Financial Reporting Council

August 2023

Ethical Standard 2023 Invitation to comment and impact assessment

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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Objective

1. In June 2022 the FRC published a Position Paper which committed to a revision of the Ethical Standard.[1] The purpose of this revision was:

   - To take account of changes to the International Ethics Standards Board for Accountants (IESBA) Code of Ethics (including a significant expansion of the Code's definition of a Public Interest Entity (PIE));
   - To respond to issues identified through audit inspection and enforcement cases;
   - To provide greater clarity in respect of specific prohibitions and requirements;
   - To allow the FRC to consult on whether to withdraw the Other Entities of Public Interest (OEPI) category introduced in 2019.

2. A Revised Ethical Standard is therefore published for public consultation alongside this Invitation to Comment and Impact Assessment. We highlight in the detail below some of the key changes that we propose, however we are consulting on all aspects of the Ethical Standard.

3. Alongside specific proposed changes we are also consulting on whether to withdraw the category of 'OEPIs'. Entities which fall within this category are subject to enhanced restrictions on the types of non-audit services which their auditors can provide. This consultation is in the context of the government's likely proposal to extend the UK statutory definition of a PIE, and changes to the IESBA Code PIE definition which have already been implemented, and which come into effect from 15 December 2024.

4. The revised Ethical Standard is less complex and therefore allows for enhanced compliance by practitioners. It is also more consistent with the IESBA Code, ensuring that the FRC's Ethical Standard reflects international ethical standards whilst being responsive to the particular circumstances and needs of the UK.

Invitation to Comment

5. The FRC is requesting comments on this consultation by 31 October 2023. Comments are invited in writing on all aspects of the consultation, particularly in relation to questions 1-8 as detailed below. Comments on the Consultation Paper should be sent to:

   James Ferris

   Director, UK Audit Policy
   Financial Reporting Council
   E-mail: AAT@frc.org.uk

[1] Restoring Trust in Audit and Corporate Governance, https://www.frc.org.uk/getattachment/aafabbc3-81a3-4db3-9199-8aaebb070c7f/FRC-Position-Paper-July_2022_.pdf

Introduction

1. The Financial Reporting Council (FRC) is committed to acting as a proportionate and principles-based regulator and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work, to maintain investor and wider stakeholder confidence in audit and assurance.

2. In revising the Ethical Standard our key objectives continue to be to enhance confidence in audit, ensure that consideration of the public interest is placed at the core of UK audit firm culture, and strengthen auditor independence. We are seeking to meet these objectives within the current legal, regulatory and financial reporting frameworks in the UK. At the same time, we will continue to liaise with the other regulatory reviews looking at the health and competitiveness of the UK audit market, regulation and the scope of audit.

3. The FRC's Ethical Standard applies to statutory audit engagements and other public interest assurance engagements, which include:

   - Reporting accountants acting in connection with an investment circular (the Standards for Investment Reporting – 'SIRs');

   - Reviews of interim financial information by the independent auditor of the entity (International Standard on Review Engagements (UK) 2410); and

   - Engagements to provide assurance on client assets to the Financial Conduct Authority (the CASS Standard).

4. The standard sets out overarching ethical principles in Part A, focussed on threats to objectivity, independence and integrity. This includes the perspective of an Objective, Reasonable and Informed Third Party (ORITP) [paragraphs I14 & I15]. These principles are well established and consistent with other relevant ethical codes, so proposed revisions to this Part are limited in nature.

5. Part B of the standard deals with specific areas including General Requirements (section 1); Financial, Business, Employment and Personal Relationships (section 2); Long Association with Engagements and with Entities Relevant to Engagements (section 3); Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation (section 4); Non-audit / Additional Services (section 5); and Provisions Available for Audits of Small Entities (section 6). We set out in detail below the more extensive revisions we propose for each of those sections of the standard.

Withdrawal of the OEPI Category

6. The 2019 revision of the Ethical Standard introduced a new category of 'Other Entities of Public Interest'. This was in response to corporate and auditing failures for entities which were not categorised as PIEs in law, which could nevertheless be considered systemically important to the UK economy. Concerns were raised about auditor independence in some of those cases and therefore we extended prohibitions on the provision of non-audit services by auditors to larger: AIM companies; pension funds; private companies, as well as Lloyd's Syndicates.

7. The government is currently considering an expansion of the UK statutory definition of PIE to include some (but potentially not all) of the entities which currently fall within the OEPI category. IESBA has also recently expanded its own

definition of PIE to include market traded entities (which in the UK will cover all AIM listed entities). The IESBA Code does not have direct effect in the UK statutory audit market, however the majority of UK audit firms voluntarily comply with it through their membership of the international Forum of Firms, and because the IESBA Code forms the basis for the Ethical Codes of the UK professional Accountancy Bodies.

8. The FRC believes that the UK economy, including the audit market, will benefit from the simplest possible definition of what a PIE is, and what restrictions then apply to the provision by audit firms of non-audit services. We therefore plan to evaluate the government's final proposal for the UK statutory definition of a PIE, but currently propose to abolish the current category of OEPI once that comes into effect. We recognise in doing so that there may not be perfect alignment between the entities currently included within the OEPI category and the government's final proposals, but believe this to be a proportionate regulatory response which will reduce the obligations on those entities which government chooses not to designate as PIEs.

Q1: Do you agree with the proposal to remove the category of OEPI from the Ethical Standard once the government's revised statutory definition of a UK PIE becomes effective?

Part B: Section 1 - Breach reporting by audit firms to the FRC

9. PIE Audit firms are required to report breaches of the Ethical Standard to the FRC on an (at least) biannual basis. This reporting is important to ensure appropriate monitoring of identified breaches, and effective remediation. This section of the ES has been revised to:

- Introduce a specific requirement for firms to design controls which are effective in identifying reportable breaches. This revision has been driven by concerns about potential inconsistencies in reporting between firms [paragraph 1.21];
- Include a specific requirement for firms to consider the perspective of an Objective Reasonable and Informed Third Party (ORITP) when assessing the implications of a breach of the ES [paragraph 1.22];
- Align the ES with our formal policy for reporting breaches by highlighting instances when firms ought to report to the FRC on a more timely basis. [paragraph 1.24]; and
- The ES includes the concept of 'inadvertent' breaches of the ES which do "not necessarily call into question the firm's ability to give an audit or other public interest assurance opinion". Additional material has been added to explain which breaches of the ES cannot be considered to be 'inadvertent'. [paragraph 1.25]

Q2: Do you agree the revisions in respect of breach reporting by firms? Could they be further enhanced?

Part B: Section 1 – Application of Prohibitions to different categories of entity

10. One of our objectives in revising the ES has been to make it easier to understand and comply with. We have therefore rewritten paragraph 1.46 to make it easier to cross refer from the general requirements section to the parts of the ES which deal with specific rules and prohibitions.

Q3: Does the revised paragraph 1.46 enhance the accessibility of the ES? Are there other areas where similar enhancements could be made?

Part B: Section 2 – Personal Financial Independence

11. Section 2 of the ES sets out prohibitions and requirements in respect of personal financial independence for engagement teams and other staff employed by audit firms. These are combinations of requirements set by the ES, and those set by statute. The dual source of these prohibitions has made the material in the extant ES hard to understand and therefore to implement effectively. Regulations of any kind which are difficult to understand must necessarily be more difficult to comply with. We have therefore completely re-drafted paragraphs 2.3 and 2.4 of the ES. Consequential changes were also made to paragraphs 2.4 to 2.10.

Part B: Section 3- Partner and staff rotation.

12. Similar to revisions highlighted in the section above, we have incorporated material from separately published FRC technical guidance on key audit partner and other staff rotation rules:

- A table has been included setting out the rotation rules for various partners on an audit engagement. [paragraphs 3.22-3.23];
- Further guidance has been added (again from previously published material) setting out circumstances such as maternity/paternity leave and sickness absence which may be relevant to those rotation rules. [paragraphs 3.23]

Q4: Do you agree that the changes made to paragraphs 2.3 & 2.4, and 2.5 to 2.10; and the addition of additional guidance in paragraphs 3.22 to 3.23 enhance the clarity of ES?

Part B: Section 4 – Fees

13. 13. Changes have been made to enhance prohibitions where an audit firm's independence could be threatened by an economic over reliance on fees from entities that are connected in substance if not in legal form. [paragraphs 4.21, 4.22, 4.23, 4.25, 4.27 & 4.29]

Q5: Do you agree with the changes made to section 4 on fees?

Part B: Section 5 – non-audit/additional services

14. Changes to Section 5 of the ES are aimed to align more closely with changes to the IESBA Code. This is in line with the FRC's commitment to have ethical standards that are at least as stringent as IESBA. This also helps UK firms who comply with the IESBA Code as part of their membership commitment to the international Forum of Firms, or because the Code forms the basis for the Ethical Code of UK Professional Accountancy Bodies. Additional changes have been made to reflect FRC inspection or enforcement findings.

- Information Technology Services to reflect stricter IESBA Code restrictions on audit firms providing hosting services to audited entities; [paragraphs 5.53-5.54]

- Enhanced tax service prohibitions that can be provided to the majority shareholders of unlisted entities, in response to supervision and inspection findings; [paragraph 5.67]

- Recruitment and Remuneration Services, reflecting more explicit IESBA Code prohibitions where audit firms provide related services; [paragraph 5.89]

- Corporate Finance Services where IESBA has introduced extended prohibitions relating to the provision of advice to audited entities on debt and financial instruments. [paragraph 5.97]

Q6: Do you agree with the changes made to section 5 which extend some existing restrictions on the provision of non-audit or additional services?

Q7: Are there any implications for the work of Reporting Accountants or CASS assurance providers that should be considered alongside these revisions?

Effective Date

15. The proposed effective date of the revised Ethical Standard is 15 December 2024. This aligns with the effective date of relevant changes to the IESBA Code.

Q8: Do you agree with the proposed effective date of the revised ES? Are additional transitional reliefs required?

Impact Assessment

16. Revisions we have made to the Ethical Standard which are intended to make it easier to use, navigate and comply with should be to the benefit of all stakeholders, including practitioners. We therefore expect them to have a net positive impact. Other changes, which relate to alignment with the IESBA Code, will already be being implemented by audit firms who are member of the international Forum of Firms. Any impact on stakeholders therefore arises primarily as a result of changes to the Code rather than to this Ethical Standard.

Financial Reporting Council

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Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk