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16 March 2020

Dear Ken,

Exposure Draft – Proposed Revisions to the Non-Assurance Services Provisions of the Code

The Financial Reporting Council (FRC) welcomes the opportunity to comment on this exposure draft. As the UK's Competent Authority for Audit, our mandate includes: the setting of auditing, assurance and ethical standards; inspection of public interest entity audits and enforcement action against auditors. We also oversee the accountancy profession in regulation of its members and take public interest misconduct cases where conduct falls below expected standards (e.g. where practitioners fail to comply with the fundamental principles and requirements set out in the Code of Ethics). The FRC also is responsible for setting the UK Corporate Governance Code and its associated guidance.

We support the aim of IESBA to ensure that all the non-assurance service (NAS) provisions in the International Independence Standard in the Code (IIS) are robust and of high quality for global application, thereby increasing confidence in the independence of audit firms. Concerns raised by parliamentary committee enquiries into high profile corporate failures in the UK have highlighted the provision of non-audit services as a threat to the integrity, objectivity and independence of auditors, and a focus on commercial factors rather than the audit itself leading to a belief that audit quality may be compromised as a result.

Given the importance of these concerns, we believe IESBA could go further in strengthening the revised requirements and related application material it is proposing. We identify specific issues and suggested actions below in our responses to the questions asked in the Exposure Draft, including:

- There is a need to be clear that a self-review threat arises in relation to <u>any service</u> that will affect the accounting records, internal controls over financial reporting, or the financial statements on which the firm will express an opinion. (see Q2)
- With regard to tax advisory and planning services, <u>we disagree</u> with the guidance in paragraph 604.12.A2, which asserts that a self-review threat will not be created in the circumstances specified (e.g. where provision of the service is supported by a tax authority). (see Q3)
- We recommend broadening the definition of a PIE to include more entities where there is a clear public interest and improve consistency across jurisdictions. (see Q4)

- The requirements for communication with TCWG should be strengthened to include more information that is important to their understanding of matters that may affect the auditor's independence. (see Q7)
- There should be an outright prohibition on valuations for tax purposes for a PIE. (see Q10)
- We do not agree that an advocacy threat does not arise if a firm is appointed by a tribunal or court to act as an expert witness in a dispute involving a client. (see Q10)

In the attachment to this letter we also give some comments on:

- The examples of actions that might be safeguards.
- An audit client that later becomes a PIE.
- Valuation services.
- Internal audit services.
- Recruitment services.
- Appointment as auditor of a PIE after previously providing NAS to that entity.

Responses to request for specific comments

Prohibition on NAS that Will Create a Self-review Threat for PIEs

1. **Do you support the proposal to establish a self-review threat prohibition in proposed paragraph R600.14?**

Yes, we are supportive of this prohibition, including that there is no materiality let out for PIEs.

2. **Does the proposed application material in 600.11 A2 set out clearly the thought process to be undertaken when considering whether the provision of a NAS to an audit client will create a self-review threat? If not, what other factors should be considered?**

It should be made clearer that each of points (a), (b) and (c) could, individually, give rise to a self-review threat. This could be achieved by linking each of the points with "or" rather than "and". As currently worded it suggests that a self-review threat would only exist if, having regard to (b), the results of the service will be subject to audit procedures. That is true in a literal sense, but the auditor's opinion is on the financial statements as a whole and accordingly a self-review threat could be considered to exist if the results of the service fall under (a) but are not being subjected specifically to audit procedures. This would also eliminate the risk that a service is undertaken that affects the accounting records, internal controls over financial reporting, or the financial statements, in the belief that the results will not be subject to audit procedures only to find at a later stage they will be.

Providing Advice and Recommendations

3. **Is the proposed application material relating to providing advice and recommendations in proposed paragraph 600.12 A1, including with respect to tax advisory and tax planning in proposed paragraph 604.12 A2, sufficiently clear and appropriate, or is additional application material needed?**

Further guidance is needed to make clear that management should have the capability to make independent judgements and decisions on the basis of the advice and recommendations

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provided by the firm. If management's mindset is to simply implement the advice and recommendations without question the firm may in effect become responsible for the results.

We disagree with the guidance in paragraph 604.12.A2, which asserts that a self-review threat will not be created in the circumstances specified. A self-review threat arises whenever the results of a service are reflected in the amounts included or disclosed in the financial statements. The threat may be mitigated to an extent if the service does not require the exercise of a significant degree of subjective judgment but will not be eliminated, as mistakes could occur in performing the service. If a tax authority or other precedent supports providing a service, that cannot serve to eliminate a self-review threat unless it can be argued that the authority or precedent will always support the outcome of the service, which seems unlikely. If a service is based on established practice, that may help reduce the chance of the provider producing an incorrect outcome, but if some judgment is required there will be a self-review threat. Even where there is no judgment, this does not preclude the possibility of mistakes, and as a result does not eliminate a self-review threat. Similar considerations apply when the service has a basis in law that is "likely" to prevail – in fact here the threats could be arguably higher as "likely" to prevail means there is subjectivity and a recognised possibility it may not prevail.

Project on Definitions of Listed Entity and PIE

4. **Having regard to the material in section I, D, "Project on Definitions of Listed Entity and PIE," and the planned scope and approach set out in the approved project proposal, please share your views about what you believe the IESBA should consider in undertaking its project to review the definition of a PIE.**

We support a position where distinctions are made in some areas between requirements applicable to PIEs and non-PIEs.

IESBAs current definition of a PIE in effect includes just listed entities at a minimum, with other entities included if defined as PIEs, or if they are required to be treated in the same way as a listed entity, by law or regulation in the relevant jurisdiction. The guidance in paragraph 400.8 of the Code 'encourages' firms to determine whether to treat other entities as PIEs because of factors such as their size, having a large number and wide range of stakeholders (including employees) or the holding of assets in a fiduciary capacity for a large number of stakeholders. The effect of this definition and guidance is that there may be wide variation in the types of entities treated as PIEs both across and within jurisdictions.

IESBA should broaden the definition of a PIE to include more entities where there is a clear public interest and improve consistency across jurisdictions. We believe, for example, that entities holding assets in a fiduciary capacity for a large number of stakeholders should be included within the definition.

The EU Audit Regulation definition of a PIE may be an appropriate starting point for IESBA's consideration, but there may also be other types of entity that would generally be considered by 'the public' to be a PIE. These might include 'large' private entities by reference to the numbers of employees or in terms of their turnover and balance sheet totals.

Materiality

5. **Do you support the IESBA's proposals relating to materiality, including the proposal to withdraw the materiality qualifier in relation to certain NAS prohibitions for audit clients that are PIEs (see Section III, B "Materiality")?**

Yes. Materiality is a judgment and, as identified by IESBA, may result in inconsistent approaches if used as a qualifier. This would also eliminate the risk that a service is undertaken on the basis

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that it is not material when there is possibility of that determination being changed later, for example as a result of a change in circumstances.

6. **Do you support the proposal to prohibit the following NAS for all audit clients, irrespective of materiality:**

   - **Tax planning and tax advisory services provided to an audit client when the effectiveness of the tax advice is dependent on a particular accounting treatment or presentation and the audit team has doubt about the appropriateness of that treatment or presentation (see proposed paragraph R604.13)?**

   - **Corporate finance services provided to an audit client when the effectiveness of such advice depends on a particular accounting treatment or presentation and the audit team has doubt about the appropriateness of that treatment or presentation (see proposed paragraph R610.6)?**

Yes, for both.

Communication with TCWG

7. **Do you support the proposals for improved firm communication with TCWG (see proposed paragraphs R600.18 to 600.19 A1), including the requirement to obtain concurrence from TCWG for the provision of a NAS to an audit client that is a PIE (see proposed paragraph R600.19)?**

Yes. However, paragraph 600.18.A1, which gives examples of matters that 'might' be communicated, should be elevated to a requirement as it is information that would be important for TCWG to understand in the context of considering threats to the auditor's integrity, objectivity and independence.

The communication to TCWG should include details of relationships with, including the provision of NAS to, a parent entity where that is relevant to an understanding of threats to the auditor's integrity, objectivity and independence. Paragraph R600.18 appears to specifically preclude such communication.

Other Proposed Revisions to General NAS Provisions

8. **Do you support the proposal to move the provisions relating to assuming management responsibility from Section 600 to Section 400, and from Section 950 to Section 900?**

We cannot see an issue arising as a result of these moves.

9. **Do you support the proposal to elevate the extant application material relating to the provision of multiple NAS to the same audit client to a requirement (see proposed paragraph R600.10)? Is the related application material in paragraph 600.10 A1 helpful to implement the new requirement?**

Yes. A proper assessment would need to take into account the combined effects of multiple NAS, not just consider them individually. The related application material is helpful.

Proposed Revisions to Subsections

10. **Do you support the proposed revisions to subsections 601 to 610, including:**

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- **The concluding paragraph relating to the provision of services that are "routine or mechanical" in proposed paragraph 601.4 A1?**

Yes, we agree that such services could be provided to non-PIEs provided the firm does not assume a management responsibility and also complies with the requirements in paragraph R601.4 to address any threats.

- **The withdrawal of the exemption in extant paragraph R601.7 that permits firms and network firms to provide accounting and bookkeeping services for divisions and related entities of a PIE if certain conditions are met?**

Yes.

- **The prohibition on the provision of a tax service or recommending a tax transaction if the service or transaction relates to marketing, planning or opining in favor of a tax treatment, and a significant purpose of the tax treatment or transaction is tax avoidance (see proposed paragraph R604.4)?**

Yes, we agree this is appropriate unless, as specified in paragraph R604.4, the treatment has a basis in applicable tax and regulation that is likely to prevail. However, there should be recognition that consideration of whether the treatment is likely to prevail is a judgment that may not be confirmed until tested with the tax authorities.

Paragraph R604.19 prohibits valuations for tax purposes for a PIE if that would create a self-review threat, unless certain conditions exist (assumptions widely accepted or techniques and methodologies are based on generally accepted standards). Given that a self-review threat will exist, there should be an outright prohibition on such services, consistent with the requirement in paragraph R600.14.

- **The new provisions relating to acting as a witness in subsection 607, including the new prohibition relating to acting as an expert witness in proposed paragraph R607.6?**

We agree with the requirement in paragraph R607.6. However, we do not agree with the statement in paragraph 607.7.A3 that "No such advocacy threat is created if a firm or a network firm, or an individual within a firm or network firm, is appointed by a tribunal or court to act as an expert witness in a dispute involving a client." We also do not agree with paragraph R607.9 permitting the provision of such services if appointed by a tribunal or court. An advocacy threat that involves adopting a position closely aligned to that of management cannot be eliminated just by virtue of being appointed by a tribunal or court, and a firm should not accept such an appointment unless required to do so by law, in which case it should apply safeguards.

Proposed Consequential Amendments

11. **Do you support the proposed consequential amendments to Section 950?**

As we have commented in our responses to other IESBA EDs (including those that addressed the structure of the Code), we believe the same independence requirements should be applied to other public interest assurance engagements as are applied to audit engagements.

12. **Are there any other sections of the Code that warrant a conforming change as a result of the NAS project?**

We have no comments on other possible conforming changes.

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If you have any questions on our response, or wish to discuss any of our observations in more detail please contact me on m.babington@frc.org.uk or +44-20-7492-2323.

Yours sincerely,

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UK Auditing Standards and Competition

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Other comments on the proposals

Examples of actions that might be safeguards

The third bullet in paragraph 600.16.A3 suggests that an example of an action that might be a safeguard to address threats is "Obtaining pre-clearance or confirmation of the outcome of the service from an appropriate authority (e.g., a tax authority)." We believe that generally it would be unlikely for an authority to give unconditional pre-clearance of an outcome. Confirmation of the outcome of the service by an authority is not a satisfactory safeguard as it would, if given, occur after the service has been provided, and there is a possibility the authority will not confirm the outcome.

Audit client that later becomes a PIE

Paragraph R600.20 in effect states conditions that would mean a firm's independence could be deemed not to be compromised when a client becomes a PIE. However, these are actually conditions designed to enable a firm to continue as auditor when its independence may in fact be regarded as compromised under the provisions of the Code applying to PIEs. For example, enabling the firm to continue as auditor even if it has performed a service that gives rise to a self-review threat. We understand that IESBA wishes to be pragmatic, but this requirement should be amended so that auditor is required to evaluate the threats, eliminate them or apply safeguards where appropriate and, if the threats cannot be reduced a level that would be acceptable to an objective, reasonable and informed third party not continue as auditor.

Valuation services

Paragraph 603.3.A1 states that "Providing a valuation service to an audit client might create a self-review threat when the results of the service will affect the accounting records or the financial statements on which the firm will express an opinion." Such a service will create a self-review threat, the consideration to be made is whether is, or can be reduced to, an acceptable level.

Internal audit services

The Code permits a firm to perform internal audit services for an audit client, subject to meeting the requirements in paragraphs R605.3 and, for PIEs, R605.6. We believe there should be an outright prohibition on providing internal audit services to an audit client. Performing such services means that in effect the firm becomes an integral part of the client's internal control. As such, there are no safeguards that will reduce the threats, in particular the self-review threat, to integrity, objectivity and independence of the auditor to an acceptable level.

Recruitment services

We disagree with the guidance in paragraph 609.4.A1. Even if accepted as not assuming a management responsibility with regard to appointment decisions, such advice could be seen as influential and give rise to threats to integrity, objectivity and independence – for example where an appointment is made in light of the advice and the candidate is subsequently found to lack appropriate competence. If necessary, management could use a separate recruitment agency. Accordingly, the prohibitions in paragraph R609.6 should also include not advising on the appointment, or the remuneration package, of any director or employee of the client.

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Appointment as auditor of a PIE

We agree that the conditions in paragraph R400.32 may help when a firm is considering appointment as auditor of a PIE to which the firm or a network firm has provided a non-assurance service prior to such appointment. However, we do not believe that appointment can be always deemed as appropriate if those conditions are met. The firm should still be required to perform an assessment of the threats and whether they are acceptable in the view of an objective, reasonable and informed third party.

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