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20 March 2015

Dear Mr Billing

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

Deloitte LLP is pleased to respond to the FRC's consultation paper on the implementation of the EU Audit Directive and Audit Regulation.

### Introduction

In recent years, the legislative and regulatory environment for audit in the UK has been under unprecedented scrutiny. The implementation of the reforms considered in the FRC's Consultation Paper and the BIS Discussion Document come on the heels of reforms resulting from the recent Competition and Markets Authority (CMA) inquiry and changes to the corporate governance framework. Within this context we welcome the open tone of the consultation document and the FRC's commitment to incorporating the views of a wide range of relevant stakeholders as it prepares to implement the latest reforms.

### Our guiding principles

Our views on how the reforms should be implemented are guided by a number of principles:

- The public interest is best served by a competitive market of strong, highly skilled, innovative audit firms.
- Reforms are more likely to be effective when they are easy to understand and consistent.
- Perceptions matter: concerns that audit firms are too close to management can undermine confidence in capital markets.
- Reforms should be proportionate. Instead of adopting a "one size fits all" approach, they should be focused on where they will make a difference, recognising that the reforms required in the large company audit sector do not necessarily need to be replicated for smaller companies.
- Reforms need to be implemented in a manner which does not harm audit quality or cause undue disruption to audited entities. In particular:
  - transition arrangements need to allow an orderly move to the new regulatory regime;
  - companies' choice of service provider should not be unduly restricted; and
  - reforms should not result in increased costs to audited entities through work having to be duplicated by different firms.
- Reforms should be consistent across the EU to minimise the impact of a patchwork of differing

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requirements that would create unnecessary complexity for global PIEs.

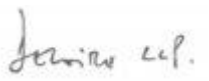
The appendix to this letter sets out our responses to the detailed questions raised in the Consultation Paper in the light of these guiding principles.

In addition to our responses to these questions, it is worth emphasising the need for greater clarity.

- Firstly, significant changes to the FRC's standards will be necessary as a result of the Directive and Regulation. We urge the FRC to consult on the changes as soon as it can, even if the detailed draft BIS regulations are not yet available for comment, in order to give to audit committees and audit firms a better idea of their options and obligations. This is particularly important for changes that will affect companies in the short to medium term. For example, depending on its auditor's length of tenure, a company with a 30 June 2016 year end may need to change its suppliers of non-audit services by 1 July 2016, and for potential tenderers the cooling in period for the provision of systems could start from 1 July 2015. In order to enable audited entities to obtain both a quality service and achieve value for money, it will need to know precisely what non-audit services will be affected as soon as possible.
- Secondly, it is not clear in some areas whether the changes will apply from 17 June 2016 or for the audits of accounting periods commencing on or after 17 June 2016. It will be helpful if the FRC's draft standards make this point clear.

If you have any questions on our comments, please contact David Barnes (020 7303 2888 or djbarnes@deloitte.co.uk).

Yours sincerely



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## APPENDIX – RESPONSES TO THE DETAILED QUESTIONS IN THE DISCUSSION PAPER

### Section 1 – Auditing Standards

**Q1 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)?**

Yes. In our response to Q47 of the BIS Discussion Paper, we support the idea that the law should clearly allow the FRC the power to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, add to the credibility and quality of financial statements). In supporting this proposal, we make the following points:

- It is important that the FRC's standards deal with the requirements of UK and Irish legislation, as well as the relevant Listing Rules.
- The FRC's role as standard setter for corporate governance and auditing has resulted in sensible auditing requirements that interact with the UK Corporate Governance Code, which should be retained and, where necessary, evolve.
- We note that the FRC is influential in the development of the IAASB's standards, and that as such there has been a marked decrease in the need for, and hence existence of, "pluses" to IAASB issued standards purely on grounds of quality. Such "pluses" are not without cost (not least in providing for consistent application in a multinational group audit), but should not be ruled out when developed after due process including a cost/benefit analysis.

The FRC has, notably, adopted a standard of its own drafting for auditor reporting, ISA (UK and Ireland) 700 *The independent auditor's report on financial statements*. There are three sets of changes to auditor reporting to be considered over the next few years:

- Firstly, the changes made by Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 for periods commencing on or after 1 January 2016 in order to respond to the EU Accounting Directive 2013/34/EU and Article 28(2)(e) of the Audit Directive.
- Secondly, the changes made by Article 10 of the Audit Regulation, for periods commencng on or after 17 June 2016.
- Thirdly, the changes made by the IAASB's auditor reporting project, principally ISAs 700, 701 and 570, which must apply for periods ending on or after 15 December 2016.

We believe that the FRC should consider implementing all of these changes into their standards at once. This would avoid making changes in two successive years, which would potentially be confusing to audited entities, audit committees and, crucially, investors.

### Section 2 – Proportionate Application and Simplified Requirements

**Q2 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 current FRC standards can be applied in a manner that is proportionate to the scale and complexity of small undertakings. The FRC's efforts in developing Practice Note 26 are particularly welcome in this regard, demonstrating that it is possible to document some aspects of the audit in a clear and concise way. We suggest that further efforts in this area should be developed on an international basis (for example the project the IAASB is currently scoping on quality control).

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**Q3 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 any simplification of the requirements of Articles 22b, 24a and 24b should be in line with the existing Ethical Standard 'Provisions Available to Small Entities' and any simplification suggested by the IAASB as part of their project on quality control.

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

**Q4 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?**

*Quality control*

The description in paragraph 3.8 is not an accurate reflection of the more stringent requirements for an EQCR review of a "listed" entity under current FRC standards; broadly all of these are required by paragraphs 19-20 of ISA (UK and Ireland) 220 for the EQCR review of all entities. It is the additional requirements in paragraph 21 of that ISA which would apply to a "listed" company as well as the presumption from paragraph A47 of ISQC 1 (UK and Ireland) that the EQCR reviewer for a "listed" entity should be a partner.

On that basis:
(a) We believe that, in practice, all of the additional requirements in paragraph 21 of the ISA would be met by compliance with Article 8 of the Regulation. Accordingly, we do not see the application of the additional requirements in the FRC's standards to unlisted PIEs to have any practical effect.
(b) We also suggest that these requirements should not be relaxed for entities that are currently treated as "listed" for the purpose of these standards but which are not PIEs (principally those entities with securities traded a market other than an EEA regulated market). To do so would lead to a non-compliance with the IAASB's standards, which require the application of these requirements to "listed" entities as defined for the purpose of the ISAs.

***Independence (including the requirement for the auditor to report on independence to those charged with governance)***

(a) For reasons of simplicity, it would seem sensible to extend the FRC's existing "listed" restrictions to unlisted banks, building societies and insurance companies. Given the extent of new restrictions in Article 5, and the nature of these entities, this would be a proportionate response.
(b) We believe that the FRC's existing "listed" restrictions should not be relaxed, except where necessary for reasons of audit quality (for example, if the outcome of the FRC's work suggests that the inability to seek advice from the auditor harms the quality of AIM company reporting more than the actual or perceived threats to independence arising from such services). The FRC's restrictions should, in any

case, not be relaxed beyond the requirements of the IESBA Code of Ethics for "listed" entities as described in that Code.

*Auditor reporting and reporting to those charged with governance*

The majority of the requirements of Articles 10 and 11 of the audit Regulation overlap with the requirements of the FRC's standards for entities complying with the UK Corporate Governance Code. The only significant effect of applying the FRC's requirements in this area to unlisted PIEs would be to require a materiality section in the audit report, which is not costly to draft or review. Extending these requirements to all PIEs will have the advantage of simplicity and clarity with little extra cost.

**Q5 Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation 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?**

*Quality control*

In practice, the majority of the matters required in Article 9 of the Regulation are already required by ISA (UK and Ireland) 220 and/or ISQC1 (UK and Ireland). For that reason, and for the sake of simplicity, it may be simplest to apply those requirements to all "listed" entities, whether PIEs or not. We suggest, however, that the FRC draw on the work of their thematic review of EQCR in forming their conclusions.

*Independence (including the requirement for the auditor to report on independence to those charged with governance)*

The new EU restrictions should only apply to PIEs, and not extended to other "listed" entities as defined in the FRC's Ethical Standards (those with securities traded on another UK or Irish market – in practice AIM, the Professional Securities Market, the ISDX Growth Market (for the UK) and the Enterprise Securities Market and Global Exchange Market (for Ireland). For example, the costs of mandatory rotation and tendering for companies traded on AIM are more likely to outweigh the benefits, whilst in areas such as non-audit services the FRC will still have the right to restrictions over and above those applicable to all statutory audits. Whilst this results in complexity, the FRC's own study of smaller listed and AIM company reporting is exploring whether restrictions on auditors of AIM companies would help or hinder quality improvements; retaining a narrow definition will allow the FRC to regulate in a way that supports the findings of their work in this area.

*Auditor reporting and reporting to those charged with governance*

The test for the requirements in ISAs (UK and Ireland) 260, 570 and 700 that most closely align with Articles 10 and 11 of the Regulation do not depend on whether a company is "listed"; rather they depend on whether an entity is reporting on compliance with the UK Corporate Governance Code. We suggest that these are not applied to all "Listed" entities as this would impose significant additional costs on those AIM and PSM companies that have chosen not to comply or explain against the Code. During the development of the FRC's standards in this area, there were no calls from AIM Companies or investors for mandatory compliance. It is well accepted by investors that AIM companies are not subject to the same mandatory governance requirements; those companies that want to do so (for example to have a voluntary "enhanced audit report") can negotiate this with their auditor and/or voluntarily include statement of compliance with the Code.

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**Q6 Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?**

No. We believe there is a balance for audit quality between the ability of an entity to seek advice from its auditor to improve the quality of its reporting and the actual or perceived threat of a lack of independence.

**Section 4 – Prohibited Non-audit services**

***Prohibition of additional non-audit services***

**Q7 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 believe that, on balance, a 'black list' is the right approach. This approach allows companies' audit committees to continue to have the ultimate responsibility for approving non-audit services which are not on the black list and where the auditor is demonstrably the most appropriate service provider. Audit committees have, in general, shown themselves to be well-placed to assess threats to independence, and the tougher role for them under Article 39 of the revised Directive and under the Regulation will help in this regard.

It also avoids any potential that a white list becomes outdated, which could deter appropriate innovation by audit firms. For example, some companies have historically had elements of their sustainability reporting assured. As such assurance would need to be provided by someone who meets at the very least the requirements of the ICAEW and IESBA Codes of Ethics, the auditor is well placed to do such work. The fact that such assurance is independent means there is no significant threat to auditor independence; indeed, as the auditor needs to consider the narrative accompanying the financial statements under ISA (UK and Ireland) 720, combining these roles may improve the quality of both the financial statement audit and the sustainability assurance. In the last year or two, some companies are now looking to Integrated Reporting, with assurance of some or all of an integrated report. If a white list had not anticipated this development, it would needlessly prohibit auditor innovation.

If a black list approach is adopted, we believe additional clarity is needed as to the scope of some of the restrictions in Article 5. For example, according to Article 5.1 (i) '*services linked to the financing, capital structure and allocation, and investment strategy of the audited entity*' are prohibited. We understand from Recital (8), and the EC staff presentation to stakeholders of 11 April 2014, that this was not intended to prohibit due diligence. It would be helpful if the FRC clarified this point, in particular as to whether:

(a) permitted due diligence included only work done in connection with other assurance reports and comfort letters (e.g. that which accompanies a working capital comfort letter provided to support a sponsor's declaration under Listing Rule 8.4.2R), or would also include broader purchaser due diligence, vendor due diligence and/or post-merger integration/separation planning and analysis;
(b) whether the reference to "assurance" services includes agreed-upon procedures engagements in respect of a transaction; and
(c) In the long term, we suggest that the FRC and FCA work together to consider ways in which services such as long form and working capital reports, currently provided as a matter of market practice by reporting accountants, could be put on a statutory form (for example, by requiring a sponsor to consider obtaining such a report), which would address this issue.

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**Q8 If a 'white list' approach is deemed appropriate to consider further:**

**(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?**

**(b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?**

If the FRC were to adopt a white list approach then it would be important that:

- the list of permitted services includes requirements of law or regulation worldwide, and not be restricted to EU or member state law;
- the list of permitted services includes advice on the implementation of current and proposed accounting standards. Such services are not currently within the ES5 definition of 'audit related services' (although they arguably should be), but are scoped out of the ES5 restrictions on accounting services by paragraph 156 of that standard. There is a presumption that the auditor is the natural person to provide such advice implicit in Section 230 of the ICAEW and IESBA Codes of Ethics;
- the term "prospectus or circular" is expanded to include similar documents (for example, in the case of an entity listed in both London and New York, some reports may be required for inclusion in an SEC Registration Statement) and references to a sponsor be broadened to other similar roles (for example, entities that have listed debt (hence are PIEs) but AIM traded shares may need to provide comfort to a Nomad); and
- the definition in the final bullet point of 4.13 is expanded to include "audit, other assurance services and agreed-upon procedures engagements relating to other information issued by the entity". This would recognise that (a) agreed-upon procedures engagements are technically not assurance services and (b) in some cases such services may be required in connection with private reporting, for example agreed-upon procedures performed on loan covenant compliance calculations and audits of the accounts of entities in which the group has a stake but which are not required to file or otherwise publish financial information.

To ensure that the services on a white list remain appropriate we believe that the FRC should seek regular input from investors, audited entities, professional bodies and audit firms. This could consider whether any services should be added to or removed from the white list to reflect innovation in company reporting or other shareholder needs.

It might also be possible to establish a mechanism to consider more urgent one-off requests for services which, whilst not on the white list, are not prohibited by Article 5(1) of the Regulation. For example, paragraph 153 of ES 5 was introduced to deal with situations where timely provision of certain restructuring services by the auditor of a distressed listed company was necessary. The FRC's argument for permitting such services was that the shareholders' interests were more likely to be served by the provision of such services on a timely fashion, which often pointed to the auditor providing them as long as they were not banned by Article 5(1)(i) of the Regulation.. However, such a mechanism would have to operate in a timely fashion.

**Q9 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?**

We do not believe any more restrictions, other than those already imposed by FRC Ethical Standards (see our responses to Q4-6) should be imposed.

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***Derogations in respect of certain prohibited non-audit services***

**Q10 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?**

*Tax services*

The case for adopting the derogation is finely balanced. Whilst there are arguments to support a complete ban on tax services at the highest end of the FTSE, we have concluded that, when applied to all PIEs, the disadvantages outweigh the advantages. In particular we are concerned that a ban would make it much harder for smaller PIEs to access expert advice (since smaller companies often rely on their auditors for a broad range of services) and restrict the provision of other services where tax input is a small but integral component of the broader service. We do not believe that either of these scenarios is in the public interest.

Our view is therefore that where there is no direct effect on the financial statements of the public interest entity, or where any direct effect is immaterial, then preventing the incumbent auditor from providing the tax services set out in Article 5(1)(a)(i) and (iv)-(vii) would be overly restrictive and could reduce the amount of choice of service providers available to companies.

We therefore suggest that such services should be prohibited only when there is a direct material impact on the financial statements of the audited entity, or where the tax services would require the audit firm to subsequently form a material audit judgment based on their own work. Otherwise, these tax services should be permissible, provided that:

- the existing guidelines in the UK ethical standards around provision of tax services by auditors are maintained;
- the audit firms identify and assess, on a case-by-case basis, the potential threats to their objectivity and independence before deciding whether to undertake a proposed engagement to provide tax services to an audited entity; and
- such services are approved by Audit Committees.

We do not think any additional criteria should be met for the derogation to apply.

It will be helpful if the FRC can also provide clarity as to the scope of some of the provisions of Article 5(1). For example:

- it is unclear whether, under Article 5(1)(a)(i) and (vi) the existing practice where by the auditor is banned from providing tax calculations for listed entities and significant affiliates, but may complete their tax returns after the audit opinion has been given would still be permitted. In such situations, the auditor has already formed a view that the tax accrual is materially correct, and the work done to support the return is mostly administrative in nature and/or finalising the analysis of certain categories of expense where the adjustment to the tax charge could only ever be immaterial; and
- it is unclear where work done on tax returns of overseas employees fits in Article 5(1)(a). Typically such services do not involve direct computation of payroll taxes. Where such services are provided to employees and not to the company, which merely pays for the services, it can be argued that these services would not be prohibited under Article 5(1)(a). If these services would be provided to the company (e.g. if they included tax equalization services), they would in any event normally have no direct material impact on the financial statements, and hence such work would be allowed under the derogation.

If the FRC decides that the derogation should not be taken in the long term, then we suggest it should be used in the short term to permit:

- Support to deal with tax inspections by tax authorities relating to immaterial items. Under the current FRC Ethical Standards, auditors can, in certain cases, provide information to the tax authorities (including an explanation of the approach being taken and the arguments being advanced by the audited entity) during a tax inspection. We believe that, for a transitional period, the auditor should be allowed to provide support regarding tax inspections provided that:
  - the support is in respect of advice provided by the auditor prior to the first financial year in which the Regulation applies;
  - neither the original advice nor the support would not be prohibited by current Ethical Standards; and
  - the need for appropriate safeguards is assessed and, where relevant, such safeguards are implemented and any necessary safeguards are applied.
- Transitional arrangements to be put in place for those long-term contracts in respect of tax services. Many companies have put in place three to five year contracts for a range of tax services, for example in relation to the completion of tax returns. Using the derogation would allow an orderly exit for such contracts and would apply only where:
  - the services in question fall within one of the permitted areas of derogation;
  - the services were contracted for prior to the start of the first financial year in which the Regulation applies;
  - the services would not be prohibited by current Ethical Standards; and
  - the need for appropriate safeguards is assessed and, where relevant, such safeguards are implemented.

It is worth noting that a common feature of the current market is alignment of tender cycles for the audit and recurring non-audit services (e.g. tax compliance), allowing companies the broadest possible range of choices for both. Allowing such a transitional period (for example, of three financial years from when the Regulation first applies) would allow most companies to adopt this approach, if they wished.

*Valuation services*

Under the existing FRC ethical standards, valuation services for “listed” entities are already highly restricted; in practice, most “listed” groups do not seek valuations from their auditor, even if immaterial. We do not believe that the derogation should be taken provided that auditors are still permitted to perform a valuation in those jurisdictions where the auditor (in their capacity as such) is required to do so by law

**Q11 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?**

See our response to question 10.

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

**Q12 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 the existing audit committee approval requirements in the UK Corporate Governance Code and Guidance for Audit Committees, supplemented by the Directive, Regulation and where applicable the CMA Order, provide for a robust challenge to the decision to appoint the auditor to provide

non-audit services. In our response to question 25 to the BIS consultation paper we set out suggestions to improve the disclosure of non-audit fees, which will in turn increase the quality of audit committee explanations to shareholders.

***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***

**Q13 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?**

See response to Q14 below.

**Q14 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 other auditors whose work they decide to use in performing the audit of the group? If not, what other standards should apply in those circumstances?**

We are answering questions 13 and 14 together.

In principle, yes. ES 1 requires component auditors (whether within the network or not) to comply with the IESBA Code of Ethics and confirm their compliance to a UK group auditor; network firms not involved in the audit are also required to have policies and procedures in place to remain independent under the IESBA Code. However, the requirement for a "listed company" to have a policy on non-audit services applies has the de facto effect of extending the existing restrictions in ES 5 to all component auditors involved in the audit of a "listed" group, whether members of the network or otherwise.

However, it may be less easy to apply some of the other provisions in the FRC's standards to (a) members of a network who are not involved in the group audit and (b) component auditors who are not members of the group auditor's network. Indeed, the challenges of doing so could render some groups unauditable. For example, typically a joint venture will be audited by the auditor of one of the venturers; if an entity has multiple joint ventures in a jurisdiction, each with a different auditor, widening the application of the Ethical Standards too widely could result in either (a) no firm being able to carry out the audit, as members of a large number of networks are conflicted or (b) no suitable firm being able to provide non-audit services in that jurisdiction.

We suggest that a sensible requirement would be to apply the requirements of ES 5 to the provision of non-audit services by:

- members of the group auditor's network who are acting as component auditors for the purposes of the group audit; and
- component auditors outside the group auditor's network who are performing work for the purposes of the group audit.

It would be sensible to take the opportunity to update the Ethical Standards to use terminology consistent with ISA (UK and Ireland) 600 (e.g. group auditor, component auditor) at the same time.

Some of the provisions of the Regulation apply "upwards" to an EEA incorporated parent undertaking of a public interest entity. We believe that these restrictions should not be extended to non-EEA incorporated parent undertakings; in many cases, a small EEA incorporated PIE several layers down in a group

structure will have little influence over its ultimate parent. It would be impractical to apply EEA restrictions to the audit of that larger group.

**Section 5 – Audit and Non-audit Services Fees**

***Fees for non-audit services***

**Q15 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 the 70% cap is sufficient for two reasons:

- firstly, there are already tough restrictions on services whose nature could impair actual or perceived auditor independence, whether a black list or white list approach is adopted, so the threats to independence are already reduced;
- secondly, there are some permissible services which could have relatively significant fees on a sporadic basis, for example services as reporting accountants in connection with public reporting and comfort letters etc for a takeover or a Class 1 acquisition. The provision of these services requires that the reporting accountant be independent and have detailed knowledge of the target's and/or acquirer's financial reporting practices, which in practice points to the work being carried out by the auditor of target or acquirer, both on grounds of timeliness and quality. As explained in our response to Q7, Some of these services (those relating to public reporting) will be outside the cap; other services (those relating to comfort letters and private due diligence) will not be. Unless the requirements for these private reporting services provided for within the regulatory environment (as suggested in our response to Q7), a significantly lower cap could harm the quality of public reporting and the robustness of sponsor declarations.

Anecdotally we have been told by CFOs and audit committee chairs that the need to be able to procure reporting accountant services, sometimes in a hurry, is likely to result in "keeping back" some of the cap each year to allow for unexpected needs; in practice this means that even with a 70% cap the actual level of services provided will routinely be much lower.

Finally, as an interim review is not required by law or regulation, the carrying out of such reviews (typically 15-30% of the audit fee) would count against the 70% cap. The interaction between the procedures required by ISRE (UK and Ireland) 2410 as part of an interim review and the requirements for an audit (e.g. the requirement to update the auditor's understanding of internal control) is such that it would be nonsensical to have interim reviews carried out by someone other than the auditor. This could have an additional impact on entities that choose to report quarterly and have their reports reviewed.

**Q16 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?**

Yes. We believe that any request should be:

- made by the audited entity;
- include a statement by the audit committee (or, if there is none, the wider board), confirming that, if the FRC agrees to the request:
  (a) they believe that the provision of the services will not impair the auditor's independence
  (b) that they have considered the threats and any proposed safeguards, and will monitor the application of the safeguards; and
  (c) where applicable, their proposed explanation to be included in the disclosure required by UK Corporate Governance Code provision C.3.8 as to why it is in the interest of the shareholders to purchase the services from the auditor as opposed to another service provider (paragraph 4.46 of the FRC's Guidance on Audit Committees);

- be supported by an analysis by the auditor confirming that the services are not prohibited by the law or the FRC's standards, the assessed threats to independence, proposed safeguards and an explanation of how those safeguards address the threats; and
- where applicable, be supported by comments from any supervisor (FCA/PRA) – for example, where the supervisor believes the auditor would be best placed to provide a skilled persons' report or firm commissioned report (perhaps on the grounds that such a report is an independent assurance report).

**Q17 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?**

See response to Q18below.

**Q18 If your answer to question 17 is yes, for a group audit where the parent company is a PIE, should the audit and non-audit fees for the group as a whole be taken into consideration in calculating a modified alternative cap? If so, should there be an exception for any non-audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?**

We believe that the basis for the numerator and denominator in the cap calculation should be consistent. Article 4(2) refers to the denominator being the "average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertaking, of its controlled undertakings and of the consolidated financial statements of that group of undertakings."

- We understand that the European Commission's interpretation of Article 4(2) is that this reference is to statutory audit fees *payable to the statutory auditor*. If this is the case, the numerator for the statutory cap should only be non-audit fees payable to the statutory auditor to compare like with like.
- We believe that many stakeholders outside audit firms have little knowledge of, or interest in, firms' network structures and we don't think that firms should be advantaged or disadvantaged merely as a result of their legal structure. We suggest an alternative approach, therefore, would be to compare non-audit fees paid to the statutory auditor and other network firms with audit fees payable to the statutory auditor and other network firms. In addition, we suggest that the fairest comparison would be "audit fees" rather than just "statutory audit fees". The numerator would include non-audit services to all entities within the group and the denominator would include statutory audit fees as well as fees for (a) audits required by law or regulation outside the EEA, (b) voluntary audits or those required by contractual agreements and (c) audits required by UK or other member state law but which are not "statutory audits" for the purpose of the Directive, for example the audit of pension funds.

In our response to the Q25 of the BIS consultation, we suggest that the auditor's remuneration disclosures in the notes to the financial statements be restructured to allow shareholders to easily identify the numerator and denominator. Potentially this could be extended to require disclosure of the level against the cap, where applicable.

Deloitte.

**Q19 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 (see paragraphs 5.3 and 5.15)?**

We suggest that:

- The first three years of the auditor's tenure should establish a baseline for the cap. Once established, a cap (updated each year on a rolling three-year basis) should continue to apply for the remainder of the auditors' tenure, even if there is a break in provision of permissible non-audit services. Whilst restarting the clock following a break in service would seem to comply with the legal interpretation of Article 4, we do not believe it would be appropriate to do so.
- The cap should not apply to an incoming auditor until its fourth year of appointment. Our rationale for this is that when there is a change of auditor, the level of audit and non-audit fees is frequently atypical (for example because the incoming auditor may need to perform extra work to comply with ISAs 510and 710, and because non-audit services carried out by the incoming auditor may need to be completed or put into run-off.
- The cap should not apply to an entity becoming a PIE for the first time until its fourth year as a PIE The most common mechanism for an entity to become a PIE will be through an initial public offering (IPO) on an EEA regulated market. The level of audit and non-audit services immediately before and after an IPO may well be atypical because:
  - non-audit fees are likely to spike in the year of the IPO as a result of reporting accountant work carried out in connection with the IPO. Whilst some of this work would be required by regulation and therefore outside the cap, other work such as the provision of comfort letters and associated "long form" reporting to sponsors in connection with their responsibilities under the Listing Rules is not. This could well lead to a breach of the cap for every entity undertaking an IPO. We have argued elsewhere that the work in connection with private reporting should also be excluded from the calculation of the cap, which will help to alleviate this particular concern; and
  - audit fees for the pre-IPO years are likely to have been lower.

***Total fees for audit and non-audit services***

**Q20 Do you believe that the requirements in ES 4 should be maintained?**

Yes. We are not aware that they have caused practical difficulties for audited entities in finding a suitable auditor.

**Q21 When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?**

Yes. We believe for the sake of simplicity in drafting the restrictions in paragraphs 31 and 35 of ES 4 could be extended to all PIEs as well as "listed" entities. This is unlikely to cause any practical difficulties for audited entities in finding a suitable auditor.

**Q22 Do you believe that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute an expectation of "regularly" exceeding those limits? If not, please explain what you think would constitute "regular".**

Yes. In practice, as long as the restriction in the Regulation only applies to PIEs as defined by the EU, we believe that few firms auditing PIEs will exceed these limits in one year, let alone three.

Deloitte.

**Section 6 – Record Keeping**

**Q23 Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?**

We suggest that, whilst the Regulation applies automatically, it would be helpful for the FRC to include a retention requirement in ISQC (UK and Ireland) 1 and/or ISA (UK and Ireland) 230 to remind auditors of the requirement.

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

***Audit firms***

**Q24 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?**

Yes.

***Key audit partners***

**Q25 Do you believe that the requirements in ES 3 should be maintained?**

Yes.

We are aware from the minutes of the Audit and Assurance Council that one suggestion was that a period of five years should be adopted for the rotation of all key partners involved in the audit, as opposed to the period of seven years in ES3. Applying a period of five years for the audit engagement partner and seven years for other key partners involved in the audit allows for a period of overlap as one audit engagement partner takes over from another. This contributes to audit quality and to the "appropriate gradual rotation mechanism" required by Article 17(7) of the Regulation.

**Q26 When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?**

We believe that they should apply to PIEs as defined in European legislation.

We do not believe that they should apply to other entities that may be deemed to be of such sufficient public interest as discussed in Section 3. Firms should determine, as required by ES 1, the extent to which they believe it is necessary to apply the "listed" independence requirements to other classes of audited entity.

**Consultation Stage Impact Assessment**

**Q27 Are there any other possible significant impacts that the FRC should take into consideration?**

No.