BLACKROCK

19 March 2015

Keith Billing
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Sent electronically to: k.billing@frc.org.uk

Re: Consultation: Auditing and ethical standards - Implementation of the EU Audit Directive and Audit Regulation

Dear Mr. Billing,

BlackRock is pleased to have the opportunity to respond to the above consultation on the implementation of the EU Audit Directive and Audit Regulation.

BlackRock is a leading provider of asset management, risk management, and investment advisory services to institutional, intermediary, and individual clients worldwide. As of 31 December 2014, the assets BlackRock manages on behalf of its clients totalled £2.99 trillion across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds.

BlackRock has a pan-European client base serviced from 22 offices across the continent. Public and private sector pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock.

BlackRock represents the interests of its clients by acting in every case as their agent. It is from this perspective that we engage on all matters of public policy. BlackRock supports policy changes and regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analysis, preserves consumer choice.

We welcome the opportunity to address, and comment on, the issues raised by this consultation and we will continue to contribute to the thinking of the Financial Reporting Council (FRC) on any specific issues that may assist in improving the implementation of the Audit Directive and Audit Regulation. As financial statement preparers and users, we have a considerable interest in the impact of this legislation, particularly with regard to our investment funds based in the United Kingdom and throughout Europe.

We have set out our comments to your questions in the following pages. We have responded to the questions we consider relevant to ourselves as a corporate entity, and as an investor. Our overriding view is that any available option that restricts the audit committee's ability to determine the most qualified audit firm for specific services should be avoided.

Key points

Maintain the prohibited list of non-audit services rather than replace with a 'white list'

We do not support amending the prohibited list of non-audit services under Article 5.2 of the Regulation, by replacing it with a 'white list' of permissible non-audit services. We believe there are other safeguards in place where an audit firm may be engaged for such services to mitigate threats to audit firm independence and to protect investor interests such as all non-audit services requiring approval from the audit committee (after having assessed the threats and safeguards to auditor independence).

The new UCITS and AIFMD depositary regime justifies the audit committee exemption

We support the audit committee exemption available for UCITS and AIFs in Article 39.3 (b) of the Directive as these funds are subject to a well-established regulatory regime and additional specific governance requirements such as the appointment of an independent depositary. In addition, we support the audit committee exemption in Article 39.3 (a) where the group audit committee is discharging the requirements that would be imposed on a Public Interest Entity's (PIE) own audit committee as this exemption avoids any duplication that would otherwise occur where a PIE would have to create an audit committee in addition to one that already exists at the group level.

No reduction to the 70% non-audit fee cap

We do not support any reduction to the 70% non-audit fee cap under Article 4.2 of the Regulation as we consider that there are existing safeguards regarding independence. We believe any reduction could result in the creation of 'pure audit firms' which we do not support. We have concerns that such firms may not be able to attract staff of suitable quality because of the lack of opportunity offered compared to multi-disciplinary firms, with a consequent adverse impact on audit quality. Accordingly, we believe that the cap of 70% under Article 4.2 should not be reduced.

70% non-audit fee cap effective date

We welcome the Department of Business, Innovation and Skills (BIS) stating in their Discussion Document that they consider the first calculation for the cap must be undertaken in respect of the accounting year beginning on or after 17 June 2019 (i.e. the 4th accounting year beginning after the application of the Regulation). This provides companies with sufficient time to change their non-audit service providers or auditors, if required, in an orderly and considered manner. However, in the interest of removing any uncertainty we would welcome the FRC clarifying that this is also how it would implement the cap provisions.

Potential extra-territorial application of the legislation

We have concerns that Article 5.4 in the Regulation implies that the PIE's audit committee (or the group audit committee acting on behalf of the PIE) would have to pre-approve all permissible non-audit services provided by the statutory auditor (including its member firms) even if they are to be provided to non-EU parent entities or non-EU controlled undertakings. We understand that the European Commission's Q&A on Implementation of the new statutory framework dated 3 September 2014 (the European Commission's September 2014 Q&A) in relation to an analogous question "*What if the audit client has subsidiaries which operate in different jurisdictions (EU and non-EU) which are required to apply different auditor rotation rules?" clarified that "The Regulation does not have any extraterritorial effects – it applies to PIEs that operate within the EU only. Thus, if a PIE incorporated in the EU has a subsidiary incorporated in a third country, there is no legal obligation upon this PIE to rotate its auditors in this third country, unless the law of the latter states so."* [1] Applying this by analogy would result in the PIE's audit committee having a duty to pre-approve non-

[1] The European Commission's Q&A is available here:
http://ec.europa.eu/internal_market/auditing/docs/reform/140903-questions-answers_en.pdf

audit services for controlled undertakings of the PIE and its parent within the EU, not those outside the EU. This is consistent with our interpretation of the legislation but we would welcome this being clarified by the FRC..

Confirmation of transitional provisions to avoid retrospective effect

In order to mitigate the additional risk to a PIE resulting from auditor transition, and to allow the development of institutional knowledge, BlackRock supports the extensions permitted by the Regulation where a public tender has been undertaken. Requiring rotation after 10 years reduces the competitiveness of the tender process and results in additional start-up time and costs for new auditors, which reduces the savings and investment returns for Europe's citizens and employers. However, we believe that the tender/rotation timeline where an incumbent auditor of a PIE has been appointed as auditor for fewer than 11 consecutive financial years as at 17 June 2014 should be clarified by the FRC. The European Commission's September 2014 Q&A confirms that the Regulation first starts to apply for financial years commencing after 17 June 2016. However, this is contradicted by a letter from the Director General for Internal Market and Services dated 2 September 2014 which states that companies with auditor tenures of 8 to 11 years at June 2014 will have to rotate/tender their auditors by 16 June 2016[2]. This implies that PIEs would need to change auditors before the rules actually start to apply and contradicts the general principle that EU law does not apply retrospectively. Further we note that as part of the UK consultation process BIS have published additional supplementary information[3] confirming that they are in agreement with European Commission's September 2014 Q&A. We would welcome the FRC confirming that they are in agreement with BIS in order to remove any uncertainty.

A service such as investor tax reporting should not be prohibited

Germany, the UK, Switzerland and Austria all require detailed per unit taxable income information to be provided to investors. If this is not undertaken, the fund will not have tax status in that jurisdiction and the investors will pay excessive tax on their holding in the fund. This is a high volume activity, so to illustrate BlackRock provides well in excess of a million pieces of tax data per annum under these tax reporting regimes taken together.

Much of the calculation work is undertaken by fund administrators, but typically there is a very large process involvement by one of the Big 4 audit firms. Most fund managers choose to get a degree of independent tax compliance assurance over the figures, and further in Germany it is requirement of the tax regime that a licensed steuerberater (tax adviser) certifies the key tax disclosure figures. Owing to the highly operational, high volume nature of the process, moving between tax service providers requires lengthy planning.

We believe that services such as investor tax reporting should be permitted to be carried out by the audit firm or a member of its network. We are concerned that removing the possibility of using the fund auditor for this work will reduce choice and competition in this material, specialised tax services market to an unacceptable degree. Investor tax reporting has no direct or material impact on the financial statements of a PIE, nor does it involve any advice or element of discretion to the fund itself. Rather, the consumer of the service is the end investor, who uses the data to complete their tax return. Therefore, we would suggest that the FRC clarify that investor tax reporting is not a prohibited service under this legislation with reference to Article 5.3 of the Regulation.

[2] The letter is available here: http://ec.europa.eu/internal_market/auditing/docs/reform/140903-audit-rotation-letter_en.pdf

[3] BIS, AUDITOR REGULATION – SUPPLEMENTARY INFORMATION, The implications of the EU and wider reforms, March 2015.

Yours sincerely,

Colin McDonald
Director

Tom McGrath
Director

Responses to questions
Section 1 – Auditing Standards

Question 1
Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

We agree, subject to appropriate consultation and due process being followed.

Section 2 – Proportionate Application and Simplified Requirements

Question 2
Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

Yes, we believe that the FRC's current audit and ethical standards can be applied in a proportionate manner.

Question 3
When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles 22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available for Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

We believe that the requirements in Article 22b, Article 24a and Article 24b are fundamental basic requirements which should apply to all audits and audit firms regardless of the size of the audited entity.

Section 3 - Extending the More Stringent Requirements for Public Interest Entities to Other Entities

Question 4
With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:

(a) should they apply to PIEs as defined in the Audit Directive?

(b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

We agree that the more stringent requirements should apply to PIEs and all other Listed entities as currently defined by the FRC.

Section 4 – Prohibited Non-audit services

Prohibition of additional non-audit services

Question 7
What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

We do not consider that any further non-audit services should be added to the prohibited list, nor do we support the 'white list' approach as it risks further restricting the audit committee's ability to determine the most qualified audit firm for specific services to be provided. Also, proposed services may not always be easily classified into one of the allowable services groupings and would thereby create the potential for misinterpretation. We believe there are other safeguards in place to mitigate threats to independence such as all non-audit services requiring approval from the audit committee (after having assessed the threats and safeguards to auditor independence). Further, the list of prohibited non-audit services in Article 5 is more extensive than the rules set out in Ethical Standard 5.

Question 9
Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

For the reasons detailed in our response to question 7, we do not believe there are any other non-audit services that should be added to the Regulation's prohibited list.

Derogations in respect of certain prohibited non-audit services

Question 10
Should the derogations that Member States may adopt under the Audit Regulation – to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

We support this Member State option as it is appropriate to allow the provision of these services where they have no direct or have immaterial effect, separately or in aggregate, on the audited financial statements. We believe that where these conditions are met, audit committees should be empowered to monitor and approve such services without regulatory restrictions. Also, audit firms are already subject to performance and ethical standards to ensure that non-audit services do not introduce independence conflicts.

The definition of ‘no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate’ could benefit from further clarification. In particular, we recommend applying the derogation to allow investor tax reporting that is required to distribute UK domiciled investment funds in other EU countries as this service has no impact on the ‘audited financial statements’ of the fund or manager, and should, in our view, be a permissible service. However, clarifying what is meant by ‘no direct or have immaterial effect, separately or in the aggregate on the audited financial statements’ would be beneficial so as to remove any uncertainty prior to implementation.

Question 11
If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be ‘immaterial’ sufficient? If not, is there another condition that would be appropriate?

We believe the condition of immaterial effect of non-audit fees on the financial statements is sufficient if the derogations are taken up subject to clarification being sought in relation to the points raised in our response to question 10.

Audit Committee’s role in connection with allowed non-audit services

Question 12

For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?

We believe that it is sufficient to require the audit committee to approve an auditor to provide non-audit services after it has properly assessed threats to independence and the safeguards applied. For the reasons detailed in our response to question 7, we do not support the ‘white list’ approach.

Geographical scope of the prohibitions of non-audit services, by the audit firm and all members of its network, to components of the audited entity based outside the EU

Question 13
When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based? If not, what other standards should apply in which other circumstances?

We have concerns that Article 5.4 in the Regulation implies that the PIE's audit committee (or the group audit committee acting on behalf of the PIE) would have to pre-approve all permissible non-audit services provided by the statutory auditor (including its member firms) even if they are to be provided to non-EU parent entities or non-EU controlled undertakings. We understand that the European Commission's Q&A on Implementation of the new statutory framework dated 3 September 2014 (the European Commission's September 2014 Q&A) in relation to an analogous question "*What if the audit client has subsidiaries which operate in different jurisdictions (EU and non-EU) which are required to apply different auditor rotation rules?" clarified that "The Regulation does not have any extraterritorial effects – it applies to PIEs that operate within the EU only. Thus, if a PIE incorporated in the EU has a subsidiary incorporated in a third country, there is no legal obligation upon this PIE to rotate its auditors in this third country, unless the law of the latter states so."*[4] Applying this by analogy would result in the PIE's audit committee having a duty to pre-approve non-audit services for controlled undertakings of the PIE and its parent within the EU, not those outside the EU. This is consistent with our interpretation of the legislation but we would welcome this being clarified by the FRC.

Section 5 – Audit and Non-audit Services Fees

Fees for non-audit services

Question 15
Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

We believe that the cap of 70% on non-audit services should not be reduced. Audit firms are currently subject to performance and ethical standards to ensure permissible non-audit services do not introduce independence conflicts. We believe any reduction could result in the creation of 'pure audit firms' which we do not support. We have concerns that such firms may not be able to attract staff of a suitable quality because of the lack of opportunity offered by such firms compared to multidisciplinary firms, with a consequent adverse impact on audit quality.

[4] The European Commission's Q&A is available here:
http://ec.europa.eu/internal_market/auditing/docs/reform/140903-questions-answers_en.pdf

Question 16
If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

We support the United Kingdom implementing the exemption from the stipulated threshold on an exceptional basis for a maximum period of two years, which we do not believe should be reduced. The exemption provides PIEs with the flexibility to engage permissible non-audit services so as to benefit from the efficiency of using the knowledge of their statutory auditor without compromising independence, when unusual events and transactions prompt the unavoidable use of the auditor. We believe that the term ‘exceptional basis’ does not need to be defined as it will vary by entity. Instead the responsibility for approving this cap exemption should rest with the audit committee as they are best placed to determine whether or not ‘exceptional’ circumstances exist that require this exemption.

Question 17
Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms?

As detailed in our response to question 15 we do not support applying more stringent requirements to the cap provisions.

Question 19
Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances?

We consider this appropriate and welcome BIS stating in their Discussion Document that they consider the first calculation for the cap must be undertaken in respect of the accounting year beginning on or after 17 June 2019 (i.e. the 4th accounting year beginning after the application of the Regulation). This provides companies with sufficient time to change their non-audit service providers or auditors in an orderly and considered manner. However, in the interests of removing any uncertainty we would welcome the FRC clarifying that this is also how it would implement the cap provision.

Section 7 – Audit Firm and Key Audit Partner Rotation
Audit firms

Question 24
Do you believe that the FRC’s audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?

We support the FRC’s view that audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms.

Key audit partners

Question 25
Do you believe that the requirements in ES 3 should be maintained?

The integrity of financial statements depends on the auditor being free of any impediments to being an effective check on management. To that end, we believe it is important that auditors are, and are seen to be, independent and therefore consider it appropriate to maintain the requirements of ES 3.

Consultation Stage Impact Assessment

Question 27
Are there any other possible significant impacts that the FRC should take into consideration?

BlackRock does not support joint audits, which would duplicate efforts and result in additional costs. To the best of our knowledge, joint audits have not resulted in better audit quality and may actually reduce audit quality because of the inherent difficulty in coordinating complex, global engagements and the potential risks associated with overlapping responsibilities between two auditor firms. In addition, management would spend additional time communicating issues and responding to duplicative procedures. However, in order to retain flexibility going forward the option should be taken but only used in exceptional circumstances.

We support the audit committee exemption available for UCITS and AIFs. These funds are subject to a well-established regulatory regime and additional specific governance requirements such as the appointment of an independent depositary with a duty to maintain ongoing oversight over the fund's assets. Accordingly we believe the incremental costs associated with requiring audit committees for these types of entities outweighs the benefits. Similarly, we support the exemption where the group audit committee is discharging the requirements that would be imposed on a PIE's own audit committee. This exemption avoids any duplication that would otherwise occur where a PIE would have to create an audit committee in addition to one that already exists at the group level.

In our view it would be beneficial to include a definition for the terms 'statutory audit fees' and 'non-audit fees'.

'Other assurance services' are referred to in the introductory text of the Regulation. It would be helpful to provide guidance as to what services would be envisaged as 'other assurance services'. For example, listing rules may require auditors to review half yearly financial statements or circulars that form part of the capital raising process.

In order to mitigate the additional risk to a PIE resulting from auditor transition, and to allow the development of institutional knowledge, BlackRock supports the extensions permitted by the Regulation where a public tender has been undertaken. Requiring rotation after 10 years reduces the competitiveness of the tender process and results in additional start-up time and costs for new auditors, which reduces the savings and investment returns for Europe's citizens and employers. However, we believe that the tender/rotation timeline where an incumbent auditor of a PIE has been appointed as auditor for fewer than 11 consecutive financial years as at 17 June 2014 should be clarified by the FRC. The European Commission's latest FAQs dated 3 September 2014 confirms that the Regulation first starts to apply for financial years commencing after 17 June 2016. However, this is contradicted by a letter from the Director General for Internal Market and Services dated 2 September 2014 which states that companies with auditor tenures of 8 to 11 years at June 2014 will have to have rotate/tender their auditors by 16 June 2016. This implies that PIEs would need to change auditors before the rules actually start to apply and contradicts the general principle that EU law does not apply retrospectively. Further, we note that BIS has published additional supplementary information[5] in which it states that: *"It is true that on 17 June 2016, some audit engagements under the third transitional provision will be of more than 10 years' duration, and up to 13 years' duration. This is because the transitional provision covers audit engagements for financial years that began on or after 17 June 2003. This will be the case for all audit engagements for which the first financial year began between that date and 16 June 2006.*

For these audit engagements, we consider that the auditor of the accounts for the financial year beginning before 17 June 2016 is still able to complete the audit of those accounts. However at the start of the first financial year beginning after that date, the auditor could not be reappointed to audit the accounts for that year other than on the basis of a tender."

We would welcome clarification on whether this view is shared by the FRC as soon as is practical as the new rules will mean that decisions will need to be taken now by audit committees so that their companies are able to be compliant when the law comes into force in just over a year's time.

[5] BIS, AUDITOR REGULATION – SUPPLEMENTARY INFORMATION, The implications of the EU and wider reforms, March 2015.