THE INVESTMENT ASSOCIATION
INVESTMENT MATTERS

The Investment Association
65 Kingsway, London, WC2B 6TD

T +44 20 7831 0898
W theinvestmentassociation.org
Twitter @InvAssoc

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

k.billing@frc.org.uk

23 March 2015

Dear Keith

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

The Investment Association represents the asset management industry in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £5 trillion (€5.6 trillion) of assets, which are invested in companies globally. In managing assets for both retail and institutional investors, our members are major investors in companies whose securities are traded on regulated markets. Therefore, as users of these companies' accounts they have an interest in the requirements governing the audit and the auditor's report.

We believe that the main purpose of accounts is to provide investors, the holders of ordinary shares, with the information they need for the purposes of deciding to buy, sell or hold their shares and fulfilling their responsibilities as owners – assessing company management and the strategies adopted, stewardship. High quality audits are pivotal to this and for ensuring that markets value the information reported and investors believe what they are told about the financial position of their investee companies.

The requirements of the EU Audit Directive and Regulation seek to address a number of investors' concerns around audit, including those around auditor independence and objectivity which may be compromised by long term relationships with clients and the provision of non-audit services, the limited number of audit firms with the capabilities to audit large multinational entities, and the nature of auditors' communications with investors.

We support these objectives and welcome the FRC issuing this Consultation on the range of Member State options for the development of its audit and ethical standards. We set out in the attached Annex our answers to the detailed question raised and our key observations below.

- **Scope and the FRC's more stringent requirements.** One of the issues highlighted in the paper is that Public Interest Entities (PIEs), as defined in the Regulation, include unlisted credit institutions and insurance undertakings which are not within the FRC's definition of 'Listed entities'. Similarly the FRC's definition of 'Listed entities' includes companies listed on AIM, and debt and equities listed on a recognised exchange or equivalent, which are not included in the definition of PIEs.

  Moreover, in certain areas the FRC's audit and ethical standards include more stringent requirements relating to areas such as engagement quality control reviews, limits on the total audit and non-audit fees and non-audit services, and for entities that apply, whether voluntarily or because it is required, the Corporate Governance Code, auditor reports to the audit committee and to the market. We would be concerned if these requirements were to be lost or limited in any way. In particular, investors have welcomed the additional transparency which should improve confidence and the attractiveness of the UK market internationally.

  Thus we consider the more stringent requirements in the FRC's standards should continue to apply to 'Listed entities', as defined by the FRC, and should also be applied to PIEs. Similarly, we consider 'Listed entities' are of sufficient public interest that their audits should be subject to the same requirements as PIEs as set out in the Regulation. Such an approach would avoid unnecessary complexity with different requirements being applied to different types of listed entity and is important to maintaining confidence in audit. It is also one of the costs of a 'Listed' entity being able to access capital from the markets.

- **Prohibited and capped non-audit services.** Non-audit services, particularly those of an advisory nature, can introduce a potential conflict of interest and impact an auditor's independence in that the auditor may identify himself with the interests of management rather than those of investors. Where there is a clear conflict then we support a 'black' list of services that firms are prohibited from providing to their audit clients. It is important that there is clarity over the exact type of services the 'black' list covers and it would be helpful if there was guidance to address this. The list should also be open to amendment as requirements and services evolve.

  We also support the 70% cap on fees from other (non 'black-list') non-audit services in that when the non-audit fees earned are significant compared to the audit fee then again independence can be affected. We do, however, have certain concerns due to the way the Regulation has been drafted which need to be addressed as set out in the last two bullets.

  Moreover, at this point in time we do not support the UK extending the list of prohibited services or introducing a lower cap for non-audit fees without a clearly identified need. It would be a concern to us if the UK exercised options that would further limit the audit committee's ability to determine the best qualified firm for particular services and reduced the number of firms that are willing or able to tender for a particular audit.

  In this context, a minority of investors consider that it would be helpful to have both a 'black' and a 'white' list in that this would provide clarity to audit committees when considering audit tenders and audit firm rotation as to which firms would be precluded and which could be appointed. The committee would also be clear that assurance type services, such as reporting accountants work and audit related services, can be provided by the statutory auditor.

- **Network firms and non-audit services.** There is inconsistency in scope between the non-audit services the auditor is prohibited from providing, and the cap which limits the non-audit services that can be provided. An audit firm *and* its network firms are prohibited from providing certain services to a PIE and members of the PIE's group that are *based in the EU*. On the otherhand, the cap applies to the audit firm only, *excluding firms in the network*, but includes *all members of PIE's group wherever based.*

  Only prohibiting the provision of non-audit services to PIEs within the EU means that parts of a multinational group that are outside the EU would not be subject to the same requirements and could avail themselves of these services. Similarly only the audit firm itself and not its network firms are subject to the cap such that network firms could provide permitted non-audit services to a PIE without any restrictions. These factors would impact the perception of the auditor's independence and would not necessarily be transparent to investors.

  To address this, the FRC should take a 'top down' approach and ensure that the lead group auditor and any of its network firms used in an audit comply with the FRC's standards with respect to all group components wherever based. Otherwise there is a risk that services could be provided to a group component that could compromise independence and impact audit confidence.

- **Three consecutive years for calculating the cap on non-audit services.** Article 4 of the Regulation stipulates that the total fees for non-audit services should be limited to no more than 70% of the average of statutory group audit fees paid in the last three consecutive years. We understand if there is a break in the provision of non-audit services, the calculation of the cap stops. We are concerned that that this would allow an audit firm to provide non-audit services for two consecutive years in excess of the 70% cap, have a year where it does not provide non-audit services and then provide such services in year four. To avoid this, the FRC should consult on applying a simpler cap that limits non-audit services in a year to 70% of the estimated audit fee for that year.

I trust that the above and the attached are self-explanatory but please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall
Director, Stewardship and Corporate Reporting

Section 1 – Auditing Standards

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)?*

The Investment Association agrees that the FRC should be able to impose additional requirements in auditing standards adopted by the Commission where necessary to address national law and, where agreed by stakeholders, to add to the credibility and quality of financial statements. This should be subject to appropriate consultation and due process. We would be concerned if these powers were to be lost or limited in any way. We support the FRC's 'ISAs UK and Ireland' and particularly welcomed the UK leading the way internationally with the enhanced audit report which is now largely followed by the International Auditing and Assurance Board.

Section 2 – Proportionate Application and Simplified Requirements

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.*

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 you views as to the impact of such actions on the actuality and perception of audit quality?*

As regards questions 2 and 3, our main focus in representing the interests of institutional investors is in the audits of listed companies. We believe that the same standards of reporting and auditing should apply to listed entities regardless of size and that this is one of the costs of being able to access capital from the markets. There may also be systemic issues with unlisted entities that are Public Interest Entities, as defined in the Regulation, such that their auditors should be subject to the same more stringent requirements.

On the otherhand for unlisted entities which do not access capital from the market and which are small such that they do not give rise to systemic issues, there are far less risks. Thus it may be appropriate to apply audit and ethical standards in a proportionate manner to the scale and complexity of such undertakings and simplify the requirements of Articles 22b and 24b. In such instances, the audit report should clearly disclose that the auditors of these entities are not required to apply certain of the audit and ethical standards in full so that users are aware and if possible, provide a reference or link to where the reader can determine what this means in practice.

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

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?

The Investment Association supports the more stringent requirements in the FRC's standards[1] being applied to PIEs (part (a)) and continuing to apply to the broader range of 'Listed entities' as defined by the FRC (part (b)) - see question 5 below. In particular, the additional reporting the FRC requires of entities that have to apply or choose to apply voluntarily the Corporate Governance Code are helpful communications to the market and it would be a backward step should they now be removed. This approach also avoids unnecessary complexity with different requirements being applied to different types of listed entity and is important to maintaining confidence in audit. Moreover, requiring PIEs that are not listed such as certain banks and insurance undertakings to apply these more stringent requirements could be important given the potential systemic risks they present. We note that the AQRT already covers such entities in its inspections.

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?*

We believe that 'Listed entities' as defined by the FRC are of sufficient public interest that their audits should be subject to the same requirements as PIEs as set out in the Regulation. As for question 4 above, this would avoid unnecessary complexity in different requirements being applied to different types of listed entity and is important to maintaining confidence in audit. It also means that the requirements for PIEs would be extended to companies listed on AIM, and debt and equities listed on a recognised exchange or equivalent. We consider this is one of the costs of a company being able to access capital from the markets. Moreover, it is consistent with what the EU Audit Directive and Regulation envisage in that they clearly establish a minimum scope recognising that Member States should be able to include more entities.

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?*

As noted under question 3, our main focus in representing the interests of institutional investors is in the audits of listed companies. As regards applying the more stringent requirements in the FRC's standards and/or the Audit Regulation to entities other than 'Listed entities' as defined and PIEs, we have not identified an investor protection or public interest

[1] As set out in paragraph 3.8 of the Consultation Paper.

issue that needs to be addressed. Thus we do not support these requirements being applied to other types of entity.

Section 4 – Prohibited Non-audit services

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

Non-audit services, particularly those of an advisory nature, can introduce a potential conflict of interest and impact an auditor's independence in that the auditor may identify himself with the interests of management rather than those of investors. Where there is a clear conflict then we support a 'black' list of services that firms are prohibited from providing to their audit clients. Whilst a 'white list' could improve the perception of auditor independence in that it is clear what is permissible, we would be concerned if the UK exercised options that would further limit the audit committee's ability to determine the best qualified audit firm for particular services. In instances where there is no clear conflict then there can be benefits in the audit firm providing certain services and with hindsight, it may be evident that certain services were not taken up that could have been allowed.

In summary, we believe that the proposed 'black list' provides safeguards to mitigate threats to auditor independence and protect investors' interests. In this context, it is important that there is clarity over the exact nature of services the 'black' list covers and it would be helpful if there was guidance to address this. The list should also be open to amendment as requirements and services evolve.

In this context, a minority of investors consider that it would be helpful to have both a 'black' and a 'white' list in that this would provide clarity to audit committees when considering audit tenders and audit firm rotation as to which firms would be precluded and which could be appointed. The committee would also be clear that assurance type services, such as reporting accountants work and audit related services, can be provided by the statutory auditor.

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?

In the event a 'white list' approach is adopted, we agree that the list proposed is broadly appropriate with one potential exception. We understand that auditors are often engaged to undertake tax compliance work i.e. completing and submitting tax returns, particularly for smaller entities, for example, small building societies. We consider that there can be benefits in auditors undertaking this work, which should be distinguished from tax advice/planning which could impact their independence when undertaking the audit. As such we would support tax compliance being added to the 'white list'. As regards the risk that an auditor is inappropriately prevented from providing a service that is not on the 'white' list, we note under question 7 our reservations as regards such an approach.

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 have not identified any other non-audit services in addition to those detailed in the Regulation that should be specifically prohibited. Increasing the list of prohibited non-audit services would further limit the audit committee's responsibility to make decisions in the best interests of the entity as well as reducing the number of firms that are willing or able to tender for a particular audit. We believe it important that audit committees approve any non-audit services provided by the auditor and welcome the Regulation establishing this.

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?*

Subject to our comments under question 11 below, we support derogations to allow the provision of certain prohibited non-audit services if they have no direct or have an immaterial effect on the audited financial statements being taken up.

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?*

As noted above non-audit services should be allowed where they have no direct or have an 'immaterial' effect on the financial statements. To prohibit services that do not have a material effect could be considered disproportionate. But it is important that the use of such derogations is controlled and we consider there is a need for guidance on the definition of 'direct' and 'immaterial' and over who should make such a decision so as to remove any uncertainty prior to implementation.

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?*

For an auditor to provide non-audit services that are not prohibited, we agree that the audit committee should be required to pre-approve such services, after it has properly assessed threats to independence and the safeguards applied. This is consistent with the provisions of the UK Corporate Governance Code.

In this context, it would be helpful if the Financial Reporting Lab were to consider how the transparency of non-audit services in the audit committee report and/or the audited financial statements could be improved. Currently such disclosures tend to be minimal which limits the extent to which shareholders can hold boards and their audit committees to account.

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?

One of the concerns we have with the Regulation is the inconsistency in scope between:

- prohibited non-audit services which apply to services the auditor and its network firms provide to the PIE, the PIE's parent undertaking and any entities controlled by it based in the EU; and
- the cap which applies to the audit firm only and not its network firms (albeit there is an option to include them) but includes all members of the audited entity's group wherever based.

Only prohibiting the provision of non-audit services to PIEs within the EU means that parts of a multinational group that are outside the EU would not be subject to the same requirements and could avail themselves of these services. Similarly only the audit firm itself and none of its network firms are subject to the cap such that network firms could provide permitted non-audit services to a PIE without any restrictions. These factors would impact the perception of the auditor's independence and would not necessarily be transparent to investors.

We recognise that there may be limitations as to the extent to which the FRC can impose its standards on auditors in other jurisdictions. Nevertheless, it should take a 'top down' approach and ensure that the lead group auditor and all of its network firms used in an audit comply with the FRC's standards with respect to all group components wherever based. Otherwise there is a risk that services could be provided to a group component that would, if covered by the FRC's standards, be deemed to compromise independence and impact audit confidence. With the implementation of the EU Audit Directive and Regulation, it is unlikely that continuing to rely on the International Code of Ethics would be sufficient.

Moreover, to address the potential issue that the auditor in a particular jurisdiction is required to provide certain non-audit services by law or regulation which would be prohibited under the FRC's standards, an exception could be allowed for where such services are required.

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?*

We agree that when an auditor is used in the audit of a group which is not part of the lead group auditor's network, then it is for the lead group auditor to ensure that the same standards of independence apply and that the FRC should require this and ensure it is adhered to.

Section 5 – Audit and Non-audit Services Fees

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?*

There is a risk that audit quality can be impaired by non-audit services particularly when the non-audit fees are significant compared to the audit fee then it can affect auditor independence and lead him to identify himself with the interests of management rather than those of investors. We consider that non-audit services beyond a certain threshold should be prohibited and that the threshold of 70% is sufficient. In particular, there are already safeguards regarding independence and reducing the cap could be seen as a step towards creating "pure audit firms". This may limit a firm's ability to attract quality staff because of the lack of opportunity offered compared to multi-disciplinary firms. This could adversely impact audit quality.

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

We agree that if the FRC is made the relevant competent authority, it should be able to grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years. There may be instances where the auditor could be the most appropriate provider of a service where the fees would cause the cap to be exceeded. For example, where the auditor acts as reporting accountant in relation to information in circulars and prospectuses the fees can often be significant but could be limited by the cap. In this context, it is important that the overriding criteria before such an exemption is granted is that the service concerned does not impact auditor independence and objectivity, and hence audit quality which should be paramount. The FRC should justify any exemptions and make the justification available to investors.

We also question how this would work in practice, for example, if non-audit fees arise in a rescue financing arranged at short notice. Speed may be of the essence - would the FRC grant the exemption pre or post the limit being breached? Also, this would involve the FRC forming a view as to the merits of an exemption and evaluating the relevant factors in terms of the best interests of the company. We understand that the FRC has not tended to get involved in decisions on the on-going governance of individual companies.

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

As noted in question 13, one of our concerns with the Regulation is the inconsistency in scope between the prohibitions which apply to services the auditor and its networks firms provide and the cap which applies only to the firm. Both the prohibitions and cap are designed to address the perceived lack of independence when an auditor provides both non-audit and audit services. We consider this inconsistency needs to be addressed such that the cap should apply to non-audit services provided by network firms and that a modified cap should be calculated.

18. *If your answer to question 12 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?*

Similarly for a group audit where the parent company is a PIE, the audit and non-audit fees for the group as a whole should be taken into consideration in calculating a modified

alternative cap. The only non-audit services that should be excluded are those where a specific exemption has been given – see question 16.

19. Is the basis of calculating the cap by reference to three or more preceding consecutive years when an 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)?

Article 4 of the Regulation stipulates that the total fees for non-audit services should be limited to no more than 70% of the average of statutory group audit fees paid in the last three consecutive years. We understand if there is a break in the provision of non-audit services, the calculation of the cap stops. We are concerned that that this would allow an audit firm to provide non-audit services for two consecutive years in excess of the 70% cap, have a year where it does not provide non-audit services and then provide such services in year four. To avoid this, the FRC should consult on applying a simpler cap that limits non-audit services in a year to 70% of the estimated audit fee for that year.

In the event that the cap is calculated by reference to three or more preceding consecutive years, then as set out in the BIS Discussion Document[2], as it needs three years track record, the first calculation should be in respect of the accounting year beginning on or after 17 June 2019. This would allow time to change any provider of such services in an orderly manner.

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

We support the more restrictive requirements in ES 4 being maintained whereby the audit and non-audit fees for a listed entity should not exceed 10% of the audit firm's annual income as opposed to the 15% for PIEs required in the Regulation.

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?

As set out in this response, we consider the same restrictions should apply to PIEs as set out in the Regulation as apply to 'Listed entities' as defined by the FRC.

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".

We agree that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute "regularly" exceeding those limits.

Section 6 – Record Keeping

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?

[2] Page 25

This question is outside The Investment Association's remit.

Section 7 – Audit Firm and Key Audit Partner Rotation

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 that statutory requirements imposed on audited PIEs for rotation of audit firms?

We agree 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 that statutory requirements imposed on audited PIEs for rotation of audit firms.

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

We support the more restrictive requirements in ES 3 being maintained whereby audit engagement partners can only be involved in an audit for a maximum of five years as opposed to seven in the Regulation. We are not aware of any practical difficulties arising from this restriction and believe it ensures objectivity.

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?

As set out in this response, we consider the same restrictions should apply to PIEs as defined in the Regulation as apply to 'Listed entities' as defined by the FRC.

Consultation Stage Impact Assessment

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

The Investment Association has no further comments.