Grant Thornton

An instinct for growth™

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Dear Mr Smith

Auditor Regulation
Discussion document on the implications of the EU and wider reforms

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Department for Business, Innovation and Skills (BIS) discussion document 'Auditor Regulation: Discussion document on the implications of the EU and wider reforms'.

We do not support change that could negatively impact on the growth of business in the UK and which could drive businesses outside of the UK to countries where they perceive regulation to be less burdensome, unless it is clearly justified by public interest. We therefore support the implementation of Member State options contained within the Directive and Regulation, only where they are in the public interest, or where they do not result in additional cost and bureaucracy for UK companies compared to their European counterparts. However, we are supportive of changes that would make the audit market more open to competition, as we believe they would be in the public interest.

Wherever possible, we would prefer the implementation of any Member State options to be dealt with by non-legislative action and dealt within the remit of other bodies. Keeping legislative requirements to a minimum also makes it simpler for business to apply the rules, and provides greater flexibility in allowing bodies such as national standard setters to enhance legislation where this is considered to be necessary and in the public interest. As an extension of this, where appropriate and permitted by law, we are also very much in favour of allowing audit committees maximum flexibility to take decisions in the interest of the business and shareholders to whom they are accountable, rather than imposing rules and regulations. Such an approach can be enhanced by additional reporting by audit committees, for example on any decision to purchase non-audit services from the statutory auditor, which would then provide the necessary transparency to enable investors to consider whether the audit committee is acting in the best interests of the business.

We attach separately the detailed answers to the BIS discussion document. The key principles underlying those answers are set out in the following paragraphs.

Supporting the growth of UK business

We support the implementation of the EU Regulation and Directive in the UK, where it does not have a negative impact on the growth of UK business. In this regard, there are various Member State options that have the potential to hinder growth in the UK, if they are taken up directly by BIS, or indirectly as a result of additional requirements imposed by the FRC through Auditing Standards and Ethical Standards.

In this respect, we agree that BIS should not define additional entities as Public Interest Entities (PIEs).

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This is because we believe that companies such as those traded on AIM should have some regulatory advantage over those companies which choose to list on a regulated market. Extending the definition would be costly not only to the entities concerned, but to the UK economy as in the long run it could drive companies outside of the UK, to run their business in markets where they perceive the regulatory burden to be less stringent.

Furthermore, smaller companies listed on markets, such as AIM, often need more support on a range of issues from their advisers. If they were to be defined as PIEs then the enhanced restrictions on the provision of non-audit services, for example, could be unhelpful, give rise to unnecessary costs and therefore hinder growth, without proportionate benefits arising, given the non-systemically significant nature of such entities.

Another area where we would not wish to see more stringent requirements adopted is in relation to the 70% cap on fees for non-audit services. The 70% cap (albeit now mandatory) is arbitrary and we believe conceptually unnecessary in a market where the "threats and safeguards" approach has proved effective, as is evidenced by the continued reduction on non-audit fees. The 70% cap is a blunt regulatory instrument and as far as is possible within the restriction imposed by the law it is an area which should be governed by principles.

If the cap were set at a level lower than the statutory 70% cap, it is more likely that smaller listed companies would have to obtain non-audit services from firms other than their auditor, which our clients and experience tell us might not be the most beneficial choice for the company. Such companies often do not have the time or resources to manage multiple professional relationships and would tend to gravitate to a smaller number of advisers, including their auditor who already has an extensive knowledge of the business. Forcing such companies to engage more service providers with less knowledge of the company's business is likely to increase costs and consume management time. Accordingly, we support any exemptions that could mitigate such problems, placing the emphasis on audit committees to explain their choices to stakeholders, particularly as "audit related" services (as described by the FRC), which are most appropriate for the auditor to carry out, will count towards the cap unless they are actually required by law.

We note from the BIS discussion document that it is proposed that the FRC will address the changes to the rules on non-audit services in their Ethical Standards, and accordingly we have responded in more detail on this point in our response to the FRC consultation document.

More generally there are a number of provisions in the Regulation, which contain additional reporting requirements by the auditor. There seems to be an underlying presumption in the Discussion Document that because most of the matters subject to this additional reporting only reflect what is already done in practice, then there should be minimal extra burden. To some extent this is true but we think it is an over-simplistic presumption. Any additional reporting will only be done after due care and attention and will inevitably involve additional training, procedures and consideration by appropriately senior people, and therefore will likely result in extra costs for companies.

Application of EU regulation should be simple and avoid 'gold-plating'

When implementing the EU Regulation and Directive, we encourage BIS to keep things as simple as possible for UK business and also avoid gold-plating EU regulation, unless there is a strong argument for doing so and where it is clearly in the public interest.

In this context, we have already noted above that we are not in favour of the extension of the definition of a PIE. Also we would not want to see UK gold-plating by the inclusion of additional services on the "black list" of prohibited non-audit services as part of the Member State option. Whilst we understand that there is a need to balance the growth of UK business with investor (and the wider public) perception of auditor independence, our fundamental view is that a responsible audit committee, operating within an appropriate regulatory environment should be capable of managing non-audit services to the satisfaction of investors without the need for an extended list of proscribed services. The role of audit committees should not be undermined by further legislating for matters that should be within their remit.

On small company audit thresholds, in order to reduce complexity in the application of the Accounting Directive and the Audit Directive for UK business, we support aligning the audit exemption threshold to that of the new accounting threshold, based on the same timeframe. This reduces complexity. Furthermore, in the case of smaller companies the distinction between management and ownership is less marked, which means that the statutory audit process is rightly concentrated on larger companies, where there is a greater distinction between those managing the business and investors and greater focus on the value of the independent perspective that is provided by the audit.

Single competent authority and division of responsibilities

As noted above wherever possible, we believe that the implementation of Member State options and any additional rule making should be kept outside of legislation and delegated to other bodies.

In this regard, we note that the Regulation and Directive require that the Government is or must designate a 'Single Competent Authority' (SCA) with ultimate responsibility for all the regulatory tasks provided for in the Directive. Other authorities could also be authorised to carry out tasks but subject to oversight by the SCA.

We agree that from a practical viewpoint, if there is to be delegation to an SCA, then in the UK the FRC is the appropriate body, given its current role and status - there is no obvious alternative.

However, as a result of implementing the EU Regulation, the statutory powers of the FRC would be further widened and could potentially cover direct responsibility for all aspects of audit regulation. To the extent that these statutory powers would have to be given to the SCA under the EU Regulation, we appreciate that this is outside the control of the Government. However, we still encourage that where flexibility is permitted, for example in the case of non-PIEs, responsibility should instead be given to other bodies, such as the existing Recognised Supervisory Bodies (RSBs). In the UK at present, the FRC acts primarily as an oversight body and standard setter, focussing its attention on the minority of audits that could cause systemic risk to the financial markets, with the RSBs undertaking the bulk of the regulatory work. For PIE audits, the FRC already exercises most of the functions envisaged in the Regulation and we think this should continue to be its primary area of focus. Our preference is wherever possible to leverage and adapt the existing UK model rather than to seek a radical restructuring which could cause significant disruption and costs.

We are also concerned that the further concentration of responsibilities in one body is less than optimal from a governance perspective, could risk losing public trust and confidence and place undue pressure on the FRC's resources. Further concentration of responsibilities runs counter to the important principle of maintaining appropriate segregation of duties between the rule-maker, the regulator and the sanctioning body. Segregation of these duties provides opportunity for independence of action and room for challenge. Furthermore, if there is concentration of responsibility in one regulator and if for any reason in the future that regulator is discredited in any way then the scope for turning to another appropriate body to help maintain the credibility of the UK market would be limited.

Other consultations

We have also responded to the parallel FRC consultation document, Auditing and Ethical Standards: Implementation of the EU Audit Directive and Audit Regulation. This document asks for views on a range of reforms to enhance confidence and strengthen the audit regime; there is of course some overlap with the issues dealt with in the BIS document. In line with the overall positioning we take in responding to this discussion document, in responding to the FRC consultation we have stated that wherever possible our preference is for the implementation of EU Member State options to be on a non-legislative basis so as to allow for greater flexibility and simplicity in their implementation.

If you have any questions on our response, or wish us to amplify our comments, in the first instance please contact Andrew Vials (tel: 020 7728 3199, email: andrew.vials@uk.gt.com) or Mary Starr (tel: 020 7728 2063, email: mary.m.starr@uk.gt.com).

Yours sincerely

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Department for Business Innovation & Skills

AUDIT REGULATION

Discussion document on the implications of the EU and wider reforms – Response Form

DECEMBER 2014

Regulation on the Specific Requirements Regarding Statutory Audit of Public Interest Entities and Directive amending Requirements on Statutory Audits of Annual Accounts and Consolidated Accounts

Discussion document response form

The Department may, in accordance with the Code of Practice on Access to Government Information, make available, on public request, individual responses.

The closing date for responses is 19 March 2015

Name:
Organisation (if applicable):
Address:

The form can be submitted by email or by letter to:
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Please tick a box from the list below that best describes you as a respondent.

	Business representative organisation/trade body
	Non-government standard setting/regulatory body
	Charity or social enterprise
	Individual
x	Large business (over 250 staff)
	Legal representative
	Local Government
	Medium business (50 to 250 staff)
	Micro business (up to 9 staff)
	Small business (10 to 49 staff)
	Trade union or staff association
	Other (please describe)

Chapter 4

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.

As noted in our covering letter, to the extent permitted, we favour non-legislative implementation as this is likely to provide a framework for efficient and timely updating of requirements if/when circumstances change and flexibility to add UK-specific guidance.

To the extent that implementation is non-legislative then it is important it should be done in a way that is consistent with the overall direction set by legislation.

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 the discussion 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.

Wherever possible we prefer that any Member State options are introduced in a non-legislative fashion. However, when taking up options, the potential impact on the growth of UK business should be taken into account. Such options should be used to facilitate the implementation of appropriately practical and flexible approaches to be adopted or maintained. They should not be used to gold-plate EU regulation unless there is a very clear justification. Wherever possible consistency between regulation in the UK and that of other EU Member States should be maintained.

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?

The discussion on the single competent authority in chapter 4.2 concerns the merits or otherwise of designating just one authority as responsible for all aspects of audit regulation, albeit with power of delegation. The debate appears to focus very much on the efficiency and simplicity aspects of such an arrangement. There are also wider governance and public interest issues that should feature in this debate, which we think should be a key part of BIS's deliberations. We discuss this further in our detailed responses to the questions in chapter 4.2.

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?

The main impact of the changes will fall on PIEs and the auditors of PIEs. The new requirements will undoubtedly add to costs and this is likely to be felt most by small PIEs with limited

resources and by any audit firm auditing a small number of PIEs. The Regulation leaves limited room for any mitigation here but, wherever possible when implementing the legislation in the UK, for example when considering Member State options or the possible UK extension to the requirements, this issue needs to be borne in mind.

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?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

The EU requirements have been finalised after considerable debate and consideration of the public interest in the EU.

We agree that BIS should not define additional entities as PIEs. To do so would put such entities at a disadvantage (compared to their counterparts in other Member States) in terms of having to apply more stringent regulations. This would be costly not only to the entities concerned but to the UK economy as in the long run it could drive companies out of the UK to run their business in markets where they perceive the regulatory burden to be less stringent.

Furthermore, we are not aware there is evidence to suggest that there is a need for more companies to be defined as PIEs. In our view it is accepted that companies such as those traded on AIM should have some regulatory advantage over those companies which choose to list on a regulated market, and importantly investors accept this.

We also note that if the definition of a PIE is not extended, the Single Competent Authority in the Member State would, subject to appropriate consultation, be able to enhance its rules in specific areas in a non-legislative way, for entities that are not PIEs but where further oversight or regulation is considered appropriate.

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 implications for PIEs and their auditors in terms of the choice of auditor and the choice of provider of non-audit services. The EU clearly believes that any impact for PIEs is counterbalanced by enhanced stakeholder confidence in the independence of the auditor. As noted in our responses to the FRC consultation, we are not in favour of any move to widen the impact of the reforms beyond the scope of the measures determined by the EU to be necessary.

There will be additional costs, not only in monetary terms but also in terms of training and education, to be incurred by some institutions such as unlisted banks and insurance companies which do not currently have an audit committee and for audit firms auditing a PIE for the first time. Furthermore, whilst many of the enhanced requirements for both the audit committee and the auditor are already part of the regulatory framework in the UK, the EU legislation requires

more formal, extensive and additional reporting as part of its framework . This will add to the cost of compliance with regulation.

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?

We do not anticipate the need to broaden the application of the 2006 directive to the above entities, which now require an audit under EU law, would give rise to significant issues as the majority are already incorporated as companies, LLPs, open-ended investment companies, unit trusts or qualifying partnerships.

The discussion document notes that further amendments will also be needed in legislation applying to each of the above entities. As part of this BIS will need to consider how the new framework applies to any sole traders and general partnerships that undertake any of the above activities, eg MiFiD investment firms.

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?

This will depend on how many variations are made in UK implementation from the core requirements of the Directive and Regulation. Therefore we cannot give a definitive answer.

For any firm auditing PIEs for the first time the costs of introducing new procedures, training, the reporting requirements and the increased interface with a new regulator are likely to be significant and may be a disincentive to enter that market. For a firm which already audits PIEs the costs will be less significant but nevertheless the increased reporting requirements and the need to monitor carefully the new restrictions on non-audit services and the fee cap will lead to increased costs.

In this context it is important to note that these additional costs are likely to flow through, at least in part, to the business being audited. Some will regard this as an unnecessary and disproportionate cost.

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

This will depend on how many variations are made in UK implementation from the core requirements of the Directive and Regulation. Therefore we cannot give a definitive answer.

Given the extended list of prohibited non-audit services and the introduction of a cap on the level of permitted non-audit services, a key operational change will be in relation to the collection and recording of non-audit fees provided to each PIE audit client and, depending on how the Directive and Regulation is implemented in the UK, liaison with other members of the audit firm's network and (possibly) other firms that are involved in a group audit. The costs of doing this could be quite significant; the impact will depend on the size and complexity of an individual client group and the number and identity of component auditors.

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

For firms auditing PIEs for the first time costs are likely be considerable. More generally, total training time will be proportionate to the number of partners and staff who deal with PIEs.

Costs of oversight of non-audit services and fees will depend on the complexity of the group structure of each individual PIE and its geographical spread, rather than the size of the audit firm.

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?[1]

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

We agree that from a practical viewpoint, given its current role and status, if there is to be delegation to an SCA then in the UK the FRC is the appropriate body - there is no obvious alternative.

Vesting all responsibility in one body, subject to its ability to delegate where appropriate, has the merits of simplicity. However, as a result of implementing the EU Regulation the statutory powers of the FRC would be further widened and could potentially cover direct responsibility for all of the setting of auditing and ethical standards, audit inspections, investigations and discipline, the approval of individuals and firms as eligible for appointment as statutory auditors and continuing professional development. To the extent that these statutory powers would have to be given to the SCA under the EU Regulation, we appreciate that this is outside the control of Member States.

However, we would still encourage that, where flexibility is permitted, particularly in the case of

[1] In answering this question, it may help in particular to consider the tasks of audit inspection, investigations and discipline, auditor approval and continuing professional development and the setting of technical and ethical standards for statutory audits and auditors.

non-PIEs, direct responsibility should be given to other bodies, such as the existing Recognised Supervisory Bodies (RSBs) and that the FRC's role is one of one oversight - consistent with Article 32(1) of the Directive. This is essentially what we have in the UK at the moment. The FRC acts primarily as an oversight body and standard setter, focussing its attention on the minority of audits that could cause systemic risk, with the RSBs undertaking the bulk of the regulatory work. For PIE audits the FRC already exercises most of the functions envisaged in the Regulation and we think this should continue to be its primary area of focus. Accordingly, our preference is wherever possible to leverage and adapt the existing UK model rather than to effect a radical restructuring.

Although under the EU legislation there are options for the SCA to delegate responsibility to other bodies, the retention of responsibility, albeit through delegation, is different from an oversight role and we are concerned that the concentration of responsibilities in one body is less than optimal from a governance perspective and could risk losing public trust and confidence.

Such concentration also runs counter to the principle of maintaining segregation of responsibility for rule making, regulating and sanctioning. Segregation of these duties provides opportunity for independence of action and room for challenge. In this respect one might argue there is already the potential for conflict of interest and self-review threat within the FRC as a result of its various functions – for example it is possible that it might pursue regulatory action against an audit firm or a company in respect of matters that were previously subject to review by the Audit Quality or Corporate Review team without any undue adverse comment at the time. Adding to its responsibilities would only exacerbate this situation.

Furthermore, if there is concentration of responsibility in one regulator and if in the future that regulator is discredited in any way then the scope for turning to another appropriate body to help maintain the credibility of the UK market would be limited.

The concentration of additional responsibilities under the FRC could put undue pressure on its resources, result in it being unable to act on a timely basis and potentially having to concentrate on the larger company audits at the expense of medium and smaller-sized company audits. Additional funding is also likely to be necessary. If other bodies (such as the RSBs) are given responsibility for certain functions, this would allow the FRC to focus on its oversight responsibilities and allow the professional accountancy bodies to retain primary responsibility for regulating the vast majority of audits and auditors. We also believe the changes to the current UK framework for audit regulation that will be brought about by implementation of the EU Regulation and Directive, whichever of the above options is chosen, also provide a good opportunity to set out clearly the respective roles of the FRC, FCA and PRA and how they interact with each other. All three bodies have to date had an interest in this area and we presume this will continue to be the case. However, we are unsure how, and to what extent if any, the designation of a single competent authority impacts the current situation. A clear exposition would be helpful.

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?

Inevitably there will be some changes to the statutory framework for audit regulation as a result

of the new legislation. However, we do not believe a fundamental overhaul of the current regime is required, particularly as it relates to non-PIEs. We favour an approach going forward that, to the extent permitted by the Directive and Regulation, maintains a credible role for the professional bodies in relation to members who do not carry out major audits, whether that be by direct retention of the responsibilities, or by delegation, where this is the only possible course of action under the legislation, such that the SCA's primary role is one of oversight.

This is further explained in our response to question 9 above.

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?

The public debate in recent years has very much focussed on the audit and the role of the auditor. There are many other activities undertaken by accountants and we are not sure there is any clear link between this current audit reform initiative and those other activities. Clearly firms who provide a variety of services already have in place processes for monitoring the way in which the audit regulatory regime impacts those other services.

Specifically, to the extent that ethical standards regarding audit matters are amended as a result of this reform then consideration would need to be given to see if this has any implications for the wider body of ethical standards.

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?

☐ Yes ☒ No ☐ Not sure ☐ Not applicable

We favour an approach going forward that, to the extent permitted by the Directive and Regulation, maintains a credible role for the professional bodies in relation to members who do not carry out major audits. We would therefore prefer it if the professional bodies could retain direct responsibility and authority for functions that are not required to be carried out by the SCA, particularly in relation to non-PIEs.

This is further explained in our response to question 9 above.

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 agree that appropriate criteria would need to be established for retention of or reclamation

of delegated responsibility so there is clarity as to the powers of the SCA and the circumstances in which they can be exercised. As a general principle this should only be the case in respect of PIEs and other matters where there is a public interest angle or perhaps, for example, where there is a dispute as to due process between the RSB and auditor.

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 have not identified any such issues to date.

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[2]?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

If so, which body or bodies do you think should have statutory powers for the removal of statutory auditors from the register?

The RSBs as is currently the case unless it relates to a PIE. We are not convinced that the FRC needs to get involved across the board on this matter.

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?

☐ Yes ☒ No ☐ Not sure ☐ Not applicable

We do not think that specific approval per se goes hand in hand with the oversight role as discussed above and we think that such approval is unnecessary in a UK context. There is already a well-established UK regulatory regime, although obviously in its oversight role if, in the unlikely event the FRC objected to some of the rules of those supervisory bodies because they were inconsistent with the Regulation or Directive, there should be a course of action open to it, after appropriate dialogue and consultation, to ensure that appropriate changes are made.

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?

[2] The Statutory Auditors (Registration) Instrument 2008 currently applies for this purpose, having been made by the FRC using powers in section 1239 of the Companies Act, which are delegated to it.

As is noted in our response to question 9, broadly we favour leveraging and adapting the existing UK model rather than making wholesale change. That would certainly minimise the costs of any changes. If there were to be wholesale changes such that all responsibility for audit regulation was vested in the FRC then we think the one-off costs and disruption from moving to that regime could be significant. It could potentially have a significant impact on the role of the RSBs, and the way in which audit firms interact with their regulator. Furthermore, we are concerned that the additional responsibilities could put pressure on the FRC's resources (with the possible consequences that we noted in our response to Q9).

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?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

Yes, so that all of the ethical requirements applicable to auditors are in one place and any future updates will go through the FRC's due process.

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?

The impact will depend on whether the basis for applying the cap is changed from that set out in the Regulation.

In this regard, we do not wish to see the level or application of the cap made more restrictive. In our view, the introduction of an arbitrary cap (albeit now mandatory) is conceptually unnecessary and a responsible audit committee and audit firm, operating within an appropriate regulatory environment should be capable of monitoring this area to the satisfaction of investors without the need for a specific cap. We firmly believe that the onus for monitoring the nature and scope of non-audit fees should be on the audit committee, with accountability to shareholders via appropriate dialogue and explanation of the policy and approach adopted.

Accordingly, we favour a "minimalist" approach to the introduction of the cap, ie to implement it as is required by the EU legislation but not to extend it in any way. We are in favour of exemptions that could mitigate problems, particularly as "audit related " services (as described by the FRC in its consultation document) are most appropriate for the auditor to carry out, but will count towards capped fees, unless they are actually required by law.

As noted above non-audit services that are required by legislation are exempted from the cap. We also think that services required by regulation, for example a public report by a reporting accountant for the purposes of a prospectus, should also be exempt and in this respect clarity regarding the exact scope of the exemption would be welcome. More generally we urge BIS/the FRC to give consideration as to what might come within the scope of an exemption and whether it is possible to adopt a broad interpretation such that services closely related to the audit or other services required by legislation (eg private comfort work in relation to the public reporting work for a prospectus), can be excluded from the cap.

Furthermore, we note in our response to the FRC consultation that any extension to the 70%

cap to include non-audit services provided by network firms would add further administrative burden and, in a cross- border environment where different rules might apply in different jurisdictions, will only compound the difficulties that will ensue following the introduction of the cap. In any case network auditors already have to abide by the current IFAC ethical standards. Against this backdrop appropriate monitoring by both the audit committee and the parent auditor should prove sufficient protection to an independence threat without the need for an undue costly process.

Furthermore, the calculation of the fees that are capped as currently set out contains a number of potential anomalies where clarification is required. For example:

- there is some ambiguity in terms of how non-audit service fees are to be calculated - are they to be based on when the work was performed, when billed or when settled by the audited entity receiving the non-audit service?

- on the basis set out in the Audit Regulation, the cap would not have effect until non-audit services had been supplied to a PIE for three consecutive years. The clock would be "reset" if non-audit services that fall within the scope of the cap are not provided for a period of one year. As a result, a firm could provide permitted non-audit services for six years out of a period of seven years without limit. Although we are not in favour of the cap, given that it has to be introduced in the UK, this seems to run somewhat contrary to the objective behind it.

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?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

Wherever possible we believe the rule making on this subject should be delegated to the FRC rather than dealt with by BIS.

Currently the ethical standards in the UK are more stringent than those contained in the EU legislation. As a matter of general principle we do not favour gold-plating but in this case we have no strong views as to whether the existing thresholds should be maintained if they are considered to be working well. However, the inclusion in the definition of PIE of unlisted banks and insurers might have some impact and need further consideration.

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 ☐ No ☐ Not sure ☐ Not applicable

We agree that the FRC should be able to grant exemptions from the cap in situations where it is in the interests of the company and its investors that it procures or continues to procure a particular non-audit service from its auditor. However, the fact that an exemption had been granted, together with the reasons for granting the exemption, would need to be disclosed in

the annual report of the company in the interests of transparency and to avoid any negative perception in the market.

We are in favour of exemptions that could mitigate problems, particularly as "audit related " services (as described by the FRC) are most appropriate for the auditor to carry out, but will count towards the cap unless they are actually required by law. In particular this could be a problem for companies with a relatively small audit fee but which have undertaken major transactions or have a major project in hand which lend themselves to the provision of such services by the auditor.

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?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

Yes, so that all of the ethical requirements applicable to auditors are in one place and so that any future updates will go through the FRC's due process.

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 black listed services include services that have not been restricted by the APB ESs in the past or have not been prohibited if the result of the service was immaterial to the audited financial statements. Even if the UK takes full advantage of the member state option to permit certain services to be provided where they would have an immaterial or indirect effect on the financial statements, the introduction of this black list is likely to have a significant impact, particularly on smaller businesses with more limited resources. Of particular significance are (a), (h), (i) and (k) that would currently be subject to the APB's "threats and safeguards" approach.

Furthermore, as is evidenced by recent trends, the attraction of an increase in the provision by firms of non-audit services to non-audit clients that will result from these new prohibitions may act as a disincentive to tender for particular audits.

It is difficult to see how these issues can be "addressed" given that this prohibited list is a mandatory provision of the EU requirements, other than to retain the maximum derogation possible and not to add further to the list of proscribed services. In this respect, as we note in our response to the FRC consultation, adding additional non-audit services to those prohibited by the Audit Regulation could potentially be damaging to business in the UK, particularly where the UK requirements are not aligned to the rest of Europe. This would not be in the public interest. The law should be kept as simple and as cost effective as possible. We consider that it should be left to the audit committee to monitor such discretionary purchase of non-audit services.

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.

We agree. We believe that it is important that all of the ethical requirements applicable to auditors are in one place and so that any future updates will go through the FRC's due process.

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?

☐ Yes ☐ No ☒ Not sure ☐ Not applicable

We have no strong views on this matter. Large companies in the UK already have to provide a breakdown of audit and non-audit fees. We understand the Regulation requires a split of non-audit services earned by the statutory auditor between those that are and are not required by legislation. The addition of this overlay does not seem onerous.

However, the existing disclosure requirements include fees paid to network firms and so consideration would need to be given as how best to align the requirements in the regard. As regards disclosure of non-audit fees more generally then please see our response to Q31.

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?

This will of course vary from client to client and from firm to firm. Various reports on the level of non-audit fees have been published in the past. Across the board, however, we estimate that for this firm non-audit fees for the PIE population amount to approximately 40% of audit fees.

(b) the additional costs associated with reallocating some of the non-audit services that would otherwise have been provided by the same statutory auditor?

Companies will be best placed to answer this question.

(c) the extent to which these additional costs vary by the size of PIEs?

Even if the UK takes full advantage of the Member State option to permit certain services to be provided where they would have an immaterial or indirect effect on the financial statements, the introduction of this blacklist is likely to have a particularly significant impact on smaller companies. Of particular significance are (a), (h), (i) and (k) that would currently be subject to the "threats and safeguards" approach in the UK .

Such companies often do not have the time or resources to manage multiple professional relationships and would tend to gravitate to a smaller number of advisers, including their auditor who already has an extensive knowledge of the business. If such companies have to engage more firms with less knowledge of the company's business is likely to increase costs.

(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?

For an audit firm of any size the cost of training and embedding processes around the new restrictions could be quite substantial.

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?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

As a matter of practice the situations to which the first two alternatives apply do not preclude the involvement of the company's audit committee and we would indeed expect this to be the case. The third alternative is a useful "catch-all" and provides for unforeseen circumstances. We see no reason to delete these helpful alternatives from UK legislation.

Are there any other systems that should also be provided for on the grounds that a competitive tender process is not appropriate?

On the basis that it is impossible to envisage every situation that might arise and that we are moving to an audit firm rotational regime for the first time, there may be exceptional circumstances in which it is inappropriate or impossible to carry out a competitive tender process as envisaged by the legislation, for example when unforeseen or difficult conflict issues might

arise. We believe that it would be appropriate for the regulatory framework in the UK to cater for this rare eventuality. Clearly the FRC as the designated authority would be involved in any such situation but it might be appropriate to consider if the third of the above legislative alternatives might be able to deal with this situation.

If such an eventuality arose in practice and an exemption granted then there should be appropriate disclosure in the annual report .

Q28. 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?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

Yes. In the absence of another governance body that fulfils the role of an audit committee, the relevant responsibilities and duties should be exercised by the entire board.

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?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

We agree that there should be no variation for the appointment of joint auditors.

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 ☐ No ☐ Not sure ☐ Not applicable

Yes we agree. The new regulations around audit firm rotation are a significant step change from the current arrangements and have been the subject of much consultation and deliberation. Within the parameters of this new framework we believe that audit committees should be given flexibility to reconsider and revise plans and adapt to any change in circumstances where necessary. It would seem rather odd if the extension to a 20 year term could only take place if there was a tender at year 10.

See also our response to Q31 below

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 ☐ Not sure ☐ Not applicable

b) when the audit engagement was last retendered?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

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 ☒ Not sure ☐ Not applicable

d) the directors' reasons for considering that the proposed year is in the best interests of the company's members?

☐ Yes ☐ No ☒ Not sure ☐ Not applicable

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

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

The discussion document refers to a "new element of the annual report". We are unsure precisely what this means and in view of the initiative to keep annual reports as simple and as concise as possible we believe that such disclosure, if provided, could be part of the audit committee report, or possibly on the company's website rather than as a separate standalone section of the report.

We support disclosure and transparency over the term of the existing audit appointment and a company's approach to the audit tender and audit firm selection to the extent it adds value. However, care should be taken to avoid imposing disclosure for the sake of it as this will just become boilerplate language. More specific comments in this regard follow.

Whilst we agree that it may be appropriate (and become best practice) to give indications as to when a company next expects to put the audit out to tender and to specify a particular year and maybe the reasons for it, we think that to mandate the disclosure of one particular year is unnecessarily bureaucratic and, if binding on the company, could cause a number of problems if there is a change in circumstance which warrants reconsideration of the tendering time line. As noted above, within the parameters of the new framework, we believe that audit committees should be given flexibility to reconsider and revise plans and adapt to any change in

circumstances as and when necessary.

We are not convinced of the merits of the disclosure contemplated at d above as there is a real risk that this could just result in standard boilerplate language.

As regard the disclosure at a above we presume this relates to the audit firm rather than the engagement leader.

More generally on disclosure, we believe that the following more broad-based disclosures should also be considered;

- The company's policy for using a range of accounting firms; and details of how they get to know and use accounting firms which are not among the most dominant firms;

- The company's policy for using its auditor for undertaking non-audit services and use of firms other than the auditor; and

- The company's approach and policy for ensuring that sufficient engagement/dialogue is had with the company's shareholders in the above areas.

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?

☐ (a) ☐ (b) ☐ (c) ☐ No preference ☒ Not applicable

We are not clear what status or authority would be attributed to a provision for when "the next tender process should be expected to take effect".

In any case we do not believe that a decision to apply tendering before the maximum period of 10 years should irrevocably commit a company to that frequency of tendering. In line with our responses to Q30 and Q31 above we favour the retention by the audit committee of maximum flexibility. The imposition of "expectations" seems unnecessary as long as a tender is carried out at least every 10 years and as long as the total appointment period does not exceed 20 years. This is the core principle and to create additional complex rules is unnecessary. Of the options noted above option (c) has merit in that it provides the audit committee with discretion and flexibility to make an informed decision about the appropriate timing of the next tender exercise. However, to the greatest extent possible any over-engineering of this framework should be

avoided.

More generally, there is certainly a need for greater clarity around a number of the transitional rules for audit firm rotation and we welcome the supplementary information issued by BIS earlier this month. In this respect, we found the answers given to Q10 and Q13 quite difficult to follow and believe that greater clarity could be provided if simple examples were provided. In addition, we think that the extent to which the provisions of Articles 41(1), 41(2) and 41(3) relate to each other, take priority over another and are mutually exclusive, or otherwise, could be made clearer, again with simple examples.

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 should they be addressed?

The achievement of the objectives of the EU requirements in terms of stakeholder confidence as to auditor independence and the credibility of the UK implementation of these requirements will be undermined if there is no appropriate enforcement mechanism. We suggest that there needs to be a channel for an auditor to report to the regulator a situation in which a client has not taken necessary steps to comply with the regulations (for example to retender the audit) so that an appropriate way forward can be determined, including whether in considering its own ability to act the auditor needs to consider resigning from the audit.

As regards sanctions more generally, then the overriding principle is that they must be proportionate. To declare an audit invalid is a draconian step and would result in significant costs and have major consequences for the company and its stakeholders. An inadvertent breach of the tendering or rotation rules, whilst unlikely, should not invalidate an audit opinion.

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?

Whilst we are unable to give specific figures in relation to estimates of costs and resources, we can make some general observations.

The most significant additional costs are likely to fall on the audit firm in familiarising itself with a new company, but under current practice almost all audit firms will absorb the cost and will not pass it on to the audited entity - the more tendering activity that takes place the more such costs become the cost of business as usual.

Whilst companies are likely to be best placed to comment on the time and costs that they are

likely to spend and incur as a result of audit retendering and rotation, in our view the time spent by companies would be significantly less than the auditor would have to spend on familiarising itself with the company – management will already understand their business and it will be the auditor that has to make the significant investment. The amount of that investment will depend both on the complexity of the PIE as well as the size of the PIE .

In our experience evidence that is available on tender costs indicates that for many companies they are not as a general rule significant in the context of the market caps concerned. However, for smaller companies the cost will be proportionately more.

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?

We do not believe that there are any significant issues arising from including this requirement in legislation as this is already well established practice in the UK. ISA (UK and Ireland) 570 already requires such a statement in the form of an emphasis of matter immediately following the opinion, where such conditions exist.

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.

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

We agree that the provisions of Article 10 (covering the risks, response and key observations by auditors in audit reports) should be included in the FRC's ISAs (UK and Ireland) so that all of the reporting requirements applicable to auditors are in one place and so that any future updates will go through the FRC's due process.

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?

☐ Yes ☐ No ☐ Not sure ☐ Not applicable

The regulation requires reporting of a number of matters not previously covered by the audit report.

In respect of the more substantive additional requirements, we do not consider that there will be any issues arising from the inclusion of a description of the most significant assessed risks of material misstatement and a summary of the auditor's response to those risks, as many statutory auditors will be familiar with these matters from their experience of reporting on entities

that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code.

However, there may be issues arising from the requirement to include a description of the "key observations arising" with respect to those risks, as this new requirement (which is consistent with the IAASB's recently revised ISA 701) will be less familiar or unfamiliar to most statutory auditors. Further guidance from the FRC is likely to be required, particularly if "observations" is equivalent to "findings". In this respect to date findings have only been reported in very few audit reports.

Where a PIE has not previously been subject to such reporting, making that report will lead to significant costs which may be passed on to the PIE. In our experience the new form of audit reporting, whilst it is to be welcomed, adds significantly to the audit costs. A further extension of the requirement to include key observations will only add to this.

Furthermore, regarding the requirement to "explain to what extent the statutory audit was considered capable of detecting irregularities, including fraud," we note that all audits carried out under ISAs adopt the same approach to this issue and so BIS should be aware there may be little variation in the reporting of this consideration.

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)?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

We have no strong views as to the inclusion of the provisions of Article 11 ('Additional report to the audit committee') in the FRC's ISAs (UK and Ireland). This would have the benefit that all of the reporting requirements applicable to auditors are in one place and so that any future updates will go through the FRC's due process.

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 requirements in Article11 are extensive and add greater formality to reporting by the auditor to the audit committee. Whilst some of them only reflect formal documentation of issues already considered in the audit, a number of the requirements are new and will be unfamiliar to statutory auditors. In view of the cost, both to the auditor and the company, of producing and processing this information, it is important that the requirements can be interpreted sufficiently flexibly to allow value to be added from the company's perspective.

Of particular note is the requirement to describe the methodology used in respect of all balance sheet categories. This is potentially onerous and the benefits are not clear – application guidance as to how to address this adequately but effectively should be included. In doing so the way in which, and the extent to which, such descriptions might relate to the increased transparency around materiality in the audit report and other recent advances in enhanced audit

reporting need to be considered. Furthermore, the use of the words "verified based on system and compliance testing" is flawed in two key areas. First, the use of the word "verify" implies 100% accuracy and could create expectation gaps and have unintended legal consequences - an audit does not "verify" anything. Second, it implies that assets and liabilities can be neatly segregated into those which have been tested substantively and those where solely compliance testing has been used. This is over-simplification and in most cases both substantive and compliance testing will be used. The merits of such reporting are therefore questionable.

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?

The additional resources needed will be mainly time requirements in providing guidance, updating methodology and software tools, training, and then in the preparation and review of the report. In this respect we think that there will be a base cost for production and submission of the report to the audit committee and for considering their responses. That base cost will then increase depending on the complexity of the PIE and the issues arising.

The consultation document notes that many of the specific requirements in Article 11 are new but that *none should require additional audit work and none individually is expected to have a significant impact on the audit*. Given the profile of audit committee reporting, the understandable reaction of auditors to the new requirements will be to perform more work rather than less and this will involve more senior time and proportionately higher costs .

(b) the additional annual cost of the audit committee considering the additional report?

Additional costs will be incurred by the audit committee in discussing the format and content of the new report and responding thereto. The amount of time spent doing this will depend on the complexity of the issues that have arisen. In this respect, audit committees will need to take care that they remain focussed on the key issues and not get lost in the detail of such a report.

(c) how these costs vary by size of PIE?

The costs are likely to be higher for larger PIEs but will also depend on the complexity of the PIE and the issues arising. For smaller PIEs, the costs will be proportionately higher (as will the costs for audit firms who do not audit many PIEs).

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)?

☒ (a) ☐ (b) ☐ (c) ☐ No preference ☐ Not applicable

Aligning the change in the auditing threshold to that of the new accounting threshold based on the same timeframe would reduce complexity for smaller companies. Where regulatory requirements for companies are reduced, this allows companies to invest their time and resources in growing their business and that is a positive step which we support.

In our response to the Accounting Directive, one of our observations was that, whilst raising the audit exemption threshold may result in the cost of an audit being saved for a large number of companies, this may be outweighed by the potential costs associated with an audit not being undertaken: for example access to external finance may be more limited or become more costly for companies that cannot provide audited accounts.

However, we appreciate that this is a business decision that those running a company have to take. There is of course the option for companies to have an audit on a voluntary basis. However, this could become an inefficient process if, for example, an audit was required in a particular year by potential investors or fund providers, but not in the next or subsequent years. We appreciate that this will form part of the discussions that companies will probably have with their advisers when deciding whether or not to take advantage of the rise in the audit exemption threshold or to continue with an audit.

We note that in a group situation the audit exemption regime remains tighter than for a small company that is not part of a group. This is because, whilst a subsidiary which belongs to a group can be small for accounting purposes, for audit exemption purposes the entire worldwide group of which the subsidiary is a member must be "small". This is an important safeguard that should be maintained, as not doing so could increase creditors' exposure as only the accounts of the group and the parent would be audited fully and subsidiaries only audited as components of the group, and thus possibly to a much higher materiality threshold. In addition, subsidiaries do not need to have an audit as the parent could give a guarantee and, if they took that route, creditor protection would be maintained. If there were any proposals to change the existing provision in respect of group situations they should be the subject of further consultation.

Chapter 5

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?

The principal issues that arise from the measures considered in this chapter are set out in our covering letter and in our responses to the detailed questions. We also have the following comments:

In chapter 5.10, views are sought on the first two member state options (i) and (ii) arising from

Articles 30(2) and 30a(3) regarding sanctions.

In respect of item (i), we agree that it is sensible to include infringements that are already subject to criminal law within the scope of administrative sanctions. The criminal law will sit elsewhere on the statute book and its provisions may not be immediately obvious when considering infringements under the new rules. Also, should the criminal law be revised or become inoperative for any reason, this would leave the SCA without the rules that it is required to have by Article 30.

In respect of item (ii), if it is deemed necessary for other authorities or other authorised to apply additional sanctions then this should be dealt by non-legislative action.

Q43. For the purpose of our impact assessment, we would welcome any information you can provide on the expected costs and benefits of the measures considered in this chapter, particularly any estimates of costs or benefits that you consider it would be possible to quantify?

There are a number of changes for audit firms arising from Chapter 5 such as additions to auditing standards, attendance at audit committee meetings for audited entities that will be required to have an audit committee for the first time, new regulatory reporting to supervisors of PIEs, changes to the inspection regime and changes to the investigation and sanctions regime. As a result there will be costs for firms arising from training significant staff members (of the order of 1,500 audit professionals in our case) and the knowledge sharing consequences across the firm of these changes. There is a risk that the extent of these changes may act as a disincentive for smaller firms to operate in this market.

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)?

☒ Yes ☐ No ☐ Not sure ☐ Not applicable

We agree that the implementation of these requirements should be made through changes to ISAs (UK and Ireland) so that all relevant requirements remain in one place and future changes will go through the "due process" of the FRC.

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?

We do not have any such estimate. As a general comment if the definition of PIE is not extended in the UK then we think that it will only be in extremely rare cases where the quality control review will have to be undertaken by an individual from outside the audit firm. Where this was necessary then the implications for audit rotation and any consequential ethical matters need to

be considered.

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?

As regards influencing the Commission then as a matter of general policy we favour alignment of auditing standards between the UK and the rest of Europe to the greatest extent possible and therefore we think that UK representatives should ensure that there is consistency between ISAs (UK and Ireland) and the ISAs adopted in the EU, such that the impact of any adoption in the UK is kept to a minimum. Importantly, whilst we acknowledge the endorsement mechanism in the EU, we think every effort should be made to avoid "carve outs" from the international standards, which undergo a rigorous consultation process prior to issue. In addition, UK representatives will need to be aware of the extent to which any ISAs do not conform with UK legal and regulatory requirements and raise any concerns with the EC.

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 ☐ Not sure ☐ Not applicable

Notwithstanding our desire for maximum cross border consistency, if there are clear gaps in professional standards then it is sensible to allow UK-produced standards to continue to be able to be applied. The addition of a completely new standalone standard is a big step and the need for it would require very clear justification. Furthermore, its continued existence would need to be reviewed from time to time.

(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 ☐ Not sure ☐ Not applicable

The UK-specific context needs to be capable of being reflected in ISAs for application in the UK. However, any power to impose additional requirements should be exercised with caution and as far as possible cross-border consistency should be maintained. ISAs issued by the IAASB undergo a thorough review and consultation process and therefore should be generally fit for purpose.

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 agree that DTR 7.1 'Audit committees' is the appropriate place to include the new requirements. Further Guidance from the FRC is also likely to be required.

Most of the changes are aimed at making the audit committee more independent. There will be additional costs to be incurred as a result of the new provisions but the impact in the UK is unlikely to be that significant for listed companies that already have an audit committee. Independence is already an important part of the audit committee framework, for example the UK Corporate Governance Code requires the board to establish an audit committee of at least three independent non-executive directors.

Of the other changes, the requirement for audit committee members as a whole to have competence in the sector is potentially the most problematic. The current requirement in the UK Corporate Governance Code is for recent and relevant financial experience. "Competency in the sector" is open to interpretation and could cause real practical difficulties. In this respect, there is a strong argument that a broad range of experience rather than concentrated expertise in one sector is an equally valid model. At the very least further guidance on this area would be required.

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 agree that the logical place for the new requirements for bank, building societies and insurers is the PRA rules as this is the primary source of reference for such institutions. To the extent that any banks, building societies or insurers do not currently have audit committees then, even in a heavily regulated environment, it is likely there will be significant costs in implementing the requirements and a steep learning curve in building up the necessary expertise. In particular the need to appoint a new body of independent members could be very costly and if there is strong support to take the specific derogation from these provisions envisaged in the legislation (for those entities not listed on a regulated market and with listed debt below Euro100m), or perhaps more broadly via the PRA using any discretion available to it, we would support this.

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?

We do not have precise data. However, in our experience unlisted banks already have an audit committee but this is less likely to be the case for unlisted insurers.

(b) the cost of recruiting members to be part of an audit committee?

PIE companies would be best placed to provide this information.

(c) the annual cost of attendance of a member?

PIE companies would be best placed to provide this information.

(d) the auditor's fees for attending audit committee meetings?

The cost of attending an audit committee is of course only one element of the work that relates to communicating with those charged with governance. There is much preparatory work in collating findings and drafting reports etc. In total the costs of such work can be very significant. As for attendance itself this will of course depend on the length of the meeting but if we assume say a meeting lasts somewhere between 3 to 7 hours then cost estimates would range from say £3000 to £7000. Such costs are of course not feed separately but are taken account of in setting the overall audit fee.

(e) how these costs vary by size of PIE?

See response to 50d above

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?

☐ (a) ☐ (b) ☐ (c) ☐ No preference ☐ Not applicable

For clarity we assume this proposal suggests copying to the SCA the information which has to be sent under Article 12 of the Regulation to the competent authorities supervising the entities (ie the PRA and FCA) rather than taking over their role in this regard. On the one hand this seems a simple step to which it is difficult to object. On the other hand we question the merits of the proposal in that it is just another administrative burden and we are not sure what the SCA will do with the information and whether it could give rise to a lack of clarity as to which body is responsible for actioning the information and duplication of effort. There are already adequate channels of communication between the various regulatory bodies in the UK and it is not clear what this extra step will achieve.

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

(a) the costs of the auditor providing this information to supervisors of PIEs?

The costs of providing this information will depend on the level of reporting that will be required

and the complexity of that reporting. However, the costs are likely to be significant as it will involve the time costs of senior staff for preparation and review of the information, as well as the costs of updating existing systems or introducing new systems to capture and provide the information. In particular the requirement to report "a breach of the listing rules, licensing rules, or other provisions governing the authorisation of a PIE" is potentially onerous. In this regard, the current requirements in the UK cover specific reporting to the financial regulator for regulated institutions and for other entities ISA (UK & Ireland) 250A points to a more general requirement to consider statutory reporting responsibilities (eg money-laundering, crime etc) as part of the audit.

It would appear that these new requirements could be more onerous than the current arrangements, particularly for non-financial institutions and we think it is important that appropriate guidance is provided as to the scope of this provision, in particular to what extent it is an extension of existing reporting requirements, and the criteria to be used for such reporting.

(b) the frequency with which the PRA is provided with this information for banks building societies and insurers under existing requirements?

The reporting of matters under the current rights and duty provisions occurs at modest frequency and is in line with the regulated firms' own reporting of material circumstances. The PRA should be able to provide more data.

(c) the frequency with which the FCA is provided with this information for other PIEs in practice already?

We believe this happens rarely.

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?

☐ Yes ☐ No ☒ Not sure ☐ Not applicable

We have no strong view on this matter.

As a general observation we note that companies generally want choice, flexibility and mobility in their business. Similarly there is an argument for greater mobility and mutual recognition of auditors. Opening up boundaries between Member States will mean that the structures of audit firms could be better aligned to those of the companies they serve. Ultimately market forces will play a key role in determining the acceptability of "cross-border " appointments.

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;

see response to Q54c

(b) adaptation periods (if these were to be provided for)?

See response to Q54c

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

As noted in our response to Q53 we have no strong view on this matter. To the extent that this is about protecting the "UK brand" then the FRC is the logical choice rather than any particular one of the existing RSBs. However, as a practical matter we do question whether, if the FRC is designated as the SCA, it will have the resource to deal with this type of issue and some practical alternative arrangements would probably need to be put in place.

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