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

19 March 2015

Dear Keith,

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

PricewaterhouseCoopers LLP (we) welcomes the opportunity to respond to the above Consultation Document on the implementation of the EU Audit Directive 56/2014 (Directive) and EU Audit Regulation 537/2014 (Regulation).

We thank the Financial Reporting Council (FRC) for its work in producing a clear and balanced consultation. We particularly appreciate the way in which the alternative approaches to implementation are presented in an objective way, and trust that this will encourage different stakeholder groups to respond to this important consultation.

The FRC holds an influential position amongst global audit regulators, meaning that the decisions it takes during this implementation process are particularly critical.

The UK statutory audit market has already undergone significant changes, which we believe have added to the credibility and quality of audits of financial statements. These changes include the FRC's tendering regime (introduced in 2012 as part of the UK Corporate Governance Code) and the implementation of ISA 700 (UK & I) on auditor reporting. In relation to both of these areas, the FRC was the first regulator to introduce change, which has emphasised the UK's position as a leader and innovator in the audit profession.

When negotiating this legislation, the guiding priorities of UK Government were: choice, independence and audit quality without undue regulatory burdens. FRC should continue to uphold these priorities.

UK Government's negotiating priorities in Europe

In responding to the Consultation Document, we have been guided by the four key negotiating priorities of the UK Government, which were maintained by the Department for Business, Innovation and Skills (BIS) throughout the negotiations in Europe. These priorities were outlined by Jo Swinson MP in her evidence to the European Standing Committee C on 30 October 2013[1], as follows:

> "*The Government have consistently stated that any proposed audit measures should balance four objectives: avoiding excessive concentration*

[1] http://www.publications.parliament.uk/pa/cm201314/cmgeneral/euro/131030/131030s01.htm

in the audit market, securing independence in auditor judgments, securing high-quality audits more generally, and not imposing additional burdens unless they are objectively justified. In respect of audit quality and independence, we agree with Commissioner Michel Barnier that no change was not an option."

They can be summarised as follows:

- avoid excessive concentration in the audit market;
- secure independence in auditor judgements;
- secure high quality audits more generally; and
- only impose additional burdens where they are objectively justified.

These priorities are of the utmost importance and, we believe, should override other objectives and certainly any of our own commercial considerations. The UK implementation of the EU legislation must uphold and reinforce these priorities.

Good regulation

The FRC should embrace the UK Government's principles of good regulation.

We encourage the FRC to maintain the UK's approach of minimum regulatory interference to ensure efficient functioning of the UK's capital markets. This approach is essential, particularly during a period of economic recovery, when UK business must be focussed on a return to department. The principles of good regulation, to which the Government is committed, are set out in "Transposition guidance: how to implement European Directives effectively"[2]. These include the following:

- not to go beyond the minimum requirements of the measure required by the EU (the requirement not to "gold plate");
- to ensure that UK businesses are not at a competitive disadvantage, when compared to their European counterparts; and
- to implement changes, wherever possible, using alternatives to regulation.

Adherence to these three principles will ensure that EU requirements are followed, without creating costly disruption and distraction to UK business. We also encourage the FRC to ensure that the main focus of its implementation of the legislation is focussed on areas of material public interest. Taken together, these priorities and aims should ensure that the EU legislation is implemented in the UK so as to maximise the positive impact on the UK capital markets, whilst minimising the cost and disruption for UK business.

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/229763/bis-13-775-transposition-guidance-how-to-implement-european-directives-effectively-revised.pdf (April 2013)

The UK has an excellent heritage of corporate governance, with some of the highest standards of governance in the world. This heritage has been protected by the FRC via the UK Corporate Governance Code. We would urge the FRC to ensure that this work is not undermined by implementing the EU legislation in such a way as to reduce the ability of boards and audit committees to make judgements in the interests of companies and their shareholders.

EU consistency

The FRC should use its leadership position amongst global regulators to work proactively for consistent implementation across the EU.

Recognising the leadership position of the FRC amongst global regulators, we would encourage the FRC to work proactively with other European regulators in aiming for consistency of application of the legislation across Europe as far as possible; this is of particular relevance for the many multi-national groups that operate throughout Europe. It is also important in order not to discourage inward investment from outside Europe. Consistency in the implementation of the Regulation will reduce complexity for those UK businesses with European operations, and help to ensure a level playing field, or at least one that is not harmful to the UK's capital markets. We are aware, from discussions with our clients' executive board members and audit committees, that there is a real concern about the complexity of having to deal with many different versions of this legislation, due to differences in implementation in individual Member States.

Our overall views

We have reviewed the FRC's Consultation Document, and support many, but not all, of the proposals and alternatives set out in it. Of the suggested alternatives, we believe that some compromise the critical principles set out above. We have addressed the detailed questions raised in the Consultation Document in the appendix to this letter, but have some important observations on the following areas.

1. Non-audit services

We recognise and strongly support the critical principles of audit independence that were fundamental to Michel Barnier's initial proposals and which the UK Government, as well as BIS, and the FRC, are seeking to uphold. We also recognise that the current restrictions on the provision of non-audit services in the UK need to change to reflect developments (such as increased frequency of audit tendering and audit firm rotation) in the market in which audit firms are operating. However, we are concerned that some of the alternatives in the FRC's Consultation Document compromise the important principles set out above and we give some examples below.

1.1. Extending the non-audit services restrictions to a wider group of entities

The Consultation Document considers extending the scope of non-audit service prohibitions to entities that would not be PIEs under the EU definition. This appears to be in direct contravention of BIS's clearly stated intention not to extend the PIE definition (see page 11 of the BIS Discussion Document on the implications of the EU and wider reforms[3], dated December 2014), and would be contrary to the ideal of European consistency.

We recognise that the FRC is looking to find a simple solution to resolve the misalignment in scope between the FRC's current Audit and Ethical Standards and the EU PIE definition. Whilst simplicity of any regime is important, the FRC must not strive for simplicity at any cost, and must ensure that UK businesses are not subjected to additional cost that cannot be justified.

In considering the possible extension of non-audit services restrictions to a wider group of entities, the FRC should focus on where the public interest lies.

It is important that the FRC focus on areas where the public interest rests and, in our opinion, the public interest lies with protecting non-professional investors investing in companies in regulated markets, which is the objective of the Regulation. We therefore believe that this is an opportunity for the FRC to consider whether there are entities which come within the scope of its existing standards, which should not really be the focus of attention. In particular, we would encourage the FRC to consider entities with securities, often debt (for example, high yield bonds), listed on recognised but not regulated markets such as markets in the Channel Islands, Ireland and Luxembourg and which are generally the preserve of sophisticated investors. These entities will regularly be smaller companies, which are vital to UK growth and which are often cost and resource constrained. Such companies often rely on their auditors to provide additional non-audit services and find that their auditors are best placed to provide cost effective and high quality advice. To extend the scope of the non-audit service provisions to these companies will impose a cost burden and may restrict their access to advice unnecessarily, with little public interest benefit, but a detrimental impact on growth.

We suggest that the scope of the listed entities to which the FRC's Audit and Ethical Standards apply should be revisited and should be amended as far as is considered possible within the confines of the public interest, so that it aligns where possible with that for PIEs in the Directive. This will help achieve objectives of maximising simplicity and consistency between Member States We have set out a detailed proposal as to how this might be achieved in our response to question 4 of the Consultation Document.

[3] https://www.gov.uk/government/consultations/auditor-regulation-effects-of-the-eu-and-wider-reforms

1.2. The “black list”

During the negotiation of the Regulation, the "black list" was UK Government's preferred approach.

The Regulation, which is designed to ensure auditor independence, proposes a “black list” of prohibited non-audit services in Article 5. We believe that the “black list”, which has been the subject of lengthy negotiations in Europe, is the Government’s preferred approach. This was confirmed by Jo Swinson MP in her evidence to European Standing Committee C on 30 October 2013, when she referred to the agreed “black list”, as a list which “mirrors existing ethical standards” and “will impose no further burden”.

Our strong preference is for the FRC to follow the UK Government’s preferred approach and to adopt the “black list” as set out in the Regulation. This is likely to be consistent (subject to the specific derogations) with the approach to be taken in other Member States, for example Germany, and will go some way to reducing complexity for multi-national companies operating across a number of Member States. Where services are not specifically prohibited by the “black list”, this will require audit committees to continue to exercise an important role in approving the provision of non-audit services, after taking account of any threats to independence and safeguards applied under principles already set out by the FRC and in the IESBA code.

We also believe that the derogations over the provision of certain tax services and valuation services should be taken, to allow the provision of these services as long as they do not have a direct, or have an immaterial effect, on the audited financial statements. This will enable audit committees to continue to act in the best interests of the company and its shareholders, without compromising auditor independence.

The "black list", with derogations, will enable audit committees to continue to exercise judgements in the best interests of companies and their shareholders.

It is important that audit committees have the confidence to make judgements on the provision of non-audit services by the auditor, and that the scope of the prohibitions is interpreted in a consistent manner by different audit committees. Consequently, we would urge the FRC to focus at a later stage of the consultation process on the precise wording of the prohibited services, to give clarity as to the interpretation and scope of those prohibitions.

1.3 A “white list” - an overly restrictive non-audit services regime

A "white list" could stifle innovation in the field of assurance, and would have a highly detrimental impact on choice. Ultimately, audit quality could be impacted.

The Consultation Document sets out, as an alternative to the “black list”, a “white list” of permitted audit-related services. We believe that this would introduce an overly restrictive regime for the provision of non-audit services in the UK. A “white list” would not only depart from the EU’s common standard of a “black list” of prohibited non-audit services, but would also impose a regime in the UK which is substantially more restrictive than the Government’s preferred position, and contrary to the “UK open for business agenda”.

We note that a “white list” approach is inherently inflexible. By definition, a new assurance service, created in the future, will not be on a “white list” of services which is compiled today. The approach will stifle innovation in the field of assurance and, therefore, constrain the development of better audits, assurance and reporting.

In our opinion, a “white list” would have a highly detrimental impact on choice for both audit and non-audit services. A restrictive non-audit services regime can rapidly reduce a company’s choice of audit provider. In a world where auditor rotation will become mandatory (and therefore one firm is always unable to compete), the impact on competition and choice could be material. Companies may wish to continue with existing suppliers of non-audit services, who, under a restrictive regime, would therefore be unable to compete in a tender for the audit appointment. This is important because it undermines the UK Government’s negotiating priority of upholding competition and avoiding concentration in the audit market.

In the medium term, we are concerned that a “white list” could have a negative impact on audit quality, with careers in audit becoming less attractive due to there being limited opportunities to obtain experience outside the audit practice. Further strains would be placed on the multi-disciplinary firm model; we believe that it is essential that the multi-disciplinary structure of UK audit firms is maintained and indeed celebrated. The multiple disciplines which co-exist within audit firms mean that the right expertise can be brought to today’s audits, and firms can innovate to develop the audit of tomorrow.

2. The fee cap

We support the FRC's proposals in respect of the fee cap, whilst noting the need for an efficient and effective regime to deal with cap exemptions.

In our opinion the 70% cap on fees for non-audit services required by the Regulation, and based on thorough negotiations in Europe, is sufficient and we do not believe that a lower cap should be implemented. We note that the fee cap in itself provides a strong safeguard against the "self-interest" threat to independence, thereby reducing the need for an overly stringent prohibitions regime. The Government's support for this cap was indicated by Jo Swinson in her evidence to the European Standing Committee C on 30 October 2013, as follows:

> "*On the cap of permitted non-audit services—an issue raised by the European Scrutiny Committee—the Council proposal is less favourable. None the less, we can accept it in the context of the overall negotiation that took place on that particular directive. .... For exceptional cases, the regulator might lift the cap for up to two years. Overall, the combination of that flexibility and the 70% cap, which in itself is better than some had wanted, is sufficient to make the proposals acceptable to the UK.*"

Adopting the common European standard of 70% for the cap will help to ensure consistency within the EU. A lower cap would further limit the ability of companies to obtain non-audit services in cases where the auditor is clearly the best provider, and therefore engaging the auditor would be in the best interests of the shareholders. A more restrictive regime might place the UK listed market at a disadvantage compared to overseas alternatives. This aside, we support the FRC in making some aspects of the cap more intuitive (and thereby giving it a more strict application).

In certain circumstances, it will clearly be in the best interests of both the company and the shareholders for the auditor to be engaged to provide permitted non-audit services. Here the ability of the FRC to grant exemptions from the cap will be important. For certain services (for example private reporting aspects of reporting accountants work), the fees may be significant compared to the audit fee, and there may be no realistic alternative provider apart from the auditor (for reasons of speed and price sensitivity, especially in view of the requirement for the appointed firm to satisfy independence requirements which, in the normal course, only the auditor would meet). We recommend that exemptions from the cap should be granted, either on the basis of a pre clearance in certain specified circumstances, or a "guaranteed" exemption following a formal application. There are situations where failure to grant an exemption from the provisions of the cap could have significantly adverse consequences for a company which might, for example, be unable to complete a transaction.

We note that the Consultation Document does not deal with the question of the exclusion from the calculation of the fees from non-audit services of those services that are "required by law" (other than briefly in the Consultation Stage Impact Assessment at page 52 of the Consultation Document). Given the importance of maintaining choice for listed issuers, we agree with the assertion made at paragraph 32 on page 58 of the Consultation Document that public reports required in relation to information in circulars and prospectuses are required by law and therefore are outside the calculation of the fees earned from non-audit services. We support a view that other "reporting accountant" services are also, albeit indirectly, required by law as a way of ensuring flexibility to appoint a reporting accountant in what can be highly confidential and/or time critical situations. It would also be helpful if the FRC could identify other services that are defined as being "required by law".

3. Engaging with multiple clients simultaneously

Difficult issues could arise for engagements where it's necessary to engage with multiple clients. A practical solution will be needed here.

Situations where an audit firm engages with multiple parties simultaneously are not considered in the FRC Consultation Document. However, this is an important issue that should be considered carefully by the FRC because of its potential to have highly disruptive impacts. The EU Directive and Regulation, the FRC Consultation Document and the BIS Discussion Document consider only simple situations where an auditor provides services to a single audit client, or an entity within that audit client's group. In practice, situations arise where multiple parties need to procure services jointly from an accounting/audit firm. An example of such a situation would be a syndicate of banks wishing to appoint an accountant to perform a business review of a borrower that is in financial difficulty. It is unlikely to be in the public interest for companies to be faced with a very limited choice of audit firms to provide the services, particularly in material restructuring and turnaround situations where only a small number of firms would have the capability to provide the services required. Clarity is required so that the multiple companies and audit committees who might consider it their responsibility to assess the situation have a clear framework to follow, which will avoid different (and conflicting) approaches being taken.

We welcome the implementation progress made so far and look forward to continuing to support the FRC in its work.

Conclusion

In conclusion, we welcome the progress that FRC has made in considering the implementation of the EU legislation. There is further work to be done, and we would encourage the FRC to ensure that this is done in such a way to support the Government's key negotiating priorities and to minimise the burden on UK businesses. We would be happy to assist and support the FRC throughout the implementation process.

Yours sincerely,

Ian Powell
Chairman and Senior Partner

cc: Jo Swinson MP
Richard Carter, BIS
Sir Winfried Bischoff, FRC
Stephen Haddrill, FRC

Appendix - FRC consultation document

PwC's responses to questions

Q1. Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

We welcome the work that the FRC has done to date in adding to the credibility and quality of the financial statements. In particular, the FRC was the first regulator to implement ISA 700 (UK and I), which has emphasised the UK's position as a leader and innovator in the profession.

We agree that, in the future, the FRC should exercise the provisions in Directive 2014/56/EU amending Directive 2006/ 43/EC (the Directive) and Regulation 537/2014 (the Regulation) to impose additional requirements in auditing standards adopted by the Commission. However, this should be done in such a way as to balance the four key objectives that the Government wanted the new audit regime to achieve; namely maintaining audit quality, avoiding excessive concentration in the audit market, securing independence in auditor judgments, and not imposing additional burdens unless they are objectively justified. The benefits of harmonisation should prevail and, to the extent possible, standardised global and pan-European solutions should be the goal. Any proposals to introduce additional requirements and auditing standards beyond those in the ISAs adopted by the EU should not be automatic, but should be subject to consultation.

Q2. Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

We believe that the FRC's current Audit and Ethical Standards can be applied in a way that is proportionate to the scale and complexity of the activities of small undertakings for the reasons explained below.

A number of commentators have over the years maintained that "an audit is an audit", irrespective of size, and that a single set of generally accepted audit standards (GAAS) with a single level of reasonable assurance being provided to all users is the best means to maintain confidence in audit.

On the other hand, some other commentators have suggested that audit standards such as the International Standards on Auditing (ISAs) have become increasingly complex and onerous for smaller engagements, and argued for greater segmentation. For example, an

ACCA policy paper 'Restating the Value of Audit'[4] (dated 2 February 2010) argued that "in respect of the current audit, standard setters should establish clearer and more practical 'small entity' standards and procedures to open up a new quasi-audit service stream for the smaller end of the market".

Our view favours the former position. We believe it is important that an audit remains an audit, in the sense that the inputs and performance of the audit (in terms of independence and ethical considerations, and the disciplines of audit planning, evidence gathering, application of professional judgement in evaluating the evidence, etc) should be the same regardless of the size of the audited entity. We believe these elements are essential to a reasonable assurance audit, and equally of value to all users of accounts. At the same time, we believe the outputs from the audit process (in terms of detailed documentation, the extent of the auditor's report, etc) can differ depending on the size of the entity.

Hence we fully support the concept of scalability of the ISAs. We believe the existing standards are capable of being applied proportionately, and believe that scalability is already allowed for in the existing ISAs as follows.

- *Detailing matters for the auditor to address, rather than detailed procedures to be undertaken, leaving the auditor to exercise judgement as to the level of detail and degree of procedures to be undertaken to address these matters.*
- *Containing different approaches to take where control environments are less formal.*
- *Explicit acknowledgement in several standards that the nature, timing and extent of procedures will vary depending on the size and complexity of the entity being audited.*
- *Conditionality both within the overall framework (i.e. no need to address ISAs which are not relevant to the audit) and within the ISAs themselves (i.e. no need to address a matter if it is not relevant to the audit of the entity).*
- *Specific guidance in the application notes for the audit of smaller entities.*
- *Documentation standards that do not set a re-performance level, but set a lower bar, being sufficient documentation to allow an experienced auditor with no connection with the audit to understand what work was done.*
- *More comprehensive reporting requirements in the case of some types of entities, for example, the new requirements to set out critical or key audit matters in the auditor's report on listed companies.*

In our experience in the PwC network, the advantages of a single global methodology for audits that is scalable and adaptable to specific circumstances outweigh any disadvantages. We also believe that this aids the "portability" of the audit qualification, as well as the movement of professionals both between firms and between countries.

[4] http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2010/february/restating-the-value-of-audit.html

To have separate GAAS for large and small entities would, in our view, lead to a number of undesirable consequences. These include:

- *contributing to cost and complexity, (for example, in respect of audit inspection and oversight), through the fragmentation of audit frameworks;*
- *additional costs in training professional staff and potential inadvertent 'specialisation' within the profession, and potentially entrenching perceived differences between auditors of large and small undertakings and building in further structural impediments to choice in the market; and*
- *difficulties where entities are at the margin of the size thresholds, or in groups where there may be a mix of small and larger undertakings.*

Regarding Ethical Standards, there is already differentiation between listed or public interest clients, and other clients, as well as the Ethical Standard "Provisions available for small entities" which provides certain dispensations to help facilitate the cost effective audit of small entities.

In conclusion, we agree with the FRC's view that further specific action is not necessary at this time to provide for proportionate application of the Audit and Ethical Standards.

Q3. When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles 22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available for Small Entities, and your views as to the impact of such actions on the actuality and perception of audit quality.

Our view is that the FRC do not need to simplify the requirements in Articles 22b, 24a and 24b for entities below a particular threshold.

Consistent with our response to question 2, we continue to support the concept of further simplification where it is appropriate to do so and where the principle that an 'audit is an audit' is maintained – that is, the value of the audit as a reasonable assurance engagement is preserved.

The independence and other organisational elements highlighted in Articles 22b, 24a and 24b are important inputs to the audit and we believe they are sensible safeguards to ensure audit quality and are appropriate for any entity, irrespective of size. We support the continued application of the limited reliefs in the Ethical Standard 'Provisions Available for Small Entities'.

Questions 4 – 6

Our responses to questions 4-6 are based on the following underlying principles:

- *that appropriate requirements are applied to those entities in which there is a significant public interest; and*
- *any requirement that goes beyond the requirements of the Regulation will almost certainly increase inconsistency between how the rules operate between different Member States, which we believe the UK should be seeking to avoid unless it can be objectively justified.*

Adherence to these two core principles will enable both the regulator and auditors to focus on areas in which there is a material public interest, as well as reducing cost and complexity for UK businesses.

Q4. With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:
(a) should they apply to PIEs as defined in the Audit Directive?
(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?

In considering our response to this question, we have taken into account the current definitions of "listed entity" in the glossary to UK Auditing Standards and in the glossary to UK Ethical Standards (noting that these two definitions are different – a point which is not discussed in the FRC's Consultation Document), and the definition of public interest entity in the EU Audit Regulation, each of which is different in their approach to defining what we might loosely refer to as a "listed entity". The table below shows these differences.

	UK & Ireland regulated exchanges			UK & Ireland non-regulated exchanges			Other EU regulated exchanges			Other EU non-regulated exchanges			Other exchanges elsewhere in the world		
Entities incorporated in UK & Ireland	AS	ES	EU	AS	ES		AS		EU	AS			AS		
Entities incorporated elsewhere in the EU	AS	ES	*EU**	AS	ES		Non-UK/Ireland entities listed outside of the UK/Ireland are not relevant to this analysis								
Entities incorporated elsewhere in the world	AS	ES		AS	ES										

Key (to the table above)
AS – an entity treated as a "listed entity" for the purposes of the Auditing Standards; ES – an entity treated as a "listed entity" for the purposes of the Ethical Standards; EU – an entity treated as a "listed entity" for the purposes of the EU Audit Regulation.

** EU entities (non-UK & Ireland) who have securities listed on a UK/Ireland regulated exchange do fall within the scope of the EU Regulation. However, the home nation version of the EU Regulation will be applicable to them, in accordance with the concept of local law*

In our opinion, there is a need to balance both simplicity in applying the requirements and also consistency across the EU, and we are not in favour of extending more stringent requirements unnecessarily. However, it is important that the public interest is taken into account, and therefore our proposal is as follows:

- *Revise the UK Ethical Standards so that the ethical requirements for "listed companies" at least comply with the minimum requirements of the EU Audit Regulation in respect of listed EU public interest entities. This would include, for example, amendment to the non-audit services regime within the UK Ethical Standards, so that the EU Regulation "cap" and "blacklist" were incorporated.*

- *Revise the definition of "listed company" as used in the UK Ethical Standards to be as follows:*

  "Listed company: A company with securities listed on an EU regulated exchange." (Note that we have suggested here that the reference should be a "company" not a "UK company" or "EU company". This minimises the degree of de-regulation from the existing Ethical Standards definition.

- *Revise the requirement for auditors to consider the application of listed entity requirements on other audit engagements included in paragraphs 47 and 48 of ES 1 to read as follows:*

  47 "The audit firm shall establish policies and procedures which set out the circumstances in which those additional requirements listed in paragraph 46 that apply to listed companies are applied to other audit engagements."

  48 "Such policies and procedures should take into consideration the scope of the EU Audit Directive and Regulation and so, in particular, would be expected to ensure that entities classified as "credit institutions" or "insurance undertakings" are identified and are subject to the additional requirements.

  *In addition, the policies and procedures should take into consideration additional criteria set by the audit firm, such as the nature of the entity's business, its size, the number of its employees, the range of its stakeholders and whether the entity has a material listing of securities on an unregulated exchange. [*In our view this final category introduces a specific requirement for audit firms to consider whether companies with listings of securities on an unregulated exchange should be treated as "listed entities" for the purposes of the Ethical Standards. Again, this approach minimises deregulation when compared to the existing Ethical Standards definition.*]*

The overriding criterion should be whether the audit firm determines that there is a material public interest in the entity.

For example, an audit firm might decide to extend the additional requirements to audit engagements of large AIM companies with a substantial retail shareholder base whilst not extending the additional requirements to smaller AIM companies, or to apply them to the audit of a large charity."

In our opinion, the public interest lies with non-professional investors investing in regulated markets, and we believe this is the objective of the Regulation. Our proposals above would, for example, exclude from the more stringent restrictions on non-audit services in the Ethical Standards those companies that solely have listed debt on unregulated exchanges, such as high yield bonds and shareholder loans which are held either by sophisticated investors or by the shareholders. In such cases, we do not believe that a material public interest exists, in the way contemplated in the Ethical Standards.

Consideration should also be given to an equivalent requirement for audit firms to determine whether the auditing standards for listed companies should be applied to audits of other entities. We note that ISQC (UK&I) 1 paragraph 35 already requires this in respect of the engagement quality control review.

Q5. Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

In its Discussion Document on auditor regulation published in December 2014, the Department for Business, Innovation and Skills (BIS) has indicated that the Government is not proposing to take up the option to extend the definition of a PIE.

We note however that the FRC, whilst acknowledging BIS's position, is considering extending the scope of entities to which some of the more stringent requirements of the EU Regulation would apply (for example the prohibitions on non-audit services).

Our preference is that there should be no extension of the scope of entities to which the requirements of the Regulation apply. This will be in accordance with the protocol of ensuring that the UK's implementation of EU legislation fosters the growth of British companies by imposing governance that is appropriate and competitive with similar markets. A more restrictive regime in the UK may also deter overseas companies from seeking a UK listing, which would put the UK at a competitive disadvantage with our European competitors. We also believe that, in the interests of simplicity, a co-ordinated and consistent approach across the EU is desirable.

The need for a co-ordinated and consistent approach across the EU is most clearly illustrated by considering a financial services group that operates throughout Europe and could, therefore, be faced with complying with 28 different variations of the Regulation, or

alternatively a group with companies incorporated in one country with securities listed in another. Further, consistency is also important for non-EU investment into the UK; a non-EU company may be deterred from investing in the UK, if an inconsistent approach has been taken to implementing the Regulation, when compared to the rest of the EU.

Notwithstanding these comments, we understand the complexity faced by the FRC in reconciling the current scope of the FRC's Ethical Standards with the scope of the Regulation. The approach that we have suggested in question 4 (of amending both the definition of "listed entity" in the Ethical Standards and the requirement to consider the application of the listed entity requirements to other audit engagements) would, we believe, have the advantage of applying the requirements of the Regulation, as intended, to those entities where it is in the public interest for there to be additional safeguarding, but would not place unnecessary obligations on the market as a whole.

By contrast, as explained under question 4 above, applying the requirements of the Regulation to entities within the current FRC definitions of "listed entity" would catch companies with securities listed on recognised, but not regulated, markets. We believe that this is extending the requirements of the Regulation to situations where there is not the public interest on which both the EU Regulation and the FRC standards are focused.

For example, the Channel Islands Securities Exchange (CISE), which is a recognised but not regulated EU exchange, is a members' exchange on which special securities, including Quoted Eurobonds (typically used for UK private equity backed business), are listed but not traded. These securities are listed, but not traded, in order to benefit from a statutory exemption from withholding tax on interest which HMRC decided to retain, following consultation. Securities of this nature are predominantly for institutional investors, who use Quoted Eurobonds primarily to reduce administration costs, as there is no requirement to reclaim withholding tax. There is, in our view, limited public interest in extending the definition of a PIE to cover an exchange of this type.

Similarly portfolio companies that have debt (for example high yield bonds being bonds with a lower credit rating than investment grade bonds and which therefore have a higher yield to reflect the higher risk of default) listed on the Luxembourg Euro MTF or Irish GEM exchanges would not be caught by the EU PIE definition, as these are recognised, but not regulated, exchanges. These exchanges are typically used by sophisticated institutional investors, rather than retail investors, and as a result there will be no significant public interest in companies listed on exchanges of this type. However, if the PIE definition is expanded via the Ethical Standards to include entities that have issued listed securities these companies could fall within that definition.

The current Ethical Standards require audit firms to establish policies and procedures which set out the circumstances in which additional requirements for listed companies are applied to other audit clients. Similarly, the IESBA Code of Ethics encourages audit firms to consider whether there are other entities that should be treated as "public interest entities" because they have a large number and wide range of stakeholders. In the interests of maintaining audit quality and in the public interest, we suggest that this requirement could

be extended so that there is an onus on audit firms to determine whether the provisions of the EU Regulation should be applied to specific entities.

Q6. Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)?
If yes, which requirements should apply to which other types of entity?

For the reasons stated above, we do not believe that the requirements of the FRC's Audit and Ethical Standards, or the Audit Regulation, should apply to any entities outside the definition of a listed entity as defined by the FRC, or outside the definition of an EU PIE. However, as suggested in our answer to question 5, audit firms could be required to scope other entities into the provisions of the revised Ethical Standards, if there is considered to be a sufficient public interest so to do.

Q7. What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

As a general point, we note that the FRC refers to continued perceptions of threats to the auditor's independence arising from the provision of non-audit services. We question whether regulation alone will address the perception of threats to auditor independence. A balance needs to be struck between implementing the provisions of the Regulation, and addressing the perception issue, whilst not restricting businesses' choice of provider of non-audit services unnecessarily. We believe that, in addition to implementing the Regulation, the perception issue could be addressed through the FRC working together with the professional bodies and firms on a programme of communication to enhance stakeholders' understanding of, and engagement with, the audit profession.

"Black list" of prohibited non-audit services

We believe that the "black list" approach is the UK Government's preferred approach on the basis of the following evidence given by Jo Swinson MP to the European Standing Committee C on 30 October 2013[5]:

> *"On non-audit services to the largest companies, a black list of services that auditors would not be able to provide has been agreed. The hon. Gentleman expressed concerns about this issue, but we are reassured by the proposal on the table, because the list now mirrors existing Ethical Standards. If firms are already complying with the standards that we would expect of them as responsible auditors, the proposed black list will impose no further burden. That should reassure the Committee."*

[5] http://www.publications.parliament.uk/pa/cm201314/cmgeneral/euro/131030/131030s01.htm

We strongly favour a "black list" of prohibited non-audit services, together with the derogations permitting tax and valuation services, underpinned by a threats and safeguards approach. A "black list" will make it clear what services the statutory auditor is prohibited from providing and will not go beyond the minimum requirements of the Regulation as required by the UK Government's guiding principles when transposing EU legislation into UK law, detailed in "Transposition guidance: how to implement European directives effectively"[6].

We also believe that this approach is likely to be consistent (subject to the specific derogations) with the approach to be taken in other Member States, for example Germany, thereby reducing complexity for multi-national companies operating across a number of EU Member States.

However, it is critical that the "black list" is implemented in an effective and proportionate manner, and we address this below.

The "black list" and the role of the audit committee

We support the important role played by audit committees, and are in favour of proposals which strengthen that role. Standards set by the FRC should not undermine the role of the audit committee by being too prescriptive, and thereby removing an audit committee's ability to exercise judgement in the best interests of the company and its shareholders. We support the role of audit committees in approving the provision of non-audit services, and do not believe that conditions should be imposed which mean that the important audit committee assessment of threats to independence and safeguards applied is diminished, or becomes redundant. In some cases this may mean that the audit committee decides against the provision of permitted non-audit services by the statutory auditor, but our view is that it is important for the audit committee to retain the power to make that decision.

Clear scope of prohibited non-audit services

Whilst recognising the continuing importance of audit committee judgement, we also believe that it is important that where services are to be prohibited, the scope of those prohibitions is clearly defined. The prohibitions in Article 5 of the Regulation are widely drawn and open to a range of interpretations. For example, it is unclear what is intended by the prohibitions on "the provision of general legal counsel" (Article 5(1)(g)) and "services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity" (Article 5(1)(i)). The extent of the prohibition in Article 5(1)(d), "services that involve playing any part in the management or decision-making process of the audited entity" is also very unclear, especially as regards when an activity becomes "part" of the management or decision-making process.

[6] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/229763/bis-13-775-transposition-guidance-how-to-implement-european-directives-effectively-revised.pdf

By way of further example, whether a service is prohibited or not may be determined by the manner in which the service is provided, as much as the subject matter of the service. Direct outsourcing of the internal audit function is clearly prohibited; however, an engagement to give an audit committee assurance on the effectiveness of the internal audit function would not present any threats to independence, and so should not be prohibited. There is however, a risk that this type of service could be described as "services related to the audited entity's internal audit function".

More precise wording, and greater clarity over the scope of the prohibitions, will give audit committees the confidence to make judgements on the provision of non-audit services by the auditor. Lack of precision may lead to a lack of consistency in interpretation, resulting in applications which may not give the optimal outcomes for the public interest.

A "white list"

In our opinion, a "white list" goes against the fundamental principle of free movement in the capital markets, and could adversely impact UK business. For example additional costs could arise as a result of the inefficiencies from a company being forced to use an adviser without the audit firm's knowledge of the business. The result of a "white list" approach could result in the non-audit services regime in the UK being overly restrictive when compared to other Member States, which could have a significant negative impact on the UK as an attractive location to do business, and would run contrary to the Government's "UK open for business agenda".

A "white list" of permitted non-audit services could also stifle innovation in the development of new non-audit services, which would be contrary to the public interest. By way of example, it could discourage companies from engaging their auditor to provide integrated assurance reporting services (e.g. on sustainability and other factors), where the specific service has not yet been developed and, therefore, by definition, cannot be included on a "white list", or broader assurance reports (e.g. ISAE 3000 reports which are assurance engagements other than audit or reviews of historical financial information). The experience in France of a principles-based "white list" (accompanied by some specific prohibitions) is that it is inflexible and not responsive to the changing market in which audit firms operate. If a "white list" were to be introduced, there would need to be a rigorous and frequent review of it by the FRC in order to consider the addition of new services, as well as consultation with audit committees and audit firms to discuss additions to the list as service areas develop. Further, a "white list" would be contrary to the Government's Transposition Guidance to which we believe, the FRC should pay close regard, including the obligation to avoid "gold plating".

We do not support the introduction of a "white list", but if the majority of respondents favour a "white list" approach, we would recommend that, in the interests of offering sufficient flexibility, a principle could be added to any services based "white list". This would allow the statutory auditor to provide "assurance" type services (e.g. reporting accountants work, audit related services), as well as reporting to the Board on the operation of systems, controls, compliance etc, whilst continuing to uphold the values of independence, objectivity

and integrity as are required by the FRC's Ethical Standards governing the provision of audit.

In conclusion, we strongly favour a "black list" of prohibited non-audit services with the derogations permitting tax and valuation services taken, and underpinned by a threats and safeguards approach. Whether a "black list" or "white list" approach is adopted, it is essential that there is clarity over the definitions of services included, to ensure certainty and consistency of implementation by audit committees.

Q8. If a 'white list' approach is deemed appropriate to consider further:
(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?
(b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the "white list" be mitigated?

We strongly favour the "black list" approach. However, if the majority of responses to this consultation are in favour of a "white list" approach, our response to each of the sub-questions is as follows.

(a) Our view is that the list in paragraph 4.13 should be expanded, with no deletions of non-audit services currently included.

The Consultation Document (at 4.13) suggests that, in addition to "audit related services", a "white list" could include "other services identified for which it would be evident to stakeholders that the auditor of the entity is clearly an appropriate provider and an objective, reasonable and informed third party would not conclude that the auditor's independence is compromised by providing these services". This would, in our opinion, be an essential addition to any "white list" as it would uphold the important role of audit committees to exercise judgement in determining which "other services" are allowable. To assist audit committees in making this judgement, we suggest it could be helpful to develop a small number of "white list" principles, and if a non-audit service met these principles, it would be included as permissible. This would also help any "white list" become "future proof" as new services could be tested against these principles. In any event, we believe that the provision of all services should remain subject to an overall audit committee approval to ensure that there is no risk that the auditor's independence could be compromised.

Due diligence is identified in paragraph 8 to the Recital to the Regulation as an example of a permissible service. We agree with this, as we do not see it as likely to pose a threat to auditor independence. Rather, we see it as consistent with the role of an auditor, as it requires an independent advisor to provide comfort on a business and its financial information (including tax), using the same key values of independence and objectivity required of an auditor. Furthermore, were it to be a prohibited service, we see this as creating a restriction in choice of which firm could be used in an area where other factors may already limit choice, such that there would often be very limited or

no choice available to the company, especially for large multi-national transactions. This arises because some companies have a policy of not using the target business' auditor to undertake due diligence and / or not using a firm that has undertaken vendor due diligence commissioned by the vendor or target. Similarly, some targets object to buyers using the target's auditors and /or sell-side advisors to act for them. There is, of course, a need for confidentiality on public company transactions, which may be facilitated by using a limited number of advisers. To impose another restriction on which service providers buyers can use, would be a further limitation on choice which we do not see as necessary.

In relation to tax services, our view is that the derogation in the Regulation, which permits certain tax services, should be taken and accordingly, tax advice, where that advice has no direct, or has an immaterial effect, on the financial statements, should also be included on a "white list", as presenting no threat to independence. Audit committee decisions on the provision of such services would still be governed by the fundamental principles of safeguarding auditor independence.

(b) If a "white list" is deemed appropriate to consider further, our view is that either a service specific "white list" supplemented by some overriding principles, or a principles-based "white list", would be the most appropriate means of ensuring that the list remains flexible in a changing market.

Q9. Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

We do not believe that there are any other non-audit services which should be prohibited in addition to those prohibited by the Regulation. Our reasons are as follows.

(1) The role of the audit committee is to exercise judgement regarding the provision of non-audit services by the statutory auditor, in the best interests of the company and its shareholders. The "black list" already covers the prohibition of any non-audit services in respect of which there is a threat to independence that cannot be safeguarded. For other services, in our opinion, it is appropriate and sufficient for audit committees to exercise their own judgement.

(2) Any further prohibition of non-audit services would go beyond the minimum requirements of the Regulation, and would be inconsistent with the political consensus reached in finalising the Regulation.

(3) Any further prohibition of non-audit services risks imposing an inconsistent regulatory framework for auditors across Europe. This would in turn create uncertainty regarding the provision of non-audit services to the PIE parent company and its subsidiaries in other EU Member States.

Q10. Should the derogations that Member States may adopt under the Audit Regulation – to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

We believe that the Member State options to allow the provision of certain non-audit services that have no direct, or have immaterial effect, on the financial statements, should be taken up. This will give audit committees the scope to exercise their judgement in the best interests of the company and its shareholders.

Specifically we do not believe that tax or valuation services, subject to their having no direct or having immaterial effect on the financial statements, would in any way compromise either the reality, or the perception, of auditor independence.

Q11. If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be 'immaterial' sufficient? If not, is there another condition that would be appropriate?

Our view is that the derogation condition that any direct effect on the financial statements is "immaterial" is sufficient. This condition is concerned with the self-review threat, and follows existing auditor independence rules. In particular, existing International Ethics Standards Board for Accountants (IESBA) rules clarify that where a "direct effect" is immaterial "this would generally not create threats to independence"; thus an immaterial effect does not give rise to a threat that would require safeguards. The provision of any such non-audit services should also be assessed, and approved, by the audit committee.

There may need to be more guidance as to what the FRC, and other stakeholders, would consider to be an "immaterial" direct effect on the financial statements. This would help to ensure that auditors and audit committees are able to make well-informed professional decisions in the best interests of both the company and shareholders.

Q12. For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a "white list" approach was adopted?

Our view is that audit committee approval of permitted non-audit services by the statutory auditor is appropriate and sufficient, and that no other conditions are required. The existence of the fee cap will also ensure that any self-interest threat will inherently be limited.

Audit committees consist of independent non-executive directors, ensuring that, when approval is sought, there will be an objective review of any non-audit services to be provided. The role of the audit committee is well established in the UK. This includes reviewing and monitoring the external auditor's independence and objectivity, and the

effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements. To impose additional conditions could be seen to undermine the role of the audit committee.

Audit committee approval is already a required and sufficient safeguard under other regulatory regimes, for example the Securities and Exchange Commission (SEC) rules.

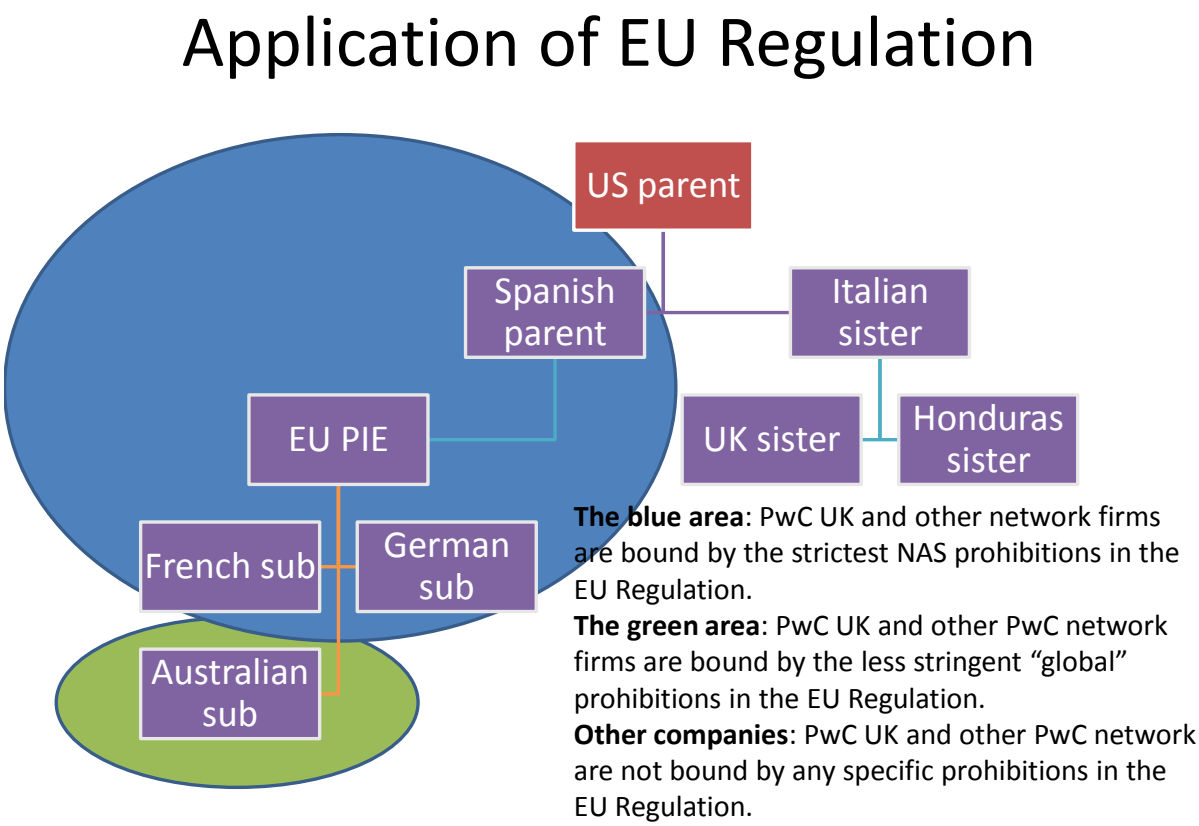
In addition, the more detailed disclosure requirements on non-audit services which are proposed by BIS in their consultation (page 26 BIS Discussion Document) will, in our view, act as an effective safeguard against any risk to the auditor's objectivity. These requirements will allow shareholders to review the judgements made by the audit committee and challenge the approach taken, if necessary, thereby creating an additional protection for shareholders.

Q13. When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based? If not, what other standards should apply in which other circumstances?

The Regulation establishes a more permissive regime outside Europe for the prohibitions on the provision of non-audit services, and we support this approach. In our opinion, the FRC's proposal to extend the provisions to all members of the network whose work is used by the group auditor in performing the group audit is unnecessary, as the current arrangements for compliance by network firms with the IESBA rules are sufficient.

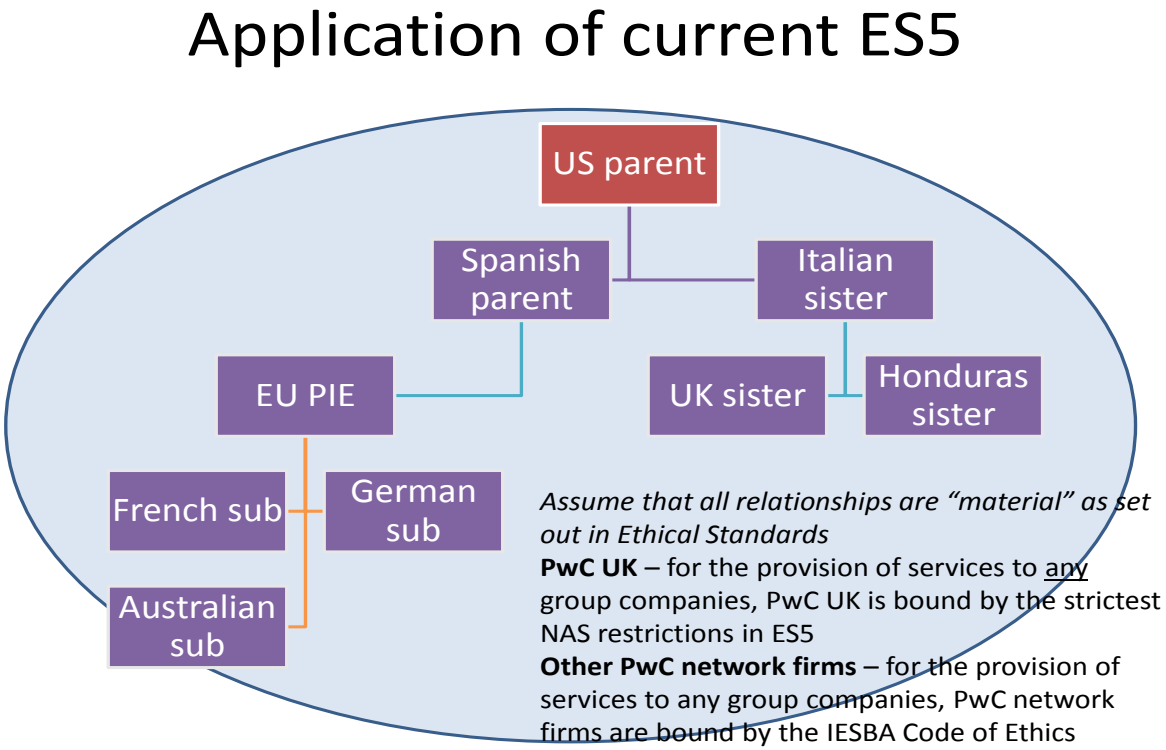
However, there is a practical issue that needs to be dealt with when incorporating the "black list" into the existing Ethical Standards so as not to go beyond the minimum requirements of the Regulation, due to a difference in scope between the provisions of the Regulation and ES 5, which will need to be reconciled.

FIGURE 1



Under the Regulation, the strictest prohibitions on the provision of non-audit services apply to the audited PIE entity, its parent undertaking and its controlled undertakings within the EU, with the non-audit services restrictions applying to both the PIE auditor and members of network firms. Thus, in figure 1, the Regulation's strictest non-audit service restrictions will impact the EU PIE, the Spanish parent and both the French and German subsidiaries.

FIGURE 2



As currently drafted ES 5 para 12 covers the provision of non-audit services by a UK firm, to the audited entity, and its affiliates. Consequently the provisions of ES 5 will apply when a UK audit firm provides any non-audit services to the following affiliates (whether located in the EU or in a third country) of an audited entity (references are to figure 2):

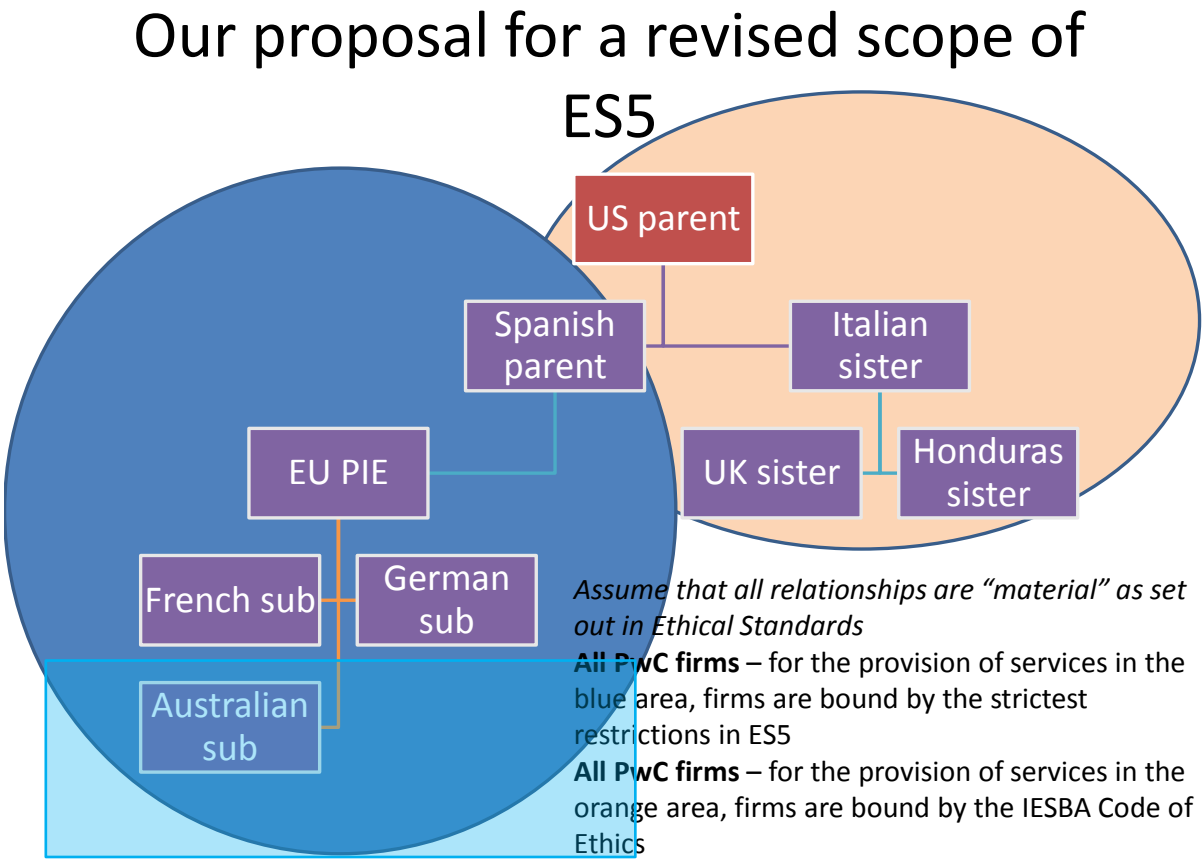
- *an entity that directly or indirectly controls the audited entity, if the audited entity is material to that entity (i.e. US and Spanish parent companies);*
- *an entity over which the audited entity has direct or indirect control (i.e. the French, German and Australian subsidiaries); or*
- *a sister entity i.e. an entity which is under common control with the audited entity, if both are material to the joint parent (i.e. the Italian, Honduras and UK non-PIE companies).*

Where the UK audit firm provides the services to the audited entity or its affiliates, the provisions of ES 5 will apply, and if these services are provided by local members of the same network, the IESBA code applies.

However, if the non-audit services prohibitions are implemented in the UK by inserting the Regulation's "black list" into ES 5 with no further amendments, the impact will be more prescriptive than intended by the Regulation, which will impose a disproportionate restriction on certain affiliates with, in many cases, no public interest benefit.
To limit the impact of the EU provisions, to something that is closer to the intention of the Regulation, whilst extending the provisions to all members of the network whose work is used by the group auditor in the group audit, we have the following suggestions.

1. *The simplest solution would be to amend the definition of non-audit services in ES 5 para 12, by replacing the wider "affiliate" with a reference to parent and controlled subsidiaries, wherever located. This would achieve the intention of the Regulation, whilst also extending the principles of independence to non EU subsidiaries. However, we note that this would be deregulatory for some entities which we understand may not be a desirable outcome.*

FIGURE 3



2. *A more complex solution, which would meet the requirements of the Regulation, without undue "gold plating", would be to insert the "black list" prohibitions into ES 5,*

so that they would apply only to an audited PIE entity, its EU parents and its EU controlled subsidiaries (i.e. the UK PIE, its Spanish parent and its French and German subsidiaries). If the principles of independence are to be extended to all members of the network whose work is used by the group auditor, this could be extended to apply to all controlled subsidiaries wherever located (i.e. bringing in the Australian subsidiary). For non EU parents and sister companies (whether EU or third country), the IESBA provisions would apply. This is shown in figure 3.

This second option will, in our opinion, implement the Regulation without imposing a disproportionate restriction on certain affiliates outside the scope of the Regulation, whilst maintaining a regime very similar to the status quo for entities not within the scope of the Regulation.

We also wish to comment on paragraph 4.51 ("Breaches of the requirements") of the FRC's Consultation Document, where the FRC states that it is aware that inadvertent breaches of ethical requirements can occur and that the consequences for the audit need to be clarified. ES 5 paragraphs 3 and 4 provide that there must be an assessment of threats and safeguards when an actual or possible breach is identified, and gives the circumstances in which the audit firm can still give an audit opinion. However ES 5 is silent on the consequences of an inadvertent breach.

We draw the FRC's attention to the requirement in the Regulation for a statement in the audit report (Article 10(2)(f)) which confirms that prohibited non-audit services were not provided by the auditor and that the statutory auditor remained independent of the audited entity. We are concerned that there is no allowance for, or mechanism to deal with, inadvertent breaches by the auditor of the prohibitions on non-audit services. Although instances of such breaches are expected to be rare, internal controls and procedures are not infallible and it is therefore possible that a "prohibited" non-audit service might inadvertently be provided by the auditor, for example, a minor service to an immaterial subsidiary in the group, in circumstances which did not compromise auditor independence.

In an extreme case if the breach became known after the release of the auditor's report, as might typically be the case, the original auditor's report may need to be withdrawn, with significant implications for the auditor/audit firm, and also economic consequences for companies and investors. The consequences seem to us to be disproportionate, particularly in the case of an immaterial inadvertent breach. In our opinion, there are two separate elements of Article 10(2)(f), being a confirmation that no prohibited non-audit services have been provided and, separately, a confirmation of independence. It is clear that a minor immaterial breach of a "rule" should not automatically render the firm or the audit engagement team "not independent", or unable to provide an objective opinion and we need a proportionate way of dealing with these situations.

Q14. When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit

services) are complied with by all other auditors whose work they decide to use in performing the audit of the group? If not, what other standards should apply in those circumstances?

We believe that the current position, which requires external audit firms to comply with the IESBA rules, is sufficient. We do not think that it is proportionate for the FRC to seek to extend the provisions of the Regulation to component auditors whose work may be used in the group audit by the statutory auditor. The proposal to extend the FRC's rules to other firms would not only give rise to a number of different rules that apply to auditors, but could also have the effect of reducing choice for UK and overseas companies when seeking providers of non-audit services. This in turn may impact adversely on the willingness of audit firms to tender for component audit work, which would have a negative impact on audit quality.

These extra territorial provisions could put UK companies at a disadvantage, as they may act as a disincentive to UK companies considering overseas investment.

We also wish to comment on paragraph 4.51 ("Breaches of the requirements") of the FRC's Consultation Document, where the FRC states that it is aware that inadvertent breaches of ethical requirements can occur and that the consequences for the audit need to be clarified. The FRC set out their current Ethical Standard on non-audit services, but do not seek to set out the consequences of an inadvertent breach. We have considered this in our response to question 13.

Q15. Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

The 70% cap on fees for non-audit services is sufficient, and we do not believe that a lower cap should be implemented, particularly as the level of cap was based on a thorough and lengthy European negotiation process. The Government's support for the 70% cap was highlighted by Jo Swinson MP in her evidence to the European Standing Committee C on 30 October 2013, as follows:

> *"On the cap of permitted non-audit services—an issue raised by the European Scrutiny Committee—the Council proposal is less favourable. None the less, we can accept it in the context of the overall negotiation that took place on that particular directive. .... For exceptional cases, the regulator might lift the cap for up to two years. Overall, the combination of that flexibility and the 70% cap, which in itself is better than some had wanted, is sufficient to make the proposals acceptable to the UK."*

Additionally, we agree with the statement in the Consultation Document (at 5.9) which acknowledges that lowering the cap would not be appropriate, as it would limit the ability of companies to obtain non-audit services in cases where the auditor is clearly the best provider, and therefore engaging the auditor would be in the best interests of the shareholders. We would suggest that, in respect of these services, there may be an argument that, in exceptional cases, there should be the ability to breach the 70% cap.

If the level of the cap was to be reduced, it would lead to inconsistency within the EU in relation to the implementation of the Regulation. Rather, we believe that it should be a key objective in implementing the Directive and Regulation to minimise the likelihood of inconsistency between the rules that would then apply in different Member States.

Q16. If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

Exemptions from the cap

Our view is that the FRC should grant exemptions from the cap, on an exceptional basis and for a period not exceeding two years. This is in line with the UK Government's position, as outlined by Jo Swinson MP to the European Standing Committee C in her evidence to them on 30 October 2013, as follows:

> *"On the cap of permitted non-audit services — an issue raised by the European Scrutiny Committee — the Council proposal is less favourable. None the less, we can accept it in the context of the overall negotiation that took place on that particular directive. …* ***There are some helpful potential exemptions. For exceptional cases, the regulator might lift the cap for up to two years. Overall, the combination of that flexibility and the 70% cap, which in itself is better than some had wanted, is sufficient to make the proposals acceptable to the UK."***

We note that ES 4 para 34 states that resignation, or not standing for reappointment, is not intended as a result of an individual event or engagement, the nature or size of which was unpredictable and where a reasonable third party would regard ceasing to act as detrimental to the shareholders (or equivalent) of the audited entity.

Pre-dispensation or "guaranteed" exemption

There are some situations where we believe that, for practical purposes, a pre dispensation (under the exclusion from the cap in Article 4 of the Regulation) would be appropriate or, failing this, a "guaranteed" exemption should be granted following a formal application.

Some of the services included on the illustrative "white list", which require in depth knowledge of the client, and often carry very significant fees, would be appropriate for a pre-dispensation, or a guaranteed exemption. A more onerous regime in relation to these services, in particular, may disadvantage the UK listed market, compared to overseas alternatives, as it may discourage investors from considering an IPO in the UK.

For example, the need for a pre-dispensation could arise in respect of the private reporting aspects of reporting accountants' work. We are of the opinion that this work should be deemed to be "required by law", since the sponsor needs this work in order to satisfy its own requirements under the Listing Rules. However, if it is determined that this work is not

"required by law" (the Consultation Document indicates that the legal position for such work is being clarified), and hence the fees for such work would come within the cap, we believe this is an area where a dispensation should be granted. The Consultation Document indicates (at page 31) that the nature of such services would not compromise the auditor's independence and objectivity. In addition, there will be a benefit to the company, in terms of cost and speed, if the auditor undertakes the work, as the auditor will have greater knowledge of the client, which will facilitate a more efficient capital market. It would be unfortunate if, notwithstanding that the service is permitted, it was effectively prohibited as the fees for such work could exceed the fee cap.

A further example arises in relation to bid situations where there are timetables prescribed by the City Code to ensure that bids do not extend for a prolonged period thereby creating market uncertainty, with such timetables often being very tight (for example, 14 days for the offeree company to respond to an offer and 39 days to provide any further information). Such information, for example, a report on a profit forecast, may need to be prepared by a reporting accountant who is required to satisfy the relevant independence obligations. The auditor will, of course, be independent, but there would often be insufficient time for another firm to be selected, ensure that it is independent and perform the work. This is, therefore, another area where the fees would be expected to exceed the audit fee, and where a dispensation should be granted. It should be noted that, given that available time within the context of a timetable set down by regulation may be the justification for dispensation, any process put in place to deal with dispensations on a case by case basis, rather than on a pre-approved basis, would need to be able to respond within a very short timeframe.

On a practical point, we do not believe that the FRC will want to review all such applications for exemptions from the cap, nor establish infrastructure to deal with such applications within the very tight timescale that would be necessary, and this would indicate the need for a pre-approved approach.

Q17. Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms?

The FRC's proposal of having a consistent numerator and denominator when calculating the cap, with the total group audit and non-audit services fees being taken into account, would result in a more restrictive approach than under the Regulation. Whilst in general we would encourage the FRC not to go beyond the minimum requirements of the measure required by the EU, in this case this approach would ensure a symmetrical and more intuitive calculation and would also address an apparently illogical position in the Regulation.

Q18. If your answer to question 17 is yes, for a group audit where the parent company is a PIE, should the audit and non-audit fees for the group as a whole be taken into consideration in calculating a modified alternative cap? If so, should there be an exception for any non-

audit services, including the illustrative 'white list' services set out in Section 4, be excluded when calculating the modified cap?

As indicated in our response to question 17, we favour a modified cap in the interests of clarity, and would agree that comparing the audit fees of the PIE, its parent and its subsidiaries, to the fees for non-audit services provided to the PIE, its parent and subsidiaries, would be a more logical and symmetrical approach. However, in our opinion, the fees taken into account in this symmetrical approach should only be the fees paid to the PIE auditor and its network firms, and should not include any fees that are paid to audit firms that are members of different auditing networks, that audit any part of the PIE group.

The Regulation refers to the audit fees that are paid to the PIE auditor; in our opinion this should more correctly refer to the fees in respect of the work done by the PIE audit firm, on an accruals basis, which would not only be clearer, but would also prevent any manipulation of the cap through timing of payment by the PIE group. We would welcome the FRC's views on this important point.

The Regulation, at Article 4.2, provides that any services that are required by Union or national legislation are excluded from the calculation of the cap. We would welcome clarity, through the publication of an illustrative list, of services that are commonly provided that would fall into this category. For example, the private reporting aspects of reporting accountants work (discussed in question 16) should, in our opinion, be deemed to be "required by law" since the sponsor needs this work in order to satisfy its own requirements under the Listing Rules, and this should therefore be included on any such illustrative list.

If a modified cap is adopted as described in question 17, we suggest that, in addition to any services that are required under EU or national legislation, the fees for any services which are included on a "white list" (if a "white list" approach is adopted as the preferred option by the majority of respondents) are also excluded from the cap.

Q19. Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances (see paragraphs 5.3 and 5.15)?

In our opinion, limiting the calculation period for the cap to three or more consecutive years is appropriate for a first year audit, or for a new PIE. From a practical point of view, in these situations, any non-audit services which were commenced either prior to the auditor's appointment, or prior to the company becoming a PIE, will need to be concluded in an orderly manner. If an auditor is appointed, and was providing permitted non-audit services as part of a long term programme, there could be significant disruption to the company's business if the fee cap is introduced part way through the project, resulting in the audit firm having to withdraw. However, for existing audit clients, it is difficult to justify a three year transition, as there will have been sufficient lead time before the provisions of the Regulation apply for firms to comply with the cap in year 1.

Allowing the basis for the calculation of the cap to be reset if there is an interruption in the provision of non-audit services, so that such services are not provided for three consecutive years, could be open to abuse. In an extreme situation, this might allow a strategic approach to provision of non-audit services, which is not, in our opinion, in the best interests of the market, or of shareholders, and could not be considered to be a course of action which is in the spirit of the Regulation.

If the FRC were of the view that the basis for calculating the cap by reference to three or more preceding consecutive years is not appropriate, then we would suggest that the FRC consider the adoption of a 'comply or explain' principle in extending the cap, as this would enhance transparency and allow shareholders an opportunity to object.

We note that the Regulation does not deal with the situation where an entity makes a major acquisition or disposal, and consequently the size of the group changes significantly within one year. Addressing this problem in a way that complies with the Regulation is problematic, and we would suggest that, in these circumstances, the only solution would be for the FRC to grant an exemption from the cap.

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

The requirements in ES 4 set an overall fee cap of 10% for listed companies, and 15% for non-listed companies. We are not in favour of extending the more stringent requirements unnecessarily, however, in this case we do not believe that the FRC should be pulling back from its existing regulations in the interests of consistency, and would therefore suggest that the Member State option is taken to apply the more stringent 10% overall fee cap to all PIEs.

Q21. When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

As set out in our response to question 20, we believe that the Member State option should be taken to apply a more stringent 10% overall fee cap to PIEs, with the 15% cap continuing to apply to non-listed, non-PIE entities.

We do not believe that the more restrictive requirements of ES 4 should be extended to other entities. Our general views on extending the more stringent requirements for PIEs to other entities are as set out above (in response to section 3 of the Consultation Document).

Q22. Do you believe that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute an expectation of "regularly" exceeding those limits? If not, please explain what you think would constitute "regular".

We 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. By way of example, in the case of a new audit appointment, the audit fees in the first two years could be higher during the transitional period, with equilibrium being reached in year three.

Q23. Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?

The ICAEW's existing Audit Regulations include a requirement to retain "all audit working papers which auditing standards require for an audit" for a period of six years from the end of the relevant accounting period. Article 14 of the Regulation also requires documentation to be retained for a period of at least five years following the "creation" of such documents. Consequently, the existing UK requirement for retention for six years should be sufficient to meet the requirements of the EU Regulation. However, this is dependent on a requirement that all of the documents referred to in Article 14 are included in the audit file. The Article 14 requirements include, for example, information about fees in each of the last three years; currently this would not normally be retained in the audit file, but in future as it will be an integral part of the assessment of compliance with the cap on non-audit services, it will become part of the audit file documentation.

The FRC should not stipulate a minimum retention period for audit documentation by auditors, as the current retention period under the Audit Regulations is sufficient.

Q24. Do you believe that the FRC's audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?

Our view is that the Audit and/or Ethical Standards should impose a joint responsibility for compliance, on the part of the auditor and the PIE. There is a professional requirement for the auditor to comply with the framework, and the Board has a fiduciary responsibility to ensure that there is an audit. Consequently, our view is that the right approach is joint responsibility on the part of the auditor and the PIE.

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

The outcome of the negotiations in Europe on the Directive and the Regulation, specifically in relation to audit partner tenure, concluded that a seven year tenure for the key audit engagement partner is an appropriate period to manage the risk of long association with the engagement.

The current requirements in ES 3 para 12 are more restrictive than the Regulation, providing for a maximum tenure of five years for an audit engagement partner, with a further five year period before that partner can participate in the audit again. In this case,

we believe that the FRC should retain its existing regulatory requirement, especially as five year terms will coincide more readily with the rotation and tendering regimes, and extend the scope in line with our suggestions in our response to question 4, where we discuss the current differences in scope between the Regulation and the Ethical Standards.

Q26. When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

As stated in our response to question 25, our opinion is that the more restrictive requirements should apply to all PIEs and listed entities. However, we do not believe that these requirements should be extended further.

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

There are two situations that have not been addressed in the consultation document as follows.

Engaging with multiple clients simultaneously

The issue of multiple client situations is not addressed in the FRC Consultation Document but, because of its potential impact on choices available to companies, we believe that it is an issue that should be considered carefully. The more that restrictions are applied to a wider group of entities and the more restrictive the list of those services that are permitted, the greater this issue becomes.

The EU Directive and Regulation, as well as the BIS Discussion Document and the FRC Consultation Document, considers everything in the context of an auditor providing services to a single audit client or an entity within that audit client's group. However, in practice situations arise where multiple clients are looking jointly to procure services from an accounting / audit firm. Common examples are as follows.

- *Multiple lenders to a particular borrower, whether formally part of a lending syndicate, a club or a series of bilateral lending arrangements. Particularly when the borrower is in distress, the lenders will regularly look to an accounting firm for due diligence-type services in relation to the borrower's state of affairs and projections.*
- *Consortia, for example in relation to potential infrastructure projects, who are looking for advice including modelling services, due diligence services and tax advice.*
- *Class legal actions, where the class are looking for advice or expert services in relation to accounting matters relevant to the dispute.*

The interaction between the entities to which restrictions apply and the extent of those restrictions has the potential to mean that in these situations, there would be no major accounting firm permitted to provide the required services. We believe that clarity is

required, so that the multiple clients and audit committees who might consider it their responsibility to assess the situation have a clear framework to follow and hence avoid different (and conflicting) approaches being taken.

In our opinion the principle of control, which is key to the EU regime, should be used to consider whether restrictions on the provision of non-audit services apply. Specifically, where the entities are acting jointly, the position should be analysed as though the collective were a legal entity, and consideration given to whether any one entity controls the collective. In many cases, where parties are acting jointly, no one party will have control; decisions will require consensus or majority approval. However, to the extent there is such an entity that controls the collective (the "controlling party") then the restrictions applicable to that controlling party would flow down to the collective. Most obviously, the auditor of the controlling party could provide the services only if they were permitted to provide them to their audit client. However, other firms would be available to provide the services, notwithstanding that they may be auditor of one or more other non-controlling parties in the collective.

The logic of this proposed solution is most easily seen in the context of an infrastructure consortium. Once a decision is made to move forward with the consortium, a new company is typically formed, with ownership spread among the consortium members. It would usually be the case that, under the principles in the Regulation, that consortium company would not be caught by restrictions applicable to the consortium members because it is not a company that any single member controls. Non-audit services could therefore be provided without restrictions, other than those applicable to the auditor of the consortium company itself. It would, therefore, seem illogical that in the early period while the consortium members are assessing their level of interest in the project, which would normally be before formation of the new company, and hence, when they would be engaging the accounting firm as a collective group, but with each consortium member individually listed, they could not procure initial advice (for example, in relation to tax) which would be permitted once the new company had been formed and able to engage the accounting firm direct.

In our view, the proposed solution, which would represent a clarification as to how the rules should be applied where multiple clients are looking to procure the services, is consistent with the principles of the Regulation. Any threat to independence is mitigated by the fact that it requires multiple entities, not just the audit client, to approve the arrangements. We therefore believe that it provides a solution to what could otherwise represent a material reduction in choice for companies looking to procure services from accounting / audit firms.

Transitional arrangements and temporary change in PIE status

Under the Regulation, prohibited non-audit services may not be provided for the period beginning with the start of the first accounting period for which the audited accounts will be prepared until the filing of those audited accounts. In addition, services involving the design and implementation of accounting, internal control and risk management systems

for the audited entity are prohibited for the year prior to the first period for which the audited accounts are prepared. These prohibitions apply to the PIE itself and also to its parent, and subsidiary undertakings within the EU.

We are concerned that these provisions may have significant implications around the time of a transaction, particularly in private equity situations. For example, a private equity house makes an offer for a listed company and having secured over 90% acceptances, the offer is declared unconditional. A process, which may take some months to complete, is commenced to squeeze out the minority shareholders. The private equity house could, therefore, be the parent undertaking of a PIE (and subject to the provisions of the Regulation) during the period between the offer being declared unconditional and the completion of the squeeze out (at which point the portfolio company would cease to be a PIE as it would not have any listed shares). The private equity house would not be able to obtain prohibited non-audit services from the PIE auditor during that transitional period, but moving the services to another provider would be disruptive and costly.

We suggest that consideration needs to be given to introducing grandfathering or transitional provisions, possibly subject to a time limit, to address relationships or services that are in progress that for whatever reason become restricted, for example in a situation where an audit client acquires another entity with which the audit firm has existing relationships. This is particularly important where a service has no relevance to the financial statements of the PIE audit client. The existing approach under ES 5 in relation to services is that, in the first year of appointment as auditor, non-audit services may be provided on a threats and safeguards basis and for a specified period only, where those services were already contracted for at the time of appointment. This approach is in line with the Audit Directive (which provides that sanctions for breaches should be proportionate - Art 25 Directive 2014/56/EU, amending Art 30(2) Directive 2006/43/EC), as well as with the FRC's approach to the impact of inadvertent breaches on a group audit (i.e. that such breaches would not necessarily lead to a conclusion that the group audit was invalid - ref para 4.50 FRC Consultation Document), and we suggest that this approach be continued.

We note that Directive 2006/43/EC (as amended by Directive 2014/56/EU) includes the following transitional provision in Art 22.6:

> *"If, during the period covered by the financial statements, an audited entity is acquired by, merges with, or acquires another entity, the statutory auditor or the audit firm shall identify and evaluate any current or recent interests or relationships, including any non-audit services provided to that entity, which, taking into account available safeguards, could compromise the auditor's independence and ability to continue with the statutory audit after the effective date of the merger or acquisition.*
>
> *As soon as possible, and in any event within three months, the statutory auditor or the audit firm shall take all such steps as may be necessary to terminate any current interests or relationships that would compromise its independence and shall, where*

possible, adopt safeguards to minimise any threat to its independence arising from prior and current interests and relationships."

If the FRC do not accept that the approach under ES 5 should continue, we would ask for confirmation that this transitional provision in the Directive should apply to PIEs, to provide a practical means of resolving the issues that may arise in a merger or acquisition situation.