Grant Thornton
An instinct for growth™

Mr K Billing
Financial Reporting Council
8th Floor
London Wall
LONDON
EC2Y 5AS

Grant Thornton UK LLP
Grant Thornton House
Melton Street
London NW1 2EP.

T +44 (0)20 7383 5100
F +44 (0)20 7383 4715
DX 2100 EUSTON
www.grant-thornton.co.uk

20 March 2015

Dear Mr Billing

Auditing and ethical standards
Implementation of the EU Audit Directive and Audit Regulation

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) consultation 'Auditing and ethical standards: Implementation of the EU Audit Directive and Audit Regulation'.

In considering these proposals we think the key drivers behind implementation in the UK should be:

- supporting the UK growth agenda
- clarity, reduced complexity and increased cross-border alignment; and
- the interests of investors and stakeholders more generally.

We expand upon those themes in the following paragraphs.

Grant Thornton does not support change that could negatively impact on the growth of business in the UK and which could drive businesses outside the UK to countries where they perceive regulation to be less burdensome, unless it is clearly justified by public interest. Wherever possible we encourage the FRC to avoid introducing additional requirements over and above those included in the EU legislation and to align with cross-border implementation. We support the implementation of Member State options contained within the Directive and Regulation, only where they are in the public interest, or where they do not result in additional cost and bureaucracy for UK companies compared to their European counterparts.

Extant UK regulation is more stringent than that required by EU legislation and by other EU jurisdictions in a number of areas. In particular, enhanced regulatory requirements in the UK cover a wider list of companies than those within the scope of EU Regulation. In some areas a relaxation of current UK requirements would help achieve simplification and improve cross-border alignment. However, we also acknowledge that the interests of investors and other stakeholders are paramount and if there is strong stakeholder support to keep the more stringent UK requirements, then we would not object to the continuation of an enhanced UK regime.

We set out in the appendix to this letter the detailed answers to the FRC's questions. We summarise below our thoughts on some of the key issues.

The definition of a Public Interest Entity (PIE)

From first principles our preference is for a two-tier regime where the more stringent EU requirements

around audit regulation apply only to PIEs as defined by the EU. The FRC's current more stringent requirements capture a wider body of companies, eg those traded on AIM, and if there is wide support amongst stakeholders for the retention of this heightened regulatory regime, then we would not object. Importantly however, if the FRC does decide to apply more stringent requirements to such companies, then we believe this should not be done by extending the definition of PIE as, based on our understanding of the Regulation, this would restrict any flexibility as to which provisions it is appropriate to apply to the wider body of entities and which ones are unnecessary.

The retention of the existing enhanced regulatory regime for AIM and other companies (without bringing them within the definition of a PIE, for the reasons noted above) could create a multi-tier level of regulation. As noted by the FRC in its consultation there could be potentially four levels of regulation - with a matrix of requirements depending on whether an entity is a PIE and/or whether it falls within the FRC's current wider definition of listed companies. This arrangement would add considerable complexity to the regulatory framework and risk confusion in the market place. For PIEs, the alignment of the current FRC requirements to the new EU enhanced requirements regarding audit regulation, where there is in any case already considerable overlap, would provide clarity and simplicity.

We acknowledge such a simplified two-tier regime, PIE and non-PIE, would clearly be de-regulatory in nature for companies such as those traded on AIM. However, one of the key drivers behind the regulatory framework is the need to eliminate or minimise the impact of any market failure. In this regard, such companies do not pose a systemic threat and accordingly the same level of regulation need not apply. Such companies should have some regulatory advantage over those companies which choose to list on a regulated market.

Provision of non-audit services by the statutory auditor

A "threats and safeguards" approach to the provision of non-audit services by audit firms has worked well and as far as possible should be maintained. However, we acknowledge that in order to implement the new regulations some changes are necessary and we would therefore favour the following approach:

- services that are prohibited by the Audit Directive and Regulation would be on a "black" (proscribed services) list; and
- other non-audit services would continue to be subject to the FRC's current threats and safeguards approach. In determining what services are, as a matter policy, permitted or proscribed, there would be no "white" list.

The audit committee is the most appropriate body to monitor this area and we are not in favour of any UK extensions to the black list. Where possible, for example on the grounds of immateriality, advantage should be taken of the derogations that are available under the legislation.

We are not in favour of a white list approach. It is unnecessary gold-plating that will create difficult and unhelpful issues of interpretation. It would considerably restrict appropriate oversight and the exercise of its responsibilities by the audit committee. Furthermore, it would be difficult to ensure appropriate completeness of such a list, as the market for services continually evolves and it would also need to be kept under constant review.

Enhanced reporting by audit committees on their decision to purchase non-audit services from the statutory auditor, their reasons for doing so and any specific safeguards put in place, for example, would enable investors to consider whether the audit committee is acting in the best interests of the business, shareholders and the wider market.

The above comments set out our current position on non-audit services in response to this consultation. We are also aware, however, that some user groups have advocated more wide-ranging and radical restrictions on non-audit services, particularly for the larger listed companies. If, in due course, there is wide support by investors and audit committees for introducing more restrictive measures than those contemplated by this new legislation and the accompanying consultation, then a further review of this issue would be warranted.

The non-audit services fee cap

Whilst we understand that there is a need to balance the growth of UK business with investor (and the wider public) perception of auditor independence, our fundamental view is that a responsible audit committee, operating within an appropriate regulatory environment should be capable of managing non-audit services to the satisfaction of investors and other stakeholders without the need for a specific cap; indeed there is considerable evidence of change in this area in recent times. The role of audit committees should not be undermined by further legislating for matters that should be within their remit.

In our view the 70% cap (albeit now mandatory) is arbitrary and unnecessary in a market where the "threats and safeguards" approach has proved effective, as is evidenced by the continued reduction of non-audit fees. It is a blunt instrument and we would not wish to see implementation of the cap in the UK which is more restrictive than that required by EU legislation.

Furthermore, the 70% cap is perhaps likely to have more impact on smaller listed companies aiming to grow their business. Such companies often do not have the time or resources to manage multiple professional relationships and would tend to gravitate to a smaller number of advisers, including their auditor who already has an extensive knowledge of the business. Forcing such companies to engage more firms with less knowledge of the company's business is likely to increase costs.

Services required by legislation are exempt from the cap and we urge BIS and the FRC to consider whether an appropriately broad interpretation of this exemption is possible. This might mean that some of the audit related services as discussed in the FRC consultation, which it is most appropriate for the auditor to provide and where there is no real perception of any independence issue, can be excluded from the cap. This could certainly be helpful to smaller businesses where this new requirement has the potential to cause considerable difficulty.

Other consultations

We have also responded to the parallel BIS discussion document on the implications of the EU and wider reforms on audit regulation. This document asks for views on a range of reforms to enhance confidence and strengthen the audit regime and there is of course some overlap with the issues dealt with in the FRC Consultation. In line with the overall positioning we take in responding to this consultation, in responding to the BIS document we have stated that wherever possible our preference is for the implementation of EU Member State options to be on a non-legislative basis, so as to allow for greater flexibility and simplicity in their implementation.

If you have any questions on our response, or wish us to amplify our comments, in the first instance please contact Andrew Vials (tel: 020 7728 3199, email: andrew.vials@uk.gt.com) or Mary Starr (tel: 020 7728 2063, email: mary.m.starr@uk.gt.com).

Yours sincerely

Mark Cardiff
Head of Audit
For Grant Thornton UK LLP
T 020 7728 280
E mark.cardiff@uk.gt.com

Implementation of the EU Audit Directive and Audit Regulation

QUESTIONS

SECTION 1 – AUDITING STANDARDS

Question 1

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

RESPONSE

The FRC is the most appropriate body to consider the UK requirements and therefore, when necessary and subject to appropriate consultation, should exercise the provisions to impose additional requirements in auditing standards to address national law matters and to add to the credibility and quality of financial statements. This would be a continuation of the current situation in the UK. However, any power to impose additional requirements should be exercised with caution and as far as possible cross-border consistency should be maintained. ISAs issued by the IAASB undergo a thorough review and consultation process and therefore should be generally fit for purpose. Differences in standards in different countries are likely to give rise to additional complexity and costs and therefore the hurdle for any gold-plating in the UK should be a high one. In our view the main criterion for this purpose would be that any such additional requirements should enhance a dynamic economy for growth. In this respect, for example, the enhanced audit report requirements introduced recently in the UK, in advance of their introduction elsewhere, have been seen as a very positive step in opening up the audit "black box," to the benefit of all stakeholders.

SECTION 2 – PROPORTIONATE APPLICATION AND SIMPLIFIED REQUIREMENTS

Question 2

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

RESPONSE

As a general principle we are not in favour of separate auditing and ethical standards for small undertakings as a two-tier regime would cause confusion in the market place. We believe that a sufficiently principles based set of standards ought to be capable of being appropriately adopted by small undertakings and interpreted by regulators. Rather than have any separate standards, an alternative might be the issue of practical guidance for small firms as to how the standards should be interpreted.

Question 3

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

RESPONSE

As a general principle we believe that the same requirements should apply to all audits and audit firms regardless of the size of the audited entity. The issues covered in the above Articles go to the core principles of independence, objectivity and competence of auditors and the expectations of stakeholders on such important matters will be the same regardless of the size of the audit firm.

However, it is important to acknowledge that less formal internal arrangements are likely to be present in smaller audit firms given the smaller number of partners and employees and that the interpretation of the contents of the above articles by regulators needs to be applied in an appropriate manner which recognises this situation. In particular, there are several requirements referring to systems, procedures, controls, information processing, recording and documentation etc. It is likely that the arrangements within a smaller firm will be less comprehensive than in a large firm but should nevertheless still be capable of meeting the overriding requirements of the standards without the need for specific derogations in a separate set of standards.

Furthermore, in our view it would be inevitable that any simplified Articles (or standards in the case of our response above) will be perceived as inferior to the full standards and be detrimental to the perception of audit quality, even if there is no actual negative impact.

SECTION 3 – EXTENDING THE MORE STRINGENT REQUIREMENTS FOR PUBLIC INTEREST TO OTHER ENTITIES

Question 4

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

(a) should they apply to PIEs as defined in the Audit Directive?

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

RESPONSE

We believe there is much to be said for simplicity and cross-border comparability on this issue and in line with the position expressed in our covering letter we believe that gold-plating should be avoided wherever possible. On this basis, from first principles our preference is for a two-tier regime where the EU requirements apply only to PIEs as defined. If there are different

designations in different territories this is likely to lead to much cross-border complexity and confusion, for example, in a group where there are two PIEs in two different countries and where the Member States apply different requirements.

We acknowledge that the FRC's own more stringent requirements for listed companies, similar to but not the same as those of the EU, already extend to a wider body of companies, including those traded on AIM and if there is wide support amongst stakeholders for the retention of this regime then we would not object to the inclusion of such companies in an enhanced regulatory regime. However, in this regard we note that the second option set out in the FRC's paper envisages four different types of entity with a matrix of requirements depending on whether the entity is a PIE and/or whether it falls within the FRC's current wider definition of listed companies. Such arrangements would add considerable complexity to the regulatory framework which we think it is desirable to avoid if at all possible. For PIEs, the alignment of the current FRC requirements to the new EU requirements, where there is already conservable overlap, would provide clarity and simplicity.

We acknowledge such a simplified two-tier regime, PIE and non-PIE, would clearly be de-regulatory in nature for companies such as those traded on AIM. However, one of the key drivers behind the regulatory framework is the need to eliminate or minimise the impact of any market failure. In this regard such companies do not pose a systemic threat and accordingly the same level of regulation need not apply. Such companies should have some regulatory advantage over those companies which choose to list on a regulated market.

Importantly, however, if the FRC does decide to continue to apply its more stringent requirements to such companies then we believe this should not be done by extending the definition of PIE as, based on our understanding of the Regulation, this would restrict any flexibility as to which provisions it is appropriate to apply to wider body of entities and which ones are unnecessary. For entities that are not PIEs as defined we think it is appropriate to have a more flexible and targeted approach to regulation.

Question 5

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

RESPONSE

See answer to Q 4 above.

Question 6

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

RESPONSE

For the reasons noted in our response to Q4 we do not believe it is necessary at this stage to impose, by way of any general regulatory provision, additional requirements to other types of non-PIE entity.

SECTION 4 – PROHIBITED NON-AUDIT SERVICES

Prohibition of additional non-audit services

Question 7

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

RESPONSE

Our starting position is that a "threats and safeguards" approach to the provision of non-audit services has worked well and as far as possible should be maintained. However, we acknowledge that in order to implement the new regulations some changes are necessary and we therefore favour the following approach.

- services that are prohibited by the Audit Directive and Regulation would be on a "black" (proscribed services) list; and
- a "white" list would not be created for the purpose of determining which services were permitted or proscribed; instead other non-audit services would continue to be subject to the FRC's current "threats and safeguards" approach and would fall within the scope of the fee capping rule. This approach has been around for a number of years now, is well understood and is consistent with regimes operating in other jurisdictions.

We are not in favour of a white list approach (other than in respect of the cap – see our response to Q16 below). It is unnecessary gold-plating and, whether it be drawn up as a specific list of services or more as a set of principles, we think it is inevitable that difficult and unhelpful issues of interpretation will arise and that it would considerably restrict appropriate flexibility in the choice of service provider. In addition, determining with 100% confidence the completeness of any such list would be a significant challenge given that it is often difficult to define in great detail the precise nature of a particular service and service offerings themselves are continually developing.

Practical issues could also arise, for example if a "white list" project is started by the auditor which then evolves such that the natural progression would be to extend the project to include elements of services that are not on the white list but also not on the EU list of prohibited services. In these circumstances would the auditor have to stop the project and an alternative provider be appointed?

In respect of non-audit services that are not proscribed, when deciding which firm should be the provider, it is part of the role of the audit committee to consider the relevant threats and

safeguards prior to approving the service provider. Investor perception is important but some flexibility will always be required.

Enhanced audit committee reporting in this area could also reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services. For example, audit committees could explain, in addition to their overall policy on such matters, their decision to purchase specific non-audit services from the statutory auditor, their reasons for doing so and where appropriate specific safeguards put in place.

The response to this question and the others in sections 4 and 5 set out our current position on non-audit services in response to this consultation. We are also aware, however, that some user groups have advocated more wide-ranging and radical restrictions on non-audit services, particularly for the larger listed companies. If in due course there is wide support by investors and audit committees for introducing more restrictive measures than those contemplated by this new legislation and the accompanying consultation then a further review of this issue would be warranted.

Question 8

If a 'white list' approach is deemed appropriate to consider further:

(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?

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

RESPONSE

If a white list (permitted services) approach is deemed appropriate (as opposed to a black list of services which are prohibited) we have the following observations:

(a) We agree that where the regulator or competent authority has specified that the auditor should provide the service then that service should be included as a permitted service. For the other services listed in 4.13 (eg reporting accountant work, assurance on front end reporting), whilst these are not required to be performed by the auditor, in most cases the auditor is best placed to provide that service given existing knowledge of the company and accordingly we believe they should be a permitted service. Furthermore, we are unaware of any adverse market reaction to the provision of such services by the auditor.
(b) As noted above, we are not in favour of the white list approach and therefore the issue raised by this question would not apply. However, if the white list approach was adopted then the only practical way of dealing with this matter is via the audit committee and appropriate disclosure. Any form of specific pre-clearance by the regulator would seem impractical. At a general level, the white list would need to be kept under constant review as services develop and circumstances change This is a further argument against a white list approach.

Question 9

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

RESPONSE

Consistent with our preference for an overall "threats and safeguards" approach, we do not believe that additional categories of non-audit service should be added to those that are required to be prohibited by the Audit Directive and Regulation.

Derogations in respect of certain prohibited non-audit services

Question 10

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

RESPONSE

Yes, subject to appropriate oversight by the audit committee. If such services are immaterial it is difficult to see how they can be a threat to independence. Such derogations will provide appropriate practical relief and are broadly consistent with current Ethical Standards. Absolute prohibition would be a disproportionate regulatory action.

Question 11

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

RESPONSE

The derogation relates to tax and valuation services rather than other prohibited services such as human resources where one might argue both quantitative and qualitative materiality might be more relevant. Accordingly, we think that the condition that, where there is an effect on the financial statements, it must be quantitatively 'immaterial', is sufficient.

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

Question 12

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

RESPONSE

Yes. We firmly believe that it is within the role of the audit committee to approve such services and we would not be in favour of the imposition of further conditions or procedures, whether or not the white list approach is adopted. This matter should be dealt with by the company itself. In this respect, audit committees would still have discretion to apply additional restrictions even in relation to services that might appear on an FRC list of permitted services. The imposition of any further conditions would add unnecessary bureaucracy to a process that already works well and would not be consistent with the business growth agenda.

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

Question 13

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

RESPONSE

The EU legislation prohibits the provision of certain services by network firms to all group entities in the EU. Should the prohibition now also be extended beyond EU boundaries? In this respect we note that three of the prohibited services – playing a part in management/decision making, bookkeeping/accounting services and internal control design are, under the Regulation, already deemed to impair independence and cannot be mitigated by any safeguards, wherever in the world they are provided.

We acknowledge that investors and other stakeholders are unlikely to draw a distinction between components of a group that are located inside and outside the EU in terms of whether the requirements in relation to the principles of independence (including the provision of non-audit services) have been applied. All fees received by members of the parent company auditor's network are likely to be perceived by investors as having equal potential impact on the independence of the group audit, regardless of geography. We agree, therefore, that as a matter of principle the same framework should apply to network firms outside the UK. However, we believe that this issue and the principles of independence can best be monitored by the audit committee influenced by market/investor sentiment and the parent company auditor, and that it is unnecessary for the FRC to extend the requirements beyond the UK. Appropriate disclosure of non-audit series will provide the transparency to support such an approach.

Existing international ethical standards (the IFAC code) already cover this issue and the Regulation itself explicitly requires safeguards to be put in place where the services are provided outside the EU. To impose the FRC's requirements on other companies in the group and their auditors from outside the UK will undoubtedly give rise to practical difficulties. Requirements regarding the provision on non-audit services outside of the EU are unlikely to be the same as those within it. For example, it may be required or explicitly permitted for a network auditor to provide a non-audit service to a group component located outside of the EU in the relevant jurisdiction, eg taxation services, which otherwise would be prohibited by the Regulation if that component entity were based in the EU. Therefore, in order to implement an extension in respect of the principles of independence to cover all component entities regardless of where they are based, it would be necessary to allow for exceptions such as this. The need for such steps would add additional cost and unnecessary complications to an area where market pressure and appropriate policing by both by the audit committee and the parent auditor, based on well-established principles and transparent disclosure, should suffice.

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

Question 14

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

RESPONSE

We do not believe that the provisions of the Regulation should be applied to auditors of group components who are outside the parents auditor's network. We do not think that the principles of independence (including the provision of non-audit services by non-network members) can be said to have the same perceived impact on the independence of the group parent auditor as services provided by other members of that firm's network. Non-network members have no incentive, either through financial or shared reputational ("brand") considerations, to have regard to the interests of the parent auditor. Control and enforcement of such a prohibition by the parent auditor would be difficult and in any case services provided by a non-network firm are already covered by the IFAC code.

SECTION 5 – AUDIT AND NON-AUDIT SERVICE FEES

Fees for non-audit services

Question 15

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

RESPONSE

We do not wish to see the level of the cap lowered. As noted in our covering letter we believe that the introduction of an arbitrary cap (albeit now mandatory) is conceptually unnecessary and a responsible audit committee and audit firm, operating within an appropriate regulatory environment should be capable of controlling this to the satisfaction of investors without the need for a specific cap on non-audit fees. Appropriate disclosure of non-audit services will provide the transparency to support such an approach. The cap is a blunt regulatory instrument and, as far as is possible within the restriction imposed by the law, it is an area which should be governed by principles. In this respect, in line with one of the key principles which underlie our response, the cap applied in the UK should, as far as possible, be consistent with that applied in other parts of the EU.

Accordingly, we favour a "minimalist" approach to the introduction of the cap, ie to implement it as required by the EU legislation and not to extend its impact in any way. Furthermore, the 70% cap is perhaps likely to have more impact on smaller listed companies aiming to grow their business. Such companies often do not have the time or resources to manage multiple professional relationships and would tend to gravitate to a smaller number of advisers, including

their auditor who already has an extensive knowledge of the business. Forcing such companies to engage more firms with less knowledge of the company's business is likely to increase costs.

Question 16

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

RESPONSE

We agree that the FRC should be able to grant exemptions from the cap in situations where it is in the interests of the company and its investors that it procures a particular non-audit service from its auditor. However, the fact that an exemption had been granted, together with the reasons for granting the exemption, would need to be disclosed in the annual report of the company in the interests of transparency and to avoid any negative perception in the market.

We are in favour of exemptions that could alleviate situations where problems might arise and where there is no real threat to independence, particularly as "audit related" services as described by the FRC, which it is most appropriate for the auditor to carry out, will count towards the cap, unless they are actually required by law. In particular, this could be a problem for companies with a relatively small audit fee but who have undertaken major transactions which lend themselves to the provision of such services by the auditor.

Non-audit services that are required by legislation are exempted from the cap. We also think that services required by regulation, for example a public report by a reporting accountant for the purposes of a prospectus, should also be exempt and in this respect clarity regarding the exact scope of the exemption would be welcome. More generally we urge BIS/the FRC to give consideration as to what might come within the scope of an exemption and whether it is possible to adopt a broad interpretation such that services closely related to the audit or other services required by legislation (eg private comfort work in relation to the public reporting work for a prospectus), can be excluded from the cap.

Question 17

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

RESPONSE

Our starting position is that the introduction of an arbitrary cap (albeit now mandatory) is conceptually unnecessary and that a responsible audit committee and audit firm, operating within an appropriate regulatory environment, should be capable of adopting a "threats and safeguards" approach and controlling this to the satisfaction of investors without the need for a specific cap. We therefore do not agree that a modified cap should be calculated.

An extension to the 70% cap to include non-audit services provided by network firms would add further administrative burden and, in a cross-border environment where different rules might apply in different jurisdictions, will only compound the difficulties that will ensue following the introduction of the cap. In any case network auditors already have to abide by the current IFAC ethical standards. Against this backdrop, appropriate monitoring by both the audit committee and

the parent auditor, supported by transparent disclosure, should prove sufficient protection to an independence threat without the need for an undue costly process.

Furthermore, as noted below in our response to Q19 the calculation of the cap as currently set out contains a number of potential anomalies and its monitoring will create considerable administrative process. Any extension of the cap to network firms will only compound that process.

Question 18

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

RESPONSE

As stated in our response to question 17 above, we do not agree that a modified cap should be calculated. To apply this cap across a group of any size, operating in multiple jurisdictions with different regulatory regimes, will undoubtedly give rise to practical difficulties and create an unnecessary administrative burden.

If tighter restrictions on non-audit services were to be applied to non-network members involved in a group audit, that would have the greatest administrative impact for the parent company auditors who would need to be to be continuously provided with details of proposed non-audit services to monitor compliance in a situation where they have little leverage over the non-network firm. In the event that a group company wanted a non-network member to provide a non-audit service that would impact the cap, it could be difficult to prevail upon the component auditor not to accept the non-audit assignment.

Accordingly, we think including non-network firms within any modified cap calculation would be difficult. If there is to be a modified cap, then in our view it would be appropriate to compare the aggregate audit fees received across the firm's network from all members of the audited group, with the aggregate non-audit fees received across the firm's network from all members of the audited group.

We comment in our response to Q16 on services to be exempt from the cap.

Question 19

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

RESPONSE

The three year period will help those companies transitioning to PIE status.

However, the calculation of the cap as currently set out contains a number of potential anomalies. For example:

- There is some ambiguity in terms of how non-audit service fees are to be calculated - are they based on when the work was performed, when billed or when settled by the audited entity receiving the non-audit service?

- Under the basis set out in the Audit Regulation, the cap would not have effect until non-audit services had been supplied to a PIE for three consecutive years and the clock would be "reset" if there is then a one year period in which non-audit services that fall within the scope of the cap are not provided. As a result, a firm could provide permitted non-audit services for six out of a period of seven years without limit. This would not seem to be within the spirit of the legislation.

Total fees for audit and non-audit services

Question 20

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

RESPONSE

We have no strong views as to whether the requirements of ES 4 should be maintained or brought in line with the Regulation. The current threshold under ES 4 is set at 10% for listed entities and if this safeguard is considered to be working effectively we see no reason to change it.

Question 21

When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to 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?

RESPONSE

As noted in our response to Q20 we have no strong views as to whether the more restrictive requirements in ES4 should apply to PIEs. However, we think that, in line with our response to Q4 and in order to avoid any gold-plating or unnecessary complexity, unless there is strong stakeholder objection, the limit should be applied to PIEs only and not extended to other entities.

Question 22

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

RESPONSE

We think that this is a reasonable interpretation of "regularly" and agree that such a definition would bring helpful clarity to ES4.

SECTION 6 – RECORD KEEPING

Question 23

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

RESPONSE

We have no strong views on this matter. There is a benefit in having a standard minimum retention period for all professional bodies in the UK. The EU minimum of five years effectively achieves that but in the UK six years is the requirement of most of the regulatory bodies and accords with the UK statute of limitations and therefore we see no reason for change. A further provision by the FRC seems somewhat unnecessary.

SECTION 7 – AUDIT FIRM AND KEY PARTNER ROTATION

Audit firms

Question 24

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

RESPONSE

Compliance with the firm rotation requirements will as a matter of practice be monitored by both the audit firm and each of its PIE clients and accordingly we do not see this as a significant issue. On the one hand, therefore, it is difficult to raise strong objections to formalising joint responsibility as this only codifies what will happen in practice. On the other hand formalisation of joint responsibility does provide scope for potential confusion and unnecessary duplication of roles. Our preference, therefore, is that the position in the standards/legislation should be clear – it should either be specified as the responsibility of the company or the auditor.

Key audit partners

Question 25

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

RESPONSE

Yes. As regards audit partner rotation for listed companies the actual difference between a 5 year rotational requirement (as currently contained in ES 3) and 7 years as set out in the EU regulation, in terms of the level of threat to independence, may in practice be minimal. The current five year rotation requirement in the UK has been in place now for some time and we are not aware that audit quality has fallen or that costs have significantly increased for companies or their

shareholders. In addition, a five year rotation sits well with the new provisions regarding audit firm rotation - 10 years or 20 if a tender is undertaken. Any relaxation might be deemed unsatisfactory from an investor perspective and, if that is the position as evidenced by investor responses, we do not object to the retention of the 5 year requirement.

Question 26

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

RESPONSE

No. Consistent with our response to Q21 and Q4, we believe that in order to avoid any gold-plating or unnecessary complexity, unless there is strong stakeholder objection, the more restrictive requirements in ES 3 should be applied to PIEs only and not extended to other entities.

CONSULTATION STAGE IMPACT ASSESSMENT

Question 27

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

RESPONSE

In terms of possible impacts, we have raised any specific concerns we have in the answers to the above questions and in the covering letter. In answer to this question, we highlight three particular aspects of the proposals that we urge both BIS and the FRC to consider in depth as part of the impact analysis before finalising the implementation plans in the UK.

There is scope for significant complexity to arise if different jurisdictions implement the EU legislation in different ways. This could give rise to a complex patchwork of requirements for international groups which has the potential to cause to confusion in the market and add significantly to compliance costs. An overly complex regulatory regime in the UK, if the FRC has its own additional requirement in many areas, will only add to this. Accordingly, any gold-plating in the UK should be avoided unless there is a clear justification on the grounds of stakeholder needs.

The requirements in the legislation for a PIE represent a significant step change from those for a non-PIE. That there is a differential regime for such entities is entirely appropriate but for an entity transitioning to PIE status there will be a steep learning curve in a number of areas and significant additional costs will be incurred, both in pure financial terms but also on training, education and changes to internal systems and processes etc. To the extent that any transitional relief can be provided for such entities and in order to mitigate the potential impact of such disincentives, we think that BIS and the FRC should consider what appropriate reliefs might be available.

More generally there are a number of provisions in the Regulation which contain additional reporting requirements by the auditor. There is an underlying presumption in the consultations that because most of the matters subject to this additional reporting only reflect what is already done in practice then there should be minimal extra burden. To some extent this is true but we

think it is an over-simplistic presumption. Any additional reporting will only be done after due care and attention and will inevitably involve additional training, procedures and consideration by appropriately senior people.