HAT Technical

MEMO 02/20

To: All firms
From: Simon Kettlewell
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FRC's REVISED ETHICAL STANDARD: IMPORTANT CHANGES THAT FIRMS NEED TO BE AWARE OF

The FRC's ***Revised Ethical Standard 2019*** was released in December 2019 and comes into effect for the audits of entities with accounting periods beginning on or after 15 March 2020. Whilst this means that the new Standard will generally apply to entities with financial year ends of 31 March 2021 and onwards, there are a number of significant restrictions in the Ethical Standard that auditors need to be aware of prior to the commencement of those accounting periods.

Whilst a couple of these were mentioned in a recent blog on the HAT website, on further review of the Ethical Standard it was thought necessary to issue a Technical Memo to bring the changes to the attention of a wider audience and provide some additional details.

(NB: this Technical Memo ignores the changes affecting the audits of Public Interest Entities).

Contingent Fees

The new Ethical Standard introduces a prohibition on providing non-audit services to audit clients on a contingent fee basis. Paragraph 4.10 states:

> *"The firm and any of its network firms shall not provide any non-audit / additional services, to or in respect of an entity relevant to an engagement, wholly or partly on a contingent fee basis"*

'*Contingent fee basis*' is defined in the Glossary of Terms (Auditing and Ethics) as "*Any arrangement made under which a fee is calculated on a predetermined basis relating to the outcome or result of a transaction, or other event, or the result of the work performed"*.

Therefore, carrying out work such as Research and Development Tax Credit claims on behalf of audit clients, where the fee is dependent on the tax relief obtained, will no longer be permitted.

Staff secondments

Paragraph 2.36 states:

> *"A firm shall not enter into an agreement with an entity relevant to an engagement, or with the affiliates of such an entity, to provide any partner or employee to work for a temporary period as if that individual were an employee of any such entity or its affiliates"*

For the avoidance of doubt, "*an entity relevant to an engagement*" is the audit client.

Therefore, secondments of staff from the audit practice to an audit client are prohibited, even on a short-term basis.

(*Affiliates of such an entity* is only relevant to PIE's or investment circular reporting engagements, which are outside the scope of this memo).

Recruitment and Remuneration services

Paragraph 5.85 states that recruitment services shall not be provided to the audit client where the audit practice takes responsibility for, or advises on, the appointment of any director or employee.

Paragraph 5.86 prohibits the audit firm from providing advice on the remuneration package or the measurement criteria on which the remuneration is calculated, for any director or employee of the client.

Internal audit services

Paragraph 5.54 introduces a prohibition on providing Internal Audit services to audit clients. Whilst this is not a common occurrence for the vast majority of HAT firms and their typical clients, care is needed here in certain sectors (such as Academies).

Anything else?

- Non-audit services that involve playing any part in management's decision making are banned (paragraph 1.24) – this includes the authorisation of transactions.

- There is an enhancement to the "Objective, Reasonable and Informed Third Party" (ORITP) test. Firms must now consider that "*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 ORITP test should not be based on the perspective of another audit practitioner.

- There are some amendments to the role of the Ethics partner and where potential or actual breaches of the Ethical Standard are identified, the firm must report those breaches on a biannual basis to their regulatory supervisory body and to those charged with governance of the client in a timely manner (per paragraph 1.21).

Are there are any transitional rules?

As noted above, the new Standard applies for periods commencing on or after 15 March 2020. However, paragraphs 1.70 and 1.71 are as follows:

Firms may complete engagements relating to periods commencing before 15 March 2020 in accordance with existing ethical standards, putting in place any necessary changes in the subsequent engagement period.

Engagements to provide previously permitted non-audit or additional services, entered into before 15 March 2020, and for which the firm has already commenced work may continue until completed in accordance with the original engagement terms, subject to the application of appropriate safeguards.

Firms are encouraged to familiarise themselves with the new Standard and ensure that measures are implemented to ensure that ethical conflicts are avoided.

The new Ethical Standard, which will be discussed further in the Quarter 1 2020 update, can be found here: https://bit.ly/2T1ilzR