AUDITING AND ETHICAL STANDARDS – IMPLEMENTATION OF THE EU AUDIT DIRECTIVE AND AUDIT REGULATION

ICAEW welcomes the opportunity to comment on the consultation *Auditing and ethical standards – Implementation of the EU Audit Directive and Audit Regulation* published by Financial Reporting Council (FRC) on 17 December 2014, a copy of which is available from this link.

ICAEW is the largest Recognised Supervisory Body (RSB) and Recognised Qualifying Body (RQB) for statutory audit in the UK, registering approximately 3,500 firms and 9,300 responsible individuals under the Companies Acts 1989 and 2006.

This consultation reflects the views not only of ICAEW as a regulator, but has taken account of the experience of its members in public practice and in business. Many of the latter have governance roles in UK companies and other bodies including membership of boards and audit committees.

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ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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OVERVIEW

1. ICAEW welcomes the opportunity to respond to this Consultation Paper (the Paper). The issues raised in the Paper arise largely out of the implementation of the European Union Audit Regulation and Directive ('the Regulation' and 'the Directive') in the UK and the role of standards in that implementation.

2. We agree that the FRC should pick up the audit and ethical standards requirements for audits which arise from the Regulation and Directive, and have stated this in our response ICAEW Rep 48/15 to the BIS discussion paper that was issued in parallel. The FRC has a leading role to play in reinforcing high quality auditing through such measures as thematic reviews, taking a leading role in the International Forum of Independent Audit Regulators (IFIAR), reviewing the governance code for major audit firms, working with ICAEW and the Department of Business, Innovation and Skills (BIS) through the Audit Quality Forum to create more dialogue among audit stakeholders including investors and leading the way internationally on better audit reports.

3. However, in thinking through how the Regulation and the Directive should be adopted it is important to keep in mind why the European legislation was originally conceived. When the European Commission set out to tackle perceived failings in the audit market in the aftermath of the 2008 financial crisis it stated:

> 'In the wake of the financial crisis, we need to ask the question whether the role of auditors can be enhanced to mitigate any new financial risk in the future…This work on audit is part of our effort to learn the lessons from the crisis and reform the financial sector.'

4. In short, the EU proposals were drafted to address the audit of banks as well as the largest and most complex Public Interest Entities (PIEs) – those that could pose a systemic risk to financial stability and market confidence. If the FRC focuses on those objectives in implementing them, it would in our view achieve maximum benefit with greatest efficiency.

5. To that end we believe that:

- It is reasonable for the FRC to retain powers to go beyond international standards and requirements where needed to support an overall aim of maintaining audit quality as part of a contribution to strong capital markets. However, interference in the market does have a cost to the economy, as does divergence from international standards: they should be undertaken only where there is clear and indisputable evidence of a need, supported by robust impact analysis.

- Were the UK Government to be implementing these requirements, it would start with a presumption of minimum regulation, strong evidence being needed to engage in gold plating. We urge the FRC to take the same stance as it is not currently clear to us from the Paper that this is the case.

- In particular, additional requirements for PIEs should not be expanded beyond those in the Regulation. The suggestion to change the regulation of non-audit service (NAS) provision by auditors to the entities they audit on PIE audits onto a prohibited-unless-permitted basis, would be a fundamental change in regulatory approach that is not justified by evidence. This would have a number of adverse consequences which are discussed further below.

- Changes made should not place additional regulatory burdens on smaller entities by applying standards intended for complex financial institutions. Such changes would only constrain the ability of smaller entities to drive growth. This would be assisted by re-establishing a mechanism to engage with small and medium-sized practices (SMPs) and small and medium-sized entities (SMEs).

6. The Paper does not refer to the FRC's obligation to exercise due regard to competition, following the recommendations of the Competition and Markets Authority (CMA) and to have regard to the growth duty in the Deregulation Bill. In addition the measures introduced by the Chancellor of the exchequer in late March on the review of non-economic regulators places additional emphasis on these areas. We trust that the FRC will be assessing the proposed measures that go beyond the core EU requirements in particular, against these specific requirements.

7. In view of the complexity of many of the issues, we view this consultation as part of an ongoing iterative process: we will be pleased to engage with the FRC further to see how we can assist.

RESPONSES TO SPECIFIC QUESTIONS

Section 1 – Auditing Standards

Q1. Do you agree that the FRC should, subject to continuing to have the power to do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

8. We believe the FRC should be able to reserve to itself the power to add to additional requirements to achieve credibility and quality, and deal with specific national issues. However, exercising the Article 26 (ii)(b) power should only be in exceptional situations. We have confidence in the due process of the International Auditing and Assurance Standards Board (IAASB), which involves extensive consultation. The FRC's first route to argue for change should be through those channels.

9. There are significant cost and complexity consequences of differences remaining in standards between different countries and the FRC should be required to provide a high level of justification for any additional standards. This should include a high quality qualitative and quantitative impact assessment, prior to a broad stakeholder consultation, the outcome of which should be included in the consultation. The impact assessment should consist of more than a belief that the additional national procedures, requirements or standards will improve or maintain audit quality. It should be clear who the FRC believes its stakeholders to be, the weight it attaches to their various views and the reasons and justification for that weighting.

10. There are also considerable costs in implementing change in terms of time spent in absorption, training and application. In considering the timing of application of FRC-driven changes, it would be helpful to co-ordinate where possible, with change driven by other legislation and regulation.

Section 2 – Proportionate Application and Simplified Requirements

Q2. Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

Q3. When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles

22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available for Small Entities' and your views as to the impact of such actions on the actuality and perception of audit quality.

11. The issues of proportionality and simplification overlap and we have addressed them together.

12. In principle, we support the notion of one set of standards for all audits: an audit report must mean the same thing regardless of the size of the entity being audited. One of the advantages of a principles-based approach to standard setting is that, applied sensibly, the standards should need no amendments in order to be applied proportionately. However, while current standards are scalable in principle, the reality of them is that they are something of a hybrid: founded on principles but including a number of detailed rules that apply regardless of the circumstances. Where these two approaches meet, there can be different interpretations applied. For example, a list of examples of safeguards that can be applied is sometimes interpreted as exhaustive. It is important to be clear where the standard is specifying a course of action regardless of the circumstances, and where professional judgment can be applied. Auditors are often quite unclear where they have discretion and will sometimes stick to the letter of auditing standards rather than applying them in the spirit in which they were intended. Regulators enforcing the application of auditing standards sometimes encourage this behaviour, whether they intend to or not.

13. Proportionality and simplification do not necessarily involve changing standards, but we believe that the FRC and the international boards could be doing more to produce practical guidance on the application of their standards to smaller audits. Examples of existing guidance which practitioners have found very helpful include Practice Note 26 and APB Bulletin 2010/2, although the latter is in need of updating.

14. We have made it clear to the IAASB that we believe that there are ambiguities in the documentation requirements of ISAs that are interpreted in different ways by different firms and regulators. These must be addressed in order to achieve real and even proportionality but the issue does not currently appear to be on the IAASB's radar. We urge the FRC to take this up with the IAASB.

15. While referring to the IAASB, we support giving thorough consideration in the IAASB's quality control project to the issue of proportionate application of the quality control standard ISQC 1.

16. The Ethical Standard – Provisions Available for Small Entities (PASE) is useful, proportional and pragmatic and we are pleased to see that it is to be retained. We note that we have received comments from members who undertake audit file reviews that a number of auditors of smaller entities do not seem to pick up the differences between alternatives and exemptions and urge a review of the clarity of PASE.

17. Simplification can go further. This is important not just for small-company audits but also for the audits of other small entities such as charities. We encourage the introduction of simplifications for small non-PIE audits where appropriate (see below) and we are pleased to see the BIS encouragement in this area, referred to in their discussion paper[1]. In particular we believe there is merit in utilising the Member State Options (MSOs) to simplify documentation requirements in respect of preparation for audit, description of safeguards, and breaches which involve disproportionate costs in a small audit. We do not see that this changes underlying requirements to ensure audit quality: documentation is primarily a matter of record and to assist review, not something which changes the procedures and mind-sets adopted.

[1] Auditor Regulation - Discussion paper on the Implications of the EU and wider reforms, BIS, December 2014, for example at pages 17 and 26.

18. We understand that the IAASB is reviewing ISA 315 *Identifying and assessing the risks of material Misstatement through understanding the entity and its environment*. It may be that this review will address a number of issues in this area but we urge the FRC to consider what might be done anyway. An example of where the existing ISAs could be reviewed is in respect of an initial assessment that controls are unlikely to be able to be relied upon. It should be possible, at least in the context of a smaller enterprise, to proceed from planning directly to substantive testing without testing the design and implementation of controls.

19. The former Auditing Practices Board (APB) used to have a consultation group to ensure that smaller practitioners' perspectives and experience were fully understood in standard setting. This seems to have fallen into abeyance and a mechanism to obtain such input directly could usefully be resurrected.

Section 3 – Extending the More Stringent Requirements for Public Interest Entities to Other Entities

Q4. With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:
(a) should they apply to PIEs as defined in the Audit Directive?
(b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

20. To the extent that current requirements go beyond the Regulation, that will add to complexity in compliance and potentially put UK companies at a disadvantage. Now would be an ideal time to review the add-ons to see if they are still justified.

21. When exchanges such as AIM were defined for standards purposes as listed, the differences between the requirements for listed and other audits were relatively small. These differences in requirements have grown and will grow further once the requirements of the Regulation are implemented. The scope of these should be limited. The main audits to which the FRC currently extends the listed entity requirements, that would not be defined as PIE audits by the Directive, are audits of entities listed on the AIM and ISDX Growth markets. For brevity we refer in this response to AIM only but our thinking encompasses any market that is not an EU-regulated market – for example the Channel Islands Securities Exchange and entities with, for example, private equity listed non-traded debt.

22. The purpose of AIM, as noted on the AIM website, is to offer: 'smaller growing companies the benefits of a world-class public market within a regulatory environment designed specifically to meet their needs'. The range of stakeholders is generally narrower than larger companies with a full listing; they do not present a systemic threat to the UK capital markets; and given the more limited resources available to such entities, audit quality would be likely to be enhanced as a result of additional auditor input in the preparation of their financial statements – the alternative would often be no professional input at all. The application of the full panoply of additional requirements envisaged for companies on the main stock exchanges to such entities seems disproportionate and unnecessarily harmful to their international competitiveness.

23. Accordingly we do not believe that the FRC should apply requirements that go beyond the Regulation, or indeed the PIE requirements in the Regulation, to those listed entities that are not PIEs within the EU definition of a PIE. They have a significant impact on cost, ability to assist smaller entities, and a deterrent effect on competition at the smaller end of the listed audit market.

24. We accept that what we are proposing would involve removing some entities from the existing PIE requirements in FRC standards. While we believe our proposal to be the best public

interest outcome, some investors may take a different view. There is a requirement in the existing Ethical Standards (ES) 1 for audit firms to consider whether the additional requirements for listed entities should be extended to other entities having regard to criteria such as the range of stakeholders. To address investor concerns, there may be merit in considering whether, for listed entities not included within the PIE definitions, the issue of whether to treat them as a PIE should be discussed with those charged with governance and noted in the annual report, so that shareholders can form their own view as to whether the treatment is appropriate.

25. A further competition question arises in respect of the impact that such a proposal has both on the entities that fall within this extended definition and on the audit market. The additional costs and limitations in choice of supplier inherent in these proposals are inhibitors to the willingness of audit firms to supply this sector of the market where they may only have one or two clients falling into the extended PIE definition. They are also inhibitors to the entities involved who find their choice of supplier for professional services constrained by the NAS caps. The CMA included a requirement for the FRC to have a competition duty in its findings[2] on promoting competition in the audit market. The FRC is also one of the bodies which will become subject to section 103 of the Deregulation Bill currently awaiting royal assent, which requires regulatory bodies to have regard to the desirability of promoting growth. Proposals that go beyond the requirements of the Regulation in particular, will need to be measured against those duties. The review of non-economic regulators announced in late March by the Chancellor of the Exchequer, particularly in the context of responsiveness to business, is likely to place such proposals under close scrutiny.

Q5. Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?
Q6. Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?

26. It follows from our answer to Q4 above that we do not believe that the additional requirements for PIE audits, whether included in the Regulation or not, should automatically be applied to entities not defined as PIEs by the Directive. We do however refer to our comments on transparency above.

27. The Regulation is intended to apply a comprehensive suite of safeguards in the audit of PIEs, to be regarded a whole. If an organisation requires additional safeguards because it presents systemic risk, it should be classified as a PIE and have the full statutory safeguards under the Regulation applied. If not, there is no need to apply extra requirements. Indeed in this context we question whether the continued use of the major audit distinction in the inspection arrangements would dilute the FRC's ability to focus on areas of systemic risk in the new regulatory environment.

28. In considering the effect of additional PIE restrictions, there is an interaction between the scope of entities to which PIE requirements are to be applied, and the extent to which those requirements exceed those specified by the EU. Were the FRC nevertheless to decide to include AIM and other non-EU-defined smaller entities within the scope of PIEs, we believe the FRC should consider a tiered form of application of the PIE requirements, particularly with a view to not applying the fee cap requirements (see below). AIM companies are disparate, and

[2] Final Report of the then Competition Commission: 'Statutory audit services for large companies market investigation' 13 October 2013, paragraph 16.338

the cap would generally have a disproportionate effect. Shareholder monitoring would continue to apply through the transparency requirements in the annual report.

Section 4 – Prohibited Non-audit services

Prohibition of additional non-audit services

Q7. What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

29. The ultimate aim of all audit-related standards must be high quality audits, as audited financial statements contribute to investor assessments of management's stewardship under UK law. Audit quality is a product of several factors, of which an objective mind-set is but one. Indeed a number of our members who are non-executive directors see competence as a bigger issue for audit quality than objectivity. Objectivity in turn depends on a number of factors: independence can be argued to be a partial demonstration to stakeholders of that objectivity. The provision of NAS by auditors to audited entities is itself but one of a series of relationships that could potentially compromise independence.

30. Investor assessments of business quality depend not only on the audit report, but on the underlying business results, which are at least partly attributable to business efficiency. Thus, a wide variety of factors need to be considered in determining the public interest approach to the provision of NAS: confidence, impact on quality, and ability to provide useful professional advice.

31. When the FRC was undertaking a consultation into this area in 2009, it stated[3]:

> 'In developing standards on the provision of non-audit services, the APB faced three general challenges:
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> - Non-audit services vary depending on the needs of the company (for example, some need tax assistance, others need support for their corporate finance activities) and within each activity, the remits of particular non-audit engagements differ significantly.
> - The nature and magnitude of the non-audit services, and therefore their possible impact on auditor objectivity, vary significantly; and
> - It would be necessary to allow for the fact that the types of non-audit services provided to clients are constantly evolving in response to evolving business needs.
>
> For these reasons, when developing the Ethical Standards for Auditors, and in particular ES 5 "Non-audit services provided to audited entities", the APB sought to develop general principles which would inform the auditor's approach to a variety of different situations. This approach was consistent with the recommendations of the CGAA.'

32. While the detail has been refined from time to time, the approach of prohibiting certain specified NAS but subjecting others to a threats and safeguards review is well established and is well known to regulators, auditors, audit committees and investors. It is used by the FRC, the International Ethics Standards Board for Accountants (IESBA) and the Public Company Accounting Oversight Board (PCAOB) among others. Together with other independence requirements on relationships and fees, it provides comfort that key actual and perceived

[3] Consultation on audit firms providing non-audit services to listed companies that they audit, APB, October 2009, paragraphs 4.7 and 4.8

threats to independence are addressed, without unnecessarily restricting the ability of a company to receive other services from its auditor where they do not result in a significant threat. These, and other arguments that are summarised in the Paper, were considered during the course of the debates on the Regulation and Directive, and the initial proposals for a general prohibition with exceptions were abandoned in favour of a threats and safeguards approach supplemented by specific prohibitions for services where safeguards could not reasonably be seen to apply.

33. The FRC's own research[4] has shown a steady decline in the proportion of NAS fees to audit fees, suggesting that audit committees are increasingly appointing auditors to provide NAS only where they are the optimal provider. Given the additional prohibitions in the Regulation, particularly in respect of taxation, the proportion is likely to decline further, although there are some services, such as due-diligence, which are always likely to be best provided by the auditors.

34. We have significant concerns about the regulatory policy shift implicit in an approach that presumes that everything is an unacceptable threat to independence, even where unrelated to the financial statements being audited, unless it is on a list that has been deemed not to be. This risks the counter-productive consequence of discouraging a thorough assessment of threats and safeguards, and could also have a significant effect on choice, given the impact of prohibited-NAS provision on the ability of firms to tender for audits for some time after the service is provided, and that the tender process itself could take a couple of years in more complex cases.

35. This would be a significant shift away from a principles-based approach and would go significantly beyond the requirements of the Regulation. We do not see evidence to support a change of such significance, especially as the impact of the changes from the Regulation on NAS usage is as yet unclear.

36. A white list could have an indirect counter-productive effect on quality. It will make auditing a less attractive career and will also result in firms having less breadth of expertise to apply to audit and to innovate. It would also discourage audit firms from innovating in their services because a new service would not be on a white list.

37. Even without switching to a prohibited-unless-permitted approach, the increased incidence of tendering will have an impact on choice, as mentioned above. It would be helpful to include transitional arrangements for NAS, such as are already in place in ES5.

Q8. If a 'white list' approach is deemed appropriate to consider further:
(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?
(b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?

38. As noted above, we do not support an approach that presumes that everything is an unacceptable threat to independence, unless it is on a list that has been deemed not to be. Accordingly we do not comment on the detailed list in paragraph 4.13 of the Paper beyond noting that one of the arguments made by the FRC for moving away from the current approach is that it would improve the clarity of what is permissible. We do not agree that this argument is valid to support a change of approach. There is no evidence that the current black lists (IESBA, APB and PCAOB) are flawed because of lack of clarity. Lack of clarity is not an issue.

39. There needs to be a balance of perception by some parties of a problem which has never been borne out by any documented case against the real cost to companies of reducing choice of

[4] For example, FRC Key Facts and Trends in the Accountancy Profession 2012, FRC, June 2012

NAS provider, particularly during a tender period. There are likely to be many services that would not be on a white list but would not be a threat to independence. Therefore a white list would unnecessarily restrict choice for UK companies

40. It could be argued that it would be possible to set up a list of permitted services using a series of principles, rather than a specific list of services. This could be considered to equate to the current approach in the sense that there is little difference between saying under a white list that 'a service can be provided if it does not result in xyz threats that cannot be safeguarded against' and saying under a black list that 'a service cannot be provided if it results in xyz threats that cannot be safeguarded against'. However, such a white list approach would still require a list of specific prohibitions to ensure that the Regulation does not override the ES and we do not see that this would be more than a change in writing style, with no practical gain.

Q9. Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

41. We are not aware of any evidence of a further category of services which has presented insuperable threats to independence. Given the key requirement to assess actual and perceived threats and apply safeguards or refuse the work, together with the transparency of NAS provision in the annual report, we do not see a need to add further specific prohibitions.

Derogations in respect of certain prohibited non-audit services

Q10. Should the derogations that Member States may adopt under the Audit Regulation – to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

42. Yes: we believe there is a strong case to adopt these derogations. Services that do not have a direct or material effect on the financial statements being audited do not, by their very nature, create a threat to objectivity, unless they create a dependence on the entity – and there are already independence requirements in the ethical standards on fees and reward structures to address this. In addition they would be included within the overall cap being introduced.

43. As referred to above, the FRC's own research over the years has indicated that the proportion of NAS provided by auditors has been falling, as a percentage of the audit fee. Services that generate significant fees, notwithstanding the criteria noted in the question, would feature in the disclosure of NAS for discussion with investors. Audit committees are aware of this and the scrutiny that follows: they will not choose the auditors as the default provider. They will choose them only where independence requirements allow, circumstances show a clear value to the business for using the auditors, and they can make a clear case that there is no risk of harming audit quality.

44. We are aware that some investors have a concern about the provision of tax services by auditors. While we believe the extent of the prohibition in the Regulation should be sufficient to address this, there may be merit in ensuring that where tax services are provided, that is disclosed in the analysis of NAS fees in the financial statements, regardless of immateriality.

Q11. If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be 'immaterial' sufficient? If not, is there another condition that would be appropriate?

45. Yes: we believe that 'immaterial' is a sufficient explanation of the criteria. The concept of materiality is woven throughout the current ethical standards and we are not aware of any significant problems having arisen in applying it.

Audit Committee's role in connection with allowed non-audit services

Q12. For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?

46. We agree that further conditions are unnecessary. Existing transparency and accountability requirements underpin the audit committee's role and make it powerful.

47. As noted above, we believe that a prohibited-unless-permitted approach could have the counter-productive consequence of discouraging a thorough assessment of threats and safeguards by the auditor and the company. There is a similar risk that audit committees would, not unreasonably, presume that everything on the permitted list would not need an assessment of potential threats under the particular circumstances.

Geographical scope of the prohibitions of non-audit services, by the audit firm and all members of its network, to components of the audited entity based outside the EU

Q13. When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based? If not, what other standards should apply in which other circumstances?

48. The current ES requirement for auditors outside of the UK network to apply the IESBA Code is a sensible solution to the issues of extraterritoriality that can apply when different regulators apply different standards. While some of the detailed PIE requirements are different between the two codes, the core principles, threats and safeguards of the IESBA Code are the same as those that would be in the ES. It is those requirements that underpin independence and the current requirements are not a permission to apply different levels of independence. It would be a retrograde, unnecessary and potentially complex and costly step for international audits, were the current approach to be replaced by an imposition of the FRC's requirements worldwide.

49. The experience of the PCAOB has shown that some countries can react adversely to the spread of third country law onto the conduct of entities in their own territory. Such steps can result in economic disadvantages for the entities and firms concerned and lead to heightened risk in the audit of those entities. While there is a common consensus for application across the EU, we do not see evidence that it is supported elsewhere.

50. There is also a question of how enforcement would be made of the rules in those territories. If there is not a reciprocal regulatory arrangement with an oversight body in the territory concerned, attempts at enforcement may be confined to penalising the head office auditor which may not have the influence necessary to regularise the position with the correspondent firm. This would destabilise the audit oversight within the entity under audit and the audit firm to the disadvantage of all stakeholders.

51. Given the requirements of the Regulation relating to application within the EU, and as some of the detailed prohibitions of the IESBA Code are not the same as those in the Regulation, it would be necessary to mandate additional requirements for network firms not in the UK but within the EU. If the amendments to the ES are only those necessary to comply with the additional requirements of the Regulation, it would not be unreasonable in the interests of simplicity, to extend the ES requirements to networks (and other auditors involved) within the

EU. However, were, for example, the list of prohibitions to be extended beyond the list included in the Regulation, extraterritoriality complications could warrant a tiered approach: the ethical standards within the UK, the Regulation within the EU (to the extent that it goes beyond the IESBA Code) and the IESBA Code outside the EU.

Applying restrictions to other group auditors that are not part of the group auditor's network

Q14. When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all other auditors whose work they decide to use in performing the audit of the group? If not, what other standards should apply in those circumstances?

52. Our answer to Q13 applies here also.

Section 5 – Audit and Non-audit Services Fees

Fees for non-audit services

Q15. Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

53. We have argued in the European debates on these measures, that the whole basis for a cap is unjustified. We considered it unnecessary and arbitrary given existing overall fee dependence, objectivity and transparency safeguards. The competition consequences are also quite unclear.

54. As noted in the Paper, the final wording of the Regulation applies several significant limits to the scope of the requirements, eg limits on which audit firm it applies to, when it applies, and a MSO to grant exceptions. This suggests that in the final analysis this was regarded as a political measure rather than a restriction that would significantly enhance independence.

55. That said, the mere existence of a cap rule, regardless of the detail behind it, is likely to have an impact on prudent audit committees, who would be likely to want to keep an amount in reserve to allow for any unexpected events towards the year end. This would be likely to cause the proportion of non-audit fees to audit fees to fall still further. Given that, and that NAS fees are subject to transparency for the market to make its own assessment, we support minimum implementation. It follows that we do not believe a lower cap to be necessary than that specified in the Regulation.

Q16. If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

56. We agree that a mechanism to allow exemptions to be granted should be set up. The cap is very arbitrary, and there could be circumstances where a good reason arises to go above this for short periods – particularly for smaller PIEs who may need more external assistance and whose base audit fee is likely to be lower. An example is the provision of audit related services on a takeover or listing. We would expect such an exception to be disclosed as part of the transparency around the provision of non-audit services. However, it is important that the application process itself is not overly restrictive. Events such as takeovers cannot necessarily

be anticipated, and it could be very prejudicial to the interests of a PIE if an application was excessively onerous or unpredictable in outcome.

Q17. Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms?

57. It follows from our answer to Q15 above that we do not believe it necessary to extend the requirement to network firms. This would have significant extraterritorial consequences outside the EU. Network firms already have to apply at least the IESBA Code, which prohibits NAS provision that would result in a significant threat that cannot be safeguarded against. Any circumvention of the cap by switching service provision that would be permitted by the IESBA Code, would in any event be highlighted in the disclosure of NAS fees in the annual report.

58. An extension would further complicate matters in circumstances where a 'group' could be interpreted widely – for example venture capital consortia.

Q18. If your answer to question 17 is yes, for a group audit where the parent company is a PIE, should the audit and non-audit fees for the group as a whole be taken into consideration in calculating a modified alternative cap? If so, should there be an exception for any non-audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?

59. As noted above, we do not agree that the cap should be extended to networks. However, were there to be such an extension, it would be logical to take into consideration the audit and non-audit fees of the group, less amounts attributable to non-network firms. The potential exclusion of certain types of NAS is something of an over-complication as they could not be excluded from the core EU requirement relating to services provided by the audit firm. We believe it would better to apply minimum implementation in the first place, with disclosure.

Q19. Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances (see paragraphs 5.3 and 5.15)?

60. It follows from our answer to Q15 that we do not believe it necessary or desirable to extend the requirement beyond that specified in the Regulation

Total fees for audit and non-audit services

Q20. Do you believe that the requirements in ES 4 should be maintained?

61. It is important to ensure that differences in cross-EU requirements are not maintained for the sake of it, as there is an impact on competitiveness, and the overall fee dependency requirements in ES 4 in respect of PIE audits go beyond those in the new Regulation and Directive. However, they have been in place for some years and the adverse effects on some practitioners that ensued after their introduction have long since worked through. In addition, avoidance of fee dependency is a key bulwark of the threats and safeguards approach, and indeed supports some of our arguments elsewhere that further fee restrictions are unnecessary. Accordingly we agree that the existing requirements, applied sensibly, should be retained.

Q21. When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

62. It seems reasonable and assists simplicity to apply the ES 4 PIE requirements to all PIEs, assuming the PIE definition is kept to a narrow scope. To assist mitigation of effects on smaller firms auditing smaller PIEs, it would be useful to have a transitional period in respect of entities newly included within the PIE scope.

Q22. Do you believe that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute an expectation of 'regularly' exceeding those limits? If not, please explain what you think would constitute 'regular'.

63. This seems reasonable: we have been using three years as a rule of thumb for some years, albeit open to demonstrable rebuttal if circumstances dictate.

Section 6 – Record Keeping

Q23. Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (eg, by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?

64. We see no need for any amendment to ISQC (UK and Ireland) 1 as that already deals with the matter satisfactorily. ICAEW Audit Regulations requirements already more than comply with the documentation requirements in the Regulation.

Section 7 – Audit Firm and Key Audit Partner Rotation

Audit firms

Q24. Do you believe that the FRC's audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?

65. We consider that responsibility for compliance should rest jointly with the PIE and the auditor. This would reflect reality: the auditor has a professional responsibility, and the company has a legal responsibility to appoint independent auditors. The company will also need to keep track of time periods in order to comply with the disclosure requirements anyway. Therefore we think it unlikely that there will be many instances of non-compliance.

66. Having established a responsibility, the consequences of non-compliance are also relevant to consider. In this, proportionality is key: for example, invalidating an audit already carried out in error would cause excessive cost and disruption to stakeholders who are not at fault.

67. While considering regulation in respect of audit firm rotation, we note that Article 17(6) of the Regulation permits the competent authority responsible for PIE audits to grant an extension for up to two years, on an exceptional basis. Assuming that the FRC is designated as the ultimate competent authority, we strongly encourage the setting up of a mechanism to consider such extensions. If firms are unable to apply for such an extension, they are likely to tender at least a year before the backstop date, just in case there is a major issue needing continuity in the

following year. If an extension is granted, it would be reasonable to require an explanation in the annual report.

Key audit partners

Q25. Do you believe that the requirements in ES 3 should be maintained?

68. The overall partner rotation requirements in ES3 in respect of PIE audits do go beyond those required in the new EU requirements. However, they have been in place for some years and are understood. Accordingly we agree that the existing requirements, applied sensibly, should be retained.

Q26. When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

69. It seems reasonable and assists simplicity to apply the ES3 PIE partner-rotation requirements to all PIEs, assuming the definition of PIE is not expanded beyond that in the Regulation, as perception issues arising from long association can be significant. To assist mitigation of effects on smaller firms auditing smaller PIEs, it would be useful to have a transitional period in respect of entities newly included within the PIE scope.

Consultation Stage Impact Assessment

Q27. Are there any other possible significant impacts that the FRC should take into consideration?

70. The impact analysis will be particularly important in those areas where it is proposed to go beyond the requirements of the Regulation and Directive. Evidence needs to be robust and compelling to justify gold plating.

71. We have appended to this response an analysis of the provision of services by some 600 ICAEW member firms who are registered audit practices. While the information we have does not distinguish between services to audited entities and to others, it highlights that even quite small practices provide a wide range of non-audit services and this can be a high percentage of audit fees. A wider NAS restriction would be likely to have an effect across a wide range of registered audit practices.

72. The discussion in the Paper on the additional costs of having to obtain NAS currently provided by the auditors, from providers other than the auditors, argues that such costs could be offset by the effects of competition. While this is in principle a valid argument, we think that the bespoke nature of the sort of NAS that auditors tend to be used for (including add-on or time-constrained work) would restrict such an effect.

73. We note that the only mention of competition in the discussion on impact analysis is in the context referred to in the paragraph above. However, the introduction to the Paper reminds us that the FRC's aims for audit include, among other things, sufficient levels of competition and choice in the audit market. Consideration should be given to the risk that creation of unnecessarily high barriers between PIE and non-PIE audits, and the extension of PIE requirements beyond what is necessary, deters entrants to the PIE audit market, and hastens withdrawals from it.

74. The applicability of the Audit Firm Governance Code should also be considered with a view to maintaining transparency requirements, while not creating a further barrier at too low a level.

APPENDIX

Analysis of NAS work undertaken by some 600 ICAEW member firms who are registered for audit work, based on returns for 2014.

Type of work	% of registrants undertaking	Comment on these fees as a percentage of audit fees not necessarily for the same client
Registered Financial Conduct Authority work	1.6	For most smaller firms the fees outstrip audit fees
Registered Designated Professional Body work	8.0	Fees fall some way short of audit fees in all but two cases.
Insolvency	1.5	Only two with notable fees in excess of audit fees
Tax compliance	81.6	Fee percentages vary but most are over 100%
Tax advisory	44.7	Fees generally smaller although some are over 100%
Accounting/book-keeping/payroll	90.0	Fees mostly above 100% often by a significant margin
Consultancy	25.0	Large variation in fee percentages
Corporate Finance	6.2	Large variation in fee percentages
Forensic work	2.9	Large variation in fee percentages
Training File Review	0.8	Fee percentage generally negligible
Other	36.6	Large variation in fee percentages