

Ethical Standard for Auditors - Uncovering the Covered Persons

The FRC issued a revised ***Ethical Standard in 2016***, which sought to clarify and enhance existing requirements, as well as implement the statutory audit and third country regulations (SATCAR). There are some elements of the standard which might seem quite similar to the old one and may not, therefore, have prompted a full review of the requirements.

There is also a general tightening up of attitudes on areas where judgement is required. For instance, the rules on gifts and hospitality have specifically changed, to require that any such items are trivial and inconsequential from an independence viewpoint. However, even where the specific requirements do not seem much altered we have seen evidence, when talking to regulators and hearing speeches from the FRC, that the stance is going to be tougher. And this was even before the latest auditing scandals, such as the **report on the PwC audit of Taveta** and the possible problems with the Carrillion audit. We can surely only expect attitudes to harden as a result of these.

Covered person definition

One area where the standard has tightened the requirements is in respect of those people in a firm that must comply with the FRC Ethical Standard. These are referred to as “covered persons” ie those who are “covered” by the requirements of the standard.

The current definition can be found in the **[FRC Glossary of terms – Ethics and auditing](#)**

Covered person—A person in a position to influence the conduct or outcome of the engagement.

For an audit engagement and for an other public interest assurance engagement other than an investment circular reporting engagement:

(a) (i) Each member of the engagement team with responsibilities for managing the performance of the engagement (including the person(s) responsible for ‘day to day’ direction and supervision on site at the entity, and all more senior members of the engagement team above them) and persons who provide engagement quality control review for the engagement;

(a) (ii) All other members of the engagement team;

(b) Any other natural person whose services are placed at the disposal or under the control of the firm and who is involved in the audit or other public interest assurance engagement), including for example any individual who is, or whose services are provided by, any external expert of the firm;

(c) Any person in the firm with supervisory, management or other oversight responsibility over:

(i) The engagement or the engagement partner or other key partners involved in the engagement; or



(ii) The conduct of audit or other public interest assurance engagements performed by the firm. This includes each partner, principal, shareholder and other person in the firm:

a. At each level of firm management, supervision or oversight relating to the audit or other public interest assurance engagement, up to and including individuals who have ultimate responsibility for the management or governance of the firm 5; or

b. Who is in a position to prepare or approve the performance appraisal and/or remuneration of any individual defined in (a)(i), (b), (c)(i) and (c)(ii); and

(d) Any other person within the firm or a network firm who, due to any other circumstances, is in a position to influence the conduct or outcome of the audit or other public interest assurance engagement.

It does not include any independent non-executive individuals on a supervisory or equivalent board.

Now, this is a very long definition and deserves some analysis. Firstly, as one would expect, anyone involved in the engagement team, including someone carrying out an Engagement Quality Control Review (EQCR) is a covered person. However b) goes on to say that anyone else involved in the audit, such as an external expert of the firm, is also a covered person. You should consider the independence of external experts used by the audit firm, but are you measuring this against the covered person requirements? The FRC has produced a [rolling decisions document](#) summarising issues such as this, which clarifies that you should obtain written representations from experts to confirm their independence. It is important to ask if those experts have shares in the entity, family relationships etc, which might threaten their independence and documenting their written response.

Part c) of the definition gets potentially even trickier, it now looks at those with supervisory, management or oversight responsibility. This covers those with such responsibility in regard to the engagement and the key partners involved in the engagement. Someone who is a line manager of an engagement partner or other member of the engagement team will be caught here, regardless of whether they are "audit" partners. Note that the old reference to change of command has gone, potentially widening the scope of who is a covered person.

Still looking at part c), any person with supervisory, management or oversight responsibility over the conduct of the audit (or other public interest assurance engagement) is

also a covered person. This might be difficult to judge, there is some clarification that this includes each:

- Partner;
- Principal;
- Shareholder; and
- Other person

at each level of firm management, supervision or oversight relating to audit, up to and including those who have ultimate responsibility for the management or governance of the firm.

Or those who prepare or approve performance appraisals, or remuneration for those who are more senior and involved in the direction of the audit, or who are external to the firm.

The logic with regard to those involved in performance appraisals, is that you can potentially influence conduct in the audit, if you are able to then dictate an individual's pay rise or promotion opportunities. The FRC has confirmed that this is not intended to include all those who are involved in moderating salaries for audit staff generally, for instance, if they are not more directly involved.

On top of that, anyone within the firm or a network firm, who is in a position to influence the conduct or outcome of the audit or other public interest assurance engagement is also a covered person. This may, for example, be because another person is mentoring a new engagement partner or manager, even though not part of the engagement team.

You might find the requirements both difficult to follow and interpret and perhaps conclude that non-audit staff and partners are not covered. However, if individuals have ultimate responsibility for the management or governance of the firm or otherwise are very senior, it is unlikely that you will be able to demonstrate that they have no role in the management, supervision or oversight relating to audit.

The management team (which may be all the partners) will surely make decisions over all aspects of the firm, including audit. Even if individuals are not supposed to be able to influence audit in any way, would the mythical "objective reasonable and informed third party" (RITP) used in the standard conclude that a partner responsible, at least in part, for the overall management of the firm would not be able to influence the outcome or conduct of an audit? It seems unlikely. You therefore need to consider very carefully who, in the overall management structure of the firm, gets caught as a covered person.



Practical points to consider

There are many issues potentially to review and check your firm's compliance, but set out below are a few key practical suggestions:

- **Have you reconsidered all partners' and senior staff members' covered person status?** The old ethical standard talked about those involved in both the engagement and in the chain of command for audit, and other persons who may be in a position to exert influence over the audit. Under the new standard there is no need to be within the chain of command and so it is likely that all those involved in the management of the firm could be considered covered persons. This may be all partners or, in some firms, the partners who have a managerial role.
- **Ex-partners / staff now working at a current or potential client** create threats which may be insurmountable. The standard has strict requirements for a cooling off period before a firm can audit an entity where the ex-partner was a covered person for that engagement and safeguards for other staff. Consider the detailed requirements if you are aware that this has or may happen.
- **Changes in the managing partner or management board** as explained above, those with a governance role at a firm (excluding non-executives) are generally covered persons. This means that they will not be able to have any relationships with, or investments in, audit clients which would be prohibited for a covered person. When there are changes to the people in these roles, make sure you reassess the application of the ethical standard for the relevant people.
- **What might an objective, reasonable and informed third party think?** The FRC Ethical Standard requires us to judge compliance with the standard, in respect of areas of judgement, by considering the view of an objective, reasonable and informed third party. In the past, we may have referred to the "man on the Clapham Omnibus", but this is clearly now somewhat outdated, but the idea is broadly similar. However, we should remember that what is accepted in today's environment may be very different to what was previously regarded as acceptable. For instance, auditors used to be allowed to receive discounts from audit clients equivalent to staff discounts, but this might have meant being able to save thousands of pounds on the purchase of larger items such as cars or holidays. Today, this would fail to meet the requirement that the value is trivial or inconsequential.
- **Have partners and staff had refresher training on ethics?** If you haven't run any ethics training for a few years, then now might be a good time to consider it. Even without the specific points within the ethical standards the issues hitting the newspapers, such as the audit of BHS, raise plenty of thought provoking points from an ethical perspective, as discussed in this [article](#). We are able to run in-house ethics training or we have an ethics [webinar](#) available now.

