

Reason for and credentials for this comment?

Professor Krish Bhaskar together with Professor John Flower and contributions from Rod Sellers (OBE) are writing a book whose current working title embraces the Future of Financial (and non-Financial & IR) Reporting including Auditing and Assurance. This is to be a series of publications and websites, starting with Routledge hardback in June 2016. See also www.fin-rep.com among other websites.

In the book as a literary device, Rod (by name) will support industry and the Audit profession (particularly the Big 4). John will be the left-leaning, radical, in favour of total independence of auditor and somewhat anti-profession as it is currently structured. Krish is in the middle, pro- capitalism with some state intervention and regulation, but willing to change and embrace new ideas.

Philosophy, assumptions, content and context

- a) Not gold-plating
We are worried that the FRC may go for gold-plating.
- b) Simple but effective
We hope that the new rules can be simple, concise yet clear but also subject to ideas below. So simplifying the new regulations but make them as effective as the EU intended. To buy peace with the Big 4 + 2, pragmatically it may be prudent to have flexibility in the cap and in the services provided (prohibited services). Perhaps with both a role for FRC in permitting and monitoring such exemptions.
- c) Expand to encompass the diverse sets of rules or compact to a core intersecting the current sets.
At the moment you have Current FRC regulations, the AQRT inspection philosophy (in so far as it is different) and new the EU Regulation and then the forthcoming non-Financial Information Directive.
Do you expand the scope of all of these to encompass a wider set of regulations or do you trim down to basic intersection of the core spirit of these regulations?
Interesting problem to have to deal with.
- d) Not shared by the Big 4, but well done to the FRC.
The original Regulation and Directive has some inherent conflicts embedded within it. I think the FRC has done an excellent job of teasing these out. Though my feedback suggest that the Big 4 believe you have been overly tough on them. I don't think so though on services (see below) you might have been.
Inevitably the original politicians (EU, House of Lords, part of the CC/CMA report) wanted a set of tougher conditions than even you have so far consulted on.

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Substantive issues in comments

- I favour a wider set of organisations being included. Boots, many of utilities and many households names are privately held and would fall outside the FTSE 350, listed criteria and/or other PIE criteria.
- I also favour having a blacklist (for what is prohibited) and a white list (for what is allowed). I think this is better in the interests of clarity.
- Whilst this would not please John Flower but would please Rod Sellers, the FRC might consider the following change:

Whilst the FRC have provision for much flexibility with the cap on NAS (non-audit services), there is no flexibility offered for the service aspect. I think the Big 4 think this is a mistake. I think the Big 4 will find it more palatable to have some flexibility in both service areas (prohibited and white list). May be a compromise would be for a transitional period and exceptions policed by the FRC. There is an argument for the PIEs that the auditor can achieve some strictly NAS work can be achieved more efficiently and at a lower cost. I believe that such an argument truly has some merit. That said John Flower would be against such a move. Rod Sellers would favour greater flexibility than in your consultative document.

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Section 1 – Auditing Standards

Question 1

Do you agree that the FRC should, subject to continuing to have the power to 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, add to the credibility and quality of financial statements)?

Answer to Question 1

Yes.

I have been involved with various directives and regulations over time including Block Exemption, Pricing, Dominant Position and State Aid. My view is that the resulting Directives and Regulations are the result of an intense political debate involving compromises and horse-trading. Hence the final text of many directives/regulations are full of ambiguities, conflicts and are often in need of subsequent clarifications; or introduce notions that are incomplete or are ill-defined. This Audit Directive and Regulation is more complete than most and indeed the next one (“Disclosure of non-financial and diversity information by certain large companies and groups”) that the FRC will have to consider.

So in my view it is right, fitting and proper that the FRC takes on this role.

In the subsequent answers given there is one area that I will view as being relevant in my answers. Although the FRC refer to stakeholders, this is sometimes interpreted narrowly as just the investment community, I intend to answer for a fuller and wider set of stakeholders that have been or are mentioned within Integrated Reporting and as interpreted by the Harvard strand (Professors Robert G Eccles and Michael P. Krzus) and the IIRC (as led by Professor Mervyn King and Paul Druckman).

In terms of definitions the BBC definition is:

A stakeholder is anyone with an interest in a business. Stakeholders are individuals, groups or organisations that are affected by the activity of the business.

Source:

www.bbc.co.uk/schools/gcsebitesize/business/environment/stakeholders1.shtml

I would want to widen this to:

A stakeholder is anyone with a current or possible future interest in a business. Stakeholders are individuals, groups or organisations that are affected or may be affected (in the future) by the activity of the business. That would include the investment community, debtors, creditors, suppliers, contractors, customers, intermediaries, agents, the supply chain and customers chain and so on.

So, for example, potential future employees are a stakeholder, albeit weaker and once removed. Though, a price leader in an oligopolistic situation, as in UK energy supply, can affect all energy consumers. Hence, all energy consumer might be regarded as stakeholders.

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2 Proportionate Application and Simplified Requirements

Question 2

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

Answer to question 2

Yes but see below.

Question 3 Part 1

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?

Answer to question 3 Part 1

My view tends towards to apply the same standards to all audits subject to a size limitation. In terms of audit firms this will only apply to the top (to be defined) audit firms that are involved in the FTSE350, listed companies, financial institutions falling within the scope, PIEs, plus the top 100+ private companies.

⇒ That said the requirements should be as clear and simple as possible subject to being effective.

The latest survey contained in the Accountancy Live magazine (February 2015) shows that tendering has increased but that contrary to warnings of greater concentration, all sectors of the top 75 auditing firms have experienced growth. So perhaps the size of the audit firm and the entity being audited should not be made too small.

The UK is unlike other member states, in that it has a large private equity market. Hence many of our high street names (e.g. Boots [Alliance Boots], John Lewis Partnership, Matalan, Arcadia, Iceland, Specsavers, House of Fraser, Poundland, DFS, Harrods Group, Welcome Break, Virgin Atlantic, Virgin Trains and many others) and public utilities (Thames Water, Anglian Water, Southern Water) are either owned by private equity companies or are in private ownership (sometimes with non-UK shareholders). JCB is No 3 globally in certain segments of construction and earth moving equipment (after Caterpillar and Case) yet they have no consolidated accounts and may be excluded from the more rigorous audit procedures.

This is further discussed below.

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2 Proportionate Application and Simplified Requirements/Cont.

Question 3 Part 2

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 to Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

Answer to question 3 Part 2

For small audits the requirements are about correct subject to comments above.

What worries me is that there is a raft of private companies that are large or important and who are not being covered by PIE requirements at the moment.

I think it entirely appropriate that companies in this list below:

http://en.wikipedia.org/wiki/List_of_largest_private_companies_in_the_United_Kingdom

should be treated in the same way as a PIEs.

The top 50 of these are shown on the next page.

That Wiki list is not exhaustive. I think that the default for large private companies should be subject to a number of employees, balance sheet and turnover tests.

Perhaps a simple rule (but exemptions could be allowed for [policed by the FRC]) is the Non-Financial threshold limit of 500 employees.

The scope of those non-financial disclosure requirements should be defined by reference to the average number of employees, balance-sheet total and net turnover.

SMEs should be exempted from additional requirements, and the obligation to disclose a non-financial statement should apply only to those large undertakings which are public-interest entities and to those public-interest entities which are parent undertakings of a large group, in each case having an average number of employees in excess of 500, on a consolidated basis for groups. This should not prevent Member States from requiring disclosure of non-financial information from undertakings and groups other than undertakings which are large public-interest entities, and from public-interest entities which are parent undertakings of a large group.

I think that it would be good to catch all in the list of large private UK companies referred to above. Note that this list is not complete or exhaustive. There could be an exceptions clause, or special circumstances including initial exemption for a fast growing company that has only just made any threshold.

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

Invitation to comment: Professor Krish Bhaskar

Top 50 Private Companies	Sales (£m)	Employees
Alliance Boots	25,400	74,410
Ineos	19,570	7,942
JCB	10,000	10,500
John Lewis Partnership	7,759	85,700
Stemcor	6,254	1,860
Arcadia Group	2,682	44,030
Swire		79,194
OCS Group		56,065
Specsavers		30,000
SSP		29,551
Wilkinson		23,063
New Look		22,605
Shop Direct Group		18,688
Gala Coral Group		18,125
TI Automotive		17,360
Matalan		15,858
Pentland Group		15,468
River Island		15,155
Laing O'Rourke		15,027
Clarks		14,389
Acromas Holdings		14,152
Iceland Ltd		13,462
Mott MacDonald		13,162
Merlin Entertainments		12,364
Martin McColl		12,013
Bourne Leisure		11,724
Northgate Information Solutions		10,643
Brakes Group		10,000
Arup		9,934
Enterprise		9,924
Odeon & UCI		9,591
2 Sisters Food		9,061
B&M Retail		8,864
Virgin Atlantic		8,631
Poundland		8,602
Unipart		8,533
Arnold Clark Automobiles		8,500
United Biscuits		8,156
Samworth Brothers		7,323
Travelex		7,022
TJ Morris		6,912
Anglian Water		6,898
KCA Deutag		6,696
Spire Healthcare		6,353
Biffa		6,250
Linpac		6,218
Firstsource		6,000
AF Blakemore & Son		5,809
Findus		5,651

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

Question 4

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

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

Answer to Question 4

In terms of possible impact to stakeholders, I think that all entities in both columns should be subject of the more stringent requirements as applied to the 'Listed entities'.

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 stringent requirements should apply to which types of other listed entities?

Answer to Question 5

Yes to both sets of columns and private non-listed companies as outlined in: http://en.wikipedia.org/wiki/List_of_largest_private_companies_in_the_United_Kingdom

though this list may not be exhaustive. This includes some very small firms. In practice you may have to define a turnover, profit, asset and number of employees test. In the Non-Financial information Directive, the test seems to be 500 employees. That may be too restrictive, though the use of sub-contractors could limit the number of official employees. But 500 employees is a simple and clear rule.

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?

Answer to Question 6

All the more stringent requirements apply to both columns and to private companies as defined in the answer to Question 5.

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4 Prohibited Non-audit Services

Note

I would like to raise a possible objection to paragraph 4.29.

Much of the non-audited services (NAS) provided by the BIG 4 consists of advice on systems, controls, processing of accounts, software, cost reducing, efficiency/productivity improvement, and special investigations/forecasts.

Now I do not believe that this is as low as 10% of the total fee income. Casual observation and case-studies seem to indicate that this is an order of magnitude higher. I don't have a systematic set of empirical evidence (as yet) but we are trying to generate one.

Prohibition of other non-audit services to PIEs

Question 7 Part 1

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)?

Answer to Question 7 Part 1

There is no simple answer.

The extreme approach would be to ban all non-audited services (NAS). My colleague Professor John Flower would advocate this. My close associate, Rod Sellers would argue very much in line with the Big 4 but would want simple but effective solutions. However there is an efficiency and cost augment that a PIE might want some additional work that is adjacent to or close to audit work, or uses knowledge, audit documents/information or some of the background audit workings to produce a NAS. For costs reason it may be the auditor can provide the lowest cost work and for another company to do this may require much duplication of work and even perhaps duplication of a learning curve that might take several years.

Question 7 Part 2

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?

Answer to Question 7 Part 2

In order to make this a clear, concise and water-tight as possible I believe you need to have more clarity. The Big 4 will use their best brains on finding ways to wiggle around this regulation. So I believe you need to provide clarity in the form of

Both

- a) A black list of what is prohibited
- b) And a White list of what is allowed

To do just one of these two is to open the floodgates to the very wise, intelligent and cunning Big 4 brains dealing with this.

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4 Prohibited Non-audit Services/Continued

Question 8 Part (a)

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?

Answer to Question 8 Part (a)

The extreme John Flower view would be to be even more restrictive than set put in 4.13. Pragmatically it may be appropriate to accept 4.13 and to add to it those outlined in 4.11 and ES 5. Paragraph 4.14 could allow a more palatable solution for the Big 4 plus the mid-tier firms (GT and BDO). A degree of flexibility would ensure their support. That flexibility could be by special exemption with the permission of the FRC.

Just one comment on paragraph 4.15. I think that it is not a case of either a black list or a white list but a black list **and** a white list. I would argue for this on the basis of clarity, simplicity, additional useful information and more rather than less explicit instructions. Give the Big 4 some leeway and I am sure they will take it. Better to be more proscriptive and absolutely clear.

Question 8 Part b)

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

See note above. I think the best way it to have a black list **and** a white list. I would argue for this on the basis of clarity and additional information. Helping by providing more rather than less explicit instructions. The black list provides areas and examples of services that are prohibited and the white list provides directions as to what is allowable. I feel this is clearer than just a black list **or** a white list.

If this needs to be tightened then any service not mentioned should be checked with the FRC before being undertaken. A register of who is doing what and whether it has been approved or is on the white list or a service allowed through derogation or through permitted flexibility by the FRC. In this was the FRC could provide some flexibility but with a measure of control.

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4 Prohibited Non-audit Services/Continued

Question 9

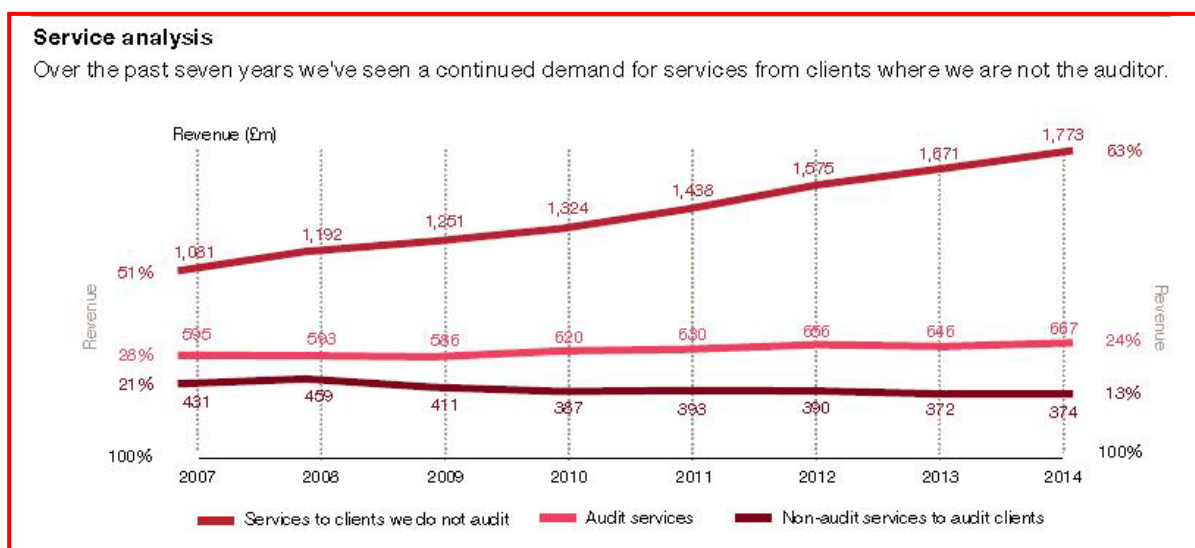
Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

Answer to Question 9

There are many different areas of NAS (non audit services) and there may be no common definitions. The UK audit firms have a traditional role that encompasses much of the old British empire and, because of the City, has links to many overseas companies, and indeed the world.

After examining all four annual reports of the Big 4 there is obviously much disagreements as to what various terms mean, the areas covered or encompass. That also applies to the information in paragraph 4.29.

All of the Big 4 show a growth in non-audit work similar to the one below, taken from PwC.



The FRC may be in a better situation to understand the nature of the fee revenue of £1,106 million of 'services to clients we do not audit'. I remain a little sceptical of these figures and whether this is completely independent of audit work broadly defined (viz group audits by network or associated companies, or such similar).

So it may be that some of this £1.106 billion is audit related as defined in a broad and non-technical sense. Especially as the UK and London is often regarded as the centre for many geographical areas, if not the world. I would want to investigate the full fee income and the associations between the various entities being worked on and a common but strict definition of work so that one can pigeon hole work accurately and characterise across these definitions across all of the top audit firms.

So I would want more information before answering this question definitively. However, the Big 4 will probably provide answers along the lines of 'no' and 'none'.

4 Prohibited Non-audit Services/Continued

Derogations in respect of certain prohibited non-audit services (see pages 35 – 36)

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?

Answer to Question 10

Of course whether they have a direct or material effect is a question of judgement. In the past judgement has been abused. My colleague John Flower would argue the case for less flexibility and therefore no exemptions. My view is that some flexibility, particularly during a transitional period, would make these new rules more palatable to the audit firms. Rod Sellers would argue for simplicity and flexibility.

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?

Answer to Question 11

Within the context of the FRC policy, I can't think of any. Take tax provisions. About 5% of the net profit may be judged as a rough rule of thumb for being material;. Most tax provisions would be in the region of 10% to 25% unless adopting tax avoidance according to the Amazon, Google, Microsoft, Virgin associated companies or Apple type models. And therein lies the rub. It is precisely those companies who might require extensive tax advice. The result of that tax advice would be to reduce the tax bill from, say 20%, of net profit/income to close to zero. Now the resulting differential effect has a direct and material effect but if considered as written they would be free to undertake such activity.

Audit committee's role in connection with allowed non-audit services

Question 12

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

Answer to Question 12

The problem is that threats to independence have never been taken seriously previously. The audit committee would tend to rubber stamp anything that senior management wanted. The white list and a black list help here – it provides a checklist. If a NAS is not on the black list or white list or where that service may be categorized imprecisely or ambiguously or one could argue both ways, the black and white list provide a checklist for the audit committee.

4 Prohibited Non-audit Services/Continued

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

Question 13

When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based?

Answer to Question 13

Yes.

If not, what other standards should apply in which other circumstances?

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

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?

Answer to Question 14

Yes.

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5 Audit and Non-audit Services Fees

Question 15

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

Answer to Question 15

Extreme views (John Flower) would say that a lower limit, preferably zero, should be applied. Realistically, 70% allows the top audit firms to undertake some work, perhaps even most of what they do today. However, as discussed above, the suspicion is that the actual broadly defined ratio is much higher than 70%. None of the Big 4 will argue for a lower limit than 70%.

Question 16

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

Answer to Question 16

Yes.

Criteria should be cost and efficiency for the PIE subject to jeopardizing the auditor independence.

Question 17

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

Answer to Question 17

Yes. The cap should apply to network firms. Independence between network firms is notoriously unreliable.

Question 18

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?

Answer to Question 18 Part 1

Yes.

If so, should any non-audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?

Answer to Question 18 Part 2

No.

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5 Audit and Non-audit Services Fees/Continued

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)?

Answer to Question 19

Yes.

Total fees for audit and non-audit services

Question 20

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

Answer to Question 20

Yes.

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 other entities that may be deemed of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply

Answer to Question 21

Yes and Yes.

We need to encompass the private companies that are not listed such as Boots, JCB and other companies discussed earlier. You could devise revenue and profit criteria. However, the criteria discussed in the Non-Financial Directive of 500 employees could be appropriate.

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”

Answer to Question 22

Expectation is subject to judgement and manipulation.

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6 Record Keeping

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?

Answer to Question 23

Yes.

Must be at least 10 years or longer.

7 Audit Firm and Key Audit Partner Rotation

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?

Answer to Question 24

Yes.

Question 25

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

Answer to Question 25

Yes.

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?

Answer to Question 26

Yes.

Other criteria could be considered but the suggestion here is private companies with more than 500 employees.

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Consultation Stage Impact Assessment

Question 27

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

Answer to Question 27

Difficult to foresee impacts. Several different forces at work.

That said I would argue a greater role for the FRC in overseeing the new regulations, being a watchdog/police force (which in turn will act as a deterrent) and fine-tuning the regulation (inevitable) as the implementation and its impact is monitored.

/Ends