

## **FRC revises the Ethical Standard (Lecture A854 – 19.05 minutes)**

On 15 January 2024, the FRC issued an updated Ethical Standard (ES). This updated version followed a consultation draft which was issued in August 2023. There are three main points that the updated ES does:

1. It provides simplifications and clarifications aimed at enabling the ES to be more concise.
2. It aligns the ES to that of the International Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants (IESBA) to ensure high standards of independence and ethical behaviour are applied consistently by UK audit firms and their networks.
3. It places a restriction on fees from entities that are controlled by a 'single controlling party'.

Some of the more notable changes arising from the updated ES are as follows:

### **Other Entity of Public Interest (OEPI)**

In the original consultation draft, the FRC proposed to remove the OEPI category. There was widespread support throughout the profession for this (but only once a final statutory definition became effective). Many also wanted the new definition of a 'public interest entity' to be simpler and aligned to the definitions in law, the ES and the IESBA Code.

The FRC does have the power to amend or withdraw the OEPI category but will not do so until a new statutory definition is introduced. The FRC has acknowledged that once details of any new statutory definition are known, it is highly likely the FRC will amend or withdraw the OEPI category given the unanimous nature of stakeholder feedback during the consultation.

### **Breaches**

There was a lot of concern when the consultation draft was issued because the proposals in the draft required any breaches, which the firm's policies and procedures failed to prevent or detect, to be treated as 'not inadvertent'. In other words, if a breach arose which was completely unintentional, it would have been considered a deliberate breach.

Thankfully, these proposals were dropped and, instead, the previous requirement to use professional judgement to determine whether, or not, a breach is inadvertent has been carried over into the revised ES. The FRC acknowledged that introducing this new requirement would have driven inconsistent reporting behaviours.

However, care must be taken to ensure a sound understanding of the requirement to report breaches (either to the FRC for listed and public interest entities; or to the relevant supervisory body for unlisted and non-public interest entities) because there are specific requirements in this respect. The revised ES requires firms to report all breaches to the 'Competent Authority' (i.e. FRC or relevant supervisory body, such as ICAEW or ACCA) on a biannual basis. Where a breach relates to a specific engagement(s), the ES requires the breach to be reported to those charged with governance in a timely manner (see paragraph 1.23 of the ES).

Paragraph 1.24 of the ES requires the firm to report individual breaches outside of the biannual timetable where the Competent Authority would reasonably expect notice. This may be due to the nature or seriousness of the breach, including, for example, where the firm may need to consider resigning from the engagement.

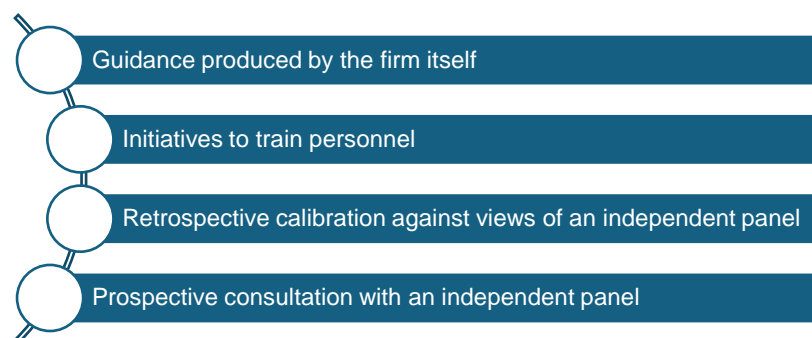
The ES requires the engagement partner (and ethics partner, where there is one) to consider the perspective of an **objective, reasonable and informed third-party test** (ORITP test – see 6.3 below) on whether it is necessary to resign from an engagement or, alternatively, what safeguards could be put in place.

## ORITP

As noted above, the revised ES includes requirements for audit and assurance practitioners to consider threats to independence from the perspective of an ORITP. The FRC has published guidance on how this may be applied in practice because it has observed that some firms have struggled to apply this test. In other words, would the third-party deem the threat to be so serious the firm should resign or not accept the engagement, as the case may be; or would they deem the threat to be mitigated to an acceptable level with appropriate safeguards in place?

Paragraph I14 of the revised ES talks about the ‘third-party test’ and states that such a person is informed about the respective roles and responsibilities of an auditor (or reporting accountant as applicable), those charged with governance and management of an entity, and is not another practitioner. The perspective offered by an informed investor, shareholder or other public interest stakeholder best supports an effective evaluation required by the third-party test, with diversity of thought being an important consideration.

The guidance suggests the following measures to enhance ORITP judgements:



## Fees

There have been some significant changes made to the ES in respect of fees received by the firm. It is well-known that prior to the revisions to the ES, where total fees for services from a public interest entity, or other listed entity, and its subsidiaries exceeded 10% of total fee income, the firm must resign or not stand for reappointment.

Where the fees are from a **collection of entities** which have the same beneficial owner or controlling party, which is not a corporate entity, this will also contribute towards the 10% limit. This is something that audit firms will need to be extremely careful of to ensure they do not breach this threshold, particularly where they act for a very large group. Keep in mind that the revised ES looks wider (than simply at a group of companies) for other entities that are connected in substance if not in legal form. For example, common ownership that is not a group is now caught when previously it was not.

During the consultation, some concerns were raised from smaller firms that if they were to breach the aggregate fee threshold, they could be caught in a downward spiral which would result in them having to withdraw from engagements which would then have a knock-on effect on their fee income. This could also bring other engagements above fee limits.

The FRC pressed ahead with the fee income proposals anyway and said that they will continue to engage with those practitioners that raised concerns.

Most audit firms (especially the larger ones) will already have systems and controls in place to protect against these fee levels. However, given that the FRC has made changes to the ES in this respect, it may be the case that there have been some firms that have not had such systems and controls in place resulting in breaches of the fee thresholds given that the changes have been triggered through audit inspection and enforcement cases.

### **Financial interests of individuals**

Generally, it is much easier for anyone in the audit firm *not* to have a financial interest in an audit. This is because there is clearly a threat to independence where a member of staff or a partner does have such an interest. The revised ES strengthens the rules in this area.

As well as disposing of the financial interest (or partially disposing of it) and not being involved in the audit engagement the ES then states that where the breach arises from a material prohibited financial interest or a prohibited transaction in a financial instrument, that individual must be excluded from **any** role which means they are operating in the same office or business unit as the audit engagement partner. In addition, the ES at paragraph 2.9 requires the firm to not accept, or must withdraw from, the engagement.

This effectively means that the person holding the financial interest would be required to change office or department. Hence, it is much easier to ensure that nobody involved in audit work has any financial interest in an audit client.

### **Conclusion and effective date**

These are just some of the 'headline' changes that have been reflected in the ES and a clear understanding of the up-to-date version must be obtained to ensure compliance across the entire ES. The updated ES comes into effect on 15 December 2024.