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Dear Mr Siong

Exposure Draft: Improving the Structure of the Code of Ethics for Professional Accountants – Phase 1

The Financial Reporting Council (FRC) welcomes the opportunity to comment on the Exposure Draft concerning the proposed revised structure of the Code of Ethics for Professional Accountants.

In January 2015 we responded to IESBA's 2014 Consultation Paper on the proposed restructure, which preceded the current Exposure draft, and expressed our support for the project as a whole. We view this project as an opportunity to address concerns we have raised in the past concerning the structure and language of the Code. Our primary concern in respect of the 2014 Consultation Paper was that the restructuring should not narrowly follow the clarity model adopted by the International Auditing and Assurance Standards Board (IAASB) for auditing standards, but should also fully embrace the principles-based approach that underpins the ISAs. This is because we believe that failing to do so would risk encouraging a 'rules based mindset', with an undue focus on requirements and process when approaching ethical issues, rather than requiring auditors to meet ethical outcomes that are consistent with user and public expectations of them in that role.

We strongly believe that a principles based approach, which clearly establishes overarching ethical principles and supporting ethical provisions, supplemented by clearly linked requirements addressing particular circumstances, will result in better ethical and behavioural outcomes. This has been one of the primary drivers behind our current revision to the FRC's Ethical Standard for auditors, which brings together the results of the FRC's own review of ethical matters and implements the requirements of the EU Audit Directive and Regulation.

The Board's decision to consult on proposed changes to the Code as a series of linked consultations, in which the contents of one are fundamental to considering the issues contained in the others makes it difficult to provide a response at anything other than a principles level at this stage. Although we have provided responses to each of the consultation questions, the detailed parts of each response are subject to a caveat, namely that they should then be considered holistically in the context of the Code as a whole and the outcomes it exists to support. When that is possible, we may have additional comments. The consultation

includes both major questions of principle, and some detailed questions of a more administrative nature. We have found it helpful, in revising our Ethical Standard, to focus on agreeing on the major points of principle first, as the answers to the more detailed questions may emerge from the conclusions drawn at the principles level.

The current Exposure Draft goes some way towards addressing our concerns raised in our response to the 2014 consultation, but we believe more should be done to clarify and emphasise the centrality of the fundamental principles in the conceptual framework, and establish an explicit linkage between the framework and the detailed requirements so that it is clearer how the requirements assist meeting the ethical outcomes. The draft currently omits the stages we found to be necessary – namely a need to clarify through supporting ethical provisions the outcomes that are necessary to act in accordance with the fundamental principles. In that respect, the Guide to the Code has a crucial role in providing users with a route map through the Code, and should contain more explanation of the purpose of the fundamental principles, as well as of the Code itself. This should emphasise the overall objective of achieving better ethical outcomes rather than simply following specific rules or establishing process.

We note that the Board has a separate project underway in respect of safeguards – to which we have already responded separately – and that those sections of the Exposure Draft in this response that relate to safeguards are currently either in draft form or are incomplete. We believe that a rounded view on the changes to the Code can only be given once the revised safeguards have been fully integrated into the text, and our response is provided with that proviso.

Refinements to the Code

1. Do you agree with the proposals, or do you have any suggestions for further improvements to the material in the ED, particularly with regard to:

a. Understandability, including the usefulness of the Guide to the Code?

- In our response to the Consultation Paper of 2014 we raised concerns that revisions to the Code might fail to clarify the importance for professional accountants to have the right ethical mindset, and urged IESBA to prioritise clarifying and emphasising the ethical principles. Whilst we recognise that both the Guide and the revised structure do place greater emphasis on the fundamental principles and conceptual framework, more could still be done. As the Guide is the starting point for users of the Code, we think more could be done to describe not just the purpose of the Code but also the purpose of the principles and the framework. In our revisions to the FRC's Ethical Standard we have emphasised the overall purpose of our framework – namely to achieve ethical outcomes driven principally by overarching principles and supporting ethical provisions. Under the heading 'How to use the Code' we suggest the following alternative wording in paragraph 6:

“The Code requires professional accountants to comply with the fundamental principles of professional ethics. These principles, together with supporting ethical requirements and application material, have the objective of focusing on the achievement of ethical outcomes in all circumstances. This will represent a basis for

users of services to have trust in the integrity and objectivity of the professional accountant.”

- In describing the purpose of Parts B and C of the Code, the Guide sets out the applicability of each component to professional accountants working in business, and those working in public practice. The current draft includes the sentence, “Professional accountants in public practice might also find Part B relevant to their particular circumstances.” [paragraph 4] This does appear to run the risk of confusing users of the document. Since all professional accountants are required to comply with the conceptual framework and the fundamental principles, this risks implying that there are specific additional requirements or application material which might be relevant which is included in Part B but not Part C – but it does not specify what those might be. This might undermine the effectiveness of the Code for users.
- The Guide includes a section on ‘exceptional circumstances’, which are defined as:
 - Circumstances where the application of a specific requirement may be disproportionate or not in the public interest; or,
 - Where there may be a perceived conflict between two or more of the fundamental principles.

We believe this is a potentially narrow definition and could usefully be replaced with a broader narrative stressing again the importance of ethical outcomes in the exercise of judgement, or when seeking external advice.

b. The clarity of the relationship between requirements and application material?

The distinction between requirements and application material is clearly explained in the Guide to the Code, and there is clear labelling within the main body of the text.

There are some examples, however, where the Code could achieve greater clarity. For example:

- Section 330 on Fees and Other Types of Remuneration includes a section on Contingent Fees [330.3.A4], which consists of application guidance for non-assurance services. A cross reference to the more stringent requirements for audit and assurance engagements is included at the end of this section – but the point could be made more clearly and prominently that prohibitions are in place for engagements of that kind;
- Section 401 which deals with Network firms includes discussion of circumstances where firms share professional resources, including ‘audit methodology or audit manuals’. 401.3. A2 and 401.3.A9 could be read to scope those arrangements out of the definition of a network relationship; however, 401.3.A8 clearly includes them.

c. The clarity of the principles basis of the Code supported by specific requirements?

There is repeated use of the same requirement throughout the main body of Part C, “A professional accountant shall apply the conceptual framework set out in Section 120”. The purpose of this repetition seems to be to reinforce the fundamental importance of that conceptual framework (in combination with the highlighted text at the top of every page). There is a risk however that this requirement becomes redundant through repetition. If the Guide to the Code and Part A are sufficiently impactful then it should not be necessary to repeat this requirement for every section. There is also a risk that the exposure draft loses focus on the principles, by articulating the fundamental principles at too high a level, and the requirements and application material being too detailed. This can impact on the ease with which an auditor (or user) can tell what outcome the auditor or professional accountant is expected to meet.

In revising our Ethical Standard, we have built on our existing requirement at the principles level that an auditor must be able to demonstrate their independence. This is intended to support better compliance with the fundamental principles of integrity and objectivity. As both integrity and objectivity are ‘states of mind’, reference to independence provides the professional accountant (and other stakeholders) with a demonstrable benchmark that provides a basis of assessment. Although this concept is covered in the detailed requirements of the Code, we suggest that the Board also considers articulating this at the level of the fundamental principles.

d. The clarity of the responsibility of individual accountants and firms for compliance with requirements of the Code in particular circumstances?

We note that further amendments to the Code may follow on from the IAASB’s review of ISQC1. However, we reiterate the feedback we provided in response to the 2014 Consultation Paper where we stated that we believe that, for audit firms, the senior management of the firm should have the overarching responsibility to ensure an appropriate ethical mindset and culture. In our view, the clarity necessary to secure this is still lacking, and further work is still needed to ensure that the Code is absolutely clear and unambiguous about who supporting requirements and provisions apply to. We recognize, of course, that some of this clarity may be achieved as the material on safeguards is developed and integrated into the Code. Describing safeguards provides an opportunity to stress the importance of effective firm wide policies and procedures, and also of the importance of the ‘tone at the top’.

What might be additionally helpful, however, would be to include some supporting material in the introductory sections, and in particular Section 120 ‘The Conceptual Framework’. The most obvious opportunity might be to develop paragraph 120.5.A4 which currently reads: “Certain conditions, policies and procedures established by the profession, legislation, regulation, the firm or the employing organization can affect the likelihood of the professional accountant’s identification of threats to compliance with the fundamental principles.” We would suggest that IESBA might consider breaking this into two separate paragraphs, and using one to stress the fundamental importance for senior management in firms and other organizations to take an overarching responsibility to ensure that ethics and ethical outcomes are at the forefront of policies, procedures and culture within those

entities. This could be further enhanced with similar additions to and language used in the 'Responsibility' section of C1, at paragraph 400.7.

e. The clarity of language?

Whilst in general we believe the current project has resulted in improvements to the clarity of language used in the Code we do have some concerns about the completeness and precision of some of the key terms being used. This is particularly the case in respect of the use of such language as 'audit firm', 'audit team member' and 'audit client'. The FRC has been revising the Ethical Standard for auditors in the UK and Ireland, and has been focused on ensuring that our language is clearer and more precise. Specifically in respect of 'audit team' in revising our Ethical Standard, we have allowed for a broader and more flexible definition of individuals who may be in a position to influence the conduct or outcome of an audit. This better reflects, in our view, the complexity of organisation and influence within audit firms. We would therefore suggest that IESBA considers how it defines each of these terms, and specifically in respect of the current glossary definition of audit team remove references to individuals in a position to '**directly** influence' the outcome of an engagement. This will help address the risk that an ability to influence is seen purely as a structural consideration (related to the position of an individual in a firm), whereas instead the assessment should be driven by a consideration which captures all of those who have the ability to influence and are relevant to the engagement.

f. The navigability of the Code, including:

- (i) Numbering and layout of the sections;**
- (ii) Suggestions for future electronic enhancements; and**
- (iii) Suggestions for future tools?**

In our response to the 2014 Consultation Paper on the reorganisation of the Code we did not raise specific concerns about the navigability of the Code. We did, however, recognise that some stakeholders did find navigation difficult and were supportive of changes which might distinguish, for example, between considerations specific to accountants in business and to external auditors. Our overriding concern was that there should not be too much focus on requirements rather than the ethical principles. We therefore welcome the introduction of the Guide to the Code for the additional clarity it provides, including the diagrammatic overview of the different sections of the Code (see our response to question (a)).

In general we find the Guide provides greater clarity about the structure of the Code, and how it is relevant to the different circumstances of professional accountants. We also welcome the inclusion of the diagrammatic Appendix setting out the various components of the Code.

There are examples of subsections where the link with the overall section is either unclear or weak. R 320.7 and 320.7.A1 on 'Using the Work of an Expert' for example is included at the end of Section 320 on 'Professional Appointment'. Arguably this is not closely related, and in addition there is scope for the content of this subsection to be expanded – it seems at least as important in its own right as section 321 on 'Second Opinions'.

g. The enforceability of the Code?

Some specific sections of the Code could be enhanced to help ensure ethical outcomes are achieved, and enhance enforceability. We note that the inclusion of material on safeguards is currently in draft form, to be finalised following the Board's recent consultation.

There are also specific sections where the FRC's Ethical Standard takes a different approach, which we consider to be more effective. There are numerous sections where the Code states that a circumstance or transaction 'might' create an ethical conflict, others where the Code is prescriptive and states that they 'shall'.

Sections 340 of the Conceptual Framework and 420 of C1 on Gifts and Hospitality, for example, state that accepting gifts or hospitality from a client 'might create self-interest and familiarity threats'. In the case of an audit or review engagement, in such circumstances the Code requires that a firm shall apply the conceptual framework; and that a firm or audit team member shall not accept gifts or hospitality 'unless the value is trivial and inconsequential'. By contrast, the FRC's Ethical Standard for auditors and other assurance engagements presumes that acceptance of gifts or hospitality creates a threat which must therefore be addressed.

We would suggest that section 340 and paragraph 420.1 are redrafted to establish a presumption that a threat is created, which must then be evaluated and (when appropriate or possible) safeguards applied:

"Accepting gifts or hospitality creates self-interest and familiarity threats."

We would also suggest that IESBA considers including the requirement that formal policies be adopted; that the cumulative impact of gifts and hospitality being accepted or offered more than once be considered; and for partners to be consulted in cases of doubt.

Section 411 which deals with 'Compensation and Evaluation Policies' also now includes the formulation that "Evaluating or compensating an audit team member for selling non-assurance services to that audit client *might* create a self-interest threat." [411.1] This is inconsistent with the approach adopted by the FRC in its current revision to the Ethical Standard, which implements the legal requirements of the EU Audit Directive and Regulation, and which prohibits the consideration of revenue derived from non-audit/additional services from forming, "part of the performance evaluation and remuneration of any person involved in, or able to influence the carrying out of, the engagement." [AD24a.1 (j)] This also represents a change in the Code from the extant 2015 version which states that a self-interest threat is created in such circumstances for a member of the audit team. We therefore suggest that IESBA reviews the drafting of this section to consider:

- Whether it is still appropriate in the light of the EU Audit Directive and Regulation to have a prohibition in this area restricted to only the 'key audit partner'; and
- Whether, in any case, it should revert to the previous presumption that such circumstances automatically create a threat for any member of the audit or engagement team.

2. Do you believe the restructuring will enhance the adoption of the Code?

We support IESBA's project to restructure the Code, alongside the project to review the clarity, appropriateness and effectiveness of the safeguards identified in sections of the Code. As we noted in our January 2015 response to the Consultation Paper on the restructuring, these two projects are intrinsically linked. The identification of a comprehensive, effective and proportionate suite of safeguards will add significantly to the value the Code can bring to stakeholders. We broadly welcome the changes already made, and which are set out in the exposure draft. However, until both projects are complete, and the revised safeguards material is integrated into the Code, it is too early to form a view on whether this will lead to enhanced application or adoption of the Code. In any event, there are other factors that may be more relevant to the adoption of the Code.

3. Do you believe that the restructuring has changed the meaning of the Code with respect to any particular provisions? If so, please explain why and suggest alternative wording.

See our comments at question g in respect of section 411 on 'Compensation and Evaluation Policies'.

Other Matters

4. Do you have any comments on the clarity and appropriateness of the term 'audit' continuing to include 'review' for the purposes of the independence standards?

In our response to the 2014 Consultation Paper we said that we do not agree that it is appropriate for the term "audit" to be deemed to include "review engagement" for the purpose of particular sections where considerations are essentially the same (e.g. In relation to independence). In the course of our revision of the FRC Ethical Standard for auditors we addressed a similar issue by referring generically to 'engagements' whilst being precise about the specific application to different types of engagement (whether audit or not) where they differed – our standard is designed to apply to all engagements for which we issue performance standards (and is broader in scope than audit and review engagements).

5. Do you have any comments on the clarity and appropriateness of the restructured material in the way that it distinguishes firms and network firms?

In respect of the definition of "network firm" the approach taken by IESBA is broadly consistent with the approach we have adopted in the revision of our Ethical Standard, which reflects the requirements of the EU Audit Directive and Regulation. One area of difference that we would encourage the Board to consider is that, in our view, setting out a definition which requires the exercise of judgement is preferable to providing a list of examples.

Title

6. Is the proposed title for the restructured Code appropriate?

We have no observations on the proposed title for the revised Code.

Yours sincerely,

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Director of the FRC and Chairman of the FRC's Audit & Assurance Council

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