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FAO Keith Billing
Financial Reporting Council
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Dear Sirs

Consultation on the Implementation of the EU Audit Directive and Audit Regulation

We are pleased to respond to your request for comments on the recently released consultation paper on the effects on auditing and ethical standards of the revised EU Audit Directive and Regulation. We have responded to the questions posed in the Consultation Paper in the Appendix to this letter, but also have overall observations on some of the wider implications for the regulation and oversight of audit in the UK.

In general, we are not in favour of 'gold-plating' EU requirements and we believe that now is the time to consider revisions to the Ethical Standards for entities that have been defined as 'listed' under the current Standards but are not PIEs as defined in the Directive and Regulation; for instance companies listed on AIM. We fundamentally disagree that restrictions on the provision of non-audit services to PIEs should be extended to any non-PIEs. We also fundamentally disagree with the concept of a 'white list' of permitted non-audit services, as we believe this would be far too restrictive and would cause practical issues in application. Regulation should be proportionate, and both of those measures would, in our opinion, be exactly the opposite.

Whilst not explicitly covered in this consultation, we have serious concerns that the expanded responsibilities and remit of the FRC (if it does become the single competent authority) under the new regime will not only compromise the oversight role of the FRC but will also lead to a disproportionate regulatory burden on smaller auditors of PIEs. Firms who audit only a small number of PIEs will now be subject to direct FRC monitoring rather than delegation of the review of the PIE audits to the relevant RSB. We would urge the FRC to work with the RSBs to ensure that the new requirements are implemented in as fair and reasonable a manner as is permitted under the Directive and Regulation.

We would also urge the FRC to undertake specific outreach to smaller auditors of PIEs to ensure that their voices are heard. Such firms simply do not have the same level of lobbying or regulatory resource as do the larger firms but it is vital their views are taken into account given the increased burdens they will face.

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We also believe it is essential that given its proposed increased responsibilities the FRC, and particularly the AQR, addresses its composition and in particular ensures that non Big Four firms are properly represented. The FRC will be monitoring a significantly increased number of small and medium sized firms as a result of the new requirements and it is vital that those conducting that monitoring have sufficient experience of the small and mid tier market in order to avoid any actual, or perceived, 'Big Four bias'.

Whilst again not specifically covered in this consultation, we are particularly concerned by a statement in the BIS consultation that 'at present there are no additional approval requirements for auditors conducting certain audits such as major audits.' Our main concern is that this statement could lead the FRC to resurrect the suggestion made some years ago by the AIU of licensing firms to conduct listed audit work. We strongly believe that this would be entirely inappropriate, disproportionate, and damaging to competitionand that it should be down to the individual audit firm to determine whether or not they are capable of conducting PIE audits in accordance with relevant professional standards, subject of course to appropriate monitoring. Any licensing procedure would make it effectively impossible for any firm that audited few, or no, PIEs to gain PIE clients, or for that matter to retain existing PIE clients or clients that might become PIEs in the future (e.g. AIM companies that might at some stage wish to graduate to the main exchange).

Whilst we can accept that there may be extreme circumstances in which a firm may need to be prohibited from conducting PIE audits, we believe this should be a 'last resort' as a result of ongoing unacceptable quality of work following a programme of *constructive* feedback and repeat reviews. We do not believe it would be appropriate to require firms to 'prove themselves' in advance of undertaking PIE audits, or to require smaller firms who have conducted a small number of PIE audits for some time to 'prove themselves' simply because they do not audit the same number of PIEs as a larger firm, or have not previously been subject to AQR monitoring.

If you have any questions on the contents of this letter, then please contact either Sir Michael Snyder or Tessa Park.

Yours faithfully

Kingston Smith LLP

APPENDIX 1: RESPONSE TO CONSULTATION QUESTIONS

1. **Do you agree that the FRC should 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 to add to the credibility and quality of financial statements?**

We believe that the FRC should have the *ability* to do so where it is necessary in order to reflect UK law and evolved practice, in order to enable the current additional requirements in the ISAs (UK and Ireland) to be maintained. However, we are against 'gold-plating' EU requirements in the Ethical Standards, particularly in relation to the provision of non-audit services. We also would stress that additional requirements should not be 'imposed' without a proper consultation process and we presume that in respect of any major changes the FRC's procedures for consultation will continue to be followed.

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 should take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.**

Generally we believe that –*as currently drafted* – the current audit and ethical standards can be applied proportionately to small undertakings (as defined in the Companies Act). The PASE provisions can of course be used where an entity qualifies as small.

Our main concern in respect of small companies, which we have addressed in our response to BIS on their consultation, is that we do not believe the small company exemption from audit should be raised to the maximum small company thresholds permitted by the EU. Whilst in theory we agree that the audit exemption and the small company accounting regime thresholds should be aligned, in our view the limits should be set at the minimum, rather than the maximum, thresholds permitted by the EU, i.e. £7m turnover, £3.5m total assets and 50 employees. Unfortunately, the raising of the small company *accounting* limits appears now to be a fait accompli; in which case, the audit and accounting limits should be de-coupled.

£10 million turnover is simply too large a threshold for an entity not to be subject to some form of independent scrutiny; indeed it is not so many years since such entities would have been at the top end of the medium-size threshold. As a company grows, it is more likely to have complex financial transactions, external finance and external investors, and stakeholders are more likely to want the protection of an audit, which in an expanded audit exemption regime would often not be the case. Even a business with a £7 million turnover could be a very significant size in relation to a local community or small town and there would be wide ranging implications for the local economy were it to fail as a result of inaccurate and unaudited accounts. Moreover, there would be undesirable consequences for the audit profession as a whole due to the resulting reduction in the number of firms able to train auditors. Whilst the largest firms would be unaffected, many smaller firms would be, therefore further reducing competition.

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? Please explain what simplifications would be appropriate.**

Generally we believe that the same requirements should apply 'across the board' with the exception of any additional requirements deemed necessary for certain types of entity (for instance the additional requirements for communication with those charged with governance of a listed audit client set out in ISA 260). Guidance on applying the requirements proportionately to small entities can, and should, continue to be provided in the form of Practice Notes, e.g. Practice Note 26 on smaller entity audit documentation.

4. **With respect to the more stringent requirements currently in the FRC's audit and ethical standards(those that are currently applied to 'listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:**
    a. **Should they apply to PIES as defined in the Audit Directive?**
    b. **Should they continue to apply to some or all other listed entities as currently defined by the FRC? If so which of those requirements should apply to which types of other listed entities?**

We believe that it is time to consider revisiting the more stringent requirements currently applied to 'listed entities' that go beyond the Audit Directive and Regulation; if the FRC is not minded to do this 'across the board' then certainly in respect of those listed entities that are not PIEs. Such a change would be both deregulatory and proportionate.

Some of the more stringent requirements – particularly in respect of non-audit services – have been entirely disproportionate in practice when applied to smaller 'listed' entities as defined by the FRC, for instance smaller AIM companies which simply do not have the same level of internal accounting resource as do larger, fully listed companies. Indeed, we have commented in our response to previous consultations – and still hold the view – that amending the Ethical Standards to permit the auditor to prepare the financial statements for AIM companies would help to improve the quality of their financial statements, an ongoing concern of the FRC and a subject of recent targeted investigation. We do not believe that in reality any conflicts of interest would arise that could not be mitigated by the use of appropriate safeguards.

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 do not believe that the more stringent requirements required to reflect the provisions of the Audit Regulation should be applied to any other listed entities as currently defined by the FRC, and are concerned that the FRC appears minded to extend some of the requirements to such entities (as per paragraph 3.7 of the Consultation Document) regardless of the fact that BIS does not seek to apply the provisions applicable to PIEs more widely. We do not see the point of such 'regulatory creep'.

Further, we believe that to do so would be entirely disproportionate given many such companies are very small and simply do not have the same level of risk or public profile as larger listed companies or systemic financial institutions. Rather, as noted above, the time has come to consider revising some or all of the requirements as applied to non-PIE 'listed' 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?**

No, we do not believe that they should be applied to any other entities, other than as required by the Audit Directive and Regulation for PIEs that are not listed entities. We would welcome an undertaking from the FRC not to extend the 'blacklist' any further.

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 blacklist 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 are disappointed that the EU's deliberations have introduced further mandatory prohibitions on the provision of non-audit services to audit clients because we believe that the Ethical Standards for Auditors were operating effectively in the UK and were, and still are, capable of addressing any actual or perceived independence issues. Indeed, as should be evident, we believe that the Ethical Standards were overly proscriptive in some areas. However, we recognise that the FRC is required to apply the requirements of the Directive and Regulation with no scope for any derogation.

We believe that the FRC should not seek to 'gold-plate' the EU requirements and should therefore adopt the 'blacklist' without amendment. We do not believe that any additional non-audit services need to be added to this list.

We do not believe a 'white list' approach is appropriate because it will be overly restrictive and will automatically rule out any services not on the list without any scope for judgement – as the Consultation Document itself notes on page 32, *'acceptable non-audit services could be unnecessarily prohibited, giving rise to an unnecessary, and potentially costly, reduction in choice for audited entities'.* This would include any newly developed services which might be provided by an auditor in the future, therefore stifling innovation.

It also implies that auditors are not capable of properly applying a considered judgement in respect of threats and safeguards for such services, which is quite simply not the case. Furthermore, it potentially reduces choice of auditor for businesses as firms that provide non-audit services on the 'blacklist' may find they are effectively ruling themselves out of future tenders for the audit. This situation will only be exacerbated if a 'white list' approach is taken.

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?**

As should be clear from our response to the above question, we do not believe that a 'white list' approach is appropriate, or that if that approach is ultimately taken, that there is any effective way of mitigating the risk that the auditor will be inappropriately prevented from providing a service that is not on the list.

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 taken)?**

No, we believe that the 'blacklist' is already too restrictive as it is (although we appreciate the FRC's hands are tied in this respect) and therefore no other services should be added to it.

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 aggregate – be taken up?**

Yes, we believe that this option should be taken up in order to allow for maximum choice for businesses.

Whilst we note the FRC's observation that materiality is a matter for judgement (and therefore, by implication, could be challenged) we would note that the additional report that the Regulation requires to be provided to the audit committee includes a disclosure of the quantitative level of materiality applied and the qualitative factors which were considered when setting the level of materiality. It is therefore simple for audit committees to compare the non-audit fees disclosed in the financial statements with the level of materiality disclosed to them in the additional report and therefore identify any issues.

Indeed, for those companies subject to full corporate governance requirements, the FRC would themselves be able to make the same comparison because the level of materiality is disclosed in the audit report. The FRC would therefore be able to monitor whether there were any issues in practice.

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?**

Whilst the concept of materiality is well understood by stakeholders, we believe the nature of the work to be undertaken and the degree of subjectivity is also important. The derogations do not really appear to take account of this.

For instance, valuation work can be highly subjective, and is on the list of services which may be provided by derogation, whereas payroll, which usually involves no subjectivity whatsoever, is not. This inconsistency arises because payroll is bracketed with 'accounting services'. Of course, if the requirements for 'listed' non-PIEs are amended as discussed elsewhere in this letter then this issue will be addressed, at least for those companies if not for PIEs.

We do however believe that the derogations as permitted should be taken up (e.g. immaterial valuation work should still be permitted).

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?**

We believe that approval by the audit committee is sufficient and that audit committees have, and will continue to have, sufficient knowledge and experience to identify possible issues.

Approval by the audit committee would in our view not be necessary if a 'white list' approach was adopted, but we disagree with this approach for the reasons described above.

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

Whilst we can see that in an ideal scenario, on a principles basis, ethical requirements should be the same across a group, the prohibitions set out in the Regulation are only mandated for application within the EU. The FRC, as acknowledged in paragraph 4.46 of the Consultation Document, cannot directly impose its standards on auditors in other jurisdictions. We believe it will continue to be difficult to mandate the application of standards in jurisdictions where they do not directly apply and that the more jurisdictions a group operates in, the greater the risk of an inadvertent breach.

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?**

Again while we can see that in an ideal scenario ethical requirements should be the same across the group audit, we believe this would be difficult to mandate in practice.

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?

In our opinion the 70% cap is sufficient and the FRC should not seek to impose any more restrictive requirements.

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?

Yes, we believe that exemptions should be able to be granted and that the FRC should consider, and then consult on, what criteria might apply with a view to including helpful examples in the Ethical Standards. We believe it would be sufficient for such circumstances to be at the discretion of the audit committee, or perhaps put to a shareholder vote, but we recognise that the Regulation appears to require that such exemptions are subject to approval by the Single Competent Authority.

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?

We believe that the FRC should not seek to 'gold-plate' the Regulation and that the cap should therefore only apply to non-audit services provided by the auditor.

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? 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?

No, we do not believe there is any need to apply a modified alternative cap.

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?

Yes, we believe this is appropriate as it gives a reasonable average as to the ongoing level of audit and non-audit fees.

20. Do you believe that the requirements in ES4 should be maintained?

As with certain other provisions in the Ethical Standards, where their provisions are more restrictive than those set out in the Directive and Regulation, we believe there is a strong case for considering whether the requirements should be revised. If the FRC is not minded to do this for all entities affected (i.e. all those entities defined as 'listed' in the current standards) then we would urge the FRC to consider this for listed entities that are not PIEs, e.g. those companies traded on the AIM or ISDX markets.

Although we tend to agree that the more restrictive requirements in ES4 are not, on the whole, causing too many practical difficulties we do not think this is directly relevant to a consideration of whether they should be retained or not. What is relevant is ensuring a workable, proportionate ethical framework which is consistent with EU requirements but does not seek to 'gold-plate' it unless there is a very good reason for doing so.

21. **Where the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES4 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 should be clear from our above responses we believe that the FRC should consider revising the requirements of ES4, or at the very least introducing derogations for listed entities that are not PIEs.

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'.**

Yes, we would agree that this is reasonable.

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

We are comfortable with the five year retention period set out in Article 15 of the Audit Regulation. We believe it would be preferable for the requirement to be set out in ISQC1 rather than, say, in legislation.

24. **Do you believe that the FRC's audit and/or ethical standards should establish a clear responsibility for auditors to ensure they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?**

We have no particular issue with this, although we do not see a need for it given that the provisions relating to the rotation of audit firms will need to be implemented in UK law.

25. **Do you believe that the requirements in ES3 should be maintained?**

We believe that, like the other requirements of the Standards that are more restrictive than the EU requires, it is time to revisit the partner rotation cycle. At present the audit engagement partner for a listed company is required to rotate every five years, save in certain very specific circumstances.

Whilst we can see that a five year rotation cycle fits neatly with the mandatory tendering and rotation cycles for PIEs of ten and twenty years, this does not necessarily mean it should be retained. We do not see anything either technically or ethically wrong with a seven year tenure as audit partner followed by three years 'off' and indeed to consider retaining the current more restrictive requirements suggests the FRC believes UK auditors are less independent than their counterparts elsewhere in the EU. This is fundamentally untrue.

Even if the FRC does decide to retain the five year period for PIEs, we believe there is scope to revise the rotation period to seven years for listed entities that are not PIEs, as they are not – and should not be – subject to the same tendering and rotation requirements.

26. When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES3 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 should be clear, we do not believe that more restrictive requirements should be extended to other entities.

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

We have discussed a number of other potential issues in our introductory remarks.