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Dear Mr Billing

Response to Consultation on Implementation of EU Audit Directive and Audit Regulation

I am pleased to respond on behalf of KPMG LLP to the FRC's consultation document of December 2014 on the implementation of the recent EU audit reforms in the UK.

Firstly, we commend the FRC for the open, balanced and clearly consultative approach which it has taken in framing the questions as well as the helpful inclusion of the arguments both for and against particular positions. Our detailed response to each of these questions is set out in the Appendix. However, we do have the following high level observations which we would like to set out up front.

We have always welcomed any measures that are taken with the intent of improving investor confidence in the quality and integrity of financial reporting and understand why it might be appropriate in certain circumstances (such as for the basis of the calculation of the fee cap) to go beyond the minimum EU Requirements.

To the extent that the FRC determines that it is necessary to do so in any area, we would nevertheless encourage further thought be given to firstly whether the benefits outweigh the costs and secondly the possibility of unforeseen consequences.

We believe that this is particularly relevant in considering the extent to which the more stringent requirements of the EU Regulation might apply to "other listed entities". Whilst we can see the logic for considering this for companies with listed equity which are not PIEs (for example AIM listed companies) the position for companies with listed debt is more complicated for the reasons we set out in our response to Question 5.

In relation to non-audit services and whether the UK should take a so called "blacklist" or a "whitelist only" approach we believe that a "middle option" would be more appropriate. Under this "middle option", the whitelist would identify those services that are always acceptable for the audit committee to allow an audited entity to receive from its auditors (subject of course to the 70% cap). However, rather than prohibiting everything else, we believe that the audit committee should additionally be

permitted to approve other services (as long as they aren't explicitly prohibited by the EU) adopting a threats and safeguards approach and with appropriate disclosure in their audit committee report where they have done so. We believe that on a practical level this would achieve greater confidence for investors and transparency at the same time as not being unnecessarily restrictive for companies.

Finally, to the extent that the revised Ethical Standards extend beyond the minimum requirements of the EU Directive or the EU Regulation, we believe that it is imperative that there are very sensible and practical transition provisions in place for all services that are not on the EU blacklist. These need to apply both at the point that the revised Ethical Standards become effective but also each time an entity has to rotate its audit firm. These transition provisions will be necessary to avoid there being a very significant impact on the choice of firms available to companies for the provision of both audit services and non-audit services. We expand further on this point in our response to Question 27.

For information, we are including a copy of our response to the BIS' parallel consultation: *Auditor Regulation: Discussion document on the implications of the EU and wider reforms.*

I trust that you will find our responses helpful. However, please do not hesitate to contact me if you have any further questions or points of clarification.

Yours sincerely

David Matthews
Partner, Head of Quality and Risk Management

Cc Mr Paul Smith, Department for Business, Innovation and Skills

Appendix I

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. We agree that the FRC (subject to continuing to have the power to do so after the Audit Directive (EU Directive) and Audit Regulation (EU Regulation) have been implemented) should continue to have the power to impose additional requirements in auditing standards where necessary to address national law or to add to the credibility and quality of financial statements, as it has done in the past.

However, we also consider that it is important that auditing standards are, wherever possible, consistently applied globally. Therefore we would encourage the FRC wherever possible to continue to work with the international standard setters to address any perceived weaknesses in auditing standards through that route rather than seeking to address them nationally in the first instance. Any such incremental requirements should be introduced only after appropriate consultation and impact assessments have been undertaken.

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 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.

By way of example, the current ethical standards adopt a threats and safeguards basis for assessing non-audit services (NASs) and this allows reference to the specific facts pertinent to the company in assessing permissibility. This approach is particularly important for smaller companies which traditionally may be accustomed to using only one firm of professional advisor (ie their auditor) for support in meeting their reporting and other obligations. If such companies were unable to use their auditors for these services (and had to engage other professional advisers or try to deliver the services 'in house') then we believe that this may either drive up cost for those companies or potentially lead to a reduction in the quality of their reporting (if they chose neither option on cost grounds).

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.

No. We do not believe that the requirements of Articles 22b, 24a and 24b require simplification and further believe that the same requirements should apply to all audits and audit firms regardless of the size of the entity being audited.

Further, we believe that it would be inappropriate for audit firms to be required to meet different standards dependent on whether they do or do not audit certain types of entity. This could lead to arbitrage between audit firms for inappropriate reasons and create practical issues as the population of audited entities of an audit firm changes. We also believe that fundamentally it would be a retrograde step in terms of clarity of understanding for those seeking to rely on audited accounts.

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?

Yes. We think that it is generally appropriate to apply these additional provisions to all entities that the EU have determined should be treated as Public Interest Entities (PIEs), in particular given the majority of these additional provisions are aimed at improving audit quality and the associated reporting.

(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?

Yes. We believe that it would be retrograde to cease to apply these provisions to other (ie non main market) listed entities as currently required by the FRC.

As previously noted, these provisions are aimed, in the main, at improving audit quality and the associated reporting; they are not unduly onerous; and they are already accepted practice in the UK. Therefore given typically these companies (ie those that are AIM listed or have debt listings) are usually held more widely than private companies, we believe that it is appropriate to maintain the higher requirements in this regard.

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?

Whilst we believe that there are strong arguments against extending the stringent new requirements to other listed entities as well as PIEs, we recognise that the choice is not straightforward. On balance, we believe that entities with equity listed on unregulated exchanges should be subject to some of the more stringent requirements in the Regulation. However, we believe the position for entities with listed debt is more varied and complicated for the reasons we explain below.

In the remainder of our response to this question, we set out firstly the reason for our view above, secondly the extent to which the more stringent requirements should apply and finally how implementation should be achieved.

The rationale for other listed entities being subject to the more stringent requirements of the EU Regulation

The stringent new requirements to be introduced to reflect the provisions of the EU Regulation are likely to result in additional costs (or restrictions) for companies subject to those requirements, and the question for the FRC to determine is whether those costs will be more than offset by the benefit of additional confidence in the audit and independence of auditors.

Other listed entities which are not PIEs (eg companies with AIM listings and companies with debt only listings on non-EU regulated exchanges) share certain characteristics of PIEs (such as public ownership) which suggest that there would be some logic in applying the same regulatory regime in order to ensure the appropriate levels of confidence in the audit and the independence of auditors. However, whilst sharing some characteristics, typically these other listed entities have a lower "public interest" profile and historically the other regulatory compliance requirements applicable to AIM listed entities are generally and intentionally less onerous than for entities listed on the main market. In this context applying the more stringent new EU requirements deriving from the EU Regulation to these entities would be contrary to that principle.

Further, the more stringent provisions of the EU Regulation may have a disproportionately high impact on these other listed entities. For example, these entities may have historically used their auditor to provide NASs, in particular for those services which enhance the quality of their accounting and reporting. Typically, these companies have very small management teams and are used to dealing with only one firm of professional advisor and the restriction of access to that advisor might result in no such advice or support being obtained with potential adverse consequences for the quality of financial and other information communicated externally.

Notwithstanding the above, we recognise that confidence in audit and the independence of audit is essential, and particularly so given the current levels of trust in business generally.

Therefore, on balance, we believe that entities with equity listed on an unregulated exchange should be subject to some of the more stringent requirements in the EU Regulation.

However, there are particular considerations for entities with listed debt. In some instance that listed debt may be:

- held throughout the period solely by an undertaking forming part of the same group; or
- issued by an entity headed by an undertaking which is itself a UK or EU domiciled PIE; or
- issued by an entity which is a portfolio company of a private equity (PE) entity.

Where listed debt has been held throughout the period solely by an undertaking forming part of the same group we believe there is no public interest element and therefore the more stringent requirements would not, in our view, be appropriate.

Where listed debt has been issued by an entity within a group headed by an undertaking which is itself a UK or EU domiciled PIE we would question whether there is any incremental benefit in the more stringent requirements being applied to the entity issuing the listed debt given that the EU or UK domiciled PIE will itself be complying with the more stringent requirements.

In the case of listed debt issued by a PE portfolio company, we believe that further consideration is necessary to assess the costs and benefits. Such debt is likely to be held by professional investors and in some cases such investors may have also have either a direct or indirect equity interest. Aside from whether there is a genuine public interest, there are some particular complexities in such circumstances. For example, PE Houses do not necessarily exert day to day control over their portfolio companies, and would not therefore expect to dictate the selection of auditor. Consequently across a PE group there could be a number of different auditors. Applying the more stringent new requirements to debt listed entities could result in a PE House being seriously restricted in its selection of professional adviser as it would potentially be unable to use a number of audit firms (possibly all of the major firms should they already be providing audit services across the portfolio) to provide important NASs across the PE group. Accordingly, we believe there is a strong argument that none of the more stringent requirements of the EU are applied to these entities.

In other cases where entities have issued listed debt, we would expect that the more stringent requirements of the EU Regulation might be applied as with (for example) AIM entities.

The extent to which more stringent requirements should apply

Broadly, the more stringent provisions of the EU Regulation might be summarised as:

1) Restrictions in relation to overall fees levels for NASs;

2) Prohibitions in relation to NASs;

3) Requirements in relation to reporting irregularities;

4) Requirements in relation to Engagement quality control review;

5) Requirements in relation to Audit Committees

6) Requirements in relation to auditor reporting externally and to the audit committee; and

7) Requirements in relation to appointment of the auditor (including tendering and rotation).

In principle, we believe that all of the above should apply at least to some extent to other listed entities. However, there are some practical issues with this – for example some of the above provisions assume the existence of an audit committee at the audited entity. Therefore the FRC will need to decide whether, if other listed entities are not regarded as PIEs (see below), those other listed entities should be required to have audit committees or otherwise how these provisions should apply.

We also believe that some additional flexibility in relation to NASs (1 & 2 above) may be necessary, particularly if the FRC introduces restrictions over and above those imposed by the EU Regulation and / or if the UK does not take advantage of certain of the derogations available to member states.

In part we believe the degree of flexibility required will depend on how the FRC implements other elements of the EU Regulation. So, for example, if the FRC were to proceed with a very limited white list only approach for PIEs, we believe that this would be unduly restrictive for other listed entities and therefore greater flexibility would be appropriate for these entities. If, however, the FRC were to adopt the "middle option" we suggest below (see our response to Q7), then the need for additional flexibility on the nature of services performed may be less important.

We also note that some AIM companies may be very small and, therefore, have relatively low audit fees. Applying a 70% NASs fee cap to such companies may therefore have a disproportionately high impact on their ability to use their auditors for providing anything other than minimal NASs. Additionally, the costs for example of moving from an AIM to a full listing can be substantial, and may be a large multiple of a single year's audit fee[1].

How implementation should be achieved

The final question is how implementation should be achieved.

Given BIS' proposal not to extend the definition of PIEs, we believe it would not be appropriate for the FRC to do so. In addition, such an approach would, potentially, mean these entities were subject to the full range of requirements in the EU Regulation, thereby reducing the flexibility that other

[1] Whilst we note that the EU Regulation allows member states to provide that a Competent Authority may allow the audit firm to be exempt from such requirements for a period of up to two years, this might result in a large number of requests to the Competent Authority.

solutions would allow to deal with the points raised above in relation to prohibitions of and fees for NASs.

Most obviously there would appear to be four options for implementation, namely:

(a) Application on the same basis as for PIEs;

(b) Application on the same basis as for PIEs but with a flexible approach for seeking derogations from the Competent Authority for some or all of the provisions;

(c) Application on the same basis as for PIEs but with a "comply or explain" basis for some or all of the provisions;

(d) Selective implementation.

Each of the above options have their own merits, although all but the first potentially would result in greater complexity in the standards implementing the requirements and, possibly, greater potential for confusion.

However, overall, we believe that the first option may be unnecessarily restrictive, given the wide range (in terms of size and public ownership) of entities within this category and so we would discount this. Similarly the fourth option would still end up being a "one size fits all" approach and, possibly, add the greatest complexity as it would result in a separate set of ethical requirements for other listed entities Either the second or third options therefore appear to be the most appropriate, but clearly the second option might place a particular burden on the Competent Authority (which we believe would probably not be workable in practice).

Therefore we believe that the third option – adopting a "comply or explain" basis should be considered. Comply or explain is a well understood concept in the UK (albeit not for AIM companies) and those companies subject to the UK Corporate Governance Code have generally sought to comply rather than explain. This would allow audit committees (or where the company was not required to have an audit committee the board) to exercise discretion against the expectation that in most cases the more stringent requirements in relation (for example) to tendering and rotation, prohibited NASs and non-audit service fee caps would apply.

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.

It should be remembered that the purpose of an audit is to enable the expression of an opinion to shareholders. The accounts themselves are for shareholder and the directors' fiduciary duty is to shareholders as a matter of law. Whilst we believe it might be appropriate for (separate) consideration be given to this legal position, placing incremental requirements on companies and their auditors in

advance of any more comprehensive assessment of fiduciary duty and the purpose of accounts and their content is misplaced.

In particular, it has to be recognised that the incremental requirements applicable to listed entities under current FRC standards and PIEs under the EU Regulation and Directive carries with it both incremental cost for those entities and restrictions in choice (for example in the selection of provider for certain NASs). For listed entities and PIEs the judgement is therefore that the benefits from increased public confidence as a result of those incremental requirements outweigh the associated costs (and restrictions).

The definition of PIEs was established after extensive consultation within the EU, and therefore it is not clear that there is any need to add to those entities regarded as PIEs (or treating such entities as if they were PIEs). We believe that the existing Ethical Standards requirements continue to be appropriate for these entities.

However, we would recommend that to the extent that these entities 'voluntarily' adopt the Corporate Governance Code then the Audit Committee should be encouraged to consider whether or not they also wished to adopt the provisions of the FRC's audit and ethical standards for 'EU' PIEs and to disclose in their Audit Committee report the decision that they have made in this regard.

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 the EU black list approach taken together with the 70% cap on NASs fees should significantly improve the public perception of independence. Whilst we acknowledge that viewed from a *perception only* perspective this may not provide as much clarity and transparency for investors on auditor independence as a white list only approach would, we believe that a white list only approach could prove to be unnecessarily restrictive for companies.

However, we believe that there is a course of action which lies between these extremes which may be the best option in order to best reduce the perception of threats to the auditor's independence arising from the provision of NASs whilst also balancing the impact on business.

In this "middle option", the FRC would define and publish a white list of services where it is generally regarded as appropriate that an auditor might provide such services (subject of course to

the 70% cap). This in turn would provide audit committees with better clarity around what services they should always be able to approve from their auditor.

Rather than prohibiting services not on this white list - which we believe might unnecessarily constrain businesses or could drive up costs - we believe that the audit committee should additionally be permitted to approve other services (as long as they aren't explicitly prohibited by the EU Regulation – ie on the black list) adopting a threats and safeguards approach and, possibly, with extended disclosure as to the rationale for using the auditor for such services in the audit committee report where they have done so. Given the 70% cap restrictions and wider investor expectations around the provision of NASs, we believe that the majority of audit committees will trend in the main towards only approving their auditors to provide white-listed services only using this ability to approve additional services in more exceptional cases.

This "middle option" might also provide greater flexibility for smaller companies, for example listed companies that would not be classified as PIEs under the Directive, over the use of the auditor for supplying NASs whilst still applying the EU blacklist – ie implicitly accepting that such companies may disclose more instances of using the auditor for services which are neither on the white list or the black list.

Whilst arguably introducing complexity over and above the black list or white list only approaches, we believe that this would be outweighed by the flexibility which would be provided to companies depending on their specific circumstances.

In terms of the specific questions raised with regards to our views of the effectiveness of a black list and white list of services, we comment as follows:

a) Effectiveness of a black list approach – the current position both in the UK and globally, under the IESBA Code of Ethics, is effectively to operate a black list approach – ie to identify and prohibit those NASs which it is considered would impair independence if delivered by an auditor to an audited entity. The black list approach is, of course, also adopted by the EU Regulation - albeit the new EU prohibitions on NASs are much more extensive than those currently applied in the UK. We are not aware of any significant issues with regards to auditor independence arising in the UK (or indeed elsewhere) from adopting this black list approach, therefore we consider it to be effective in protecting *independence in fact*. In addition, the benefit of a black list in the UK is that it is more consistent with the IESBA Code and EU legislation and therefore is supporting a more consistent global approach (especially in the context of a group audit) to non-audit service restrictions. We would note, however, that generally greater clarity is required as to the practical application of the service prohibitions set out in the EU legislation. In particular on what is meant by the following:

- Services that involve playing any part in the management or decision-making of the audited entity;

- Legal services, with respect to the provision of general counsel;

- Services linked to the financing, capital structure and allocation, and investment strategy of the audit client; and

- To the extent that the UK takes up the Member State derogation available for certain tax services, guidance will be needed as to *"...no direct or have an immaterial effect, separately or in the aggregate, on the audited financial statements"*.

b) *Effectiveness of a white list only approach* – the greater restrictiveness of a white list only approach is both its potential benefit (improved clarity and transparency for investors) and its downside (its lack of flexibility as to how companies might be able to use their auditors in certain situations). It should also be recognised that the black list / white list question deals primarily with the independence threat created by the *nature* of the services, whilst the potential self-interest threat created by the *quantum* of NASs is separately addressed by the cap introduced by the EU Regulation. So the potential danger of any white list depends, at least in part, on what services are included on (and excluded from) such a list, and that it inappropriately omits services whose *nature* would not impair independence. Of course, this could be addressed by the Competent Authority operating a very flexible and responsive mechanism to allow companies to request derogations from the white list (in exceptional circumstances) to avoid increased cost/undue hardship, but we question whether that is practicable. We would further note that if a "white list only" approach were adopted ***and*** the FRC extended the requirements to ***all*** listed companies (ie not just those with a main listing), then the impact would be particularly significant for smaller (ie not main market listed) entities (see our response to Q5).

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?

If a white list only approach to NASs were adopted then we believe that, as an absolute minimum, all audit and assurance services should be permitted as well as any services where the provider needs to be able to demonstrate objectivity. We believe that all of the services set out in paragraphs 4.11 and 4.13 meet these criteria and as such should be included on a white list (should the FRC ultimately implement that approach). We also believe that consideration should be given to inclusion of the following services, all of which also meet the criteria, on any white list:

i. all Assurance services delivered under International Standards on Assurance Engagements and in accordance with the independence requirements of s291 of the IESBA Code (eg sustainability assurance, service centre organisation controls assurance, contract compliance assurance, bank covenant compliance assurance etc);

ii. all services such as due diligence (including long form reports prepared by reporting accountants) and forensic investigations instigated by the audit committee where objectivity

is inherent to the nature of the service and consequently the service does not pose a threat to auditor independence; and

iii. provision of generic technical reference material (in hard or soft form) or technical advice on, for example, accounting standards, legislation relevant to accounting, tax and other areas of expertise in the firm and technical training non-client specific; and

iv. Any service where local legislation requires that it be undertaken by the auditor (if the final non-audit service restrictions are to be applied across the whole of the network ref Q13).

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 believe that the best way in which to ensure that the white list is not unnecessarily restrictive is to adopt the approach that we recommended in our response to Q7. That is, to publish a white list of services which an audit committee can then safely adopt by policy (should it wish to) in the knowledge that these services are always permissible for the auditor to provide and then allow the audit committee to pre-approve any other services that it is proposed that the auditor provide (that are not otherwise prohibited by the EU), using a threats and safeguards approach subject to: being satisfied as to (i) the consideration of threats and safeguards; (ii) the overall application of the cap on fees for NASs; and, potentially, (iii) disclosure in the audit committee report of what services the audit committee have approved outside of the white list.

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?

No.

We believe that the existing list of prohibited services has been subject to much consideration and consultation by the EU and we do not see the need to go beyond this.

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?

We believe that there are strong arguments for taking up the derogations in relation to otherwise prohibited NASs. However, we also recognise that the appropriateness of the provision of (for example) tax services by the auditor has been, and remains, the subject of debate. Accordingly we would understand if the FRC were to determine that the derogations should not be taken up.

In making this decision, the question for the FRC is whether taking the benefit of the derogations (enhanced investor and public confidence) will outweigh the cost. In terms of the "cost", the biggest impact will be on companies themselves in respect of tax services where (i) invariably they will incur cost in changing tax adviser (in particular in respect to getting a new firm of advisers up to speed on historic tax matters/enquiries that are open with the Revenue) and (ii) for large groups with immaterial overseas subsidiaries, determining who can assist with the reporting to the tax authorities where the local auditor (as recognised by the consultation document) may well be the best placed provider. In addition, in some jurisdictions, it is a requirement for the auditors to certify the tax returns and this would clearly need to continue to be permitted even if the UK didn't avail itself of the derogations in relation to tax services.

If the FRC does not take up the tax derogations it will be critical to ensure that the final UK Ethical Standards include appropriate grandfathering provisions (effectively allowing audit firms to continue to provide any existing tax services which are already being delivered and which are otherwise permitted under the EU Member State tax derogation) not only at the point that the regulations become effective but also each time a company rotates auditor. Without sensible grandfathering provisions in this regard, recognising for example that concluding tax enquiries with HMRC can extend over a long period of time (often queries can be raised by HMRC years after the tax engagement has concluded), both auditor and professional advisor choice could be very significantly adversely impacted as a result of historic tax services provided and indeed HMRC itself could be impacted on its ability to conclude tax enquiries. Therefore, we believe the FRC needs to take up the Member State derogation to allow audit firms to respond to HMRC enquiries on historic tax matters on which they have previously advised (see our response to Q27 for further explanation of this point).

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 Q7 above.

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?

Yes, we believe that this is a sufficient requirement although the form of audit committee approval might differ.

Audit committee approval might be on the basis of categories of NASs which are pre-approved (possibly subject to certain financial parameters) without further reference to the audit committee or by specific consideration of individual services. We believe that this would be most appropriate for

services on any white list (of course, with the audit committee retaining the right to specify a more specific approval process), for other services (for example under the "middle option" as described above in response to Q7) it may be appropriate for engagements to be considered by the audit committee individually.

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?

Yes.

We believe that it is appropriate to require the same NAS restrictions for all network firms and their associated NASs for the downstream entities within a group which is headed by an EU PIE. The logic for this is that it is hard to see why a service performed in, for example, the United States, should be any less of a threat to independence than, say, a service performed in Germany. We also believe that this, in turn, this would help improve investor confidence in the group audit opinion issued.

However, we believe that as a practical matter such restrictions should not apply to upstream entities (if any) where the ultimate parent or sister entities are outside of the EU (as neither the EU audit firm nor the audit committee of the EU parent will have the ability to control what services are provided to these entities).

In addition, from a practical perspective we believe that further considerations need to be given to circumstances where there is more than one PIE in a group. It may in practice be hard to determine which NAS prohibitions apply if member states (or other regulatory bodies outside of the EU) have introduced different prohibitions with extra-territorial application.

As already noted above (see our response to Q10), there are some other potential challenges in seeking to apply the restrictions extra-territorially – for example, in some instances there might be a conflict between the independence standards set by the FRC and services required by law in certain local jurisdictions to be delivered by the auditor. In these instances, we believe that the local jurisdiction law must prevail.

The other potential consequence of applying the independence standards extraterritorially outside of the EU (in particular if the Member State tax derogation is not taken up in the UK) is that it might adversely impact large UK groups where they have immaterial overseas subsidiaries with limited local management presence and rely on their audit firm to help with tax filings etc.

Applying restrictions to other group auditors that are not part of the group auditor's network

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?

The group auditors can of course require this through the group audit instructions and seek confirmation from audit firms from other networks that they have complied with the requirements. However, in this scenario the group auditor will have very limited means of otherwise 'ensuring' the other audit firm's independence. We believe that the main onus should be on the audit committee itself to ensure the independence of 'other audit firms'. Companies could achieve this by setting group policies and audit committee pre-approval parameters accordingly which apply to all firms engaged with the audit. In addition, as already explained in our responses to Q10 and Q13 above, there are some additional considerations (in particular with respect to tax services) which will need to be addressed. Finally, guidance will be needed to clarify if this should apply for any entities within a group structure that are not wholly controlled, such as for joint ventures and affiliated entities.

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?

Yes. We believe that the 70% cap on non-audit fees is sufficient.

We don't believe that it is necessary to introduce different caps for different types of service (adding this level of complexity in particular could be very difficult to monitor without any appreciable benefits) nor do we believe that it is necessary to lower the cap below 70% (ie to go beyond what the EU has established as the minimum). We believe that a combination of much tougher NAS restrictions (either through a black list approach, a white list approach or our "middle option") and the impact of an absolute cap of 70% is a significant change from the status quo and will in turn reduce the threat of any perceived lack of independence of auditors.

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 the competent authority should be able to grant exemptions.

Such exemptions should be considered on a case by case basis by reference to some commonly established and transparent principles – for example where the services are required to support a capital market transaction or where the work is commissioned to improve investor confidence in the company's financial reporting. In order to address any threat of a perceived lack of independence, we believe that it would be sensible for any such request for an exemption to be made by the audit committee (not the auditor).

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?

We recognise the logic behind the FRC's suggestion that non-audit fees paid to network firms other than the auditor of the PIE itself should be included in the calculation to make both the denominator and the numerator in the calculation consistent and as such would be generally supportive of this approach as well if implemented. We comment further on which network firm fees should be included in our response to Q18 below.

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?

As stated above we would be generally supportive of a modified approach to the cap which included non-audit fees paid to the network firms as a whole. However, we do not believe that non-audit fees paid to audit firms that were not part of the network of the auditor of the PIE itself should be included in the calculation (as these cannot either in fact or by perception) impair the parent auditor's independence. In addition, we believe that whilst it is appropriate to include in the calculation all network firms and their associated NASs for the downstream entities within a group which is headed by an EU PIE, it would not be appropriate to include upstream entities (if any) where the ultimate parent is outside of the EU or sister entities outside of the EU (as neither the EU audit firm nor the audit committee of the EU parent will have the ability to control what services are provided to these entities).

We believe that it is appropriate to exclude any services required by law from the NASs fees total used in calculating the ratio (as explicitly set out in Article 4).

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 believe that the average of three years audit fees is generally a good proxy for the recurring level of audit fees for the purpose of calculating the cap.

However, we believe that "re-setting the clock" (i.e. when no NASs have been provided in particular period, the three year period recommences with effectively no cap for the first two years) does not make sense and as such is inappropriate.

Clarification is also required as to how the three year rule should operate when a company first becomes a PIE by virtue of a listing as typically the audit fee for a listed entity is significantly higher than for a private company of the same size/complexity because of the associated reporting requirements which require the auditors' review. We believe that in this scenario the pre-listing audit fees would need to be excluded from the calculation of the average audit fee.

Total fees for audit and non-audit services

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

Yes.

We believe that these limits act as an ultimate safety valve on independence and whilst it would be exceptional to see them triggered (at least for larger audit firms) it is sensible to retain them in the Ethical Standards.

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 that the more restrictive requirements in ES 4 should apply to all PIEs and to all other entities that the FRC ultimately deems to be of sufficient public interest.

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. We believe that three years is a sensible proxy for a recurring level of fees.

We note that it is also consistent with the period that it being suggested to be used in the calculation of the average audit fee for the purpose of applying the 70% cap.

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?

Yes.

The current retention arrangements of six years for audit documentation is sensible and has not (to our knowledge) given rise to any issues. We believe that it would be sensible to codify the required retention period in ISQC1 though, in particular given the ICAEW and Association of Chartered Certified Accountants currently have different requirements in this regard.

Section 7 – Audit Firm and Key Audit Partner Rotation

Audit firms

1 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?

The requirement to rotate audit firm is a direct obligation specifically placed on a company under the EU Regulation. As such, we do not think that it is appropriate to move the primary obligation for ensuring that the company rotates auditors from the company to the audit firm. However, that said, as for other areas of corporate governance we believe that the audit engagement partner should be required to monitor their audit client's compliance with the rotation requirements. We note that to date there have been a number of questions as to how the transitional provisions of the EU Regulation apply in practical examples and that on 6 March BIS issued some clarifying guidance on certain questions. Given the complexity of this area, and as envisaged by the recent BIS document, we believe that it is important that the competent authority establishes a mechanism for audit firms and companies to be able to consult with them when the rotation or tender dates are not clear.

Key audit partners

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

Yes.

We are not aware of any evidence that these requirements are causing practical difficulties or impacting audit quality. However the definition of Key Audit Partner should be reviewed to ensure there is greater clarity to remove ongoing debate and discussion with Audit regulators over its practical application. In particular, we would caution against drawing the definition so wide that too many partners involved in an audit are regarded as potentially Key Audit Partners - given the desire

to bring broader specialisms into audit teams to enhance audit quality there is a concern that too broad a definition will impact the ability of being able to allocate appropriate resources to engagements (in particular where this might necessitate a deep specialism).

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?

Yes.

We believe that the requirements in ES3 should be consistently applied to PIEs and other listed entities where appropriate (see our response to Q5). In addition, and consistent with our response to Q5, we believe that these should also be applied to other listed entities so as to avoid the implementation of the EU Directive and EU Regulation being deregulatory for those entities.

Consultation Stage Impact Assessment

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

Yes. If a limited white list approach is adopted or if the Member State derogations (in particular those that are available for tax) are not taken up then in order to allow clients to have sufficient choice of provider for both audit services and NASs there needs to be practical transition provisions on both entry into and out of an audit relationship for all NASs where the FRC has gone beyond the EU minimum requirements.

Without such provisions there is the very real risk that firms will not be able to get themselves sufficiently independent to be able to tender for the audit with the consequence and that this will further restrict the choice available to audit committees of audit firms able or willing to participate in a competitive tender.

In addition, without sensible grandfathering provisions in these circumstances there could be the following consequences:

i. Reduction in choice of provider of NASs to clients in the pre-tender period as providers may chose not to tender for NASs on the basis that they would not be independent for the audit tender - this may drive up costs for businesses;

ii. Reduction in choice of provider of NASs in the post-appointment period if the exiting auditor cannot commence non-audit service work prior to exiting the audit relationship. This is particularly relevant for global tax compliance engagements which generally can only be provided by the major accounting firms with sufficient geographic coverage;

iii. Extra costs for the companies if they have to engage another party to complete the NASs if the initial provider needs to exit the relationship for independence purposes;

iv. Disruption and extra costs to other third parties such as potentially HMRC and other government bodies if the firm engaged to provide NASs has to exit the relationship before completion of the engagement; and

v. Difficulties in supporting and/or maintaining technology already implemented by businesses where the historic NASs delivered includes the provision or implementation of a technology solution.

To mitigate these risks, we believe that firms should be able to complete engagements for which they have contracted prior to appointment as auditor for any services which are not explicitly prohibited by the EU Regulation. This could mean, for example, the UK taking full advantage of the derogations available for tax and valuation services for the purposes of any services delivered in such a period of transition (even if the UK does not take advantage more generally of these derogations in establishing which non-audit service restrictions should apply). We recognise that there is the need for a backstop date for any transitional period, however, this needs to allow sufficient time to close off engagements involving, for example, tax authorities. We are concerned that applying the EU Regulation in its most restrictive form in the specialist and complex area of tax will have significant implications for UK PIEs. In particular, the immediate withdrawal of tax services relating to assisting audit clients in dealing with long standing enquiries with the tax authorities required on becoming auditor (or transitioning into the new regime) is the most concerning as we believe that this disruption is neither cost efficient nor in the interests of the audit client or the tax authorities, and ultimately the shareholders, to resolve complex tax issues quickly.

Similarly, we believe that an auditor who is exiting an audit relationship should be permitted to commence work on otherwise prohibited services provided that (i) another firm of auditors has already been appointed, (ii) the work commences after the end of the final audit engagement period for which the audit firm will be signing the accounts (iii) the substantive part of the work takes place after the audit relationship has ended and (iv) any outputs of the service will not be subject to their own audit.

Finally, to the extent that the requirements in relation to NASs and the application of fee caps are applied extra territorially outside of the EU, we believe that given it is the company and its audit committee who will be purchasing and approving the NASs, the FRC should additionally place joint onus on the company to set group policies in this regard and require audit committee pre-approval parameters to be set accordingly.