RBS
The Royal Bank of Scotland Group

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Dear Mr Billing

Consultation: Auditing and ethical standards – implementation of the EU Audit Directive and Audit Regulation

We welcome this opportunity to set out our views on the FRC's Consultation document.

The consultation document sets out a number of matters of importance to RBS both as a preparer and user of accounts. RBS has, in the course of 2014, undertaken an audit tender process, which provides it with particular insight on the challenges of undergoing auditor change.

In many cases, the proposed changes fall in line with existing corporate governance practice in the UK, and represent sound principles for governance. However, there are certain proposals that RBS does not consider result in improvements to corporate governance.

Overall changes

- We are supportive of FRC being the competent supervisory body, and the changes that would follow from the need for this to be legally underpinned
- RBS, as a user of accounts, supports proportionate application and simplification
- We are not wholly persuaded of some of the options with respect to auditor rotation, and non-audit services where this creates undue complexity in application, or creates an unduly restrictive commercial choice for organisations resulting in sub-optimal outcomes for stakeholders
- We note that there are some operational complexities, based on our recent experience of auditor change, in the execution of the proposals. We are particularly concerned about that as a large banking group, a 2-year time frame is necessary to effect a change of auditor
- We are not persuaded of the benefits of the auditor making reports submitted to regulatory supervisors available to the FRC as the competent supervisory body

Auditor rotation
RBS undertook a competitive tender process in 2014 that resulted in a decision to change external auditor. This change will take effect in 2016.

In deciding to change auditor, we recognised that:

- A change of auditor would result in business loss, since each of the challenger firms carried significant banking arrangements with RBS that would require to be exited under auditor independence rules. The firm selected must exit firm banking relationships in 7 countries, and hundreds of their staff must change their banking arrangements;

- Each of the challenger firms were engaged in significant services across RBS, many involving intricate and multi-year programmes that would have to be exited and transitioned to new providers;
- As a consequence, we expect the appointed firm to be formally independent only in the second half of 2015, some 9 months after their selection.

We do not consider ours to be a unique situation; it is one that any large bank would face in undergoing a change of auditor. We have particular concern about how this 2-year change process would sit with the regulation as drafted, which appears to assume that a Year 10 tender would enable a new appointment to take place in Year 11.

We support the good corporate governance practice of 10-year tenders, but there should be due regard to the complexity of managing a change of auditor. A 10-year cycle of tendering fits with a change of lead partner. As such, we would support an approach that allowed for any of:

(a) A Year 9 tender and a subsequent Year 11 change of auditor (as relevant)
(b) A Year 10 tender and a subsequent Year 12 change of auditor (if relevant)
(c) Where relevant, a Year 19 tender with a Year 21 change of auditor

The RBS tender process specifically aimed to ensure that the Board could appoint the audit firm that was best equipped to undertake its audit and would deliver the best audit quality to the organisation. We are concerned that the changes proposed could limit our ability to select the best auditor. Our 2014 process took six months to complete, and each of the participating firms indicated that the process we undertook was a model approach to the selection of an auditor. We do not believe that for a large banking group it is possible to achieve a change of auditor in a period less than 2 years – following a thorough process of auditor assessment and a subsequent period to enable the appointed firm to take the necessary steps to achieve independence.

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? Do you have views on the effectiveness of (a) a 'blacklist' of prohibited services, and (b) a 'whitelist' of allowed services?

We consider that the audit committee represents the best and most appropriate governance forum to manage the use of the auditor outside the core audit process. A 'blacklist' approach is the most appropriate mechanism to highlight areas where conflict is most likely, and to promote consistent market practice. A 'whitelist' approach removes the flexibility of the organisation to procure the best commercial outcome, and is less likely to reflect emerging market trends and issues. Either approach is likely to create areas of uncertainty that require judgment. As such, we believe that the 'blacklist' approach represents the best mechanism to guide the Audit Committee.

To provide suitable transparency, we would consider it appropriate that an organisation be required to disclose its policy on procuring additional services from its auditor, such as through inclusion of the policy on its website or within its annual report. RBS already includes comment on its non-audit services policy within the Report of the Audit Committee within our annual report, as well as explaining procedures in relation to the *ad hoc* use of the auditor.

- RBS's practice regarding non-audit services is restrictive. The bank procures few services other than activities where the involvement of the auditor is most relevant (notably private reporting on quarterly reporting, debt issuance reporting accountant work and regulatory reporting including s166 work).

- As a bank, there is a wide range of activity where the involvement of the auditor is the best commercial outcome in terms of efficiency and effectiveness. We are concerned that the use of a "whitelist" approach, which is likely to focus on activities common across all corporate entities, would be unduly restrictive to RBS as a regulated financial services organisation and would not be sufficiently flexible to recognise changes that occur in the roles that auditors and accounting firms take, or indeed in business practices.

- As a banking provider, RBS makes significant use of accounting firms to support restructuring activities with customers. We are concerned about the consequences of limiting the choice of firm selection and the risk of creating sub-optimal outcomes for customers where a bank is prevented in

appointing the accounting provider with the best skillset and experience. Indeed for syndicated lending arrangements, it is possible that all of the major accounting firms could act as auditors for the lenders.

As a provider of finance, RBS is also a key user of the reports of auditors from its clients, and sees how smaller businesses utilise auditors in their wider business. While larger organisations typically have a wide-level of access to multiple accounting firms, making their engagement more straightforward this is not true for smaller entities. We do not consider it appropriate to require the same restrictions on non-audit services for such smaller entities. We do recognise that rotation is relevant for smaller entities given the possibility of this greater reliance.

Consolidated Groups

Question 17: Is it appropriate that the cap should apply 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?

Question 18: 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?

We are concerned about how the Audit Regulation and Audit Directive would apply within a consolidated group.

We believe that both the assessment of independence and the assessment of the scale of non-audit services are best assessed once within the context of a consolidated group, at the parent entity level. RBS is a complex group with 15 separate regulated entities that could potentially fall into the scope of the Regulation and Directive.

As drafted, the proposals would require application individually by each of these entities individually:

- We believe that conceptually it is preferable for the assessment of fees to be made once on a group-wide basis. This avoids any ambiguity over which entity sources a piece of work, and ensures a consistent approach within a consolidated group
- This approach also marries with the best approach to independence, which is for a consolidated view, made by the audit committee of the group and not individually made at each entity level
- At a group level, all aspects can be properly considered

While we recognise that the Directive and Regulation only have legal force within the EU, we believe that as a principle based approach, this single group-wide application is appropriate on a global basis. We believe that an EU only approach would create potential anomalies that do not sit comfortably with the ability to support the perception and principle of independence.

Similarly, we believe that the audit firm responsible for the audit of the parent company and consolidated group should take account of the activities of its fellow member firms (across its global network) in making its assessment.

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?

Question 16: Should the relevant supervisory authority 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 believe that the 70% cap is appropriate and generally sufficient to allow commercial flexibility, but that a process should exist to manage exceptions to that policy. Since we believe a cap is a blunt mechanism that could restrict the use of the auditor, even where they are most experienced and skilled provider, we do not support a further restriction.

While we accept that exceptions could be provided by the relevant supervisory authority, this is not the simplest approach that could be applied. An audit committee is best placed to ensure that independence is maintained in such a situation, which should be disclosed. Such situations might arise due to significant changes in the size and structure of a group (arising through acquisitions and disposals), or as a result of capital raising or listings (especially if these are significant).

Sanctions

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

The proposals do not cover what the consequences/sanctions would be for a failure to comply with matters under the Directive or that are written into regulation by the competent supervisory body.

Since, we believe a two-year window is necessary to effect a change of auditor, we do not believe a sanction of disqualifying an auditor from acting on a particular entity is appropriate as it would create a situation where the organisation was unable to comply with other legal requirements (eg the requirement to have an audit). We would be interested to understand what proposals for dealing with non-compliance with regulation would be.

We have separately responded to the questions raised by the BIS, which cover some of the same items, and have attached a copy to this letter.

We would be happy to meet to discuss our comments in more detail if this was considered helpful.

Yours sincerely

Rajan Kapoor
Financial Controller

Enc
Letter to Mr Smith on Auditor Regulation#

Responses to other questions

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)?*

Yes, we believe that the proposal to appoint FRC as the competent supervisory body is consistent with its current role in UK audit landscape.

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 this action is appropriate. As an active player in the SME marketplace, we wholly endorse the simplification of measures that apply to this important grouping within the economy.

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.*

Yes, we believe simplification should be offered. In particular, we believe that:

1. Greater flexibility should be offered in terms of the provision of services by the auditor to smaller clients, where there is a risk of higher costs from not being able to use the auditor
2. Modification of the audit fee cap should be applied, recognising the smaller underlying fees received by the auditor make the cap more onerous in comparison to larger organisations. This should also reflect that in the context of a smaller absolute fee level, there is less impediment to the independence of an auditor by virtue of the quantum of audit fee
3. A prohibited service should, in general, be consistently applied to all organisations since it is the nature of the service rather than the quantum of the fee level that creates the conflict of interest. However, we would note that tax compliance work is an important service for many smaller organisations, and where this does not stray into tax advisory or planning work we do not see this as a conflict – since this is more akin to account preparation and not advisory or record-keeping

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 believe that costs and benefits should be carefully weighed in terms of whether an extension of the requirements is considered. It is not clear that a broad extension of the PIE requirements would sit well with a wider goal of simplifying regulation for smaller entities. However, the approach established for PIEs is likely to represent "best practice", and organisations could be encouraged to consider to what extent they comply with this best practice.

Question 5 *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?*

Please see response to question 4.

Question 6 *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?*

Please see response to question 4.

Question 7 – dealt with in main response.

Question 8 *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?

We do not believe the best approach would involve the use of a 'whitelist'.

***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?*

We believe that the proposals broadly echo existing requirements laid down by UK and US bodies, save the extension of restrictions on tax service. We do not believe these need further extension.

***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 believe that the question of prohibition should be a matter of principle under which the defined prohibited services are ones that create clear conflict, and we therefore do not believe that materiality should be taken into account. We also believe that, in practice, it would be difficult to prove whether something had a material impact – especially since the Regulation also seeks to tackle the appearance of conflict as well as actual conflict.

***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?*

Please see response to question 10.

***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?*

Yes, we believe the audit committee is best placed to oversee this.

***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?*

This question has been considered as part of the responses to questions 17 and 18 in the main part of our letter. We believe that the group auditors are responsible for maintaining a dialogue with the audit committee about the delivery of non-audit services. The group auditors should therefore be required to provide accurate information to the audit committee reflecting the use of network members, but it is not appropriate for them to be responsible for full adherence.

***Question 14** 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?*

This question has been considered as part of the responses to questions 17 and 18 in the main part of our letter. We believe that the group auditors are responsible for maintaining a dialogue with the audit committee about the delivery of non-audit services. The group auditors should therefore be required to provide accurate information to the audit committee reflecting the use of network members, but it is not appropriate for them to be responsible for full adherence.

Question 15 – dealt with in main response
Question 16 – dealt with in main response
Question 17 – dealt with in main response
Question 18 – dealt with in main response

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

We believe that the cap should never apply in the first year a firm is appointed because a new auditor may have received fees in other capacities prior to becoming auditor. As such, the proposal appears proportionate to ongoing relationships.

***Question 20** Do you believe that the requirements in ES 4 should be maintained?*

No comment.

Question 21 *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?*

No comment.

Question 22 *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".*

No comment.

Question 23 *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 believe the current requirements are appropriate and consistent with wider requirements on the retention of financial records.

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 believe it should be a matter for the auditor to raise with the audit committee. However, particularly in the absence of understanding of likely sanctions, there may be circumstances that no other competent auditor is capable of completing a statutory audit and an audit committee may need to request an auditor to take office because of a lack of alternatives.

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

We believe 5-year rotation of lead partners has some global consistency and is appropriate.

Question 26 *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?*

For PIEs partners will invest a large portion of their time. For smaller organisations this does not apply and therefore we do not see a need to extend the requirements to all entities.

Question 27 – dealt with in main response