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Dear Paul

RE: Auditor Regulation: Discussion Document on the implications of the EU and wider reforms

The Investment Association represents the asset management industry in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £5 trillion (€5.6 trillion) of assets, which are invested in companies globally. In managing assets for both retail and institutional investors, our members are major investors in companies whose securities are traded on regulated markets. Therefore, as users of these companies' accounts they have an interest in the requirements governing the audit and the auditor's report.

We believe that the main purpose of accounts is to provide investors, the holders of ordinary shares, with the information they need for the purposes of deciding to buy, sell or hold their shares and fulfilling their responsibilities as owners – assessing company management and the strategies adopted, stewardship. High quality audits are pivotal to this and for ensuring that markets value the information reported and investors believe what they are told about the financial position of their investee companies.

The EU and wider audit reforms seek to address a number of investors' concerns around audit, including those around auditor independence and objectivity which may be compromised by long term relationships with clients and the provision of non-audit services, the limited number of audit firms with the capabilities to audit large multinational entities, and the nature of auditors' communications with investors.

We support the reforms and welcome the opportunity to respond to BIS's Discussion Paper on the reforms. We set out in the attached Annex our answers on the questions raised where we have only responded to those questions we consider relevant to ourselves as users of accounts. Set out below are our key observations.

- **Prohibited and capped non-audit services.** Non-audit services, particularly those of an advisory nature, can introduce a potential conflict of interest and impact an auditor's independence in that the auditor may identify himself with the interests of management rather than those of investors. Where there is a clear conflict then we support a 'black' list of services that firms are prohibited from providing to their audit clients and restrictions on the level of permitted non-audit services, i.e. a cap. In this context, it is important that there is clarity over the exact type of services the 'black' list covers so there is no ambiguity. It would be helpful if there was guidance to address this. The list should also be open to amendment as requirements and services evolve.

  However, at this point in time, we would not support extending the list of prohibited non-audit services or introducing a lower cap for non-audit fees without a clearly identified need. It would be a concern to us if the UK exercised options that further limited the audit committee's ability to determine the best qualified firm for particular services and reduced the number of firms that are willing or able to tender for a particular audit (question 18).

  In addition, we have certain concerns due to the way the rules have been drafted which need to be addressed.

  First, there is inconsistency in scope between the non-audit services the auditor is prohibited from providing, and the cap which limits the non-audit services that can be provided. An audit firm and its network firms are prohibited from providing certain services to a PIE and members of the PIE's group that are based in the EU. On the other hand, the cap applies to the audit firm only, excluding firms in the network, but includes all members of the PIE's group wherever based.

  Only prohibiting the provision of non-audit services to PIEs within the EU means that parts of a multinational group that are outside the EU would not be subject to the same requirements and could avail themselves of these services. Similarly only the audit firm itself and not its network firms are subject to the cap such that network firms could provide permitted non-audit services to the audited entity without any restrictions. These factors would impact the perception of the auditor's independence and would not necessarily be transparent to investors.

  To address this, we consider it important that a 'top down' approach is taken and that the lead group auditor and any of its network firms used in an audit should be required to comply with the requirements in relation to non-audit services with respect to all group components including those outside the EU. Otherwise there is a risk that services could be provided to a group component that could compromise independence and impact audit confidence.

  Secondly, Article 4 of the Regulation stipulates that the total fees for non-audit services should be limited to no more than 70% of the average of statutory group audit fees paid in the last three consecutive years. We understand if there is a break in the provision of non-audit services, the calculation of the cap stops. We are concerned that that this would allow an audit firm to provide non-audit services for two consecutive years in excess of the 70% cap, have a year where it does not provide non-audit services and then provide such services in year four. To avoid this, the FRC should consult on applying a simpler cap that limits non-audit services in a year to 70% of the estimated audit fee for that year (question 19).

In this context, a minority of investors consider that it would be helpful to have both a 'black' and a 'white' list in that this would provide clarity to audit committees when considering audit tenders and audit firm rotation as to which firms would be precluded and which could be appointed. The committee would also be clear that assurance type services, such as reporting accountants work and audit related services, can be provided by the statutory auditor (question 23).

- **Audit tenders.** We agree with not taking up the option to provide for an extension of the maximum duration of the engagement where a joint auditor is engaged. Joint audits are not common in the UK and can give rise to concerns about audit quality and increased costs. As such we do not consider they should necessarily be encouraged (question 29). On the other hand, we support the extension to a maximum duration of 20 years where a PIE has tendered the audit. Requiring rotation after 10 years could be costly and disruptive.

  Auditors essentially act as independent scrutineers of management's reports for the company's shareholders. We support PIEs being required to disclose their plans for retendering the audit in the annual report and specifying when they intend to tender next. In planning ahead it is important that the audit committee allows sufficient time to confer with its institutional investors, as appropriate (question 31).

- **Audit Committees.** We support the exemption for UCITS and AIFs in Article 39.3 (b) of the Directive from being required to have an audit committee. These funds are subject to a well-established regulatory regime and additional governance requirements such as the appointment of an independent depositary (question 48).

I trust that the above and the attached are self-explanatory but please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall, Director, Stewardship and Corporate Reporting

As noted in the covering letter, we have only responded to those questions we consider relevant to ourselves as users of accounts.

Application of the Regulation and the Directive

Question 5. Do you agree that the Government should not expand the definition of a PIE beyond the EU minimum requirement – that is listed companies, banks, building societies and insurers?

The requirements apply to Public Interest Entities (PIEs) which includes credit institutions, insurance undertakings, issuers of securities admitted to trading on a regulated market, and entities designated by Member States as public interest entities as they are of significant public relevance. The Investment Association considers that this definition is sufficiently comprehensive and welcomes BIS not proposing to widen it for statutory purposes as to do so would only add complexity and cost.

Question 7. What issues, if any, do you consider arise from the need to broaden the application of the implementation of the 2006 Directive as amended to include:

- *other entities whose securities are admitted to trading on a regulated market;*
- *electronic money institutions;*
- *payment institutions;*
- *MiFiD investment firms;*
- *Undertakings for Collective Investment in Transferable Securities (UCITS); and,*
- *Alternative Investment Funds (AIFs).*

How do you consider these should be addressed?

We would have had an issue if UCITS and AIFs had been required to have an audit committee. This would have:

- been superfluous, given the current investor protections enshrined in the UCITS Directive which covers retail mutual funds, and the AIFM Directive which covers alternative investment funds. Both of these Directives require that the funds have an independent depositary that is responsible for safekeeping, oversight and monitoring of the fund's cash flows.
- resulted in increased costs for investors and unintended consequences.

We thus supported the introduction of the exemption for UCITS and AIFs in Article 39.3 (b) of the Directive from being required to have an audit committee.

Competent authorities

Question 9. Do you agree the FRC should be the single competent authority with ultimate responsibility for the audit regulatory tasks and for oversight under the 2006 Directive as amended by the new Directive and under the Regulation?

We agree that for reasons of practicality and efficient co-ordination, the FRC should be the single competent authority with ultimate responsibility for audit regulation and oversight under the 2006 Directive, as amended, and the Regulation. It should then be able to delegate to the Recognised Supervisory Bodies the inspections, investigations and discipline of non-PIEs and reclaim delegation on a case by case basis. To be consistent with the FRC having ultimate responsibility, it should also approve the rules of the

Recognised Supervisory Bodies. In this context, there are concerns about the FRC's independence from the accounting profession and it would be helpful if these were addressed.

Audit fees and non-audit services

Question 18. Do you agree that the provisions of Article 4 of the Regulation on the cap on non-audit services should be included in amendments to the FRC's ethical standards for auditors?

Non-audit services, particularly those of an advisory nature, can introduce conflicts of interest and impact an auditor's independence in that the auditor may identify himself with the interests of management rather than those of investors.

We agree that the provisions of Article 4 of the Regulation on the cap on non-audit services should be included in amendments to the FRC's ethical standards for auditors. The provision of non-audit services is already regulated by the FRC and as the single competent authority it will be receiving the analysis of fees for audit and non-audit services as required by Article 14 to enable it to enforce the cap.

In this context, we would not support introducing a lower cap for non-audit fees without a clearly identified need. It would be a concern if the UK exercised options that would further limit the audit committee's ability to determine the best qualified firm for particular services and reduced the number of firms that are willing or able to tender for a particular audit.

Question 19. What issues, if any, do you consider arise from the application of the provisions on the cap on non-audit services? If there are any, how do you consider these should be addressed?

We have certain concerns due to the way the Regulation has been drafted which need to be addressed.

First, an issue we have identified is the inconsistency in scope between:

- prohibited non-audit services which apply to services the auditor and its network firms provide to the PIE, the PIE's parent undertaking and any entities controlled by it based in the EU; and
- the cap which applies to the audit firm only and not its network firms (albeit there is an option to include them) but includes all members of the PIE's group wherever based, i.e. these are not limited to group entities based in the EU.

Only prohibiting the provision of non-audit services to PIEs within the EU means that parts of a multinational group that are outside the EU would not be subject to the same requirements and could avail themselves of these services. Similarly only the audit firm itself and none of its network firms are subject to the cap such that network firms could provide permitted non-audit services to a PIE without any restrictions. These factors would impact the perception of the auditor's independence and would not necessarily be transparent to investors.

We recognise that there may be limitations as to the extent to which EU standards on auditors can be applied in jurisdictions outside the EU. However, we consider it important that a 'top down' approach is taken and that the lead group auditor and any of its network firms used in an audit should be required to comply with requirements in relation to non-audit services with respect to all group components including those outside the EU. Otherwise there is a risk that services could be provided to a group component that would, if covered by the requirements, be deemed to compromise independence and impact audit confidence. With the implementation of the EU Audit Directive and Regulation, it is unlikely that continuing to rely on the International Code of Ethics would be sufficient.

Secondly, Article 4 of the Regulation stipulates that the total fees for non-audit services should be limited to no more than 70% of the average of statutory group audit fees paid in the last three consecutive years. We understand if there is a break in the provision of non-audit services, the calculation of cap stops. We are concerned that that this would allow an audit firm to provide non-audit services for two consecutive years in excess of the 70% cap, have a year where it does not provide non-audit services and then provide such services in year four. To avoid this, the FRC should consult on applying a simpler cap that limits non-audit services in a year to 70% of the estimated audit fee for that year.

Question 20. Do you agree that the Member State options in Article 4, to set more stringent requirements on the cap and on the auditor's independence where their total fee income from a PIE exceeds 15% of their total fee income overall, should be capable of being applied by the FRC in its ethical standards for auditors?

We agree that Member States should be able to set more stringent requirements where an auditor's total fee income from a PIE exceeds 15% of its total fee income. However, we do not consider that this should necessarily relate to the cap in that we support the existing requirements in the FRC's Ethical Standard 4 whereby if the total fees for both audit and non-audit services receivable from a listed entity regularly exceed 10% of the annual fee income of the audit firm then the firm is not allowed to stand as auditor and has to resign or not stand for reappointment, as appropriate.

Question 21. Do you agree that the FRC should have the ability to exempt an audit firm from the 70% cap for up to two financial years on an exceptional basis and on application by the firm?

We agree that if the FRC is made the relevant competent authority, it should be able to grant exemptions from the cap and set a higher limit, on an exceptional basis, for a period not exceeding two years. There may be instances where the auditor could be the most appropriate provider of a service where the fees would cause the cap to be exceeded. For example, where the auditor acts as reporting accountant in relation to information in circulars and prospectuses the fees can often be significant but could be limited by the cap. In this context, it is important that the overriding criteria before such an exemption is granted is that the service concerned does not impact auditor independence and objectivity, and hence audit quality which should be paramount. Nor do we consider that the FRC should grant an exemption that is open ended in terms of quantum in that it should set a higher limit.

Question 23. What issues, if any, do you consider arise from the application of the provisions on the blacklist of non-audit services? If there are any, how do you consider these should be addressed?

As noted, non-audit services can introduce a conflict of interest and impact an auditor's independence. Where there is a clear conflict then we support a 'black' list of services that firms are prohibited from providing to their audit clients. Whilst a 'white list' could improve the perception of auditor independence in that it is clear what is permissible, we would be concerned if the UK exercised options that would further limit the audit committee's ability to determine the best qualified audit firm for particular services.

As regards the items on the 'black' list we consider services connected with tax compliance i.e., the preparation and submission of tax returns, can often usefully be undertaken by the auditor. We do not consider that such work would impact the auditor's independence and should be allowed. However, we would have concerns should the auditor provide tax advice or planning as this may influence the audit if that advice involved restructuring or tax avoidance schemes.

We also consider that non-audit services should be allowed where they have no direct or have an 'immaterial' effect on the financial statements. To prohibit services that do not have a material effect could be considered disproportionate. But it is important that the use of such a derogation is controlled and we consider there is a need for guidance on the definition of 'direct' and 'immaterial' and over who should make such a decision so as to remove any uncertainty prior to implementation.

In this context, a minority of investors consider that it would be helpful to have both a 'black' and a 'white' list in that this would provide clarity to audit committees when considering audit tenders and audit firm rotation as to which firms would be precluded and which could be appointed. The committee would also be clear that assurance type services, such as reporting accountants work and audit related services, can be provided by the statutory auditor.

Question 25. Do you agree that the existing framework on disclosure by PIEs in notes to their accounts of the audit and non-audit fees they paid their auditor should be adapted, to ensure public disclosure of the information the auditor is required to provide to the competent authority under Article 14 of the Regulation?

We support the separate disclosure of statutory audit fees, fees for permitted non-audit services required by national or Union law, and fees for services not required by national or Union law. This should aid clarity, improve comparability and be an additional check that the provisions of the Regulation are adhered to.

Tendering and duration of audit engagements

Question 27. Audit Committees must submit a recommendation to the board for the appointment of an auditor. However, under Article 16(1) sub-paragraph (2) of the Regulation, this does not apply where the Member State has provided an alternative system for the appointment of the auditor. The current alternative systems set out in the Companies Act 2006 are where:

- *the directors appoint the auditor before the company's first accounts meeting;*
- *the directors appoint the auditor to fill a casual vacancy in the office of auditor; and where,*
- *the Secretary of State appoints the auditor because a public company failed to do so.*

Do you consider that all of these alternative systems for the appointment of an auditor should continue to operate in the UK as they do at present? Are there any other systems *that should also be provided for on the grounds that a competitive tender process is not appropriate?*

We consider these alternative systems for the appointment of an auditor should continue to operate in the UK as they do at present.

Question 28. Where the PIE is exempted from having an audit committee (e.g. because it is an unlisted bank), there is no provision as to which body should fulfil the audit committee's role. Do you agree that in this situation the directors should determine the recommendations that should be put to shareholders of the audited entity?

Where a PIE is exempted from having to have an audit committee, we agree that the directors, as the persons responsible for governance, should determine the recommendation to be put to the shareholders of the audited entity.

Question 29. The Government does not intend to take up the option to provide for an extension of the maximum duration of the engagement beyond 10 years where a joint auditor is engaged. Do you agree that the replacement of a single auditor with two joint auditors, one of whom was the original auditor, should be made on the basis of a retender?

Investors are concerned that where auditors hold office for long periods, this can materially impact their independence and objectivity which are vital in ensuring audit quality. There is the risk of a reduced willingness to challenge management, especially where audit firms foster other non-audit relationships with their audit clients. Reduction in average tenure represents a well-founded public policy objective and one that audit committees on behalf of shareholders/investors should seek to achieve. There needs to be a strong measure of accountability to shareholders in this regard.

In this context, we agree with the Government not taking up the option in Article 17.4 (b) to provide for an extension of the maximum duration of the engagement where a joint auditor is engaged. Joint audits are not common in the UK and investors believe there are risks that they could adversely impact audit quality - concerns run to accountability, the danger of missing issues, etc. Joint auditors could also lead to the smaller firm always becoming the junior party and being consigned to this role in future. We thus do not believe that they should necessarily be encouraged. We agree that the replacement of a single auditor with two joint auditors, one of whom was the original auditor, should be made on the basis of a retender.

On the other hand, we support the extension to a maximum duration of 20 years as permitted by Article 17.4 (a) where a PIE has undertaken a tender. To require rotation after 10 years could be both costly and disruptive.

Question 30. We are considering whether provision should be made so that, where a PIE has stated in its annual report it will appoint an auditor based on a tender process before the expiry of the maximum duration of 10 years, it should still be able to take advantage of an extension of the maximum duration beyond ten years, following that tender. Do you agree?

We support this extension. Tendering too frequently is a cost for both auditors and companies which the latter would ultimately pass to investors.

Question 31. We are seeking views on the proposal that for companies that are PIEs the company's plans on retendering should be part of a new element of the annual report setting out key matters for the audit committee on the appointment of auditors. Do you agree that the report should include:

a) when the current auditor took up the audit engagement at that company?
b) when the audit engagement was last retendered?
c) the start of the next accounting year in relation to which the company expects that the auditor appointment will be based on a tender?
d) the directors' reasons for considering that the proposed year is in the best interests of the company's members?

Do you consider that any other information should be included in addition the above? Please provide further information to support your answer.

Auditors essentially act as independent scrutineers of management's reports for the company's shareholders. Thus when a company undertakes an audit tender it should have regard for investors' interests – providing a strong measure of accountability. We support PIEs being required to disclose their plans for retendering the audit in the annual report and specifying when they intend to tender next.

In particular, as companies adapt to the new limits on length of audit tenures they ought to be able to plan ahead adequately. Moreover, in planning ahead it is important that the audit committee allows sufficient time to confer with its institutional investors, as appropriate, and in accordance with the guidance that was issued by the Institutional Investor Committee.

Question 32. We are considering whether, where the statement under point (c) above is included in the company's annual report, and the incumbent auditor is reappointed on the basis of the planned tender process before the expiry of the 10 year maximum duration (e.g. at 7 years), the next tender process should be expected to take effect:

- *after the same period has expired again (i.e. year 14 in this example);*
- *after a further 10 years has expired (i.e. year 17 in this example); or,*
- *after the same period has expired again, though with the potential to extend it by the full 10 years via further notice from the audit committee in the annual report (i.e. in this example at year 14 though this could be extended to year 17)?*

Which option would you prefer?

Audit Committees should be encouraged to retender more frequently and thus if they do so they should still be allowed to take advantage of the maximum duration of 10 years if they wish. Thus we consider, at the minimum, the next tender should be after the expiration of a further ten years, i.e. year 17 in this example. However, this still falls short of the maximum duration of 20 years. We consider it would be helpful if the PIE could hold another public tender at year 17 and still retain the incumbent auditor for a final 3 years. This would ensure that PIEs that tender early, say in year 3, would not be penalised or in have their choice of auditor restricted to a greater extent than a PIE that always waits until year 10.

Auditor reporting and additional reporting to the audit committee

Question 35. What issues, if any, do you consider arise from the inclusion in legislation on audit reporting of a requirement for the auditor to include a statement in the audit report where there is a material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern? How do you consider these should be addressed?

We support the requirement for the auditor to include a statement in the audit report where there is a material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern being incorporated into statute. However, as the Sharman review noted there can be confusion about what "going concern" means. First, there is whether it is appropriate to use the going concern basis of accounting as articulated in International Financial Reporting Standards and secondly, there is the interpretation of whether the company can meet it liabilities as they fall due.

The concept of going concern is an underlying assumption in the preparation of financial statements, hence it is assumed that the entity has neither the intention, nor the need, to liquidate or curtail materially the scale of its operations for the foreseeable future. International Accounting Standard 1, Presentation of Financial Statements deems the foreseeable future to be a period of 12 months from the entity's reporting date. If management conclude that the entity has no alternative but to liquidate or curtail materially the scale of its operations, the going concern basis cannot be used and the financial statements must be prepared on a different basis (such as the 'break-up' basis).

On the other hand, the ability of a company to meet its liabilities as they fall due is, de facto, the higher hurdle, and an important one for investors in that it helps ensure that companies do not abuse their limited liability protection.

It is important that any legislative measures are clear as to what the going concern assertion relates to i.e. whether it is referring to the going concern basis of accounting or the higher hurdle of the long term viability statement. Our preference is for the latter. Ideally, the auditor should attest that he has reviewed and challenged the principal assumptions, particularly where there is a material uncertainty, and satisfied himself that the going concern/viability statement is appropriate.

Question 36. Do you agree that the provisions of Article 10 of the Regulation on the audit report should be included in amendments to the FRC's International Standards for Auditing (UK and Ireland)? Please provide information to support your answer.

We agree that the provisions of Article 10 of the Regulation on the audit report should be included in amendments to the FRC's International Standards for Auditing (UK and Ireland). The FRC amended ISA 700 (UK and Ireland) effective for accounting periods starting on or after 1 October 2012 and introduced a more enlightened audit report for entities that have to apply or voluntarily apply the UK Corporate Governance Code. As set out in Article 10 this has already required the auditor to report on what the main risks of material misstatement were and how the approach was modified in relation to those risks (i.e. the auditor's response).

This information helps investors identify and understand the significant judgements made in preparing the financial statements. They can then further challenge executive management and hold the audit committee and external auditor to account. Greater understanding should contribute to the relationship between management and investors, and enhance trust.

Where the Regulation introduces new requirements, we do not believe that they will require more audit work or have a significant effect on the audit.

Question 37. What issues, if any, do you consider arise from the application of the provisions of the Regulation on the audit report? If there are any, how do you consider they should be addressed?

One of the issues in the application of the provisions on the audit report is that the Regulation applies to PIEs as defined, which includes unlisted credit institutions and insurance undertakings. These entities are not required and rarely voluntarily apply the UK Corporate Governance Code and thus have not been required to provide a more enlightened audit report in the FRC's ISA 700. In implementing the Regulation in ISA 700 (UK and Ireland) there will need to be clarity as to the scope.

Question 38. Do you agree that the provisions in Article 11 of the Regulation on the additional report to the audit committee should be included in amendments to the FRC's International Standards for Auditing (UK and Ireland)?

We agree that the provisions in Article 11 of the Regulation on the additional report to the audit committee should be included in amendments to the FRC's International Standards for Auditing (UK and Ireland).

Question 39. What issues, if any, do you consider arise from the application of the provisions of Article 11 of the Regulation on the additional report to the audit committee? If there are any how should they be addressed?

Audit committees

Question 48. What issues, if any, do you consider arise from the implementation of the new requirements on audit committees via amendments to the existing DTR 7.1 in the FCA Handbook (for companies with securities admitted to trading on a regulated market)?

We support the exemption for UCITS and AIFs in Article 39.3 (b) of the Directive from being required to have an audit committee. These funds are subject to a well-established regulatory regime and additional governance requirements such as the appointment of an independent depositary. In addition, we support the audit committee exemption in Article 39.3 (a) where the group audit committee is discharging the requirements that would be imposed on a PIE's own audit committee. This avoids any duplication that would arise if a PIE had to create an audit committee in addition to one that already exists at the group level.