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Dear Mr Ferris

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

I am writing to set out Deloitte LLP's response to your Call for Feedback, published in November 2018.

This comes at a critical time. Current perceptions of the audit profession are coloured by a number of high-profile corporate failures in the last year, and the CMA market study together with the , Kingman and Brydon reviews are considering options for fundamental change. In many ways, the transformation that these reviews will deliver continues the changes that were heralded by the EU Audit Regulation and Directive – at the time, the revised Ethical Standard and the changes to International Standards on Auditing (ISAs) to reflect these represented some of the most significant regulatory changes to the audit profession for many years. That the current reviews are seen as necessary is not a result of the failure of the 2016 changes - rather it is due to increased societal expectations, as noted in paragraph 6 of your document.

Against this background it is timely to reflect on the impact on the 2016 changes, and we welcome the FRC's role in this. We have set out our responses to your detailed questions in the attached appendices. Given the status of the three aforementioned ongoing reviews, our views on individual changes may evolve depending on the different combinations of reform packages that may be proposed over the coming months. Our most up to date thinking is contained in our responses to the CMA Study and the Kingman Review; we will be taking this thinking forward in our response to Sir Donald Brydon in due course.

I would welcome the opportunity to discuss our views with you, if you feel it would be helpful.

Yours sincerely

Stephen Griggs
Deloitte LLP

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Appendix 1 - Feedback Questions

Over-Arching Questions

i. How well do you think the 2016 revisions to auditing and ethical standards have met the objectives set out in our September 2015 consultation 'Enhancing Confidence in Audit' and summarised in paragraph 3 of this consultation document?

The 2016 revisions do broadly meet the objectives set out in the September 2015 consultation.

However, we recognise that those objectives do not always meet society's current expectation of what an audit should achieve. We are therefore strongly supportive of the reviews led by Sir Donald Brydon, Sir John Kingman and the CMA, which provide a once in a generation chance to properly debate the purpose and extent of audit – understanding society's demands and the extent to which audit can practically respond to these.

In our responses below we have set out a small number of areas where we feel the 2016 standards could be improved to meet the current objectives, but we believe the focus of the FRC's work (and that of any successor, following implementation of the Kingman Review), should be on areas where changes which go beyond those objectives are necessary. We explore these in particular in our responses to questions xvi-xix below.

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

Yes.

The overriding objectives for ethical and auditing standard setting must be around serving the public interest. This means that audit quality should be the primary consideration for both the regulation of, and the structure of, the market - as well as the scope of the audit of the financial statements and the auditors' responsibilities in respect of other parts of the annual report.

This review must be considered in the context of the Kingman and CMA findings and of the forthcoming Brydon Review, to ensure consistent and complementary improvements to the financial reporting ecosystem. These must also take account of the current and evolving nature of corporate reporting and of the needs of the users of annual reports.

Where necessary, legislation to implement the Brydon, Kingman and CMA review findings should allow:

- Changes to the auditor's statutory duties – in particular the broader scope demanded by society and the resulting changes to the key matters on which they must report
- Changes to the auditors' rights to information and explanations necessary to enable them to carry out their work to that broader scope – for example, in respect of the information supporting the 'front half' of the annual report
- Changes to the duties of the directors responsible for the preparation of the annual report and financial statements – requiring them to have records to support the annual report as a whole and, where relevant, to implement systems and controls which the auditor will test as part of their opinion

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

Yes, a well-executed audit does address the expectations that users should have within the current scope of an audit.

However, as set out above, higher expectations of audit call for a wider scope to the auditor's work, and debate is needed around the purpose as well as the scope of an audit to examine whether it still meets the needs of 21st century stakeholders:

- Today's financial insight is frequently generated from an abundance of real time, forward-looking financial and operational information.
- Not all of this information is contained within the annual report; and, based on work carried out by the Global Public Policy Committee (GPPC) of the six largest accountancy networks, we are concerned that there is a risk to the capital markets due to the perception by the users of the annual reports that all information in the report is of equal quality.
- This perception is reflected in the clear expectation gaps around the auditor's responsibilities for the level of assurance provided over the 'front-half' of annual reports. The current UK approach has grown piecemeal over time – some material is read for consistency with accounting records and information obtained during the audit; some is subject to an audit and some to review; some to an obligation to report if the auditor has anything to add or draw attention to - and some not.
- Whilst subjecting the whole annual report to assurance to the same level may not be necessary or desirable, a more holistic approach is needed.

It is vital that the Brydon Review, this current FRC review and the implementation of the work of the CMA and Kingman consistently and coherently work together to address these issues.

iv. Are there further steps that the FRC should consider as part of this review to ensure the delivery of high-quality audit? If so, please state what they are and why.

Yes. As we have set out above, this review should be considered in conjunction with the findings of the CMA and Sir John Kingman as well as those of the forthcoming Brydon Review to ensure consistent and complementary improvements to the financial reporting ecosystem. These need to go beyond a narrow consideration of the audit. In particular:

- Changes are also required more broadly in the financial reporting ecosystem. The FRC should consider all participants who have responsibility for the quality of financial and other annual reporting including both management and those charged with governance (the Audit Committee, where relevant, and the board of directors (or equivalent)).
- The primary responsibility for the quality and integrity of financial reporting rests with the company's management and board. We support the introduction of a proportionate UK Sarbanes-Oxley type regime for the largest listed companies in the UK. This will place appropriate accountability on companies' boards and management to ensure the quality of their financial reporting.
- The particular role of the Audit Committee and the expectations of its challenge of management, based on an evolved view of what should be reported where, should be clearly established.
- The auditor's interaction with each of these parties (and with users of the annual report) and appropriate level of assurance given by their work should then be determined.
- It should be clear which role each party is playing, and this should be explained clearly to users using the directors' responsibility statement and auditor's report.

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Questions relating to the Ethical Standard

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

Broadly, yes.

There have been a number of cases where the FRC has engaged with auditors, investors and others via its Technical Advisory Group and issued Staff Guidance Notes or entries in the Technical Advisory Group Rolling Record. As with auditing standards (see our response to questions xiv and xv below), we think it would be worth reflecting these in the body of the Standard, whether by clarifying the requirement or adding new application material. This would make the Ethical Standard clearer and more user friendly to audit firms as well as to users of financial statements.

We comment on specific areas for improvement and clarification in our response to question viii below.

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

Not necessarily.

The definition of PIE (which must, as a minimum, include those entities defined as PIEs in the Statutory Audit Directive), imposes significant independence requirements on fairly small companies admitted to trading on an EEA regulated market, such as the Main Market of the London Stock Exchange. These do not apply to far larger entities with arguably a greater degree of public interest – for example a significantly larger AIM company or private company.

In our response to question ix below we suggest that the PIE requirements should apply to a broader class of entities that are not currently categorised as PIEs.

vii. Do you believe that user confidence would be strengthened if the FRC required the application of the independence requirements of FRC Ethical Standard to all components of a group audit?

Yes, in part.

Whilst the effect of the current Ethical Standard is sensible, in that it applies the FRC's requirements to those overseas firms most likely to have an actual or perceived influence on the audit, it can be confusing to an outsider.

The current Ethical Standard applies as follows:

	Firms that are members of the group auditor's network	Firms that are not members of the group auditor's network
Firms that are used as a component auditor as part of the group audit	FRC, including IESBA	IESBA
Firms that are not involved in the group audit	IESBA	None

The standard explains that it works this way because of the perception that members of the group auditor's network are part of the same firm as the group auditor, even though they are separate independent firms.

We suggest that extending the FRC's rules to all non-network component auditors may be:

- Ineffective – in particular because not all components are subsidiaries. Consider, for example, a joint venture with three investors. The group's parent company will only have 33% of the votes and be unable to force the joint venture to refrain from contracting with its auditor for the purchase of non-audit services that are not banned under the IESBA Code or local rules.
- Impractical – some of the FRC's restrictions on personal independence may not be workable in countries where the component auditor cannot restrict certain actions by their employees and family members, for example because of local employment law.
- Restrictive – the CMA's Update Paper explores the ideas of joint audits and shared audits. Extending the FRC requirements to all non-network component auditors may restrict the ability and appetite of firms to act as a joint or component auditor.

If the FRC were, nevertheless, to consider applying additional requirements to non-network component auditors, we suggest that these are restricted to rules on non-audit services – as these could be restricted, at least for subsidiaries, by the action of the group's parent entity as well as the group auditor.

When considering members of the auditor's network not involved in the group audit, we believe that the IESBA Code provides a fair balance:

- Application of the FRC's personal independence rules, particularly in respect of family members of the firm's partners and employees, may still be problematic under local employment law.
- Firms are already broadly subject to restrictions on provision of non-audit services. In any case, the rules on non-audit services in paragraph 5.167R will already apply to such firms within the EEA, and the scope of this rule will extend globally after the UK leaves the EU as a consequence of the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2018.

The same post-Brexit legal change would apply to members of the group auditor's network used as component auditors. In our experience, many (but not all) PIEs have chosen to apply the restrictions in paragraph 5.167R to subsidiaries globally, even though only services which involve playing a management role, design and implementation of financial controls and systems and bookkeeping and accounting services are banned worldwide. If the FRC were to want to address the perceived threat from other services, this could be done by pre-empting the post-Brexit legal change.

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

We have had a few areas where interpretation of the standard has been needed. These largely relate to areas where, at the time of the FRC's original consultation, the view of BEIS was that the FRC could not interpret EU law as this was a matter for the Courts. There are, nevertheless, a few areas where late changes were made, particularly in relation to the integration of the former Ethical Standard for Reporting Accountants into the Ethical Standard as applied to Investment Circular Reporting Engagements (ICREs). We set out details of the areas that have caused difficulty and our suggestions for change in appendix 2.

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

We believe that the FRC's changes made in 2010 and 2011 had already gone a significant way towards addressing actual threats to independence, objectivity, integrity and audit quality, and had already prohibited

many of the services which the EU Regulation banned in 2016. The only significant area of change in the UK arising from the 2016 changes has been in the provision of tax services to PIEs. We are not aware of any cases in recent years where actual audit quality has been compromised as a result of permissible non-audit services being provided by the auditor.

However, we recognise there is still a perceived threat to auditors' independence, objectivity and integrity, and therefore a perceived threat to audit quality. For this reason we have put forward to the CMA that, as part of a package of measures to provide comfort in the quality of audit, a ban on non-audit services other than those which are closely related to the audit (such as an interim review of a half-yearly report) and other independent assurance and attest reports (such as reporting on regulatory returns) for FTSE 350 entities and the largest UK private companies as part of a package of measures may help to address this perception. We expand on this in our responses to questions x-xiii below.

x. Do you believe there should be further restrictions, or even an outright prohibition, on non-audit services?

a. Should any further restrictions or prohibitions also apply to "audit related" services, that the auditor is not required to provide? If so, please explain your views.
b. Should any further restrictions or prohibitions also apply to services required by law or regulation (i.e. permitted by the Audit Regulation)? If so, please explain your views.

Yes, as part of a package of measures as set out in our responses to the CMA. We explain in our answer to ix above that any ban would be addressing a perceived, rather than an actual, threat to audit quality, and should form part of a package to improve confidence in audit.

Any further restrictions or prohibitions should be principle-based. We believe that they should:

- Allow independent assurance and attest services (where the practitioner provides an independent opinion or report on information) and due diligence (where the practitioner provides an objective challenge of information presented to them)
- Prohibit services that are advisory in nature or involve playing any perceived role in the management of the audited entity. All management services and many advisory services are already banned, particularly after the 2016 changes which significantly reduced the scope of tax services to public interest entities, but there is a perception that auditors still do a lot of this

The focus of such a ban should be on services provided directly to the entity and its affiliates; in order to be workable it would need to exclude those services only provided indirectly where the entity (and its affiliates) are not responsible for the appointment of the firm. We expand on this issue below.

In this context, and in response to the two points in the question:

a) Yes, we believe that if such restrictions are required, they should apply to all services that are not assurance, attest or due diligence related. This would allow the auditor to provide an interim review (which is not required by law or regulation) and assurance required by law (e.g. on regulatory returns); to act as a reporting accountant (providing independent assurance either required by the FCA Handbook or overseas equivalents, together with related due diligence and comfort letters); to allow for voluntary assurance (e.g. assurance over a bank's risk-weighted capital or over environmental KPIs reported in the front half of a listed company's annual report), whilst not allowing advisory services.
b) Likewise, the effect of restrictions should be to ban advisory services or those which involve acting in a management role. Many, but not all, advisory services and all management services are already banned - but the perception is that they are not. We are not aware of any laws (at least in the UK or the EU) which require '*the* auditor' to provide such services, as opposed to '*an* auditor' (which would allow an auditor who was not appointed to audit the entity to deliver the service), so a provider other than the appointed auditor could be found.

xi. There is currently a derogation in the Ethical Standard allowing for the provision of certain non-audit services where these have no direct effect or an inconsequential effect (where indirect) on the financial statements. Should this derogation be maintained in the Ethical Standard, and if so why?

No.

It is telling that many, but not all, audit committees of public interest entities have already imposed a complete ban on the use of the auditor to provide tax services where those services are purchased by a PIE and its worldwide subsidiaries. In our experience, directly procured services benefitting a PIE (or an EU affiliate of a PIE) are very rare. Whilst there are a smaller number of PIEs that do procure tax services for non-EU affiliates, the legal changes that would take effect upon the UK leaving the EU would extend the geographic scope of the existing restrictions to all subsidiaries worldwide. There is, however, one area where the provision of indirect services with an inconsequential effect does occur. This stems from the FRC's interpretation of the wording "indirect" in the context of banking syndicates, as explained in Staff Guidance Note (SGN) 01/2018, which causes significant issues when work is carried out on behalf of a non-audit client but from which an audit client indirectly benefits:

- The interpretation of "indirect" in SGN 01/2018 concludes that a service to a loan syndicate member that is an audit client (and must therefore have only an inconsequential impact and counts towards the 70% fee cap) is an indirect service, even if the work is commissioned (including setting the scope of the work and determining the fee) by the borrower or lead bank, neither of whom is an audit client.
- This is particularly difficult if the syndicate member is a "late arrival" i.e. not a member at the time the firm was chosen.
- It is the "inconsequential" nature of these which means they are permissible - typically the syndicate member is paying a small portion of the fee, and the impact of the service on the PIE loan syndicate member is very small.
- Were the derogation to be removed without a change in the interpretation of "indirect", this provision would become unworkable – even if it were possible to find a firm that audits no syndicate member at the outset, a late arrival could result in the firm having to down tools, impacting the borrower's access to credit and the banks' timely access to information to support a lending decision.
- We suggest that the mischief that "indirect" is trying to address is to avoid provision of services to one member of a group which actually benefit another – rather than this situation.

Finally, if the FRC decides to retain a derogation, it needs to address the difference between the actual wording of the Ethical Standards – which states that certain tax and valuation services are permissible where there is "no direct, or in the view of an objective, reasonable and informed third party, an inconsequential effect…" – and the FRC's interpretation that only indirect services with an inconsequential impact are permitted. The FRC either needs to align with other European regulators, and apply the test as it is written, or to change the words to reflect their interpretation to say "no direct, and only an inconsequential indirect effect…".

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

No, except in certain limited situations.

The consequences of aditional restrictions need to be balanced between the impact on the audited entity and the users of its financial statements (the ultimate 'client' of the auditor) and the actual and perceived benefits to the entity and those users:

- On the one hand, further restrictions on non-audit services may lead to additional costs for audited entities (ultimately borne by the shareholders), a reduction in the choice of auditors (or non-audit service provider – particularly if joint audits become the norm) and in some cases to delays in

obtaining services which may impact the ability of an entity to execute a transaction (e.g. an acquisition or refinancing).
- On the other hand, there is a perceived threat to the auditor's independence, objectivity and independence and to the users' confidence that a robust and challenging audit has been carried out.

This balance should be considered in light of the fact that existing bans largely address actual threats, and that the FRC's requirement to decline work if an objective, reasonable and informed third party would consider it impaired the auditor's independence is already leading firms to decline work that is not banned, even if safeguards could reduce the actual threat to an acceptable level.

Balancing these two considerations, we remain of the view originally expressed to the CMA that its package of measures should contain an outright ban on non-audit services for FTSE 350 entities and large private UK companies, other than for those services that are reasonably defined as 'audit-related' – which would be a different range of services than currently defined as such by the FRC's Ethical Standard – focussing on the auditor's position to provide independent assurance, attest and diligence services whilst banning advisory work.

Audit-related services should include those that are required to be performed by the appointed auditor (typically regulatory reporting to the FCA or PRA) and those which are assurance or attest services that require the practitioner to be independent (e.g. an interim review of the half-yearly report of a listed company, comfort letters, internal control opinions, voluntary assurance on non-financial information in the front half of an annual report and reporting as required by the Prospectus Rules and similar regulations and those services which are provided in an indirect context as referred to in xi below), together with acquisition due diligence – which, whilst it does not require independence in line with the IESBA Code, does require the provider to take an objective view and challenge of information presented to it, as opposed to providing advice – it is for this reason that they were included in recital 8 to the EU Audit Regulation.

There are two areas where we can see the potential adverse consequences outweighing the benefits in respect of currently permissible services that are not 'audit-related':

- Firstly, the effect of the FRC interpretation of indirect services. We explore the impact of this on lending syndicates in our response to question xi above.
- Secondly, the availability of alternative auditors in the event of a forced 'in year' tender is already limited as prohibited services provided prior to appointment but within the financial year rule a firm "offside" for the purposes of accepting the audit appointment. With additional restrictions this choice becomes narrower still. We suggest that the FRC acknowledges this difficultly, implementing a mechanism similar to the SEC's hardship mechanism and overseen by the FRC (or its successor) on a case-by-case basis in respect of 'in year' audit tenders that could not reasonably have been foreseen by the auditor and the PIE.

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

There are two sorts of reliefs – those for entities that are listed and those which are not.

'SME Listed' reliefs

We question whether the limited range of services that are actually permissible makes it worth their retention. However, any decision should ultimately be made by the FRC having regard to its own work on the quality of reporting by smaller quoted entities and audit quality reviews of such entities:

- The 'SME listed' reliefs were introduced in the 2016 Ethical Standard and only apply to those entities that are listed on a market that is not an EEA regulated market that either issue debt or equity securities with an average market capitalisation over three years of less than <€200m or, in the case of a debt issuer,

meet the size limits for a medium-sized company in the EU Accounting Directive. Typically such companies will be traded on AIM or the International Stock Exchange.

- In practice, many of the FRC's reliefs cannot be used by an audit firm that is a member of the IFAC Forum of Firms, which is broadly the largest thirty networks worldwide; such firms have undertaken to IFIAR and others that they will apply the IESBA Code of Ethics as a minimum, and many of the FRC's reliefs remain banned by the IESBA Code. The only reliefs that can be used by such firms are in respect of contingent fees for tax services that do not involve uncertain law (contingent fees being banned where the law is uncertain for all entities, listed or unlisted), and certain restructuring services. Given the narrowness of this exemption in practice, and therefore the low uptake of it, we question whether it is worth maintaining it for the perceived threats it may bring.
- The reliefs were, however, introduced based on concerns from the Quoted Companies Alliance and others - and the FRC's own work as part of its review of the quality of reporting by smaller listed and quoted companies - (rather than as a result of major audit firm pressure) that the inability to take advice from auditors was more harmful to the quality of financial reporting than the resultant self-review, self-interest and management threats. It is therefore important that the FRC's decision be justified by its experience of the current reliefs – are they actually improving the quality of such reporting or not?

Provisions for smaller entities

Section 6 of Part B of the Ethical Standard governs these. It largely applies to the audits of the smallest entities and to small firms; we are not aware of any use of these provisions by a major audit firm. Whilst we believe that the public interest is unlikely to be significantly improved by removing these reliefs, it is ultimately not a matter for us to conclude upon.

Questions relating to the Auditing Standards

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

As with the Ethical Standard, there are a small number of cases where the FRC's Technical Advisory Group has been consulted to promote consistent application of the Regulation and Directive, which have resulted in staff guidance notes and entries in the Rolling Record published by the FRC. We suggest that these could more usefully be included as application material within the standards to promote consistent application by audit firms of all sizes; this also helps auditors to explain their requests for information and explanations to management and those charged with governance. We set these out in Appendix 3.

We also suggest that the FRC review those paragraphs where there is a requirement copied out from the Directive or Regulation immediately beneath a very similar requirement in the underlying ISA. We suggest that these could be made clearer:

- If the Directive or Regulation requirement does not differ in practice from the ISA requirement, then the additional requirement could be removed, perhaps with a footnote to explain which requirement is addressed by the ISA.
- If the Directive or Regulation requirement does differ, it would be helpful to clarify what the incremental requirement is.

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

As with question xiv, there are a number of areas where clarification has been sought through the FRC's Technical Advisory Group; again, it would be helpful to take the opportunity to include these now in the application material (or, in occasional circumstances, requirements) of the ISAs (UK) and ISQC (UK) 1. Details are also in Appendix 3.

xvi. Is the work required of an auditor on an entity's compliance with laws and regulations, and those procedures to identify irregularity, including fraud, sufficient to meet the needs and legitimate expectations of users? If not, what additional work would you require and why?

In common with questions xvii-xix, this is an area which we expect will be covered by the Brydon Review which is considering how far audit can and should evolve to meet the needs of investors and other stakeholders.

An auditor conducting an audit in accordance with ISAs (UK) is currently responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by irregularities (including fraud) or error. Auditors are required to exercise professional scepticism, recognising that there could be a material misstatement due to irregularities (including fraud) or error, notwithstanding the auditor's past experience of the honesty or integrity of the entity's management and those charged with governance. However, an audit is carried out on a sample basis – which of necessity means that not every error could be found – and fraud may be particularly hard to detect because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion – especially if that involves a third party from whom evidence is sought. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false.

However, despite this understanding of the requirements of ISAs, an expectation gap still remains between the expectations of investors and society as a whole and what even a well-conducted, standards-compliant audit covers under current standards. In the case of a fraud there is always the assumption that if the auditor had only been (more) sceptical, the risk would have been identified and the fraud detected. Whilst in some cases this is so, it is not always the case. Simply explaining the nature of this gap is not a solution; the gap must be narrowed.

Our first suggestion relates to the audit as currently scoped – that is, based on financial statements as they are currently prepared based on the directors' responsibilities set out in company law. We believe that ISAs need to continue to evolve to address the gap, rather than just explain it:

- The IAASB has already proposed changes to the overall audit risk model[1] which separates out inherent risk from control risk. In our network's response to the IAASB, we supported these changes as they improve the robustness of the risk assessment process, as well as the degree to which the auditor understands internal control.
- This approach has also been taken in the newly issued ISA (UK) 540 (Revised) Auditing Accounting Estimates and Related Disclosures. We believe that this will improve the quality of work on judgemental areas such as the impairment of goodwill and intangibles, valuation of financial instruments (including expected credit losses), and long-term contract accounting under IFRS 15. In a group, work is performed to address irregularities, including fraud, at both the level of the group and of components.
- For this reason, we believe it is essential that the FRC works with the IAASB and other international standard setters to develop consistent changes to international standards that will be applied by group and component auditors alike.

Our second suggestion relates to the future scope of the audit, which is being considered by the Bryon Review:

- The primary responsibility for the quality and integrity of financial reporting and for the prevention and detection of irregularity (including fraud) rests with the company's management and those charged with governance.

[1] Proposed International Standard on Auditing 315 (Revised) Identifying and Assessing the Risks of Material Misstatement, July 2018

- In some situations, auditors find themselves trying to "audit in" quality where management has failed to prepare its own robust analysis to support the figures recorded in the financial statements or where the audit committee has not challenged management. For example, where management's paper to support an impairment review of goodwill, intangibles or contract balances is thin, auditors are often forced to test the evidence provided but without management having a robust set of controls to underpin the preparation of that paper on a timely basis.
- For this reason, as set out in our responses to the Kingman and CMA reviews, we support the introduction of a proportionate UK Sarbanes-Oxley equivalent type regime for the largest listed companies in the UK. This will place appropriate accountability on companies' boards and management to ensure the quality of their financial reporting. Data shows that restatements in the US spiked in the years following the introduction of Sarbanes-Oxley, as a result of the new requirement to report on the effectiveness of internal controls over financial reporting, but led to an overall improvement in the quality of financial statements over time. Such a regime would require both requirements on management to implement appropriate controls (and for audit committees to provide oversight of those) and for auditors to test the design, implementation and where appropriate operating effectiveness of such controls and report their opinion to shareholders.

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

Yes, in four key areas.

Firstly, we believe that reporting of Key Audit Matters (KAMs) should continue to evolve in a way that increases their value to users of financial statements. Findings should become mandatory, and application material should give examples of how such findings can be made meaningful to users of financial statements. This could be achieved by removing the words "Where relevant" from before "key observations arising with respect to those risks", forcing auditors to include observations for each KAM. Current practice is still varied, and audit committees still sometimes challenge whether observations are necessary. Additional application material should expand on the nature of the now mandatory observations. For example, guidance could set an expectation that auditors:

- Give an indication of where in an acceptable range management's choice of estimate lies
- Indicate the level and direction of both adjusted and unadjusted errors
- Report areas where they might have expected to be able to rely on controls but were unable to do so, either because a control did not operate as expected, or because there was no appropriately designed control placed into operation. It may also be helpful to explain areas where the auditor never planned to take control reliance – e.g. if the volume of a particular class of transactions is small – to avoid giving the opposite impression that management's controls are ineffective or missing when in fact they may very well be adequate.

Our changes may also require some parallel changes to the requirements for directors and audit committees – for example, the auditor is required to report its approach to materiality, but management is not ("in designing our control environment to prepare financial statements that are materially correct, what did we mean by 'materially'?"), and nor are audit committees ("at what level do we tell management that, even if errors are not material, they should be booked?").

Secondly, the auditors' explanation of materiality should be enhanced by making it mandatory for auditors to justify (rather than just state) the following:

- The level of performance materiality. We are aware that some investors make assumptions that a lower performance materiality always means a past history of error, while this is just one possible reason. Other reasons could include the level of disaggregation in a group's financial reporting process (are there many small components or a handful of large ones?), significant changes to controls (e.g. a new and as yet untested IT system) or the first year of an auditor appointment.

- Lower levels of materiality used for certain classes of transactions, account balances and disclosures. Currently the paragraphs 16-1 and A59-1 of ISA (UK) 701 only require an explanation of lower materialities used and how they are applied without requiring an explanation as to why they were necessary.

Thirdly, to complement an increased focus on controls in Key Audit Matters, application material could clarify the need to discuss the overall control environment and other aspects of internal control and its impact on the audit plan in the description of the scope of the audit. This could usefully be coupled with a more discursive explanation by management of their control framework and other aspects e.g. internal audit. For example, some financial institutions with a regulatory expectation of a "three lines of defence" model provide a few pages of explanation in the annual report as to how they assess, manage and monitor risk – addressing the requirements of DTR 7.2.5 and 7.2.10, whereas smaller commercial companies often do not, even if they have an equally mature control environment.

Finally, investors tell us that they want access to the auditors' explanation of materiality and KAMs sooner. We think that inclusion of the sort of report explaining these matters in any preliminary announcement should be mandatory, at least for announcements based on audited financial statements, and the FRC should work with the FCA on this. The FRC did commend a form of report for preliminary announcements in its "Bulletin: The Auditor's Association with Preliminary Announcements made in accordance with UK Listing Rules" but this has seen little uptake as it does not cover the matters in which investors are most interested. Our firm has issued a number of more informative reports that have been welcomed by investors, but without compulsion few Audit Committees have chosen to meet investor demand in this way.

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

No.

The FRC's recent Audit Quality Thematic Review: Other Information in the Annual Report includes both an acknowledgement that the current scope of an audit is misunderstood by users of financial statements and notes that the FRC will consider these as part of its work on the future of corporate reporting. We explain above that the GPPC found that many users believe that all information within the annual report was of the same quality, and that this belief gives rise to a risk to the capital markets. We believe that these need to be addressed urgently as part of the Brydon Review with regard to the auditor's involvement with other information under the current scope of corporate reporting, including the need to reconsider the piecemeal approach to the auditor's involvement in different aspects of the front half set out in our response to question iii. Having resolved the current expectation gap – in part by closing it rather than by explaining it better – the auditor's involvement needs to be kept under review as the FRC and others debate the future form of corporate reporting.

As an example of the current confusion, there is often an expectation that key performance indicators (KPIs) are subjected to the same level of assurance as numbers within the financial statements:

- Whilst the ESMA Guidelines on Alternative Performance Measures have brought some discipline around presentation of some KPIs, this is not the case for all of them.
- In any case, the auditor's work on KPIs that are not included in the financial statements need not, as a matter of law and standards, be the same level of assurance as an audit.
- In our experience when we are asked to carry out voluntary assurance engagements, we find that the information systems used by management to collect the data underpinning indicators with a non-financial element (and the steps taken to monitor the quality e.g. internal audit) are often less mature than for those which are a natural product of the financial reporting system.
- If the information systems are less mature, it may not actually have been possible for the auditor to have given assurance over some KPIs – the audit trail just simply does not exist to support an opinion.

- Firms have, for several years, offered voluntary assurance over KPIs, not least in response to investors' expectations, but preparers have generally cited lack of investor demand as a reason not to commission a report.

The FRC could usefully explore options using the Audit and Assurance Lab to provide input into the Brydon Review and subsequent implementation activities without waiting for the FRC's broader Future of Corporate Reporting project to conclude.

The FRC should also build on the IAASB's work on Extended External Reporting (EER), by encouraging investor and preparer participation in the imminent exposure draft of the International Assurance Engagement Practice Note (IAEPN): Addressing Challenges in the Application of ISAE 3000 (Revised) to EER, and promulgating the resulting IAEPN as FRC guidance.

One of the key challenges identified in the draft IAEPN is that of a lack of maturity in governance and internal control over EER reporting processes. Again, while the UK environment is more mature than most, the guidance on Risk Management, Internal Control and Related Financial and Business Reporting is not as embedded into every boardroom as the long standing duty to maintain accounting records, and this guidance does not go as far as suggesting the same quality of audit trail for the front half as the legally required accounting records to support the financial statements.

We suggest that the FRC uses the IAEPN exposure draft process to encourage boards to think about the extent to which the five components of internal control (the control environment, the risk assessment process, monitoring, the information system and detailed control activities) are in place across other areas of the annual report. The FRC should consider whether further guidance for management and audit committees is needed in these areas. Achieving behavioural change for management and those charged with governance indirectly, by asking auditors to set the expectation of the information available to support their audit work, is not as effective or timely as addressing the obligations of management and those charged with governance at source. We explore an example of this further in our response to question xix.

Finally, as a short-term measure, the FRC should also update its auditor guidance relating to the UK Corporate Governance Code, which has not been updated since 2009 (several versions of the Code and guidance ago), and issue updated guidance on the audit of the directors' remuneration report. Whilst the FRC has included requirements in ISAs relating to certain provisions of the Code (including those around risks and uncertainties, going concern and viability), there is not a consistent set of expectations around other provisions and this is evidenced in the findings of the FRC's Thematic Review. We have also asked both the FRC and FCA to consult jointly on the future of the "review" duty relating to certain provisions of the Code – again, the FRC's material is outdated and there is no clear and consistent expectation of auditors.

xix. For going concern, auditors are required to assess whether management's use of the going concern basis of accounting as required by IFRS or UK GAAP is appropriate. How could auditors make their assessment of greater value to users of financial statements? Please set out what steps you believe should be required to better underpin confidence in audit and audited financial statements.

In our experience, the quality of papers prepared by management to support their going concern assessment is variable; the same is true for those companies required to prepare a viability statement (typically over a three to five year period) and discuss the longer term prospects (typically over a longer period). As explained above, in some cases it is left to the auditor to "audit in" quality to management's assessment. We recommend that work in this area is not limited to changes relating to the adoption of the going concern basis of accounting:

- Auditors should be required to consider the controls that management has put in place over the going concern assessment; this would form a natural part of our proposal in response to question xvi above about a form of UK Sarbanes-Oxley style regime. However, in order for this to work effectively, there

needs to be a direct requirement for management to implement such controls and for audit committees to oversee these.

- The same requirements apply to the auditor's work on the viability statement, which differs from the work on going concern. Indeed, the FRC's Thematic Review on other information suggests that "the FRC expects auditors to … Require Boards to prepare, on a timely basis, appropriate documentation to support key areas of the OI such as the Viability Statement". This expectation should be placed directly on Boards, and then subjected to assurance procedures by the auditor. Setting expectations for directors to do something in auditing standards is less effective and makes it harder to achieve behavioural change than by setting that expectation directly. For example, if the Board does not prepare this, it is unclear on what basis the auditor could currently modify its opinion.
- Finally, guidance for preparers could ask them to give a flavour of the sensitivity analysis they have performed directly. The auditor's reporting on going concern (at least in the enhanced auditor report for public interest entities and listed entities which are the scope of ISA (UK) 701) could provide more colour as to the nature of the auditor's challenge of management's papers to support the adoption of the going concern basis, the existence or otherwise of material uncertainties relating to going concern, and the viability statement.

We believe the FRC's work on going concern should also feed into the international debate in this area, including the IAASB's programme of revisions to its standards.

Appendix 2 – detailed areas where changes to the Ethical Standard or additional guidance may be helpful as set out in question viii

- ***Difficulties with the areas where the FRC has diverged from the broader interpretation across Europe and gone beyond what the regulations require.*** In particular the FRC's interpretation of an indirect service (see also xii) and the FRCs extraterritorial application of UK rules. We suggest that the FRC takes the lead from the definition of 'indirectly provide' used by the European Contact Group and adopted by other CEAOB members. This states the factors that normally constitute a provision of service[2]. Making this change would re-align the extraterritorial component of the UK rules to be consistent with application in other countries. This would encourage consistent interpretation and application across Europe.

- The 70% fee cap for non-audit services to PIEs is complex and hard to understand. We welcome the fact that the FRC did address an obvious challenge as the Regulation's cap only applies to the PIE auditor and not network members. However, it does lead to an odd position where services which are closely-related to the audit and which provide assurance in the public interest (e.g. interim reviews and assurance on risk-weighted capital of a bank) but are not required by law, together with those required by non-EU (after Brexit, non-UK) law (e.g. assurance required by s404 of the Sarbanes-Oxley Act) are capped, whereas some permitted services required by law but which are not audit-related are not. We suggest that the FRC explores the operation of the cap once it has concluded on the overall permissibility of non-audit services to PIEs with firms and investors. It may also be helpful to align the requirement to consult with the Ethics Partner (an FRC-only rule not drawn from EU or UK law) in the case of significant non-audit services with the definitions used in the cap.

- We comment on the FRC's interpretation of the derogation in ES 5.168R in our response to question xi.

- Investment circular reporting engagements are unpredictable and short term in nature. This causes difficulties where a response is required quickly (for example, where the Takeover Code imposes a short deadline), yet some of the work is prohibited or capped. Furthermore, these engagements will become more complicated once the 70% cap applies as services may need to be split between two or more firms. Identifying not only one but two firms to provide independent assurance services and due diligence may be hard and may also impact competition and choice in the non-audit market.

- On long association, the FRC has chosen to apply a tougher rule to all key audit partners of five years on, followed by five years off, for all public interest entities. This term includes, as a legal minimum, those statutory auditors responsible for material subsidiaries. We agree with the FRC that, as a point of principle, there is no reason why non-EU subsidiaries and other forms of material component should be treated differently from EU material subsidiaries. However:
  - Restricting subsidiary partners to five rather than the seven years on provided for in the Regulation has caused practical difficulties, given the requirement for an appropriate gradual rotation mechanism (ES 3.18R) and the significant change in auditor appointments as a result of increased tendering.
  - For entities that have tendered and changed auditor (the majority of listed companies), every partner's term starts at the same point. We question whether the threat of changing all partners at once is not greater than the threat of allowing some component partners to serve seven years.
  - The alternative of shorter tenures for some partners is likely to prove more costly and give rise to its own quality threats. Most notably, it will cause a challenge for smaller audit firms and networks where the supply of appropriately knowledgeable and experienced partners is more limited, harming competition and choice.

  We suggest that the FRC considers changing the rule for partners (other than the audit engagement partner) to seven years on and three years off (to align with the Regulation and the revised IESBA Code), perhaps with a requirement to consider the need to implement additional safeguards in years six

[2] European Contact Group FAQs – February 2018, Question 7.33

or seven. In any case, we ask that the FRC aligns the wording in the standard with its intention rather than relying on the Rolling Record to explain its views.

- In advising fund structures and other complex groups there can be a high degree of complexity in navigating where and how requirements apply across multiple borders and with multifaceted ownership arrangements.

Deloitte.

Appendix 3 - detailed areas where changes to the Ethical Standard or additional guidance may be helpful as set out in questions xiv and xv

- ISQC (UK) 1.12(h)-1 and ISA 220.7(f)-1 define "key audit partner". Given the FRC's views that this should be applied worldwide and to other types of component, rather than just within the EEA and to subsidiaries, we believe the definition should be changed.
- ISQC (UK) 1.12(o)-1 and ISA 220.7(m)-1 will need to be updated in line with the changed definitions if there is a 'hard Brexit'.
- ISA (UK) 220.25R-1 and 25R-2 deal with the EQCR reviewer's discussion with the key audit partner. It would be helpful for application material to cover the material in SGN 02/2018 (see also our point on ISA (UK) 600.50D-1 below).
- In the Rolling Record, the FRC commented on the granularity required when complying with ISA (UK) 260.16R-2 and reporting on valuation methods (and changes thereto) to the audit committee. We suggest that this may need to be clarified given the changes arising as a result of the introduction of the new ISA (UK) 540 (revised).
- ISA (UK) 600.50D-1 deals with the requirement for the group auditor to "evaluate and review" the work of a component auditor. It would be helpful if the material from SGN 02/2018 which explains this duty could be included as an appendix (excluding the background, which will be obvious from the standard itself).
- ISA (UK) 600.50D-3 deals with the auditor's requirements to obtain documentation from component auditors outside the EEA. In the event of a "no deal" Brexit this situation may arise in respect of EEA auditors too and this material needs to be updated.
- ISA (UK) 700.45R-1 would be helped by application material which says "If the auditor is unable to give the required declaration, but believes that an 'objective, reasonable and informed third party' would not conclude that the auditor's independence has been compromised, the auditor should explain the nature of the breach; the reason why they believe their independence has not been compromised (perhaps because the breach was minor in nature); and what has been done to address the risks to their independence arising from the breach (e.g. additional audit procedures or quality control reviews)."
- ISA (UK) 701.13R-1 needs an additional paragraph of application material explaining the FRC's position on inclusion of "the explanation of the extent to which the audit is capable of detecting irregularities, including fraud", incorporating material from SGN 02/2017, and whether, as a result, the risk of management's override of controls and the rebuttable risk of fraud in revenue recognition are always key audit matters. The FRC could also usefully recommend that those key audit matters that are fundamental should be placed first.
- In its recent thematic review on the auditor's work in connection with other information, the FRC suggested a heightened expectation of what auditors should do under the existing scope of an audit and extant ISA (UK) 720, as distinct from changing the scope as contemplated by question xiii in this consultation. We believe paragraphs of application material summarising the FRC's position would help achieve consistent practice.
- Finally, whilst the directors' responsibility statement is a legal requirement for entities with securities admitted to trading (see DTRG 4.2), we believe it serves little purpose in a smaller private company annual report. This is because:
  - The auditors' report now contains a more fulsome explanation of the directors' responsibilities
  - The remaining material in the FRC's model directors' responsibility statement no longer seems to address an expectation gap
  - Inclusion of boilerplate runs counter to the FRC's own aims to encourage entity specific reporting

  We suggest that the FRC take this opportunity to amend their audit report Bulletin in parallel with any changes to the ISA to:
  - Remove the directors' responsibility statement for unlisted non-public interest entities
  - Update the directors' responsibility statement for listed and/or public interest entities to provide a more informative discussion of what the directors must do