

Post implementation review of the 2016 Auditing and Ethical Standards

London Stock Exchange Group (LSEG) welcomes the opportunity to respond to the FRC's proposed revisions to the 2016 UK Auditing and Ethical standards.

LSEG is a global financial markets infrastructure business. Its diversified global business focuses on Information Services, Risk and Balance Sheet Management and Capital Formation. The Group supports global financial stability and sustainable economic growth by enabling businesses and economies to fund innovation, manage risk and create jobs.

In Capital Markets, the Group operates a broad range of international equity, ETF, bond and derivatives markets, including London Stock Exchange; Borsa Italiana; MTS (a European fixed income market); and Turquoise (a pan-European equities MTF). Through its platforms, LSEG offers market participants unrivalled access to Europe's capital markets. The markets which LSEG operates are international in nature – for example the AIM market is home to 885 companies with operations in 81 countries. Since its launch in 1995, over 3850 companies have issued capital on AIM – raising over £114bn in growth capital, sixty percent of which has come from further issues after IPO.

A vital aspect of LSEG's markets is the disclosure-based framework providing investors with the information they need to value the securities they invest in, including that in the financial statements. LSEG welcomes the recent efforts to examine improvements in the audit market as a whole, through the work of the FRC, the Kingman Review, the Brydon Review and Competition and Markets Authority. It is important to consider how the actions proposed through these reviews will complement each other. It is also important to take note of the effect that such changes could have on the wider financing ecosystem and the impact any changes have on companies considering making the transition from private to public markets, as well as the global nature of companies and intermediaries which operate within the London market and the impact that any changes could have on the global competitiveness of the UK. The UK is home to a number of international companies, and it is important that due consideration is given to how the UK regime operates in relation to overseas regimes and that the regulatory framework is appropriately calibrated.

Our comments below are relevant to questions four and five of the consultation.

1.1 LSEG comments on the feedback statement

As an overarching comment, we would highlight that as the funding environment continues to evolve and companies are able to raise significant amounts of capital privately before admitting to public markets. Consequently policy makers have recognised that regulations intending to capture companies of a significant public interest which have traditionally used listed entities as a proxy, need to be recalibrated to ensure they still capture an appropriate population of companies.

It is important to recognise there are a significant number of the large private businesses in the UK, making a substantial economic contribution to the UK economy. According to government statistics¹ in 2018 there were 1,765 large UK private companies, employing 6.2 million people and with an aggregate turnover of £1.6tn. This compared to the FTSE 350 companies which employed 7 million people, with an aggregate turnover of £2.3tn².

¹ <https://www.gov.uk/government/publications/economic-contribution-of-private-companies-of-significant-size>

² LSEG estimate, based on data from factset.



We welcome that the FRC's review has highlighted the need to draw on lessons learned from the BHS enforcement case to ensure that the scope of certain ethical requirements apply to companies which may not be formally designated as PIEs but are clearly of significant public interest. Similarly, BEIS recent corporate governance reforms have been targeted at all companies of a significant size, irrespective of whether they are private or public.³

1.2 Scope of the changes

With this in mind, we would highlight that a number of provisions in the revised ethical standard focus on the defined terms Public Interest Entity (PIE) and Other Entity of Public Interest (OEPI). Whilst the PIE definition stems from EU regulation, broadly capturing companies on a Regulated Market, certain entities providing credit and insurance undertakings, the proposed OEPI definition⁴ cross refers to the scope of the FRC's Audit Quality Review, which has historically extended the definition to AIM or NEX quoted companies incorporated in the UK with a market capitalisation of more than €200m, Lloyds syndicates or Non-EEA entities (excluding crown dependencies) admitted to trading on a regulated market in the EEA with a UK registered auditor.⁵ We understand that both definitions are subject to further consultation and may in part depend on the outcome of the recommendations taken forward from the Kingman and Brydon reviews.

Pending the outcome of these reviews, it is difficult to comment on the appropriateness of the current way that the standards are calibrated, other than to highlight that we do not believe that the use of market capitalisation as a snapshot is an appropriate measure from the perspective of the provision of services which could be provided over a lengthy period of time. Noting that market capitalisation will vary depending on a number of factors, we believe that this could create significant uncertainty for companies and advisers, particularly where engagements have been entered into on the basis of a company's market capitalisation which changes (for reasons which may be outside of the company's control) during the course of the engagement.

Noting our comments above as regards ensuring that private companies are also considered in the scope of OEPIs, we would suggest that the timing of implementation of the ethical standard changes should not be made effective until such time as greater clarity is provided on the exact scope of the companies which will be affected. Furthermore, the type of measure used in the definition should be consistent across private and public companies. Implementing changes to the ethical standard without such certainty may lead companies and/or firms to adopt an overly cautious approach, resulting in unintended delays to services which may be critical to public company engagements which would otherwise be able to conclude. Such a development could lead to an additional, unwarranted reason for the industry to migrate towards private company work, concentrating risks in this area.

1.3 Suggested clarifications

We believe that there are certain areas where clarifications to the drafting of the revised ethical standard could improve its efficacy.

For example, section 5B ("Approach to Non-audit / Additional Services Provided to Public Interest Entities") sets out that:

An audit firm carrying out statutory audits of public interest entities and, where the audit firm belongs to a network, any member of such network, shall not provide to the audited entity, to its parent undertaking or to its controlled undertakings, services other than those set out in the rest of this paragraph, subject to the approval of the audit committee after it has properly assessed threats to independence and the safeguards applied in accordance with this Ethical Standard.

³ [BEIS - Corporate Governance Reform - The Government response to the green paper consultation \(2016\)](#)

⁴ [Glossary of Terms \(Auditing and Ethics\) Exposure Drafts - July 2019](#)

⁵ [FRC - Audit Quality Review scope of retained inspection](#)

We believe that the above paragraph intends that audit firms can provide the services set out immediately following the above paragraph, however the addition of “subject to the approval of the audit committee...” could lead firms to interpret that they are able to provide non-audit services which are not set out in the following paragraphs if they follow an audit committee approval process which is satisfied that there are sufficient safeguards in place.

Additionally, the prohibition applies to the audit firm, any member of its network, the audited entity and its parent or controlled undertakings. In the context of international companies who IPO on the Main Market, we would note that this could create a significant issue for companies who already use a particular firm for non-audit services, which may be a contributing factor in a decision to list in a jurisdiction where such restrictions do not apply, harming UK competitiveness.

Following the above paragraph, a “white list” of permitted services is set out, split into sections which are subject to the non-audit services cap and those which are not. However, at the end of paragraph 5.40, there is a further section clarifying that such services shall not include those cross referenced in Appendix B along with a statement that “No other non-audit or additional services shall be provided to the audited entity, its parent undertaking and its controlled undertakings by the audit firm or any member of the firm’s network.” This seems to suggest there is an absolute prohibition on other non-audit/additional services. Section 5.42 seeks to impose similar requirements on OEPIs.

With respect to capital markets work, we would note that the extension of the requirements to OEPIs could, depending on the extent to which AIM companies are included in such a revised definition, impose significant restrictions on AIM companies and their advisers, particularly with respect to the Reporting Accountant role and Nominated Adviser role. Whilst certain provisions of the white list refer to activities which could be interpreted to overlap with the RA/nomad role, the provisions of 5.39 (which set out instances in which an auditor is an appropriate provider of non-audit services and reads across to the white list) only refer to reporting accountant work in respect of the Prospectus Rules, Listing Rules and Takeover Code, and do not refer to other public company work such as the equivalent activities with respect to the AIM rules. This is notwithstanding the fact that AIM work is clearly referenced in paragraph 5.90, when speaking of the general approach to non-audit services provided in a statutory audit engagement.

For clarity, we would suggest combining the guidance in 5.39 with 5.40 as appropriate, and referencing explicitly that other services equivalent to those in section 5.39 but relevant to the engagement of an OEPI may also be provided as part of the white list.

1.4 Concluding remarks

We are aware of concern across the market that the timetable for implementation of the above changes is extremely short. Whilst such a timetable would be understandable in the context of changes where there is consensus across the market and where the implementation timetable has previously been well flagged/understood, LSEG has received feedback that there are material uncertainties around how to interpret the changes as currently drafted, given that the description of permitted services in the draft standard is very narrowly defined. Potentially, this could lead to increased costs for companies as advisers adopt an interpretation which goes beyond the intention of the rules changes, resulting in a reduction of choice and increased costs for companies where time and resource is diverted towards unnecessary changes to advisers or renegotiation of service agreements. In a public markets context, there is also a material risk that disorderly implementation of changes to the audit/non-audit services framework could make public capital market transactions less appealing than transactions in the private arena.

Given that the implementation date for the ethical standard is currently slated to take effect prior to consulting on fundamental definitions of PIE/OEPI we would query how much reliance can be placed on the current impact assessment. In the context of changes arising from the CMA, Brydon and Kingman reviews - all of which are likely to have a material effect on all aspects of the audit market – we would suggest that the implementation date should be delayed until such time as greater clarity can be provided.