to the section of the Code dealing with the audit committee and appointment of the external auditor until the Code was next reviewed. More detail on the impact of the CMA's Orders and recommendations is covered in Sections 3, 4 and 5.

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<sup>3</sup> The Department of Jobs, Enterprise and Innovation has also indicated to us that auditors in the Republic of Ireland will use the Ethical Standard and Auditing Standards (UK and Ireland) issued by the FRC.

<sup>4</sup> ISAs 700, 701, 705, 706

## HOW TO RESPOND

Answers on the questions set out in this consultation document and comments on the related annexes are requested by 11 December 2015. Responses should be sent by email to [ARDconsultation@frc.org.uk](mailto:ARDconsultation@frc.org.uk).

or in writing to:

Catherine Woods  
Financial Reporting Council  
8<sup>th</sup> Floor  
125 London Wall  
London  
EC2Y 5AS

As this consultation covers a number of different documents it would be greatly appreciated if responses clearly state the sections and questions they relate to. This will aid our analysis and ensure no comment is overlooked when allocating the responses for internal review by the relevant FRC team.

It is the FRC's policy to publish on its website all responses to formal consultations unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

## **SECTION 2: ETHICAL STANDARD**

### **Introduction**

The FRC is issuing, for consultation, a revised Ethical Standard (the 'FRC ES') which will apply to all audit and other public interest assurance engagements. It is intended to replace the Auditing Practices Board's (APB) Ethical Standards for Auditors 1 to 5 and the Ethical Standard for Reporting Accountants, and to apply to Client Assets Sourcebook audits when the new standard for such engagements is finalised. It also includes changes to incorporate the requirements of the Regulation and Directive. Compliance with the FRC ES will be required for all audit and assurance engagements performed under the FRC's performance standards.

The FRC's current Ethical Standards for Auditors and Reporting Accountants were developed with the intent that they should adhere to the relevant principles of the International Ethics Standards Board (IESBA) Code and not be less stringent. Our proposals for relief from certain requirements for smaller non-PIE listed entities, as highlighted below, would depart from this objective.

In April 2014, the FRC set out its work to give justifiable confidence in the quality of audit.<sup>5</sup> A key element of that work was a review of the ethical framework for auditors, including the ethical standards, and the proposals resulting from that review are also included in our consultation. These include changes to emphasise the overarching ethical principles and supporting ethical provisions in the Standard and to further clarify or amend some requirements in light of issues identified from the FRC's Conduct work.

### **General application of the Ethical Standard**

The overarching ethical principles and supporting ethical provisions in the FRC ES, which taken together establish a set of ethical outcomes that must be met, will apply consistently to all audit and other public interest engagements. Additional requirements and guidance – in some cases applicable only to certain classes of entity and/or engagement (see below) – are included to assist in meeting these ethical outcomes. However, it is the requirement to meet these outcomes which is paramount. Compliance with the requirements may not be sufficient to meet the outcomes and, where such compliance cannot be demonstrated to be sufficient, any additional steps that are necessary to meet the outcomes must be taken.

In the case of a statutory audit engagement, compliance with the overarching principles and supporting ethical provisions, and with the additional requirements of the ES other than those applicable only to certain classes of entity and/or engagement, will ensure compliance with the ethical provisions required by the Directive.

### **Overarching principles**

The FRC is a principles-based regulator, and the FRC ES is principles based. We have revised the standard to make the overarching principles and supporting ethical provisions more prominent and more clearly outcome based, and to place them at the front of the standard (see pages 17-21 of Annex 1). These outcomes must be met.

Specific requirements and guidance that are designed to assist compliance with the principles and supporting provisions in particular circumstances are still included. However, we have clarified that circumstances relating to audit and other public interest assurance engagements vary widely and compliance with the overarching principles is paramount. Compliance with the

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<sup>5</sup> [www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/April/FRCs-work-to-enhance-justifiable-confidence-in-au.aspx](http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/April/FRCs-work-to-enhance-justifiable-confidence-in-au.aspx)

specific requirements may not necessarily mean that the overarching principles and supporting ethical provisions have thereby been complied with.

However, because the FRC ES includes detailed requirements, there is still a risk that this can lead to a rules-based mind-set on the part of the auditor or assurance practitioner. A rules based mind-set can result in an approach which considers whether actions are “specifically prohibited” rather than “appropriate”. This can lead to behaviour which third parties perceive as likely to compromise integrity, objectivity and independence. Therefore, we have clarified in the requirements that safeguards have to reduce threats to “a level at which it is probable that an objective, reasonable and informed third party would not conclude that independence would be compromised” (rather than just saying reduce them to an “acceptable level”).

In implementing the required changes, we have consolidated the existing five separate standards in to one standard with sub-sections. This is intended to help avoid a situation where the current ESs 2-5 may be considered in isolation without regard to the overarching principles in ES 1.

### **Application to audits of PIEs and of listed entities**

For PIE audits, application of the FRC ES will ensure that auditors satisfy the applicable ethical requirements of the Regulation. These requirements are not being extended to audits of any other entity.

For audits of all listed entities, application of the FRC ES will ensure compliance with the existing more stringent ethical requirements for audits and investment circular reporting engagements for such entities that currently apply under the APB’s ethical standards which the FRC ES will replace, subject to reliefs from some of those requirements (principally those relating to non-audit services) that we are proposing for smaller listed entities that are not PIEs.

We are also proposing to extend, to non-listed PIE audits, the more stringent requirements that are not subject to such relief (principally relating to reporting to those charged with governance and to circumstances when a firm’s fee income from an entity is expected to exceed 5%, 10% or 15% of the firm’s total fee income), on the grounds that this will enable consistency of focus on these matters by auditors and audit committees for such entities, without requiring any additional work by the auditor beyond reporting.

Non-listed PIEs will also be subject to the FRC’s more stringent requirements relating to the rotation of the audit engagement partner, the engagement quality control reviewer and other key audit partners. The Regulation requires a maximum tenure for an engagement partner of 7 years, but provides a Member State Option allowing that to be reduced. The FRC proposes to make use of the Option and to set the requirement at five years for all PIEs and for all listed entities. This is consistent with the existing ethical standards, and allows the auditor to comply with the requirements of the IESBA code. We propose to maintain the existing flexibility that allows the engagement partner to be extended, in exceptional circumstances (for instance to maintain audit quality), to a maximum of no more than seven years where this is approved by the audit committee.

The FRC ES will continue to define a listed entity consistent with the definition used in the international standards issued by the IAASB and the international ethical code issued by the IESBA:

“An entity whose shares, stock or debt are quoted or listed on a recognised stock exchange or are marketed under the regulations of a recognised stock exchange or other equivalent body”.

In the UK context, this means that the requirements in the FRC ES for listed entities will apply to the audits of any company in which the public can trade shares on the open market, such as those listed on the London Stock Exchange (including those admitted to trading on the Alternative Investments Market, AIM), ISDX Markets and the Irish Stock Exchange (including those admitted to trade on the Irish Enterprise Securities Market), subject to the reliefs referred to above. However, we are amending the definition to clarify that an entity whose securities are technically listed, but which are not in substance freely transferrable or tradeable are not listed entities for the purposes of the ES.

We are also removing the previous language difference between the definition in the APB ethical standards and the International Standards on Auditing (ISAs) (UK and Ireland) of listed entities, to avoid any suggestion that the definition for the FRC ES is intended to apply only in relation to UK and Ireland exchanges.

***Question 1: 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?***

***Question 2: Do you support the FRC's proposals to restructure the ethical standards, as a single standard for all audit and public interest assurance engagements?***

***Question 3: Do you agree with the FRC's proposals for the application of the FRC ES to non-listed PIEs?***

### **Ethical Standard applicable to Smaller Entities**

We are proposing to retain the Ethical Standard – Provisions Available for Smaller Entities (ES-PASE). This provides alternative provisions for auditors of Small Entities (as defined in its introduction) to apply in respect of the threats arising from economic dependence and where tax or accounting services are provided, and allows the option of taking advantage of exemptions from certain of the requirements in the revised Ethical Standard for audit engagement. We will however need to disapply the ES-PASE for audits of (small) PIEs (because it would conflict with the requirements of the Regulation) and make amendments to conform with the proposed Ethical Standard. These changes are shown in Annex 5. In due course the FRC will consider whether it is desirable to simplify the structure and application of the ES-PASE.

***Question 4: Do you agree with the FRC's proposal to retain the Ethical Standard – Provisions Available for Smaller Entities and to make conforming changes?***

### **Matters consulted on in December 2014**

The December 2014 FRC consultation paper explored how the Member State options might be implemented. The responses to that consultation and the position that the FRC is now proposing to take are identified in the Impact Assessment paper. Many respondents were concerned about possible 'gold plating' of EU requirements, although there was no appetite for withdrawing existing requirements to support audit quality, where those requirements are already well established, and considered to be working effectively. We are proposing, where possible, to maintain existing FRC requirements that are more stringent (and have already been subject to public consultation) and to ensure that appropriate standards of independence are complied with by auditors whose work will be used for the purpose of the group audit.

## **Requirements applicable to other group component auditors (extraterritoriality)**

We are not proposing to mandate that ‘other auditors’ of group components’ statutory financial statements have to follow the FRC ES. However, it is important that auditors are able to demonstrate that they are appropriately independent if their work is to be used by the group auditor. We have concluded that a proportionate approach is to require the group auditor to carry out an evaluation of the independence of any network or third party firm whose work they propose to use in the group engagement and any other network firm. If the group auditor concludes that other group component auditors do not have the necessary level of independence, the lead group auditor cannot use their work and would have to obtain evidence by other means, such as doing the work themselves or requesting that another firm is used to do the work necessary for the purpose of the group audit.

The relevant test for a network firm involved in the audit would be the FRC ES as applicable to the group auditor; and for other network firms and for third party firms involved in the audit, is the extant version of the IESBA Code.

***Question 5: 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?***

## **Non-Audit Services**

The FRC does not propose to make any additions to the EU blacklist of prohibited non-audit services for PIEs. The FRC also does not propose to adopt a ‘white list’ of approved non-audit services for PIEs with all other unlisted services prohibited. These options were not supported by the majority of respondents to our December 2014 consultation. Furthermore, the FRC does not propose to utilise the Member State option to apply a more stringent (lower) fee cap relating to the provision of non-audit services, as set out in Article 4 of the Regulation. However, the FRC is proposing amendments, in accordance with the Regulation to avoid resetting the three year calculation period where interruption arises from a gap year in providing NAS and to apply the cap to firms at the network level.

The FRC has carefully considered the responses received to the December 2014 consultation, particularly in respect of non-audit services. As a result, our proposals adhere closely to the requirements set out in the Regulation. Where we have proposed amendments, we have done so to address a risk to auditor independence that would impact adversely on investor and other stakeholder confidence in audit. That might arise from anomalies regarding the application of the cap, by the artificial creation of a gap year in the calculation period, or because a firm is able to use a non-EU network member to provide non-audit services which would otherwise not be permitted by the Regulation.

In determining how to implement the requirements of the Audit Regulation and Directive in a proportionate way that does not unduly burden business, the FRC has worked closely with BIS colleagues and sought legal advice to understand those services that are subject to the cap, and those which are exempt (because they are required by national or European law) for the purposes of calculating it.

Non-audit services which are required by law or by a rule issued by a regulator in accordance with powers granted by legislation are exempt for the purposes of the calculation of the cap. Therefore, fulfilling requirements set in rules made by, for example, the PRA or the FCA will be exempt, as will be work undertaken to comply with the UK Listing Rules but this exemption will not apply to a report under the Standards for Investment Reporting (SIRs) unless there is a requirement in law or regulation for such a report. This will mean that entities which engage their statutory auditors to carry out work to comply with regulatory requirements should not be

prevented from doing so under the cap, and will not incur any additional burden as a result of having to undertake additional tenders for the provision of such services.

## **Independence ‘test’**

A key criterion in the Directive is that “an objective, reasonable and informed third party would not conclude that the independence of the auditor is compromised”. This is consistent with the extant requirement of the Statutory Audit Directive but is different from the current wording contained in paragraph 15 of Ethical Standard 1 which states that the test is whether “it is probable that a reasonable and informed third party would conclude that the auditor’s objectivity either is impaired or is likely to be impaired”. In the FRC ES, we propose to retain the more stringent reference to it being ‘probable that’ but have sought to otherwise align with the Directive wording (see definition of Independence in the FRC ES).

## **Applicability of independence requirements**

Revisions made to the FRC ES to implement the Regulation and Directive include extending the applicability of the independence requirements for individuals to include “any other natural person whose services are placed at the disposal or under the control of the audit firm and who is directly involved in audit”. In order to implement this requirement there is a series of related revisions to the overarching principles and supporting ethical provisions in the FRC ES.

In addition, certain independence requirements for individuals in the current ethical standards are applied in relation to “immediate family members” but are now revised in line with the Directive to apply instead to “persons closely associated” which follows a broader EU definition, and which is set out in the definitions section of the FRC ES. Restrictions on gifts and hospitality now reduce the limits to those where “an objective, reasonable and informed third party would consider the value thereof as trivial or inconsequential” (as required by the Directive) – see paragraph 4.54 on page 75 of Annex 1.

## **Extension of scope to other public interest assurance engagements**

The FRC believes that stakeholders expect an equivalent standard of independence for firms, their partners and staff in providing other public interest assurance engagements to that required of auditors. We therefore propose that the FRC ES applies to all audit and other public interest assurance engagements (in effect for all such engagements in relation to which the FRC issues performance standards – this includes the SIRs, reporting in connection with investment circulars), engagements where the auditor reports on an interim review of the financial statements and the forthcoming Client Assets Standard.

We identify that other bodies and regulators may also require compliance with these standards for other assurance engagements for which the FRC has not issued performance standards.

As a result, the FRC proposes to withdraw the APB Ethical Standards for Auditors and the Ethical Standard for Reporting Accountants (ESRA) from issue. Where necessary, we have retained certain specific requirements from the ESRA which are different from the equivalent requirements in the APB’s Ethical Standards for Auditors, which can be identified from the wording of the requirements but we have amended the definition of ‘person in a position to influence the conduct or outcome of an engagement’ insofar as it relates to investment circular reporting engagements, consistent with the changes made to the definition insofar as it relates to other engagements, to be clear that for an investment circular reporting engagement, the requirements only apply to those who have actual knowledge of the engagement.

There is no significant net change resulting from this proposal as it effectively has the same combined scope as the standards that would be withdrawn.

**Question 6: 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?**

## **Other matters identified in the wider review of the ethical framework**

### **Chain of Command**

The current ethical standards include the term “persons in the chain of command”. That term is defined as:

“All persons who have a direct supervisory, management or other oversight responsibility over either any audit partner of the audit team or over the conduct of audit work in the audit firm. This includes all partners, principals and shareholders who may prepare, review or directly influence the performance appraisal of any audit partner of the audit team as a result of that partner’s involvement with the audit engagement. It does not include any non-executive individuals on a supervisory or equivalent board.”

However, in practice this definition has given rise to some uncertainty as to who is in the chain of command, particularly in relation to members of the senior management of an audit firm, who may not be “directly” involved in oversight of the audit or appraisal of the audit engagement partner. Article 22.1 of the Directive, specifically requires that “any natural person in a position to directly or indirectly influence the conduct and outcome of the statutory audit is independent of the audited entity”.

The FRC proposes to eliminate the term ‘chain of command’. Instead, we have included a (revised) definition of a “*person in a position to influence the conduct or outcome of the engagement*” – see page 13 of Annex 1.

The term ‘chain of command’ is also referred to in the existing requirement in Ethical Standard 2.49 which specifies that if certain partners (including a partner in the chain of command) leave the firm and join an audit client in a senior position within two years, the firm resigns the audit and cannot accept reappointment until a two year period from that partner ceasing to have the ability to influence the audit has elapsed (or the former partner has left the audited entity). It is also relevant to other requirements that apply to persons in a position to influence an audit, as identified below.

We therefore, also propose to amend paragraph 2.49 to replace “a partner in the chain of command” with “*a partner in a position to influence the conduct or outcome of the engagement*”. This no longer specifies the need for a person in a position of influence to be able to exert “direct” influence, and now includes persons “at each successive level of firm management, supervision or oversight relating to the audit or other public interest engagement, up to and including individuals who have ultimate responsibility for the management or governance of the firm”.

The amendment to the definition of a person in a position to influence the conduct or outcome of the engagement is also relevant to a number of other requirements in the current ethical standards to which such persons are subject. These are primarily:

- the other requirements in the current Ethical Standard 2 that cover restrictions on financial interests and business relationships with audited entities;
- situations where ‘closely associated persons’ (including ‘immediate family members’ and relatives sharing the same household) and ‘close family members’ are employed by an audited entity in a position in which they could influence the accounting records or financial statements. If it is a ‘closely associated person’ the partner would need to cease to hold a position in which they could influence the audit or, if a ‘close family member’, would need to report the situation to the engagement partner to take appropriate action;
- restrictions on holding governance roles with an audited entity – similar to that where closely associated persons and close family members are employed by the audited entity;
- restrictions on the roles a person joining the audit firm from an audited entity can be appointed to; and
- remuneration and performance assessment not to include selling other services to the audited entity.

***Question 7: 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?***

### **Partners and other restricted persons joining an audit client**

The Directive includes the requirement that a statutory auditor or key audit partner carrying out an audit on behalf of the audit firm cannot join the audited entity before a period of one year (non-PIE) or two years (PIE) has elapsed since ceasing to act as statutory auditor. A partner or other person personally approved as a statutory auditor also cannot take up a position with an entity for which they were involved in the audit until one year after ceasing their involvement.

The first restriction is currently imposed through the Companies Act and Audit Regulations of the professional bodies, whereas the restriction imposed on other partners and employees involved in the audit is a new requirement of the Directive. The ethical standards, which apply to auditors rather than former auditors, establish requirements that address the consequence for the firm of someone joining an audited entity.

### **Accepting an engagement for an entity that employs a former partner or other restricted person**

The FRC proposes to include a new requirement that mirrors the existing and new requirements contained in the Directive (see page 55, paragraph 2.53, of Annex 1). If a partner or other person subject to those requirements should leave the audit firm, and join a company not currently audited by that firm, then the firm shall not accept appointment as its auditor (or provider of another public interest assurance engagement) within the time periods required by the Directive.

The moratorium for such a period is proportionate and consistent with the period for which a firm is required to give up an audit if a partner leaves and joins an existing audit client. For statutory auditors who are not partners, the moratorium period that applies is one year as required by the Directive.

***Question 8: 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?***

#### **Non-audit services provided before appointment as auditor**

To improve clarity, the FRC proposes more explicit guidance to indicate that the firm does not accept an appointment to undertake an audit (or other public interest assurance engagement) unless an objective, reasonable and informed third party, taking into account safeguards applied, would conclude that the independence of the firm, its partners and staff in performing the audit or other public interest assurance engagement is not compromised having regard to recent, current and potential non-audit services provided to the entity. This is addressed through paragraph 5.21 on page 83 of Annex 1.

***Question 9: 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?***

#### **Acting as an advocate for an audited entity in relation to tax (non PIEs)**

The current requirement in Ethical Standard 5, paragraph 104, prohibits an auditor from acting as an advocate "before an appeals tribunal or court". This requirement is considered by some to be ambiguous in respect of whether an auditor can act as an advocate for an entity in its dealings with HMRC before it gets to a tribunal or court when the 'advocacy threat' (becoming wedded to a client's position in an adversarial context) is the same. We propose, therefore, to delete the words "before an appeals tribunal or court" – see page 106 of Annex 1.

This proposed change for non-PIEs will better align, and make more consistent the applicable requirements with the prohibitions applicable to PIEs in para 5.58(a) (v). This prohibits "support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspections is required by law". The reference to 'tax authorities' is broader than 'an appeals tribunal or court'.

***Question 10: Do you support the FRC's proposal to make consistent the prohibitions over providing advocacy for an audited entity in relation to tax?***

#### **Not providing tax services on a contingent fee basis**

The FRC proposes to revise the current Ethical Standard 5 to prohibit the provision of tax services on a contingent fee basis. The FRC considers that the benefits resulting from a reduced risk of the auditor facing a conflict of interest outweigh any costs associated with obtaining those services on a fixed fee basis, or from an alternative provider. This is effected by deleting the current provision in ES 5, and amending the requirement in paragraph 4.13 that addresses contingent fees.

***Question 11: Do you agree with the prohibition proposed by the FRC in respect of the provision of tax services on a contingent fee basis?***

#### **Proposed reliefs for smaller listed entities**

The FRC is committed to being a proportionate regulator, and recognises that there can be costs that fall on business as a result of regulatory decisions that we have taken. For the audit of non-PIEs, which are not subject to the requirements of the Regulation, the FRC proposes to offer relief from certain of the requirements set out in the FRC ES, where this will not be detrimental to the public interest. This will apply to listed entities which are not PIEs (a) by

clarifying that the definition of listed entity does not include those entities whose securities are technically listed on a recognised market, but where those securities are not in substance open to trading by members of the public; and (b) in relation to restrictions on non-audit services, where the market capitalisation value of the entity is below £100 million (see below).

The FRC's proposal to provide relief is subject to a rigorous and effective assessment of threats being undertaken, and appropriate safeguards being put in place.

The FRC proposes that the £100 million threshold should be assessed using the average of the market capitalisation on the first and last days of the year six months prior to the accounting period under consideration. This is to prevent an entity from losing the proposed reliefs, in the event that market capitalisation is affected by a temporary spike.

The selection of £100 million as the threshold will mean that around three quarters of the entities listed on the AIM market benefit from the proposed reliefs, while the largest 'other listed' entities which are likely to be of greater public interest will continue to be subject to all of the provisions of the Ethical Standard in respect of non-audit services. The proposed threshold is also aligned with the value used currently by the FRC's Audit Quality Review team, to determine those entities subject to its audit quality inspections.

The FRC proposes once an entity exceeds the threshold for reliefs, it will be subject to the full requirements of the FRC ES in respect of non-audit services for a period of two financial years following the financial year in which the reliefs cease to apply, even if its market capitalisation falls below £100 million in a subsequent accounting period. The FRC considers this to be appropriate as investors may have an ongoing interest in the future performance of the entity which warrants the application of the more stringent requirements.

***Question 12: Do you agree with the FRC's proposals to offer targeted reliefs in respect of the audits of smaller listed/ smaller quoted entities?***

***Question 13: 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?***

***Question 14: 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?***

## **SECTION 3: Auditing Standards**

### **Introduction**

The FRC is issuing, for consultation, revised quality control and auditing standards. The FRC's standards are based on the corresponding ISAs and International Standard on Quality Control (ISQC) issued by the IAASB. Where necessary, the FRC incorporates additional requirements into the standards to address specific UK and Irish legal and regulatory requirements; and additional guidance that is appropriate in the UK and Irish national legislative, cultural and business context.

There are two main sources for the changes to the quality control and auditing standards.

#### **1. Audit Regulation and Directive**

Articles in both the Regulation and Directive establish requirements that relate to matters that are the subject of the FRC's auditing and quality control standards for auditors (together, auditing standards). The FRC is proposing to implement these requirements through the development of the auditing standards framework and revision of the relevant auditing standards.

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

In addition to changes arising from the Regulation and Directive, the IAASB has issued new and revised standards arising from the following projects:

##### **IAASB project: Auditor reporting**

In January 2015, the IAASB issued new and revised Auditor Reporting standards, designed to enhance auditor's reports for investors and other users of financial statements, in response to a call for a more informative auditor's report and in particular for auditors to provide more relevant information to users.

The IAASB revised the suite of auditor reporting standards (ISAs 700, 705 and 706) and introduced a requirement for auditors of listed entities' financial statements to communicate "Key Audit Matters" – those matters that the auditor views as most significant, with an explanation of how they were addressed in the audit – in a new standard ISA 701.

The IAASB has also taken steps to increase the auditor's focus on the going concern basis of accounting by enhancing the auditor's reporting responsibilities, including requiring greater focus on the related disclosures in the financial statements, and adding more transparency in the auditor's report about the auditor's work in this respect.

##### **IAASB project: Other Information**

ISA 720 has been revised to clarify and enhance the auditor's responsibilities in relation to "other information" – defined in the standard as financial and non-financial information, other than the audited financial statements, that is included in (or accompanies) entities' annual reports.

This revision enhances the auditor's work effort with respect to other information by requiring the auditor to consider whether there is a material inconsistency not only between the other information and the financial statements but also between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and

conclusions reached in the audit. It also requires the auditor to address the outcome of the auditor's work relating to other information, in the auditor's report.

## **IAASB project: Disclosures**

The IAASB has revised ISAs covering the audit of financial statement disclosures, in order to enhance the auditor's focus on disclosures, by introducing or enhancing certain requirements and application and other explanatory material in the ISAs addressing risk assessment, evaluating misstatements and forming an opinion on the financial statements relevant for the purposes of auditing quantitative and qualitative disclosures.

## **Summary of amendments**

A table showing which auditing standards have been impacted by the Audit Regulation and Directive and the IAASB's projects has been included as Appendix 2.

## **Incorporating the requirements of the Regulation and Directive into ISAs (UK and Ireland)**

The requirements of the Directive apply to all statutory audits. As the Directive does not have a direct effect in law, the UK and Ireland need to implement the requirements of the Directive into either law or regulation. The requirements of the Regulation apply to statutory audits of PIEs. As the Regulation has the direct effect of law, the FRC is not required to include the provisions of the Regulation in the auditing standards.

Given the provisions of the Regulation and Directive cover similar requirements to those already existing in the auditing standards the FRC believes there is a compelling argument to incorporate the Regulation and Directive provisions into standards. We also noted that respondents to the BIS Consultation issued in 2014 supported the view that the FRC's auditing standards were the most appropriate tool to use for the implementation of the technical requirements of the Regulation and Directive where those requirements were related to standards.

***Question 15: 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?***

## **Implementation dates**

The effective date for the ISAs issued by the IAASB are for audits of financial statements for periods ending on or after 15 December 2016. The Regulation and Directive applies to audits of financial statements commencing on or after 17 June 2016. The FRC proposes to adopt a single implementation date for all proposed changes to the auditing standards, irrespective of their originating source, aligning to the implementation date required by the Regulation and Directive – effective for audits of financial statements commencing on or after 17 June 2016. We believe that this will minimise the necessary changes that audit firms need to make, and as a result the knock on cost of audit.

As this effective date is later than the IAASB's, we propose to allow early adoption of the standards in order to facilitate changes to methodologies of international firms.

***Question 16: Do you foresee any difficulties if the effective date is for audits of financial statements for periods commencing on or after 17 June 2016?***

## Adopting ISA 700 (Revised) and ISA 701

The FRC's policy is to adopt the ISAs issued by the IAASB where possible in order to maintain the UK and Ireland's position as a leader in audit quality and to achieve harmonisation of standards internationally.

The exception to this was ISA 700 "Forming an Opinion and Reporting on Financial Statements" as it was the opinion of the Auditing Practices Board (now succeeded by the FRC) in 2008 that the introduction of the clarity version of ISA 700 "would perpetuate, indeed exacerbate, the use of 'boiler plate' language in auditor reports" and that it was preferable to issue a national auditing standard instead: ISA (UK and Ireland) 700 "The Independent Auditor's Report on Financial Statements". Despite not adopting the IAASB's ISA 700, ISA (UK and Ireland) 700 was drafted such that compliance with it would not preclude the auditor from being able to assert compliance with the ISAs issued by the IAASB.

The FRC identified two key issues which needed to be addressed with respect to auditor reporting and consequently, the FRC set out to influence the direction of the IAASB's project in regards to these areas:

- eliminating unnecessary wording; and
- making auditor's reports more informative.

The FRC has actively participated in the IAASB's auditor reporting project and has concluded that the significant concerns that the FRC had with the previous auditor reporting standard have now been addressed. For example, the IAASB's ISA 700 permits the description of the auditor's responsibilities to be cross-referenced to a website or an appendix of the auditor's report. ISA 701 includes the requirement to report on key audit matters, thereby making auditor's reports more informative.

We therefore propose to adopt the IAASB's ISA 700 (Revised) and ISA 701, subject to including additional UK pluses to retain some requirements already incorporated into our extant standard.

The FRC led the way with the introduction of extended auditor reporting in the UK and Ireland. In revising the reporting standards we have sought to retain those requirements which drove innovation in auditor reporting in the UK and Ireland. Therefore, we have extended the IAASB's definition of key audit matters to include:

- those extant reporting requirements in the UK and Ireland that the auditor's report should "describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;"<sup>6</sup> and
- the requirement in the Regulation for auditors of PIEs to include in support of the audit opinion "a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud".

We do not expect the two changes referred to above to result in an increase in the number of key audit matters communicated in the auditor's report. However, key audit matters to be communicated in the auditor's report are a matter of professional judgement and will depend on the specific circumstances of the audited entity and engagement.

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<sup>6</sup> ISA (UK and Ireland) 700 (Revised September 2014) "The Independent Auditor's Report on the Financial Statements", paragraph 19A(a)

The FRC also proposes to extend the requirement in ISA 700 (Revised) for listed entities to apply ISA 701 to both:

- those entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code – in order to maintain the existing similar requirements of extant ISA (UK and Ireland) 700 (Revised September 2014); and
- PIEs – in order to provide auditors with a framework to assess the risks that are required to be reported in accordance with the Regulation.

Investors have indicated that the information communicated by the auditor on materiality and the scope of the audit is useful and therefore we have retained this requirement in ISA 701.

**Question 17: 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?**

### **Revised requirements of ISA 720**

The FRC proposes to adopt the IAASB's revised ISA 720 which applies to other information published alongside the financial statements. ISA 720 (Revised) requires the auditor to report whether they have identified any material misstatements in the other information. Auditors will need to consider the work necessary to satisfy this requirement. However, ISA 720 clearly states that this reporting requirement should not be interpreted as a form of assurance, unless it relates to a specific requirement of the Directive.

The Directive requires the auditor to give an opinion on certain of the other information (interpreted in UK [and Irish] legislation<sup>7</sup> as the director's report and where one is required, or voluntarily prepared, the strategic report and the separate corporate governance statement and defined in the proposed standard as 'statutory other information'). Under existing legislation, the auditor is required to give an opinion on whether the statutory other information is consistent with the financial statements. The Directive goes further, and requires auditors, based on the work undertaken as part of the audit, to:

- Express an opinion on the compliance of the statutory other information with the applicable legal requirements; and
- State whether any material misstatement in the statutory other information has been identified by the auditor in light of the knowledge and understanding of the audited entity, which they have gained during the course of the audit.

Therefore, we propose to address this by incorporating requirements in ISA (UK and Ireland) 720 (Revised) to require the auditor to: obtain an understanding of the applicable reporting framework used to prepare the statutory other information; consider whether there are material misstatements between the other statutory information and that framework; and report on the statutory other information in accordance with the legislation.

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<sup>7</sup> UK Companies Act 2006, Sections 496 and 497A as amended by the Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015. Irish legislation has yet to be finalised

In addition, the following have been incorporated into ISA (UK and Ireland) 720 (Revised):

- certain paragraphs currently included in extant ISA (UK and Ireland) 700 (Revised) relating to reporting on other information;
- requirements formalising the reporting on the Listing Rules currently undertaken by premium listed entities; and
- relevant requirements and guidance (updated where necessary) from ISA (UK and Ireland) 720 Section B.

As a result, the FRC proposes to withdraw ISA (UK and Ireland) 720 Section B and “Section A” will be dropped from the title going forward.

**Question 18: 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)?**

### **Reporting on the going concern basis of accounting**

The FRC is of the view that auditor reporting related to the going concern basis of accounting is in the public interest and is valuable to investors. The FRC therefore proposes, in addition to the enhancements made by the IAASB, to include additional UK pluses in ISA (UK and Ireland) 570 (Revised) for entities where the use of the going concern basis of accounting is appropriate and no material uncertainty has been identified to:

- Where the auditor is required to or voluntarily applies ISA (UK and Ireland) 701, require the auditor to consider whether to communicate a key audit matter about going concern; and
- Require the auditor to report by exception on management’s use of the going concern basis of accounting and whether material uncertainties have been identified but not disclosed.

**Question 19: Do you agree with the FRC’s proposals to enhance auditor reporting in respect of the going concern basis of accounting?**

### **Reporting to regulators of PIEs**

The Regulation requires auditors of PIEs to report the following to the competent authorities responsible for oversight of those PIEs:

- Certain material breaches in laws, regulations or administrative provisions;
- A material threat or doubt over the continuous functioning of the PIE; and
- A refusal to issue or a modification of the audit opinion.

These requirements have been incorporated into ISA (UK and Ireland) 250 Section B ‘The Auditor’s Right and Duty to Report to Regulators in the Financial Sector’ and as such the scope of this section of the ISA (UK and Ireland) has been widened to include all PIEs, although in practice the matters that will require reporting will relate to the financial sector.

**Question 20: 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?**

## Retention of records

In the FRC Consultation in December 2014 we asked: Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?

Over 50% of the responses supported the FRC introducing a requirement stipulating a minimum retention period for audit documentation. Many of the responses that did not support this approach thought it was unnecessary as it was already dealt with by the Professional Bodies' audit regulations. However, the Regulation requires that certain documents and information be kept for a period of at least five years following the creation of such documents or information. The Regulation permits a longer retention period to be implemented.

The FRC is concerned to ensure that the requirement of the Regulation is not interpreted in such a way that results in the minimum period required not being achieved. The FRC therefore proposes to include a requirement in ISQC (UK and Ireland) requiring audit working papers which will include those documents and information required to be retained by the Regulation to be retained for a minimum period of 6 years for all entities from the date of the auditor's report.

***Question 21: Do you agree with the FRC's proposals for the minimum retention period for audit working papers for all audit engagements?***

***Question 22: 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?***

## Changes arising from the Accounting Directive

### Abridged accounts

The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 implement the requirements of the Accounting Directive in respect of 'abridged' accounts (which will come into effect for years commencing on or after 1 January 2016) such that:

- small companies will be permitted to prepare and file an abridged rather than full profit and loss account or an abridged rather than full balance sheet, or both, where all members agree;
- the previous option for small and medium-sized companies to file abbreviated accounts will be removed; and
- a special auditor's report on the abbreviated accounts is therefore no longer required and no similar provision has been introduced for abridged accounts.

Where either i) a balance sheet only; or ii) an abridged statement as part of a set of accounts; is filed, the directors are required to include a statement on the balance sheet about certain aspects of the audit (name of audit firm and senior statutory auditor, whether the opinion was modified or included an emphasis of matter) and a statement that a resolution has been passed to the effect that all members agreed to the preparation of abridged accounts (if applicable). The Accounting Directive precludes the filing of an audit report alongside these accounts.

No responsibilities are imposed by law on the auditor with respect to the filing of these accounts. It therefore does not appear appropriate or proportionate to mandate or recommend procedures that the auditor should follow (e.g. assessing whether the requirements of Companies Act with respect to the required statements have been complied with).

The FRC therefore proposes to withdraw Bulletin 2008/4<sup>8</sup> with effect for periods commencing 1 January 2016.

### **True and fair view**

Where the company has chosen to prepare an abridged profit and loss or balance sheet, or both, as its statutory accounts subject to audit, the auditor needs to be satisfied that the resulting financial statements give a true and fair view and that any additional disclosures that the auditor believes should be included have been provided.

Additional application material has been added at paragraph A15-1 of ISA (UK and Ireland) 210 (Revised) to provide guidance.

### **Micro-entities**

The micro-entities regime was introduced in UK company law in 2013 with significantly reduced financial statements presentation and disclosure requirements.

### **Deemed true and fair view**

FRS 105 is not a fair presentation framework as defined by ISA (UK and Ireland) 200 (Revised)<sup>9</sup> as it does not acknowledge explicitly or implicitly that to achieve fair presentation of the financial statements it may be necessary for management to either provide disclosure beyond that required by the framework or to depart from a requirement in the framework to achieve fair presentation. However, the financial statements of an entity prepared in accordance with the micro-entities regime are presumed in law to show a true and fair view.

Entities that prepare their financial statements in accordance with the micro-entities regime are not required to have an audit. Where one is requested the auditor will need to address the “deemed” true and fair view in the auditor’s report.

Additional application material has been added at paragraph A34-1 of ISA (UK and Ireland) 210 (Revised) to provide guidance.

***Question 23: 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)?***

### **Navigating the proposed changes**

The proposed auditing standards have changes tracked from the latest published version with the exception of ISA 700, ISA 701 and ISA 720.<sup>10</sup> For these three standards the IAASB’s revised standard has been included as the starting point and then UK and Irish specific changes have been incorporated.

Additional requirements arising from either the Regulation or the Directive are identified within the text to differentiate from the UK and Irish pluses.

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<sup>8</sup> Bulletin 2008/4 “The Special Auditor’s Report on Abbreviated Accounts”

<sup>9</sup> ISA (UK and Ireland) 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing (UK and Ireland)”, paragraph 13(a)

<sup>10</sup> The IAASB’s revised standard ISA 720 is significantly different from the old standard and therefore changes have not been tracked from extant ISA (UK and Ireland) 720 Section A for the revisions.

In addition, requirements driven by the Audit Regulation have an “R” in the requirement number (e.g. 11R-1) and those driven by the Audit Directive have a “D” in the requirement number (e.g. 15D-2).

A summary of the main changes, and their applicability is provided at Appendix 1 at the end of this consultation document. As noted earlier, Appendix 2 contains a table showing which auditing standards have been impacted by the Regulation and Directive and the IAASB’s projects.

## SECTION 4: UK CORPORATE GOVERNANCE CODE

The changes to the Code are being kept to a minimum to limit the regulatory burden. The Code was also last updated in September 2014. The FRC intends to monitor the adoption of the new 2014 Code requirements in its annual report on developments in corporate governance and stewardship to be published in January 2016. The next review of the Code is planned for completion in 2019. See Annex 3 for the marked up changes to Code Section C.3.

### Regulation and Directive Related Changes

The Code already reflects the current legal framework, and we have avoided making changes to the Code where we consider the current wording is consistent with the Regulation and Directive and have made only minimal changes where amendments are required. The inclusion in Code provision C.3.1 for the board to “satisfy itself that at least one member of the audit committee has recent and relevant financial experience” has been amended to reflect the wording from Article 39 of the Directive that at least one member has “competence in accounting and/or auditing”. In addition this provision now includes reference to the Article 39 requirement that the audit committee as a whole should have competence relevant to the sector in which the company operates.

Having reviewed the main role and responsibilities of the audit committee contained in Code provision C.3.2 the FRC is content that the requirements in Article 39 of the Directive are covered. In particular, this includes the audit committee’s responsibility for the appointment of the external auditor, and the management of the external audit process and its effectiveness. The detailed mapping is given below, and we also consider that Code provision C.3.8 covers Article 39 Section 6 (e) and (f).

Detail from provision C.3.2	Link to the Directive
<ul style="list-style-type: none"> <li>to monitor the integrity of the financial statements of the company and any formal announcements relating to the company’s financial performance, reviewing significant financial reporting judgements contained in them</li> </ul>	Article 39 Section 6 (a) and (b)
<ul style="list-style-type: none"> <li>to review the company’s internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company’s internal control &amp; risk management systems</li> </ul>	Article 39 Section 6 (c)
<ul style="list-style-type: none"> <li>to monitor and review the effectiveness of the company’s internal audit function;</li> </ul>	Article 39 Section 6 (c)
<ul style="list-style-type: none"> <li>to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor</li> </ul>	Article 39 Section 6 (f)
<ul style="list-style-type: none"> <li>to review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional &amp; regulatory requirements</li> </ul>	Article 39 Section 6 (d) and (e)
<ul style="list-style-type: none"> <li>to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken</li> </ul>	Article 39 Section 6 (e)
<ul style="list-style-type: none"> <li>to report to the board on how it has discharged its responsibilities</li> </ul>	Article 39 Section 6 (a)

**Question 24: Do you agree with the changes to section C.3 of the Code?**

## **CMA Related Changes**

In its report, and subsequent Orders, relating to the audit services market, the CMA identified adverse effects on competition (“AECs”) including a lack of switching and auditors being too close to management. In order to address these AECs it identified seven remedies. Our response to those remedies which were directed at the FRC is noted below and in Section 5. The FRC has addressed Remedies 1 (and Parts 3 and 4 of the Order) and 4 in the amendments to the Code.

Remedy 1 requires FTSE 350 companies to put their audit engagement out to competitive tender at least every ten years which will be superseded to an extent by the Regulation and Directive. As the Code includes a similar requirement (added in 2012), which is now considered redundant, Code provision C.3.7 has been amended to remove this reference. To ensure clarity with the remaining wording in C.3.7 another small change has been made. Mandatory retendering of external audits is required by the Regulation and Directive and CMA Orders, a footnote to which is included in the relevant section of the Code. Remedy 1 also relates to audit committee reporting on the tendering process. We have, therefore, suggested an addition to Code provision C.3.8 so that shareholders are informed about future audit tendering plans.

Remedy 4 relates to increasing shareholder engagement on audit matters through changes to both the Code and the UK Stewardship Code. The FRC considers that sufficient coverage is already given to this topic in both codes. It is also not appropriate for the Code to place emphasis on a particular topic over any other. Remedy 4 also includes a recommendation to introduce an advisory vote for shareholders to indicate their satisfaction with the audit committee’s annual report. The CMA considered that its introduction would increase the audit committee’s incentives to discharge their responsibilities in the interests of shareholders, in particular to assess the effectiveness of the external audit process and the approach taken to the appointment and reappointment of auditors. The FRC considers that shareholders already have sufficient rights to express their opinion on the audit committee report either by the annual re-election of the directors, which includes the audit committee Chairman, or by tabling a specific shareholder resolution. Both companies and investors have indicated to the FRC that this is an unnecessary step at this stage, but we have asked for views on such a vote.

### ***Question 25: Is an advisory vote on the audit committee report required?***

Remedy 5 makes suggestions to increase audit committee oversight of external audit. The FRC considers it unnecessary to amend the Code as it already contains provisions for the audit committee’s oversight of the external auditor that are consistent with the Order. Instead we have covered these additional specific requirements in the revised ‘Guidance on Audit Committees’ – see the next section.

## **SECTION 5: GUIDANCE ON AUDIT COMMITTEES**

The FRC's 2012 'Guidance on Audit Committees' (the Guidance) has been revised to take account of amendments to the Code and regulatory framework in light of the Regulation and Directive and the CMA's Orders and recommendations. Changes to the Guidance are numerous, so a track changed version of the document has not been included. The main changes are outlined below, but see Annex 4 for the complete version.

### **Regulation and Directive**

The main amendments involve changes to take into account the requirements of the Regulation and Directive. This includes expanding on changes relevant to the composition of the audit committee covering sectoral competence; removal of the references to audit retendering; changes covering the new rules around the prohibition of non-audit services; and consequential changes reflecting amendments to the Ethical and Auditing Standards for Auditors.

### **Recommendations of the CMA**

Many of the CMA recommendations coincide with amendments made by the Regulation and Directive, so changes to the guidance have been made with both of these sets of requirements in mind. The FRC has addressed Remedies 1 (and Parts 3 and 4 of the Order); 5 (and Part 5 of the Order); and 6 in the proposed changes to the Guidance.

Remedy 1 requires FTSE 350 companies to put their audit engagement out to competitive tender at least every ten years. To address this remedy we have removed references to audit retendering in the Guidance as these have been overtaken by the CMA Orders and requirements of the Regulation and Directive. To take account of Remedy 1 the Code and Guidance have been amended to provide that shareholders should be informed about future audit tendering plans. The Guidance expands upon this amendment, further recommending that in instances where the tender is not undertaken in line with the proposed timing this be explained to shareholders in the audit committee section of the annual report.

In Remedy 5 the CMA recommended that the Code be aligned with the order relating to an audit committee's oversight of the external auditor and the provision of non-audit services. We did not wish to override the 'comply or explain' nature of the Code by requiring certain items, but we have included the suggested clarifications in the Guidance. Again a number of these align with amendments suggested by the Regulation and Directive.

### **Audit Quality Review and Corporate Reporting Review transparency**

Remedy 6 recommended the disclosure of the FRC's Audit Quality Review (AQR) team inspection findings in audit committee reports. In addition, in 2015 the work of the FRC's AQR and the Corporate Reporting Review (CRR) teams was the subject of an externally facilitated review which also recommended greater transparency of their respective findings. The Guidance has been amended to include reporting by audit committees of significant AQR and CRR findings.

### ***Audit Quality Review***

AQR monitors the quality of the audits of listed and other major public interest entities and the policies and procedures supporting audit quality at the major audit firms in the UK. The overall objective of this work is to monitor and promote improvements in the quality of auditing of listed and other major public interest entities. At the conclusion of its inspection of individual audits AQR reports the findings to both the auditor and the audit committee.

In 2014, the FRC published a press notice outlining its suggested approach to disclosure of AQR findings on individual audits in light of the CMA recommendations. We also undertook to consider our future approach in light of the experience gained from audit committee reporting in 2015. AQR now routinely reminds audit committees where appropriate, to discuss an AQR report with its auditor together with what actions, if any, they or the committee will take in response to the review, and to consider what information should be included in the audit committee's next report. The FRC has therefore amended the Guidance to provide that:

“where a company's audit has been reviewed by the FRC's Audit Quality Review team, the Committee should discuss the findings with their auditors and consider whether any of those findings are significant and, if so, make disclosures about the findings and the actions they and the auditors plan to take. This discussion should not include disclosure of the audit quality category.”

### ***Corporate Reporting Review***

CRR seeks to ensure that the provision of financial information by public and large private companies complies with relevant reporting requirements. It writes to companies where there is, or may be, a question whether the Strategic or directors' report or accounts comply with relevant reporting requirements. The FRC's Conduct Committee changed its operating procedures last year to permit the publication of the names of companies who, at its request, had included reference to its intervention when making a substantive change to its accounts. The revised procedures also encouraged Boards to voluntarily refer to their exchanges with CRR in their reports. Our experience of the first year of working under the revised procedures has been that relatively few audit committees have provided clear disclosure of the nature and extent of interaction with CRR, except where the enquiry has resulted in a significant change to their report or accounts.

Investors are likely to have an interest in knowing whether the audit committee has engaged in substantive discussions with CRR during the year and in any significant outcomes affecting the preparation of their report and accounts. Disclosure should be factually accurate, fair and balanced in order for the market to understand appropriately and avoid the need for further public clarification. CRR will work with audit committee Chairs to achieve clear and concise disclosure.

The FRC has amended the Guidance to provide that the audit committee section of the annual report should include disclosure of:

“the nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team.”

In light of the above we will continue to monitor how audit committees report the outcomes of AQR and CRR reviews in their annual reports.

### **Ensuring consistency and minimising overlap**

The Guidance has been amended to reduce duplication with elements of the Code. The Guidance should be read in conjunction with section C.3 of the Code.

The Guidance has also been updated to ensure consistency with other recent FRC documents, for example the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting released in September 2014 and the Audit Quality: Practice aid for audit committees issued in May 2015.

## **Internal Audit**

The section on internal audit has also been updated to reflect recent reviews of best practice in this area. A number of the elements around internal audit were already included in the Guidance, but they have been expanded upon to provide an indication of best practice.

## **Insights from other work areas**

The Guidance also includes insights gathered from the FRC's other work, including changes suggested as a result of the monitoring work undertaken by the FRC's Conduct Division and evidence on the form and type of information preferred by investors as reported by the FRC's Financial Reporting Lab.

## **Appendix**

The items listed in the appendix to the Guidance are square-bracketed. When the final legislative and regulatory framework is in place the Appendix will be updated to refer audit committees to other useful documents containing information on their rights and responsibilities.

## **Audit Tenders: Notes on Best Practice**

The document 'Audit Tenders: Notes on Best Practice', released in 2013 to assist companies in applying the provisions of the Code relating to audit tenders has not been included in the Guidance. It is intended to be a practical guide, with case studies outlining how companies have approached the tendering process. As a number of companies have undertaken this process since the best practice note was first published the FRC intends to update the note incorporating their views before the end of 2015 and on a regular basis after that.

***Question 26: Do you agree with the changes to the Guidance?***

## Appendix 1: Summary of main changes to Auditing Standards

<input checked="" type="checkbox"/> = New requirement Ω = Existing requirement × = No equivalent requirement	PIEs	All Listed Entities	UK Code Co's	Other Entities
<b>Auditor reporting</b>				
What the extended auditor's report describes:				
- Risks of material misstatement	✓	✓	Ω	×
- Response/Scope	✓	✓	Ω	×
- Materiality	✓	✓	Ω	×
Explain to what extent the statutory audit was considered capable of detecting irregularities, including fraud	✓	×	×	×
Statement of compliance with independence and ethical requirements	✓	✓	×	×
Description of NAS provided and declaration that prohibited NAS not provided	✓	×	×	×
State which body appointed the auditors, the date of appointment and the total period served as auditor	✓	×	×	×
<b>Auditor reporting on Other Information</b>				
Opinion on whether OI is:				
- Consistent with the financial statements	Ω	Ω	Ω	Ω
- Prepared in accordance with the applicable legal requirements based on the audit	✓	✓	✓	✓
Statement as to whether auditor has identified any material misstatements	✓	✓	✓	✓
Report by exception on:				
- Material inconsistencies between the Other Information and financial statements/ knowledge obtained in the audit	✓	✓	Ω	✓
- Matters relevant to Fair, Balanced & Understandable and reporting to the Audit Committee	×	×	Ω	×
- Matters relevant to Solvency and Liquidity	×	×	Ω	×
- Compliance with the UK Corporate Governance Code (Listing Rules)	×	×	✓	×
- Material inconsistencies between the Directors' Statement on Going Concern	×	×	✓	×

✓ = New requirement	Ω = Existing requirement	✗ = No equivalent requirement	PIEs	All Listed Entities	UK Code Co's	Other Entities
<b>Auditor reporting on Going Concern</b>						
Consider whether a KAM is required to be communicated in the auditor's report – where ISA 701 is applied	✓	✓	✓	✗		
Report by exception on:						
- Management's use of the GC basis of accounting is not appropriate	✓	✓	Ω	✓		
- Management has not disclosed any identified material uncertainties	✓	✓	Ω	✓		
<b>Communications with TCWG or AC</b>						
Statement of independence and compliance with ethical standards	✓	Ω	(Ω) <sup>11</sup>	✗		
Non-audit services provided	✓	✗	(Ω) <sup>1</sup>	✗		
Specific additional matters relevant to the audit	✓	✗	Ω	✗		
<b>Reporting to Regulators</b>						
Report promptly:						
- Material breaches of law or regulations	✓	Ω	Ω	(Ω) <sup>12</sup>		
- Material threat or doubt over the continuous functioning (going concern)	✓	✗	✗	✗		
- A qualified, adverse or disclaimer of opinion	✓	✗	✗	✗		
<b>Quality Control</b>						
EQCR review	✓	Ω	✗	✗		
Retention of Audit Documentation <sup>13</sup>	10 yrs	7 yrs	7 yrs	7 yrs		

<sup>11</sup> APB Ethical Standard 1 (Revised) *Integrity, Objectivity and Independence* paragraph 67 requires the auditor to provide to the audit committee of listed entities: disclosure of relationships that impact their objectivity and independence; details of non-audit services provided and the fees charged in relation thereto to be provided; confirmation of the auditor's independence; any inconsistencies (or breaches) between the listed entity's NAS policy and the ethical standards; and opportunity to discuss auditor independence issues.

<sup>12</sup> Where required by law or regulation to do so.

<sup>13</sup> Currently retention periods are required by the professional bodies and are between 6-7 years.

## Appendix 2: Table of impact of changes on Auditing Standards

	European Union		IAASB's Projects						UK
	Audit Directive	Audit Regulation	Auditor Reporting		Other Information		Disclosures		Other (UK pluses)
	<i>Changes</i>	<i>Changes</i>	Changes	Conforming	Changes	Conforming	Changes	Conforming	<i>Changes</i>
ISQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements	✓	✓							✓
ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK and Ireland)	✓						✓		
ISA 210 Agreeing the Terms of Audit Engagements				✓		✓	✓		✓
ISA 220 Quality Control for an Audit of Financial Statements	✓	✓		✓					
ISA 230 Audit Documentation	✓			✓		✓			
ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements		✓					✓		
ISA 250A Consideration of Laws and Regulations in an Audit of Financial Statements		✓							
ISA 250B The Auditor's Right and Duty to Report to Regulators in the Financial Sector		✓							
ISA 260 Communication with Those Charged with Governance	✓	✓	✓			✓	✓		

	European Union		IAASB's Projects						UK
	Audit Directive	Audit Regulation	Auditor Reporting		Other Information		Disclosures		Other (UK pluses)
	Changes	Changes	Changes	Conforming	Changes	Conforming	Changes	Conforming	Changes
ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management		✓							
ISA 300 Planning an Audit of Financial Statements							✓		
ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment							✓		
ISA 320 Materiality in Planning and Performing an Audit							✓		
ISA 330 The Auditor's Responses to Assessed Risks		✓					✓		
ISA 402 Audit Considerations Relating to an Entity Using a Service Organization									
ISA 450 Evaluation of Misstatements Identified during the Audit						✓	✓		
ISA 500 Audit Evidence						✓			
ISA 501 Audit Evidence-Specific Considerations for Selected Items									
ISA 505 External Confirmations									
ISA 510 Initial Audit Engagements-Opening Balances		✓		✓		✓			

	European Union		IAASB's Projects						UK
	Audit Directive	Audit Regulation	Auditor Reporting		Other Information		Disclosures		Other (UK pluses)
	Changes	Changes	Changes	Conforming	Changes	Conforming	Changes	Conforming	Changes
ISA 520 Analytical Procedures									
ISA 530 Audit Sampling									
ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	✓	✓		✓				✓	
ISA 550 Related Parties									
ISA 560 Subsequent Events						✓			
ISA 570 Going Concern	✓	✓	✓			✓			✓
ISA 580 Written Representations				✓		✓		✓	
ISA 600 Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)	✓	✓		✓		✓			
ISA 610 Using the Work of Internal Auditors									
ISA 620 Using the Work of an Auditor's Expert	✓								
ISA 700 Forming an Opinion and Reporting on Financial Statements	✓	✓	✓			✓	✓		✓
ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report		✓	✓			✓			✓
ISA 705 Modifications to the Opinion in the Independent Auditor's Report			✓			✓		✓	

	European Union		IAASB's Projects						UK
	Audit Directive	Audit Regulation	Auditor Reporting		Other Information		Disclosures		Other (UK pluses)
	<i>Changes</i>	<i>Changes</i>	Changes	Conforming	Changes	Conforming	Changes	Conforming	<i>Changes</i>
ISA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report			✓			✓			
ISA 710 Comparative Information-Corresponding Figures and Comparative Financial Statements				✓		✓			
ISA 720 The Auditor's Responsibilities Relating to Other Information	✓				✓				✓



**Financial Reporting Council**

8th Floor  
125 London Wall  
London  
EC2Y 5AS

+44 (0)20 7492 2300

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