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**The Investment Association**

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Dear Catherine

**Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard,  
Auditing Standards, Corporate Governance Code and Audit Committee Guidance**

The Investment Association represents the asset management industry in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £5.5 trillion of assets, which are invested in companies globally. In managing assets for both retail and institutional investors, our members are major investors in companies whose securities are traded on regulated markets. Therefore, as users of these companies' accounts, they have an interest in the requirements governing the audit and the auditor's report.

We believe that the main purpose of accounts is to provide investors, the holders of ordinary shares, with the information they need for the purposes of deciding to buy, sell or hold their shares and fulfilling their responsibilities as owners – assessing company management and the strategies adopted, stewardship. High quality audits are pivotal to this and for ensuring that markets value and investors have confidence in the information reported.

The requirements of the EU Audit Regulation and Directive (ARD) seek to address a number of investors' concerns around audit. These include concerns around auditor independence and objectivity, which may be compromised by long term relationships with clients and non-audit services, the limited number of audit firms that can audit large multinational entities, and auditors' communications with investors.

We thus support the objectives of the ARD and welcome the FRC issuing this Consultation on Enhancing Confidence in Audit and changing its audit and ethical standards, together with the UK Corporate Governance Code and Guidance for Audit Committees. Our members are supportive of the FRC's work, appreciate its extensive outreach to the investor community, and want to work with it in ensuring their needs are met. In this context, we set out in the attached Annex our answers to the detailed question raised and our key observations below.

- **Relief for smaller listed entities.** We support relief for smaller listed entities where, although listed on a recognised market, they are not in substance open to trading by the public, or in relation to restrictions on non-audit services, have a market capitalisation below £100million. We understand the latter would mean that around three quarters of entities listed on AIM would benefit from the relief. It is also aligned with the value currently used by the FRC's Audit Quality Review Team to determine entities subject to its inspections. However, we consider that the threshold of £100million should be kept under review in case issues arise that merit it being reduced or reconsidered (question 13).
- **Going concern.** We do not consider that the FRC's proposals in relation to going concern go far enough. Under the going concern assumption, it is assumed that an entity will not curtail its operations for the *foreseeable future*. Given the importance of this, investors consider auditors should be required to attest that they have reviewed and challenged the underlying principal assumptions and are satisfied that the going concern statement is appropriate. They should report on any material uncertainties which should be a "key audit matter" and detail the auditor's work regardless of whether the directors have given adequate disclosures in the financial statements. Moreover, IAS 1, Presentation of Financial Statements deems the foreseeable future to be *12 months from the entity's reporting date*. But ISA 570 addresses the period *one year from the date of approval of the financial statements*. These two periods should be aligned. We consider the latter and ISA 570 is the preferred position and that the IASB should be encouraged to amend IAS 1 to ensure consistency.

The FRC also introduced requirements for companies that report under the Code to report on their viability and whether they can meet their liabilities as they fall. This is, de facto, a higher hurdle than the going concern basis of accounting and an important one for investors in that it helps ensure that companies do not abuse their limited liability protection. Auditors should be required to similarly attest that they have reviewed and challenged the principal assumptions, particularly where there are uncertainties, and satisfied themselves that the viability statement is appropriate (question 19).

- **Advisory vote on the audit committee report.** We believe shareholders already have sufficient rights to let their views be known on the audit committee report through the annual re-election of the directors, which includes the audit committee chair, and by tabling specific shareholder resolutions. We do not believe that an advisory vote on the audit committee report is necessary (question 25).

I trust that the above and the attached are self-explanatory but please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely



Liz Murrall  
Director, Stewardship and Reporting

## **Ethical Standard**



- 1. Do you agree that the overarching ethical principles and supporting ethical provisions establish an appropriate framework of ethical outcomes to provide a basis for user trust and confidence in the integrity and objectivity of the practitioner, as described in the introduction to the Ethical Standard?**

The Investment Association agrees that the overarching ethical principles and supporting provisions establish an appropriate framework to secure behaviour by auditors that enhances users' trust in the audit or assurance opinion, and confidence in the auditor's integrity and objectivity.

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

The Investment Association supports the FRC's proposals to restructure the ethical standards into a single standard (the ES) for all audit and public interest assurance engagements, and thus provide auditors with a single source for all such requirements.

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

The Investment Association's main focus in representing the interests of institutional investors is in the audits of listed companies. That said, as regards non-listed Public Interest Entities (PIEs), as defined in the Regulation, we recognise that there may be systemic issues such that we support their auditors being subject to the same requirements as the auditors of listed PIEs.

However, for non-listed PIEs which are small such that they do not give rise to systemic issues, it may be appropriate to apply audit and ethical standards in a proportionate manner to the scale and complexity of such undertakings. This accords with the approach proposed for smaller listed entities, as set out in questions 12 to 14. In such instances, the audit report should clearly disclose that the auditors of these entities are not required to apply certain of the audit and ethical standards in full so that users are aware and if possible, should provide a reference or link to where the reader can determine what this means in practice.

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

A Small Entity, as defined, is not listed nor an affiliate of a listed company, and qualifies as a small entity. As such it is unlikely to give rise to investor protection or systemic issues. We thus support the FRC retaining the Ethical Standard – Provisions Available for Smaller Entities, and making conforming changes.

- 5. Do you support the FRC's proposal for the group auditor to ensure that any component auditor, whose work they propose to use in the audit and other members of the firm's network, meet the FRC ES or the IESBA Code as set out above?**

The Investment Association believes it important that auditors can demonstrate they are independent if their work is to be used by the group auditor. We support a proportionate approach such that the lead group auditor is required to evaluate the independence of any

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

network or third party firm whose work it uses in the group engagement. If the lead group auditor concludes that the other group auditors do not have the necessary level of independence, it should not rely on their work and should have to obtain other evidence, such as doing the work itself or requiring another firm to do the work necessary for the group audit.

Thus we support the FRC's proposal that the relevant test should be for the lead group auditor to ensure that any component auditor meets the requirements of the FRC's ES or for other network firms and third party firms, the extant version of the IESBA Code.

**6. Do you support the extension of scope to other public interest assurance engagements, incorporating the requirements of the ESRA into the FRC ES, and do you agree that the restriction of scope of ethical requirements for investment circular work is sufficiently clear in the proposed text?**

The Investment Association considers that stakeholders expect an equivalent standard of independence for audit firms, their partners and staff in providing other public interest assurance engagements (i.e., any engagements in relation to which the FRC issues performance standards) to that required of auditors. We therefore agree that the FRC's ES should apply to other public interest assurance engagements<sup>1</sup>.

We thus support the FRC withdrawing the APB Ethical Standards for Auditors and the Ethical Standard for Reporting Accountants (ESRA) and, where necessary, retaining certain specific requirements of the ESRA. Investment circulars relate to transactions that are price sensitive and it is important that they are kept confidential. As such they should only be known about by a limited number of individuals, and we agree that the ethical requirements in respect of investment circular work should be limited to apply only to persons with actual knowledge of the engagement. We consider the ES is clear in this respect.

**7. To provide additional clarity in respect of auditor independence, do you support the FRC's proposal to replace the 'chain of command' definition with the revised wording of the definition of person in a position to influence the conduct or outcome of an engagement?**

The Investment Association considers that in relation to auditor independence replacing the definition of 'chain of command' with "person in a position to influence the conduct or outcome of an engagement" provides more clarity. In particular, other than for investment circular work, this no longer specifies the need to be able to exert "direct" influence, and includes those "at each successive level of firm management, supervision or oversight relating to the audit or other public interest engagement, up to and including individuals who have ultimate responsibility for the management or governance of the firm".

**8. Do you support the FRC's proposal regarding accepting an engagement for an entity employing a former partner or other restricted person, to comply with the requirement set out in the Directive?**

ES 2.49 specifies that if "a partner [or another person] having previously been in a position to influence the conduct or outcome of the engagement" leaves the firm and joins an audit client

<sup>1</sup> Currently this comprises reporting accountants acting in connection with an investment circular; the auditor reviewing the interim financial statements; and engagements under the forthcoming Client Assets Standard.

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

as a director or in a senior position, the firm should resign from the audit and not accept reappointment for two years from that partner or one year for another person "ceasing to have the ability to influence the audit has elapsed" (or the former partner leaves the audited entity, if that is sooner).

The Investment Association supports this. Similarly, we agree that if a partner [or other such person] leaves the audit firm and joins a company that is not an audit client as a director or in a key management position then the firm should not be able to accept appointment as auditor for two years in the case of a partner or one year in the case of other person. In particular, although we are in the course of updating it, the guidance issued by the [Institutional Investor Committee on audit tendering](#) has more stringent expectations and states:

- *"To ensure independence, at least three years should have elapsed from when a company director was employed by an audit firm before the firm is appointed."*

*The three year expectation may be longer where the individual will be closely involved in the future audit relationship and/or formerly had a direct relationship with the company when at the audit firm. However, it may be appropriate to consider an audit firm where the Director sits on the Audit Committee and the conflicted individual absents his or herself from the process. However, in such circumstances it will be important for the Audit Committee to explain how they have safeguarded the independence of the process".*

### **9. Do you agree with the FRC's proposal to mitigate the risk of an auditor's independence being compromised, by clarifying requirements relating to the provision of non-audit services provided before taking up appointment as auditor?**

The Investment Association supports the FRC clarifying requirements relating to non-audit services before taking up appointment as auditor or other public interest engagement to mitigate the risk of an auditor's independence being compromised. Again this reflects the guidance issued by the Institutional Investor Committee which states: *"to ensure independence, the level of non-audit services provided by an audit firm should be considered"*.

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

Currently ES 5 prohibits an auditor from acting as an advocate "before an appeals tribunal or court". We agree that the 'advocacy threat' is the same when an auditor acts as an advocate for an entity in its dealings with HMRC before it gets to a tribunal or court. We, therefore, welcome deletion of the words "before an appeals tribunal or court".

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

The Investment Association agrees with proposals to revise ES 5 to prohibit the provision of tax services on a contingent fee basis. We consider that the benefits in reducing the risk of a conflict of interest outweigh any costs associated with obtaining those services either on a fixed fee basis or from another provider.

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

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

The Investment Association's main focus in representing institutional investors' interests is in the audits of listed companies. Whilst in general we believe the same auditing standards should apply to listed entities in that this is one of the costs of being able to access capital from the markets, we recognise that smaller listed entities could benefit from some targeted reliefs. In particular, there is often little, if any, coverage by analysts and an absence of other publicly available information such that the annual reports of smaller quoted companies can be important to investors. However, whilst in general the annual reports of smaller listed and AIM quoted companies are received on a timely basis and are of a reasonable standard, there are more instances of poor quality reports as compared to the reports from their larger counterparts, and room for improvement in key areas. Smaller listed companies may benefit by being able to use their auditor to help them in this and the targeted relief suggested could facilitate this.

### **13. Do you believe that the FRC's proposals are targeted at the right level, if not what alternative considerations for the application of reliefs would you suggest?**

The Investment Association supports relief for smaller listed entities where, although listed on a recognised market, they are not in substance open to trading by the public, and in relation to restrictions on non-audit services, have a market capitalisation below £100million. We understand the latter would mean that around three quarters of entities listed on AIM would benefit from the reliefs, while large listed entities, where there is greater public interest, continue to be subject to all the restrictions in respect of non-audit services. This threshold is also aligned with the value currently used by the FRC's Audit Quality Review Team to determine those entities subject to its inspections. However, we consider that the threshold of £100million should be kept under review in case issues arise that merit it being reduced or reconsidered.

### **14. Do you agree that the reliefs should continue not to apply, to entities which exceed the threshold and then subsequently fall below the threshold, for a period of two financial years following the financial year in which the reliefs first ceased to apply?**

The Investment Association agrees that once an entity exceeds the threshold for relief, it should be subject to the full requirements of the ES in respect of non-audit services for two years following the year in which the relief ceased to apply, even if its market capitalisation subsequently falls below £100 million. Investors have an ongoing interest in the future of the entity and would be concerned if the reliefs were to change continually due to market fluctuations.

## **Auditing Standards**

### **15. Do you agree with the FRC's proposed approach to incorporate the requirements of the Regulation and Directive into the text of the quality control and auditing standards?**

The ARD cover similar requirements to those in existing standards and we agree with the ARDs' provisions being incorporated into them.

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

This question is outside The Investment Association's remit.



**17. Do you agree with the FRC's proposals to:**

- a) adopt the proposed ISA (UK and Ireland) 700 (Revised) and ISA (UK and Ireland) 701; and**
- b) extend the application of ISA 701 to (i) those entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code and (ii) PIEs?**

The Investment Association agrees with the FRC adopting the proposed ISA (UK and Ireland) 700 (Revised) and ISA (UK and Ireland) 701. The FRC amended ISA 700 (UK and Ireland) for accounting periods starting on or after 1 October 2012 introducing a more enlightened audit report for entities that apply the UK Corporate Governance Code. This already required the auditor to report on the main risks of material misstatement and how the approach was modified in relation to those risks (i.e. the auditor's response); and to provide a summary of the audit scope and the materiality levels adopted. This information has helped investors identify and understand the significant judgements made in preparing the financial statements and given them more insight into the audit.

We also welcome the clarification as to the scope. In particular, the Regulation applies to PIEs, as defined, which includes unlisted credit institutions and insurance undertakings. These entities are not required and rarely voluntarily apply the UK Corporate Governance Code and thus have not been providing the more enlightened audit report in the FRC's ISA 701 and we welcome them being required to do so.

**18. Do you agree with the FRC's proposals to:**

- a) adopt the proposed ISA (UK and Ireland) 720 (Revised);**
- b) include requirements to allow the auditor to provide the required opinions and statements under UK (and Irish) legislation; and**
- c) withdraw section B of ISA (UK and Ireland) 720 (Revised)?**

The Investment Association supports the FRC adopting ISA (UK and Ireland) 720 (Revised) which requires the auditor to report whether they have identified any material misstatements in the other information reported. We agree that this should require the auditor to: obtain an understanding of the applicable reporting framework used to prepare the statutory other information; consider whether there are material misstatements between the other statutory information and that framework; and report whether the statutory other information is in accordance with the legislation. Given that Section B of ISA (UK and Ireland) 720 (Revised) now includes the relevant requirements from Section B, we support Section B being withdrawn.

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

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

The FRC proposes that the auditor should consider whether to report a "key audit matter" on going concern and report by exception where material uncertainties have been identified but not disclosed.

The Investment Association does not consider this goes far enough. Going concern disclosures assumed a high profile following the global financial crisis and investors would welcome some assurance that the auditor is satisfied that the directors have exercised due care in undertaking their going concern assessment and that the assumptions are 'reasonable'. Thus auditors should be required to attest that they have reviewed and challenged the underlying principal assumptions and are satisfied that the going concern statement is appropriate. They should report on any material uncertainties which should be a "key audit matter" and detail the auditor's work regardless of whether the directors have given adequate disclosures in the financial statements.

Moreover, IAS 1, Presentation of Financial Statements deems the foreseeable future to be *12 months from the entity's reporting date*. But ISA 570 addresses the period *one year from the date of approval of the financial statements*. These two periods should be aligned. We consider the latter and ISA 570 is the preferred position and that the IASB should be encouraged to amend IAS 1 to ensure consistency.

Following the Sharman review, the FRC also introduced requirements for companies that report under the Code to report on their viability and whether they can meet their liabilities as they fall. This is, de facto, a higher hurdle than the going concern basis of accounting and an important one for investors in that it helps ensure that companies do not abuse their limited liability protection. Auditors should be similarly required to attest that they have reviewed and challenged the principal assumptions, particularly where there are uncertainties, and satisfied themselves that the viability statement is appropriate.

### **20. Do you agree with the proposed scope of ISA (UK and Ireland) 250 Section B being limited to PIEs, or do you believe that the requirements of ISA 250B should also apply to non-PIES in regulated sectors?**

The Investment Association considers that the proposed scope of ISA (UK and Ireland) 250 Section B should be extended to non-PIEs in regulated sectors in that entities are usually only regulated if there is a need to protect third party interests.

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

This question is outside The Investment Association's remit.

### **22. Do you agree that the minimum retention period should apply to all audit documentation rather than just those documentation requirements deriving from the Regulation and Directive?**

This question is outside The Investment Association's remit.

### **23. Do you agree with the FRC's proposal to withdraw Bulletin 2008/4 and incorporate additional application material into ISA (UK and Ireland) 210 (Revised)?**



**THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED**

The Investment Association agrees with the FRC's proposal to withdraw Bulletin 2008/4 and incorporate additional application material into ISA (UK and Ireland) 210 (Revised).

**UK Corporate Governance Code****24. Do you agree with the changes to section C.3 of the Code?**

The Investment Association supports the FRC avoiding changing the Code where it is currently consistent with the ARD and the proposed minimal changes that are necessary. We also support the annual report, in describing the work of the audit committee, giving advance notice of retendering plans. As companies adapt to the new limits on length of audit tenures Audit Committees ought to be able to plan ahead adequately. Giving sufficient advance notice will give institutional investors the opportunity, should they wish to do so, to be consulted on the envisaged tender process.

**25. Is an advisory vote on the audit committee report required?**

The Competition and Markets Authority recommended that an advisory vote should be introduced for shareholders to indicate their satisfaction with the audit committee's annual report on the basis this would increase its incentives to act in the interests of shareholders, particularly in relation to their assessment of the effectiveness of the external audit process and the approach taken to the appointment and reappointment of auditors.

The Investment Association considers that shareholders already have sufficient rights to express their opinion on the audit committee report through the annual re-election of the directors, which includes the audit committee chair, or by tabling a specific shareholder resolution. We thus do not believe that this step is necessary.

**Audit Committee Guidance****26. Do you agree with the changes to the Guidance?**

The Investment Association supports the changes to the Guidance and particularly the additional transparency around the findings of the Audit Quality Review Team and the Corporate Reporting Review.