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For the attention of James Ferris

By email: AAT@frc.org.uk

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Dear James

The Chartered Governance Institute response to the FRC Feedback statement and impact assessment – post implementation review of the 2016 auditing and ethical standards

We welcome the opportunity to comment on the FRC feedback statement and impact assessment: post implementation review of the 2016 auditing and ethical standards.

The Chartered Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. The Institute is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including audit, and our members are therefore well placed to understand the proposed changes to auditing and the ethical standards set out in the consultation.

In preparing our response we have consulted, amongst others, with members of our Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of this group, nor of the companies they represent.

Our responses to the specific questions set out in the initial consultation are as follows:



Q1. Do you agree with the revised definition of an ‘objective, reasonable and informed third party’ and with the additional guidance on the application of the test?

No. The consultation states that the proposal is to replace the extant definition with one which has greater focus on the perspective of stakeholders who are the ultimate beneficiaries of assurance, and to provide more application guidance that firms should use when making an assessment. First, we do not agree that stakeholders are the ultimate beneficiaries of assurance. We believe the ultimate beneficiaries of assurance are the company and its shareholders.

Secondly, we do not agree with the inclusion of the wording “... The perspective offered by an informed investor, shareholder or *other public interest stakeholder* ...” in the definition. In particular, we are concerned about the use of s172 Companies Act 2006 as authority for including the perspective of *other public interest stakeholder* in those to be considered as ‘informed third party’. The footnote refers to “those considered to be the stakeholders of a company for the purposes of meeting directors’ obligations under s172 of the Companies Act 2006”. Section 172 sets out a director’s duty to promote the success of the company. The s172 duty is that a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so *have regard* (amongst other matters) to a number of factors set out in s172 (1) (a) – (f).

These are not competing interests. The director’s duty is to the company alone, and in fulfilling that duty the director is required to take into account the factors in (a) to (f) which may or may not apply to the action they are about to take. At all times, and regardless of the factors taken into account, the director must act in the way most likely to promote the success of the company for the benefit of its members as a whole.

Q2. Do you agree with our proposed measures to enhance the authority of Ethics Partners, and do you believe this will lead to more ethical outcomes in the public interest?

Yes. We welcome the proposals to enhance the authority of the Ethics Partner function, to ensure the entire firm focuses on ethical matters and the public interest.

Q3. Will the restructured and simplified Ethical standard help practitioners understand requirement better and deliver a higher standard of compliance? If not, what further changes are required?

We believe the accounting bodies are best placed to comment on whether the restructured and simplified Ethical standard will improve the understanding and requirements of practitioners.

Q4. Do you agree with the introduction of a permitted list of services which the auditors of PIE audits can provide?

No. However, we agree with the feedback received that a more definitive list of prohibited services that is simplified and clarified would be helpful. We also agree that insufficient time has passed to fully assess the impact of the 2016 reforms. We understand the feedback from stakeholders that the provision of non-audit services has resulted in declining confidence in independence, but we believe an appropriate balance needs to be struck. The 2016 reforms restricted the use of non-audit services substantially for PIEs, but there are some circumstances when such services being provided by the auditor is the best option for the company. The audit firm and companies' audit committees are alive to public disquiet about the provision of non-audit services by the audit firm and, as the Consultation states, the largest UK audit firms have begun to change their policies on this matter. It is now only in very limited circumstances that the company will wish to engage the auditor for non-audit services, and where the audit firm will accept such engagements, but we believe the flexibility of doing so in these limited circumstances should be retained.

Our members have been consistent in telling us that the audit committees with which they are familiar take their work, especially insofar as it relates to challenging management and ensuring the independence of the external auditor, exceptionally seriously and profoundly disagree with those who assert otherwise. They have cited examples where an auditor has been appointed despite management opposition.

Q5. Do you agree with the additional prohibitions we are proposing to introduce – in learning from the experience of enforcement cases like BHS, if the more stringent PIE provisions are to have a wider application to non-PIE entities, which entities should be subject to those requirements?

Yes. We agree that the additional prohibition being proposed should apply to a wider range of non-PIE entities. We believe the entities included should be based on the size of the company and number of employees and that any such thresholds should be aligned with those already in use for reporting purposes.

Q6. Do you agree with the removal of the reliefs for SMEs in Section 5 of the Standard, and the retention of reliefs for 'small' entities (in Section 6 of the Standard)?

Not entirely. We have concerns that different thresholds for different sizes of entity creates the potential for confusion, but the accountancy bodies are better placed to comment on the detailed ramifications of these differences.

Q7. Do you agree with the proposed removal of the derogation in the 2016 Ethical standard which allowed for the provision of certain non-audit services where these have no direct or inconsequential effect on the financial statements?

Yes. As it is clear that the derogation at ES 5.168R is worded in a way that made it impossible to apply with most of the prohibited services referred to in ES 5.167R having a direct effect on a set of audited financial statements, we agree with the proposed removal of the derogation in the 2016 Ethical standard.

Q8. Do you agree with the changes we have made to Audit Regulation and Directive references within the ISAs (UK)?

We believe the accounting bodies are best placed to indicate agreement, or otherwise, with the changes made to the Audit Regulation and Directive referneces within the ISAs (UK).

Q9. Do you agree with the inclusion of FRC staff guidance within the application material of the auditing standards, and has this improved clarity of the requirements?

We believe the accounting bodies are best placed to say whether improved clarity has resulted from the inclusion of the FRC staff guidance within the application material of the auditing standards. Our experience is that FRC guidance is generally helpful and that criticism of it, notably in the Kingman review, is misinformed.

Q10. Do you agree with the changes we have made to ISAs (UK) 700, 250 A and 250 B, including the extension of the requirement for auditors to report on the extent to which their audits are capable of detecting irregularities, including fraud?

Yes. We support the changes to ISAs (UK) 700, 250 A and 250 B, including the extension of the requirement for auditors to report on the extent to which their audits are capable of detecting irregularities, including fraud. We believe the additional reporting requirements will contribute to non-practitioner understanding of the responsibilities of auditors.

Q11. Do you agree with the proposed additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit Matters and increased disclosure around materiality?

Yes. We support the proposed additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit Matters and increased disclosure around materiality.

Although not included in question 11, we note that the relevant section of the Feedback Statement and Impact Assessment refers to the recommendation by Sir John Kingman that a form of 'graduated findings' for audit be introduced, and that this is being considered by the Brydon Review. We would reiterate our comments in our response to the Brydon review that, although we can see the advantages and disadvantages of the binary audit opinion vs more graduated disclosure, on balance we think the clarity provided by the current 'pass or fail' test with the three types of modified opinion available if needed, to be preferable to graduated disclosure, particularly in the light of the more detailed extended auditor reports.

In addition, we support the proposal in the March 2019 Position Paper that there be public reporting on the ES 4.1 requirement that the engagement partner is able to demonstrate that an audit engagement has assigned to it sufficient resources (and the right type of resources) with appropriate skill and competence to carry out the engagement with all applicable legal and regulatory requirements.

Q12. Do you agree with the revisions we have made to ISA (UK) 720, including the enhanced material setting out expectations of the auditor's work effort in respect of other information?

Yes. We agree with the revisions to ISA (UK) 720 to simplify the text and clarify the FRC's expectations of audit. However, we do not believe this is sufficient to address the 'expectation gap' identified as existing by almost all respondents to the November 2018 Call for Feedback. We believe much more needs to be done to achieve a higher level of understanding of audit by the general population in order to increase public confidence.

Q13. We are proposing changes to the standards to be effective for the audit of periods commencing on or after 15 December 2019. Do you agree this is appropriate, or would you propose another effective date, and if so, why?

Yes. We agreed that the effective date of the changes should be audit periods commencing on or after 15 December 2019, to correspond with the effective date of the changes to Going Concern under ISA (UK) 570

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours faithfully

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