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Mr Paul Smith
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Our ref dm/dlg/181

20 March 2015

Dear Mr Smith

Auditor Regulation – Response to Discussion document on EU audit reforms

I am pleased to respond on behalf of KPMG LLP to the Government's discussion document of December 2014 on the implementation of the recent EU audit reforms in the UK. This response also takes into account the helpful Supplementary Information issued by BIS very recently.

Firstly, we very much welcome the open, deliberative and consultative manner of the Government's approach to this implementation which, it is hoped, will lead both to an optimum implementation of a highly complex set of measures and options in the Directive and Regulation with the widest level of support and understanding among all the key stakeholders. We particularly welcome the repeated commitment to exercise the option to extend the 10 year audit firm rotation rule to a 20 year maximum tenure subject to a tender process by the audit committee to be held at least before 10 years has elapsed.

Secondly, there are some key principles which we believe should underpin the approach to implementation, namely to (i) further enhance audit quality and public confidence in and visibility of audit; (ii) support the strong UK corporate governance framework and the role of independent Audit Committees; (iii) promote the EU single market and avoid measures that increase barriers or complexity for European or global entities and / or going beyond the EU minimum regulations (except where there is good existing UK practice or a clear public interest case to do so).

Thirdly, there remain some very complex issues to work through to effectively implement the reforms while avoiding unintended consequences (such as reduced competition in audit tenders) and we are willing to work with the Government, the FRC and other stakeholders to ensure clear, workable and sustainable solutions that best help meet the objectives above are developed.

Our detailed responses to the questions on the discussion document are set out in the appendix to this letter.

For information, we are including a copy of our response to the FRC's parallel consultation: *Auditing and ethical standards – Implementation of the EU Audit Directive and Audit Regulation.*

Please do not hesitate to contact me if you have any further questions or points of clarification.

Yours sincerely

David Matthews
Partner, Head of Quality and Risk Management

Cc Mr Keith Billing, Financial Reporting Council

Appendix

Chapter 4: The proposals – The main changes

Section 4.1 – Audits of Public Interest Entities and application of the Regulation and Directive

Q1: In relation to the measures discussed in both this and the next chapter, we would welcome comments on the balance between legislative and non-legislative implementation of the requirements of the new Directive and Regulation

Broadly, we believe that non-legislative implementation is preferable wherever possible. Implementation through codes, Financial Reporting Council (FRC) standards and, where necessary, secondary legislation is preferable to primary legislation. This allows for greater flexibility if experience suggests the need for modification.

Implementation via primary legislation is potentially cumbersome. Frequently it would need incremental guidance and codes to supplement its application. Standards and codes are more flexible and can be written in a simpler to follow format with application guidance as required. They can be refreshed and updated more easily.

In particular, we believe that part 42 of the Companies Act 2006 should be reviewed with a view to including within that section only the minimum necessary to authorise the relevant authorities or bodies to set the standards, perform monitoring etc with the backing of law.

Q2: In relation to all the Member State options in the Directive and the Regulation, we would welcome comments to inform our thinking on whether and how these should be taken up. Though many are discussed in this document and in specific questions, all the options in the Directive and Regulation are considered in the options tables that are being made available separately

As a principle, we believe the Government should avoid any "gold-plating", which moves beyond minimum EU requirements, unless there is settled UK practice or policy or a clear public interest case which should be subject to extensive consultation and an independent regulatory economic impact assessment.

Member state options should be taken up consistent with the above principle. Care should be taken to ensure that any additional requirements can be applied in practice without the need to apply complex decision making processes or capture incremental information or analysis.

Q3: In relation to the measures discussed in both this and the next chapter, what issues do you think arise that have not been considered as part of the discussion? If there are any, how do you think these should be addressed?

We have no points to raise over and above those made in response to other questions in the consultation.

Q4: In relation to the measures discussed in both this and the next chapter, we would welcome comments on any burdens applied to small and micro sized companies and audit firms in particular by the proposed implementation, which you consider are disproportionate to the wider benefits

Care needs to be taken to achieve an appropriate balance. The challenges facing many smaller entities are often different from those facing larger entities. These include access to adequate finance, skills and expertise, and segregation of duties challenges. All of these factors can increase the level of risk attaching to these types of entities, but we would not favour any tightening of regulation that restricts their ability to innovate, grow and take risks. Restricting the role of the auditor (either in their role as auditor or as an advisor) potentially adds cost to this population of entities which are important contributors to UK employment and economic growth.

Q5: 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? Please provide further information in support of your answer

Yes.

We do not see the need for the government to extend the categories of entity classified as PIEs beyond the definition established by the Directive. We recognise that the FRC in its parallel consultation (FRC Consultation)[1] is seeking views on the extent to which the more stringent requirements included in the Regulation should be applied to other entities. We have set out in our response to that consultation our views on this, but believe that the benefits can be achieved through this route of equivalence rather than expanding the statutory definition of PIEs.

Q6: What issues, if any, do you consider arise from the application of the provisions of the Regulation to audits of PIEs as defined in the Directive? How do you consider these should be addressed?

There will be incremental costs to entities on becoming designated as a PIE for the first time. This is most notably the requirement to have an audit committee and the consequential costs and restrictions arising from the more stringent requirements applicable to PIEs contained in the Regulation.

The requirement for an audit committee will (to the extent that the member state option in Article 39 of the Regulation allowing the functions of the audit committee to be performed by another body in certain circumstances is not taken up) add cost to such entities but more importantly there is currently a shortage of individuals with the skills, experience and inclination to take on audit

[1] *Consultation: Auditing and ethical standards – Implementation of the EU Audit Directive and Audit Regulation*, December 2014

committee roles. The more stringent requirements applicable to PIEs contained in the Regulation will increase costs (eg from increased tendering) and increase restrictions (eg in the form of reduced choice for audit and non-audit service providers).

In addition, for PIEs which are members of groups with more than one PIE operating in different EU jurisdictions, there will be increased complexity (due to the need, potentially, to comply with differing requirements imposed by different member states), which the respective audit committees of those PIEs will need to accommodate.

Q7: 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?

Please see our responses to Q5 and Q6 above.

In addition, entities within the categories above may themselves be direct or indirect subsidiaries of an undertaking which is itself a PIE. In this instance the application of the requirements of the Regulation at different levels within the same group is likely to cause particular challenges and complexity, which will be further exacerbated to the extent that different member states implement the Regulation in different ways (for example, in terms of going beyond the baseline requirements in the Regulation to different extents). We would urge BIS to consider how the provisions of the Regulation might be applied flexibly (for example through member state options and derogations) to reduce the burden on such a subsidiary undertaking when its parent undertaking is itself complying with the Regulation in a different member state.

Q8: What do you think are likely to be the familiarisation costs to auditors of PIEs arising from all the changes affecting them? In particular:

(a) How many person hours likely to be involved in an individual statutory auditor and their team understanding and preparing for the changes?

(b) What are the costs to audit firms of updating internal management systems to reflect the changes?

(c) How this is likely to vary by size of audit firm?

It is very difficult to provide a generic response to these questions.

The incremental costs on individual audits where the incumbent auditor remains in place are likely to be relatively limited on a recurring basis with more in the year of transition to the new requirements. The impact on entities that become PIEs for the first time we will be more significant even if there is no change in auditor - perhaps 10-15% each year.

However, there may be cases where the incumbent auditor does not wish to audit PIEs and the audit firm therefore changes. In such cases the incremental year one effort from a new audit firm may be a higher uplift combining the change to PIE and the familiarisation costs of a new auditor (see our response to Q34).

Finally, the additional tender and rotation rules that are coming into force will also add time and cost to incumbent audit firms as more frequent tenders will be held than at present. The impact on internal management systems will, in part, be dependent on how the requirements are implemented. This will have a disproportionate impact on firms that currently do not audit PIEs and choose to do so.

Section 4.2 - Competent authorities - Designation and delegation of tasks

Q9: 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?

In our view the question of the appropriate regulatory architecture is driven by two considerations: what is desirable for the UK, and what does EU law require? The hope is that the latter can accommodate the former.

In terms of what is desirable for the UK, we would not object in principle to the FRC taking on the role as the so-called "single competent authority", but this should be on the basis that it results in an enhancement to audit quality. The case for this is not yet articulated or proven:

- The present system does not appear to be in need of radical change, eg no case is put forward as to the extent to which it is failing.
- Over-loading the FRC with regulatory responsibility may reduce its focus on the areas of greatest risk and / or public interest companies (ie PIEs).
- The centralisation of regulatory authority will present accountability issues if there are no checks and balances built into the structure. We return to this in our response to Q10.
- There does not appear to be any consideration of potential unintended consequences of any such changes.

On the latter point, we believe that removing independent regulatory authority from the professional bodies risks undermining the profession. The professional bodies in the UK are

highly regarded in the UK and internationally, for the quality of the Chartered Accountant qualification, for the thought leadership in relation to audit, accounting, reporting and other relevant matters and, increasingly, for supporting overseas professional bodies in enhancing the quality of their own professional qualifications and regulatory capabilities. In turn, the quality of Chartered Accountants have contributed significantly to professional services (one of the UK's strongest performing sectors) and supported growth of SMEs (and, therefore, the UK economy). We believe that these achievements of the professional bodies are, at least in part, attributable to the fact that they are part of a *profession*.

Robert Downie, a professor of moral philosophy, has written extensively on the subject of professions and has developed a number of characteristics of professionals in order for them to have legitimised authority. To achieve this authority, Downie states (emphasis added) that "*If a profession is to have credibility in the eyes of the general public, it must be widely recognised as independent, **disciplined by its professional association**, actively expanding its knowledge base and concerned with the education of its members. If it is widely recognised as satisfying these conditions, then it will possess moral as well as legal legitimacy, and its pronouncements will be listened to with respect; it will have legitimised authority*"[2].

Removing independent regulatory authority from the professional bodies risks undermining the profession, since this (regulatory authority) is one of the features of a profession, with the professional bodies potentially becoming mere trade bodies. We do not believe that this would be in the public interest, in particular as we believe that this would reduce the attractiveness of accountancy as a profession with the consequential impact on the quality of the people joining audit firms and, ultimately, audit quality. Further, the ability of the profession to support growth, particularly in SMEs, may also be undermined.

In terms of what is possible under EU law, we agree that the Directive requires one competent authority to have ultimate responsibility for the five areas of audit regulation (Article 32(4) and (4a)), ie the so-called "single competent authority". However, we are aware that there are competing views about the relationship between this competent authority and other actors on the regulatory stage, ie the professional bodies:

- On the one hand there is the view that only a hub-and-spoke model is possible. Here all authority is given by law to the single competent authority at the centre, effectively the "sole competent authority", which then chooses which regulatory tasks to delegate out, on its authority, to other bodies at the end of the spokes. In this model the other bodies draw their authority from, and so are not independent of, the single competent authority.

- On the other hand, there is the view that an alternative, flat model is also possible. Here the single competent authority is one of a number of competent authorities, each with its own tasks given to it by law. One of the tasks of the single competent authority is, however,

[2] *Professionals and Professionalism* – Journal of Philosophy of Education, Vol 24, No 2 1990, pages 147-159.

to have oversight over the others. In this model all of the regulatory actors draw their authority from the law directly, even though all of them are overseen by one, "lead competent authority", and it is only that lead competent authority that needs to meet the restrictions (Directive Article 32(3) and Regulation Article 21) over membership.

So whilst we agree that the FRC should be the single competent authority (for the reasons that we set out below) the issue is whether it does so in as sole or lead competent authority. In our view the UK needs to resolve the debate as to whether the flat model is possible under the Directive, because the case is not proven for a move to the hub-and spoke, sole competent authority model.

Subject to the foregoing, we believe that the FRC should be designated as the single competent authority because the single competent authority must meet the restrictions on its composition (no experience of audit for three years) and cannot delegate any tasks in relation to PIE quality assurance, investigations and sanctions (regulation article 24(1)); the FRC is clearly the body that most nearly meets those restrictions (although it will need to make changes to meet them fully); and the professional bodies could not meet them by the very nature of their Charters. Further, it would not serve any practical purpose to establish a higher authority than the FRC to preserve the FRC's current composition and skills mix, as it would just add greater complexity and some discontinuity.

Q10: What issues, if any, do you consider arise from the need to implement a new statutory framework for the setting of auditing standards and for audit inspections, investigations and discipline by the single competent authority to replace the current framework that requires the bodies' rules to provide for this? If there are any, how should they be addressed?

The sole competent authority, ie in a hub-and-spoke model, would be both very powerful and, as noted in our response to Q9 above, restricted, for entirely understandable reasons, from having any recent, relevant experience in positions of authority to exercise decision-making power (Regulation, art 21). We believe, therefore, that if we need to adopt such a model, then the UK legislation that creates or designating such a sole competent authority should make careful provision for its accountability. This has not been explored in the consultation document, presumably because a debate on the issue will follow at a later stage. That said, our suggestion at this stage is that, as with audit itself, self-assessment would probably be inappropriate. Some independent annual review, including taking evidence from all stakeholders (shareholders, companies, audit firms), should be considered, although we recognise that there might be practical challenges in identifying a body to undertake such a review.

In addition, we would note that the existing framework for audit regulation is complex and the Directive and Regulation present an opportunity to simplify it. To address this, as suggested in our response to Q1, we believe that BIS should start afresh with a minimalist part 42 of the Companies Act. In addition, we believe that this might also present an opportunity to simplify the layers of complexity that currently exist: as an example, at present the RSBs continue to hold that status so long as the FRC is satisfied that they have various appropriate rules in their own "rule books", which in practice means having a rule book that requires compliance with FRC

rules; we believe that the FRC should have the authority to make these rules itself. We also note that a plethora of rules apply for conducting audits including: rules in the Regulation itself, the Companies Act (eg, what the audit report should cover), EU-adopted ISAs, and FRC standards. We believe that there is a case for removing all detailed rules from the Companies Act and for the FRC to implement them directly (which would be possible given that their standards would have statutory backing). Further, the FRC could consider reproducing the relevant rules from the Regulation and EU adopted-ISAs in its own "rulebook" (for want of a better word) integrated with its own related rules, in order to improve transparency and clarity for all interested parties.

Q11: What issues, if any, do you think might arise for the current investigation and disciplinary arrangements between the professional supervisory bodies and the FRC, that apply to accountants generally as opposed to only auditors, given the changes in relation to audit? If there are any, how should they be addressed?

We are unclear that there would be significant changes.

At present any FRC investigation or disciplinary arrangements under The Accountancy Scheme can be and are extended to accountants who are members of a UK RSB where the issue is in the public interest. Any matters which related to non-PIE disciplinary proceedings would continue to be undertaken by the RSBs.

Q12: In relation to each of the tasks provided for in the Directive and Regulation, do you consider that responsibility should be allocated to the single competent authority, for it to delegate to the professional supervisory bodies as appropriate and to the extent permitted in the Directive and Regulation? Please provide further information in support of your answer

There are two issues: who should undertake the tasks and on what authority? We have dealt with the important but difficult question of authority in our responses to Q9 and Q10. Here we deal with the first, simpler issue of the allocation of tasks:

Auditor approval – We believe that the professional bodies should do this. It involves dealing with a large number of individuals and does not seem to be a good use of FRC time. Approval is closely related to professional qualifications which are established and maintained by the professional bodies.

Continuing professional development – For similar reasons, we believe this is best undertaken by the professional bodies.

Setting of technical and ethical standards for statutory audits and auditors – As set out in our response to Q10, we believe that there should be a single set of standards, albeit that there will be different layers within them (eg for PIEs and non-PIEs). If it is to be one set applying to all, it is right that the FRC does this.

Audit inspection – The single competent authority is required to undertake PIE audit inspections (Regulation article 24(1)), so the FRC must do this. To keep the FRC's workload manageable and to keep it focused on public interest matters, we believe that it would be sensible for all other audit inspections to be undertaken by the professional bodies.

Investigations and discipline – This should be split between the FRC and the professional bodies in the same way as immediately above and for the same reasons, but with the FRC also able to take on non-PIE cases where they believe that the case involves an issue of wider public interest.

Q13: For any tasks where responsibility is allocated to the single competent authority for it to delegate, what limitations, if any, do you consider would be needed to ensure that authority only retained responsibilities or reclaimed delegated responsibilities in appropriate circumstances? What do you consider these circumstances should be?

We believe that generally a transfer of responsibilities should only occur if there are significant issues of independence, or effectiveness, or areas where rulings could impact on the wider public interest and / or a precedent looks likely to be set when the involvement of the single competent authority may be required.. Such a transfer would occur in a hub-and-spoke model by reclamation by the FRC. In a flat model it would occur if the FRC's public interest responsibility (see our response to Q12 on investigation and discipline) took precedence over the RSBs' role.

Either way, the FRC should follow transparent processes and changes in policy on reclamation should follow an evidence-based and deliberative consultation. However, we note that the last section of article 32(4b) does not appear to allow restrictions on reclamation.

Q14: In relation to each of the tasks provided for in the Directive and Regulation, are there any tasks, or any aspects of those tasks, that you consider it is important should continue to be covered by provisions in legislation on the content of the rules of the supervisory bodies? Please provide further information in support of your answer

We do not believe so.

Q15: Do you consider that both the registration of statutory auditors and their removal from the register should be covered by regulations under the Companies Act? If so, which body or bodies do you think should have statutory powers for the removal of statutory auditors from the register?

We do not believe that it is necessary for registration and removal to be covered by the Companies Act or regulations under the Act. Section 1212 should suffice in providing the statutory underpinning. In the case of auditors of PIEs, the FRC should be able to remove as should the RSB for all auditors. There should continue to be a proper process following the principles of natural justice including a right of appeal.

Q16: Do you consider that, for consistency with a framework of ultimate responsibility, single competent authority approval should be required for the rules of the supervisory bodies?

We assume that the rules in question are those referred to in the current Companies Act schedule 10, ie the technical and ethical standards for auditors. We believe that these rules should be set by the FRC as single competent authority in the first instance, and these should apply directly (see our answer to Q12). However, any *additional* rules that the professional bodies choose to set should not require FRC approval.

Q17: What do you consider are the costs and benefits in monetary terms and in terms of the effectiveness of audit regulation of the proposals in this chapter and of your preferred approach to implementation of these provisions?

This chapter covers what changes to make to the structure of audit regulation by which broadly the same division of rule-making/ enforcement etc. responsibility is affected. So in and of itself, we do not expect these particular "architectural" proposals to have a significant impact on costs. That said, with the expansion of the number of entities which will be classified as PIEs and more stringent requirements in relation to them, there will be an increase costs of audit due to these particular rules. We have not sought to quantify these costs, but they are unlikely to be insignificant.

Section 4.3 - Audit fees and non-audit services

Q18: 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? Please provide information to support your answer.

Yes, we believe that although it has direct effect without further UK action, in the interests of clarity and transparency it is important that all matters related to the independence of auditors are included in the Ethical Standards to help ensure a "one-stop shop".

Q19: 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 envisage that there will be a number of issues associated with interpreting how to calculate the cap which will need to be addressed through clear guidance. This will be particularly acute if the cap is applied to non-audit services provided to all of the EU group (not just the parent as the Regulation appears to require).

In principle, we believe there is a strong logical and objective case that the calculation for the threshold should be symmetrical and consistent – with the same scope and definition of entities for the numerator and denominator (eg aggregate fees relating to non-audit services provided by members of the audit firm network as a percentage of the group audit fee).

In such circumstances, there will be issues associated with how the cap is enforced across the group. This would need to be addressed by a combination of requiring the audit committee to ensure that controlled subsidiaries were not committing to purchase non-audit services from their

auditors without their express approval[3] and the parent company auditor also having a mechanism in place with the other firms in the same network to police that pre-approvals were being obtained. There would need to be clear guidance to put beyond doubt that associated entities, non-EU parents and non-EU sister entities in the group would not be included in the calculation of the cap.

The FRC Consultation addresses the extent to which provisions applicable to PIEs should be extended to other entities. We have commented on the application of the cap to such entities in our response to the FRC Consultation.

Q20: 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? Please provide information to support your answer.

Yes we believe that the more stringent requirement set out in the existing Ethical Standard No 4 (which limits the overall fee income that an audit firm can receive from a PIE to 10% of the annual fee income of the audit firm or where profits are not shared on a firm wide basis, to that part of the firm by reference to which the audit engagement partner's profit share is calculated) should be maintained.

Q21: 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?

Yes, we believe that the competent authority should be able to grant these exemptions.

Such exemptions should be considered on a case-by-case basis by reference to some commonly established and transparent principles – for example where the services are required to support a capital market transaction or where the work is commissioned to improve investor confidence in the company's financial reporting. In order to mitigate the threat of a perceived lack of independence, we believe that it would be sensible for any such request for an exemption to come from the audit committee (rather than the audit firm).

Q22: Do you agree that the subject matter of Article 5 of the Regulation on the blacklist of non-audit services, including the possibility of setting more stringent requirements, should be included in amendments to the FRC's ethical standards for auditors? Please provide information to support your answer.

Yes, principally for the reasons set out in our response to Q18.

[3] The FRC Guidance to Audit Committees may be a suitable vehicle for doing this, setting out a consensus view as to who, under the Regulation (which has direct effect), is responsible in law for complying with the cap.

We have commented on the question of the extension of the blacklist and / or the application of a white list only approach to non-audit services in our response to the FRC Consultation.

Q23: 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?

The key issue that we foresee is that we believe that the blacklist (together with the cap on the provision of non-audit services) may restrict or deter companies from considering an audit firm for selection as its auditor (or from inviting it to participate in a tender process) where that audit firm is already a significant provider of non-audit services.

Whilst there are currently restrictions on the services that an auditor may provide, the more stringent requirements in the Regulation may exacerbate this position. Whilst this may be desirable in the context of the broader objective of enhancing public confidence in audit and audit firms, we believe that it is important that implementation in the UK does not, unintentionally and unnecessarily, have the effect of further restricting choice.

For this reason (to the extent compatible with the Regulation) there needs to be practical transitional provisions on both entry into and exit from an audit engagement. Without such provisions there is the very real risk either that the restrictions may act as a disincentive to some audit firms participating in a tender process, or that firms will not be able to get themselves sufficiently independent to be able to tender for the audit and / or that companies will not invite an audit firm to participate in a competitive tender process. In either case, the consequence would be further restrictions in the numbers of audit firms willing or able to participate in a competitive tender.

In addition, without sensible grandfathering there could also be the following consequences:

(i) reduction in choice of provider of non-audit services to clients in the pre-tender period as providers may chose not to tender for non-audit services on the basis that they would not be independent for the audit tender. This may drive up costs for businesses;

(ii) reduction in choice of provider of non-audit services in the post-appointment period if the exiting auditor cannot commence non-audit service work prior to exiting the audit relationship. This is particularly relevant for global tax compliance engagements which can generally be provided only by firms with sufficient geographic coverage;

(iii) extra costs for the company if it has to engage another party to complete the non-audit services if the initial provider needs to exit the relationship for independence purposes;

(iv) disruption and extra costs to other third parties such as HMRC and other government bodies if the entity engaged to provide non-audit services has to exit the relationship before completion of the engagement; and

(v) difficulties in supporting and/or maintaining technology already implemented by businesses where the historic non-audit services included the provision or implementation of a technology solution.

Further details on the above, together with the other issues that we believe will need to be addressed in respect of the implementation of the blacklist of non-audit services are set out in our responses to Q8a, Q10 and Q27 of our response to the FRC Consultation.

Q24: Do you agree that implementation of the revised requirements on ensuring and documenting auditor independence in the 2006 Directive should be implemented primarily via the ethical standards, with amendments to the existing legislation as necessary only to:

- *underpin the standards? and,*
- *introduce simplifications for audits of small non-PIEs?*

Please provide further information to support your answer

Yes, we believe that the FRC's ethical standards are the appropriate mechanism for addressing matters relating to auditor independence so as to provide a consolidated source for such requirements (see also response to Q18).

Q25: 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? Please provide information to support your answer.

We agree that it would be helpful if the required disclosure was consistent with the captions specified under Article 14 of the Regulation. The introduction of more stringent restrictions on the provision of non-audit services in the form of a black-list and cap may provide some opportunity for the current disclosure requirements to be simplified.

Whilst it might be felt that continued disclosure of categories of permitted non-audit services may still be helpful to investors in their understanding of the company's approach to the use of the auditor for non-audit services, the balance between disclosure in the financial statements and audit committee reporting should be considered and duplication avoided.

Q26: For our impact assessment on the changes we would welcome any estimates that could be provided on:

(a) *The percentage of non-audit services that are likely no longer to be provided by auditors due to their inclusion on the blacklist?*
(b) *The additional costs associated with reallocating some of the non-audit services that would otherwise have been provided by the same statutory auditor?*
(c) *The extent to which these additional costs vary by the size of PIEs?*
(d) *The person hours likely to be involved in a non-audit team at an audit firm understanding and preparing for the changes given that they will not be able to provide certain non-audit services to the firm's audit clients?*

(a) Currently, approximately some 10% of our firms' overall revenue is derived from non-audit services supplied to audit clients – both PIEs and non-PIEs (of this amount, approximately 45% relates to tax services). To the extent that the UK does not avail itself of the EU derogations available for tax services then we would estimate that a significant proportion of the 45% (ie that which derives from PIEs) would no longer be provided. If the UK adopted a white list only approach to non-audit services then it is not possible to accurately determine accurately how much of the 10% could no longer be delivered (as this would depend on how extensive the final white list was), although we believe that a significant proportion of those services would no longer be able to be provided.

(b) We do not believe that there would be significant additional costs to our firm in redeploying the resource currently engaged in delivering non-audit services to audit clients, assuming that we could replace such services with the same services being instead provided to non-audit clients, although there would be additional, potentially significant, bidding costs that would need to be absorbed. If we could not replace the services then there may potentially be some redundancy costs that our firm incurs (it is not currently possible to estimate what these would be). There will, however, be costs involved for business in changing their professional advisor.

(c) We believe that the cost / time burden on smaller businesses - such as small-cap companies in the main market listed - who have very small management teams and limited in-house capabilities will be much more significant and disruptive than for larger FTSE 350 companies who are used to dealing with multiple professional advisors.

(d) All our professional staff already undertake annual independence training. We believe that the incremental cost to ensure understanding of any revised position (including the differences from the current regime) should not be significant.

Section 4.4 - Tendering and duration of audit engagements

Q27: 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? Please provide further information to support your answer.

These current procedures for auditor appointment work well within the UK environment and we see no reason to change them.

Q28: Where the PIE is exempted from having an audit committee (eg 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? Please provide information in support of your answer.

We believe that the Board (as a whole) should be the body responsible for determining the recommendations that should be put to shareholders of the audited entity – albeit on the recommendation of the audit committee where such a body exists and that this is already the case under DTR 7.1.

Q29: 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? Please provide further information in support of your answer.

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.

Q30: 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?

Yes. We agree that where a PIE appoints 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.

Q31: 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? (Yes / No)*
(b) *when the audit engagement was last retendered? (Yes / No)*
(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? (Yes / No)*
(d) *the directors' reasons for considering that the proposed year is in the best interests of the company's members? (Yes / No)*

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

We support disclosures where this provides transparency of matters relevant to investors in instilling confidence in auditor independence. The mandatory tendering / rotation regime is a "hard fix" to lay to rest concerns that tenures were inappropriately long. Having done so, we do not see a particular need for the "soft fix" of a disclosure regime.

In that context, whilst it might be argued that any further disclosure is unnecessary, we can see that the disclosures (a) and (b) in the question above provide useful information at minimal cost to the reporting organisation. Disclosure (c) might provide useful information to ensure that companies and audit firms other than the incumbent auditor are cogniscent of likely tender dates when considering non-audit services which might restrict the ability of an audit firm to participate in a subsequent audit tender. However, it is also possible that disclosures (c) and (d) may well be "boiler-plate" and therefore add to the clutter in annual reports.

Furthermore, any such disclosure regime should avoid complexity and / or duplication with the UK Corporate Governance Code which provides that a separate section of the annual report should, *inter alia*, include an explanation of "how [the audit committee] has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted".

Q32: 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 (eg at 7 years), the next tender process should be expected to take effect:

(a) *after the same period has expired again (ie year 14 in this example);*
(b) *after a further 10 years has expired (ie year 17 in this example); or,*
(c) *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 (ie in this example at year 14 though this could be extended to year 17)?*

Which option would you prefer? Please provide further information in support of your answer.

We do not believe that the framework for tendering and rotation should be tied to the 'audit committee statement' as the question suggests, nor that the timing of the tender should introduce additional restrictions on the length of the appointment over and above those which applies directly under the Regulation. Accordingly, we see option (b) as the appropriate way forward, given that the Regulation is a simple rule requiring that audit tenure cannot either (i) extend beyond 10 years since the last tender or (ii) extend beyond 20 continuous years (i.e. must tender at least every 10 years and must rotate every 20 years).

The Supplementary Information[4] raises a good question, related to this, about tenders taking place prior to 17 June 2016 (its question 13). In our view the "maximum duration" referred to in article 41(3) is the duration taking into account article 17(4)'s provisions for varying the maximum (to 20 years) in the event of a tender. Indeed, article 41(3) specifically refers to article 17(4).

Q33: What issues, if any do you consider arise from the UK's obligation to apply effective, proportionate and dissuasive sanctions for failure to comply with the UK's implementation of the framework on mandatory rotation and retendering? If there are any such issues, how do should they be addressed?

Effective application could, for example, be achieved by the FRC maintaining a list of PIEs and their auditors, setting out when retendering is required and monitoring it in order to prompt it to occur. For example, faced with an apparent impending breach, the FRC could (a) issue a letter of clarification to the company seeking the facts (as there may be particular complexities of which it was unaware); (b) if a clear breach is established then there should be a notice to change auditor issued within a certain reasonable timeframe and (c) if that is not met the audit firm could be directed to stand down. This would be similar to the system of orders contemplated in the Supplementary Information.

As part of such an FRC oversight system, we believe that the FRC should be prepared to receive and respond to requests for clarification where the length of tenure, and therefore the requirement a competitive tender or rotation, might not be clear. We note that BIS, in the Supplementary Information, envisages such a role for certain aspects of operation of the Regulation on tendering / rotation, and extending it to this would be consistent.

So far as sanctions are concerned, at present the UK's sanction for an audit being conducted by an inappropriate person – and *prima facie* this would capture over-time audit firms – is in s1248 of the Companies Act 2006: The Secretary of State has the power to order a second audit (or a review of the first audit) – though this power has been delegated to the FRC. We agree with the sentiments in the Supplementary Information that to call the audit report into question (whether or not it has been laid before members in general meeting – the audit report exists from the moment is it signed) and, consequently to order a second audit, seems disproportionate: no-one has suffered harm (there is nothing necessarily defective about the audit); the failure is procedural.

[4] *BIS Auditor Regulation – Supplementary Information* – March 2015

Q34: For our impact assessment on the changes we would welcome any estimates that could be provided on:

(a) resources that are likely to be deployed by PIEs to tender audit appointments?
(b) resources that are deployed by auditors to tender for audit work?
(c) additional familiarisation costs that arise for both auditors and the audit client when a new auditor takes up an audit engagement?
(d) the extent to which this varies by the size of the PIE?

The Competition Commission (now CMA) Report on the Statutory Audit Market for Large Companies (CMA Report) concluded that the average cost to an audit firm for tendering for a FTSE 25 audit was around £1.25m[5], and some £300,000 for the FTSE 250 average. This was based on confidential costs submitted by the audit firms to the Commission on their actual costs of tendering. There is no calculation for the cost to companies, which varies significantly.

Additional familiarisation costs are generally thought to be in the range of 10-15% additional cost in the first year. The CMA Report sample found the additional hours in the first and second year of a new appointment to be even higher at 24.3% and 31.5% before reducing[6].

Number of years after appointment	*No of companies in sample*	*% change in total hours*
0	19	0.0
1	19	24.3
2	13	31.5
3	6	14.3
4	5	8.2

Section 4.5 - Audit reporting and additional reporting to the audit committee

Q35: 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?

Given the existing requirements in relation to going concern in auditing standards and the FRC's related guidance[7], we do not expect any major issues to arise.

However, some important clarifications will be necessary in FRC standards, eg:

- is a statement required if there is no material uncertainty? (our provisional view, no);

[5] Competition Commission Final Report on Statutory Audit Market, Appendix 16(2)
https://assets.digital.cabinet-office.gov.uk/media/5329db3740f0b60a73000027/131016_final_report_appendices_glossary.pdf
[6] Competition Commission Final Report on Statutory Audit Market, Appendix 2(4), table 55
[7] *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* – September 2014

- where a statement is required, is it satisfied by an emphasis of matter paragraph in the audit report? (our provisional view, yes);
- is such a statement different from any auditor's conclusion on the long-term viability statement under the UK Corporate Governance Code's new provision C.2.2? (our provisional view, yes).

Q36: 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.

Whilst the Regulation has direct effect without implementation in UK legislation or standards, we agree that the provisions of the Regulation about the audit itself, including the required content of the audit report, should under a "one-stop-shop" principle, be included in the FRC's standards.

Q37: 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?

The most significant issue are: what are "observations" and when are they "relevant" (Article 10(2)(c))? It is vital that the FRC standards address these questions. Whilst it is difficult to see what "observations" can be other than findings, along the lines of some of KPMG's pioneering reports, nevertheless since it is "ground-breaking" the profession as a whole would need clarity on it in FRC standards. It would also helpful for the FRC standards to set out a common framework for how to report findings and KPMG would be happy to contribute our experience.

We believe that legislation should also clarify that such observations (or other content included by the auditor in an audit report) do not extend the auditor's responsibility over and above that in relation to the audit opinion as a whole (ie, solely to the shareholders as a body).

There are also a number of lesser points that would benefit from clarification in FRC standards. There is, at first sight, a surprising provision in article 24(1) regarding the competent authority's powers, *viz* that it may not interfere with the content of audit reports. We assume that this refers to interference with individual audit reports (eg, what opinion is formed), rather than a prohibition on setting auditing standards on audit reports. Clarification would be welcome.

Q38: 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)? Please provide information to support your answer.

Whilst the Regulation has direct effect without implementation in UK legislation or standards, we agree that the provisions of the Regulation about the audit itself, including the report to the audit committee, should, under a "one-stop-shop" principle, be included in the FRC's standards.

Q39: 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?

The principal concern is the lack of clarity in article 11(2)(j). It requires a report on "any" deficiencies in financial controls, without any limitation along the usual lines, *viz* "which were identified in the course of the audit" (*cf* article 11(2)(k)). We trust that this is not unrestricted, positive assurance on financial controls, but that is not clear. Nor does the Directive's article 25a clarify matters.

There are likely to be some further, detailed questions of interpretation of article 11, which generally requires more content for these reports than current requirements or, to a lesser extent, practice, but these would be best dealt with by the FRC in a second stage consultation.

Q40: For our impact assessment on the changes, we should particularly welcome data on:

(a) additional resources are likely to be needed by the auditor to produce the additional report for the audit committee?
(b) the additional annual cost of the audit committee considering the additional report?
(c) how these costs vary by size of PIE?

At individual audit level, we consider that *material* additional resources are not likely, though there will be some addition to the cost base and fee. The additional resources will, of course, scale-up for all PIE audits in aggregate. On implementation some existing central resources at firm level will be employed on the production / revision of guidance/ templates. At engagement level we expect that few additional resources will be required to check / review to ensure that all issues are covered, as something very close to this is being done already.

We expect that there is little or nothing in the additional content of this statutory report that will receive material, additional attention from audit committees. Additional costs for companies are therefore unlikely.

PIE size will not be the principal driver of the content of these reports. It will depend on other factors, for example the business sector, whether the PIE is in a single or multiple lines of business, the quality of its finance function, the number of relevant issues to cover, etc.

Section 4.6 - Further consultation - The small companies audit exemption thresholds

Q41: Do you consider that the small companies audit exemption thresholds should:

(a) remain aligned with those for the small companies accounting regime, so that the number of audit exempt small companies will increase in line with the increase in the small companies accounting thresholds;

(b) remain unchanged so that the turnover and balance sheet thresholds are considerably lower than the thresholds for access to the small companies accounting regime; or,
(c) be amended in some other way (please set this out)?

Please provide further information in support of your answer.

We find the reasons given for raising the thresholds to be unconvincing. For example, a long-standing alignment of thresholds is not, in itself, a compelling policy. Nor is it a relevant consideration that there may be a small population of affected companies. As size increases we would expect the number of companies to decrease on a diminishing returns basis: eg: if there were only one company with turnover in excess of some very high size limit, that would not justify exempting that company.

Instead a public policy debate is required on the question of what is small, what accounts are required of small, eg should they be true-and-fair, and if they need not be audited then why are they needed at all? Answering such questions would provide BIS with a mandate as to where to draw a line to balance necessary requirements against the regulatory burden to the business. A clear vision in this area might also enable BIS to better influence EU policy.

Chapter 5 - The proposals - Other changes

Q42: What issues, if any, do you consider arise from the measures considered in this chapter? If there are any, how do you consider these should be addressed?

We have no comments to make over and above those made in response to the ensuing questions.

Q43: For our impact assessment, we would welcome any information you can provide on the expected costs and benefits of the measures considered in this chapter?

We have no readily available quantitative information on the likely costs and benefits of the relevant measures.

Section 5.1 - Technical standards for statutory audits

Q44: Do you agree that the implementation of EU requirements on technical standards should be primarily through changes to the FRC's ISAs (UK and Ireland)? Please provide further information in support of your answer.

Yes, in accordance with the principles in our answer to Q9.

Q45: For the purpose of our impact assessment on the changes we would welcome any estimate you could provide of the percentage of PIE audits for which the quality control review will now have to be undertaken by an individual auditor from outside the appointed audit firm (where there

is a lack of detachment from the audit or knowledge of the client sector) where this was not previously required?

Whilst we do not expect that this requirement will have any effect on our firm, we are unable to speculate on its effect on smaller firms.

Q46: What issues do you consider arise from the implementation of EU adopted ISAs in the UK that UK representatives should raise with the European Commission?

In general, we strongly support the uniform application of ISAs throughout the European Union, and indeed globally. However, we do appreciate that some ISAs have been enhanced or extended in the UK to meet the high standards of the UK corporate governance and reporting environment and we agree that the FRC should continue to do so (for which, see our response to Q47).

The issues arise, first, from the complexity of the regime. In particular the rules on audit reporting, including in relation to going concern, and to reporting to audit committees, will be governed by four sources: EU law (the Regulation), UK law (to the extent that this is used to implement the Directive), adopted-ISAs and national auditing standards. Fewer sources would be preferable, but we should not want to lose national auditing standards, the UK's national standards on audit reporting has been widely acclaimed around the world a success, influencing ISAs rather than being led by them.

The second issue concerns the extent to which adopted ISAs would restrict the extent to which UK standards could innovate. For most auditing standards this is not an issue, since auditing procedures complement rather than conflict with one another, and so additional national procedures can be added. However, audit reporting is an area where if the adopted ISA rigidly requires certain order or wording, it appears unlikely that a UK standard can require something else, potentially hindering rather than helping Europe (including the UK) to forge ahead and innovate in this area.

Next, on adoption of ISA 570 a question of conflict with existing UK standards will arise. Today the UK's going concern test period is longer than elsewhere – indeed the UK leads in this field. Is this an additional requirement (permitted) or a different requirement (not permitted)? We believe that for this and the previous two issues the FRC needs to look very carefully at what the UK's policy should be, consulting appropriately, and formulate consensus advice to BIS.

As a more general point, post-adoption there will be a major FRC task to check whether the full suite of our existing national additions fit the Directive's test to be permitted. It is time sensitive, needing to be done in advance of BIS being required to discuss ISAs at EU level.

The status of the ISAs' application and other explanatory material (appended to each ISA) needs to be considered. Their text is usually couched in non-mandatory language and is widely acknowledged as not being mandatory. However, ISA 200.19 – an actual provision of ISAs "proper" – requires an auditor to read that additional material in any given ISA in order to apply

that ISA properly. What, if anything, will adoption of ISA 200 do to the status of this application material?

Q47: Do you agree that following any adoption of ISAs by the European Commission, the FRC should have the discretion to:

(a) apply standards where the Commission has not adopted an ISA covering the same subject-matter; (Yes / No) and,
(b) impose procedures or requirements in addition to adopted ISAs if these national procedures or requirements are necessary to give effect to national legal requirements or to add to the quality of financial statements? (Yes / No)

Please provide further information in support of your answer.

Yes (to both (a) and (b)). As a general principle the FRC should be able to do both of these things, as it has in the past, subject of course to consultation and due process having been completed.

Q48: 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 do not currently foresee any specific issues arising from the implementation of the new requirements on audit committees via amendments to the existing DTR 7.1 (for companies with securities admitted to trading on a regulated market).

Q49: What issues, if any, would you consider arise from the implementation via provisions in PRA rules of the new requirements on audit committees for those banks, building societies and insurers that are not required to have an audit committee under DTR 7.1?

We do not currently foresee any specific issues to arise from the implementation via provisions in PRA rules of the new requirements on audit committees for those banks, building societies and insurers that are not required to have an audit committee under DTR 7.1 other than that they should, as far as possible, be consistent with (amended) DTR7.1.

Q50: For our impact assessment on the changes, we would welcome data on:

(a) the numbers of non-listed PIEs that currently do not have an audit committee?
(b) the cost of recruiting members to be part of an audit committee?
(c) the annual cost of attendance of a member?
(d) the auditor's fees for attending audit committee meetings?
(e) how these costs vary by size of PIE?

We do not have information on the number of non-listed PIEs that do not currently have an audit committee.

We believe that the question of recruitment costs is best directed at companies and recruitment agencies. However, we note that in addition to recruitment fees, companies will also incur internal management and HR costs (and time).

We believe that Non-Executive Director fees at the lower end of the FTSE 250 are around £40,000 with on average approximately an additional £5,000 being paid for membership of the audit committee and £10,000 for audit committee chairmen. Fees for those companies that currently do not have audit committees are likely to be smaller than this, but not significantly less[8].

Auditor fees for attending audit committee meetings will depend on the length and frequency of the meetings and the complexity of the issues addressed rather than the size of the PIE alone.

Section 5.5 - Regulatory reporting and information - Report to supervisors of PIEs

Q51: Do you consider that the single competent authority with responsibility for regulation of audit should be designated to receive the information required to be provided to supervisors of PIEs when it is provided to:

(a) the PRA for banks, building societies and insurers?
(b) the FCA for other PIEs? or
(c) both?

We appreciate and support the reasons for the requirement in Article 12's requiring these three matters to be notified by the auditor to the PRA/ FCA – after all, these are matters that might affect the prudential regulator's actions with respect to the regulated entity. Whilst the information has much less relevance to the FRC, we have no objection to that information being shared with the FRC. However, rather than to duplicate reporting consideration should be given to the PRA / FCA as appropriate making such information available to the FRC.

However, the FRC should be aware of the relatively loose requirements in this regard. Whilst there is the formal statutory duty to report incumbent on auditors, the remainder of the communications between the auditors and the PRA/FCA are in accordance with the FCA Code of Practice for the Relationship between the Auditor and Prudential Regulator[9] and mostly (at least currently) are verbal rather than written communications. This means that the information "required to be provided" is actually quite subjective and simply as described in the FCA Code as "all information relevant to carrying out their respective statutory duties".

Q52: For the purpose of our impact assessment on these changes we should be grateful for any estimates you can provide of:

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[8] Guide to Directors' Remuneration - http://www.kpmg.co.uk/email/11Nov14/OM022711A/PT/index.html#65/z

[9] FG13/3 - Code of Practice for the relationship between the external auditor and the supervisor, FCA July 2013

(a) the costs of the auditor providing this information to supervisors of PIEs?
(b) the frequency with which the PRA is provided with this information for banks building societies and insurers under existing requirements?
(c) the frequency with which the FCA is provided with this information for other PIEs in practice already?

(a) As it stands, none for the written communications given these are already prepared; this may need to be considered further under the potential private reporting regime.

(b) Bilaterals or trilateral frequency for discussions is determined based on the risk of the institution. It should be noted that there are categories of institution (that don't necessarily coincide with the definition of PIE).

For the FCA they are:

- C1 Groups with the largest number of retail customers, and wholesale firms with the most significant market presence. They have a named supervisor and a high level of firm-specific supervision.
- C2 Firms and groups with large retail customer numbers and wholesale firms with a significant market presence. They have a named supervisor and a high level of firm-specific supervision.
- C3 Retail and wholesale firms with a medium-sized customer base. They are supervised with a sector-based approach, with less frequent firm-specific engagement.
- C4 Retail and wholesale firms with a small number of customers. They are supervised with a sector-based approach, with less frequent firm-specific engagement.

For PRA they are:

- P1 firms and groups are those whose failure could cause significant, lasting damage to the marketplace, consumers and client assets, due to their size and market impact.
- P2 firms and groups are those whose failure would have less impact than P1 firms, but would nevertheless damage markets or consumers and client assets.
- P3 firms and groups are those whose failure, even if disorderly, is unlikely to have a significant market impact. They have the lowest intensity of prudential supervision.
- P4 firms are those with special circumstances – for example, firms in administration – for which bespoke arrangements may be necessary

For written communications the frequency of information provided varies significantly depending on the size and complexity of the client.

(c) The FCA prudentially regulate the vast majority (by number) of financial institutions as well as regulate conduct when the prudential risk is low/small institutions. There is very little interaction between FCA and auditor for specific firms when this is the case. For larger

institutions (dual regulated), interaction with the FCA again tends to be lower than interactions with PRA regulated firms and varies depending on the client.

As noted above in (b) the frequency of information provided varies depending on the size and complexity of the client.

Section 5.8 - recognition of statutory auditors from another Member State

Q53: Do you agree that we should enable the single competent authority to exercise the choices of aptitude test and/or adaptation period for the approval in the UK of individual statutory auditors from other Member States? Please provide further information in support of your answer.

As a general principle, all matters of qualification to act as auditor should be dealt with by the professional bodies (see our response to Q12).

That said, we can see that a question of UK-wide principle of test-vs-adaptation might equally sit with the single competent authority. Moreover, given that the issue is not likely to arise in practice – a cross-border audit practice would require all of the Responsible Individuals of the candidate firm to pass a test or a suitable adaptation period – then a departure from that general principle is acceptable anyway.

Q54: Were the single competent authority to have this role, what do you consider would be the implications for the operational provision (currently by the professional supervisory bodies) of:

(a) aptitude tests; and
(b) adaptation periods (if these were to be provided for)?

How do you think this would be affected by CEAOB discussions "with a view to achieving a convergence of the requirements of the adaptation period and the aptitude test" across the EU?

We strongly support the principle of convergence to allow greater mobility within the single market and better serve clients but appreciate this will require significant effort on the part of member states, and reassurance in terms of quality. In the UK context, it makes some sense to have a single aptitude test for other EU auditors and universal adaptation periods.

The benefits of adaptation tests must first be proven as a viable alternative to the current aptitude tests arrangement that will encourage mobility, competition and enhance quality.