

## **FRC Consultation December 2014 Auditing and Ethical Standards Implementation of the EU Audit Directive and Audit Regulation**

Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the Financial Reporting Council's (FRC) December 2014 consultation on implanting the EU Audit Directive and Audit Regulation.

The AIC is a trade body representing approximately 340 investment companies, managing assets of around £110 billion. The AIC's members include investment trusts, venture capital trusts and non-EU investment companies. Our non-EU members are primarily Channel Islands companies, listed on the London Stock Exchange.

The AIC supports the rules currently in place for auditors which are set out under the current FRC's Auditing and Ethical Standards. We consider these rules enhance investor confidence and strengthen the standards of auditing applied to Listed entities.

The AIC also supports the concept set out in the UK Corporate Governance Code (the UK Code) to 'comply or explain'. This principle helps deliver best practice in a way which is flexible and proportionate.

We consider that companies, as the purchasers of services provided by auditors, should be encouraged to 'comply or explain' against principles on audit as set out in the UK Code, but that no significant super equivalent implementation rules should be imposed on companies. This will ensure that the UK framework continues to offer a balanced regulatory approach specifically tailored to support the needs of smaller companies quoted on unregulated markets as well as those with a full listing.

### **In response to the questions posed in the December 2014 Consultation Paper:**

**Question 1 - Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?**

Yes. The competent authority should have the ability to impose additional requirements to address any national laws or specific matters that may arise as a result of cultural or business practices in the UK. For example, the requirement for some entities to report on how they apply the UK Code is a beneficial addition for investors. However, additional rules should only be imposed where there is a clear reason to do so, and the obligations are proportionate to any regulatory issues that may arise.

**Question 4 - With respect to the more stringent requirements currently in the FRC's Auditing 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?**

The AIC **recommends** that the more stringent requirements currently in the FRC's Auditing and Ethical Standards pertaining to the auditor should apply to PIEs as defined in the Audit Directive. This includes, for example:

- auditors being required to confirm their independence to those charged with corporate governance;
- for companies that report on the application of the UK Code, auditors need to communicate to the audit committee information, their views on matters such as business risk relevant to financial reporting, significant accounting policies, management's valuations, the company's system of internal control, the robustness of the directors' assessment of the principal risks facing the company, and the directors' explanation in the annual report as to how they have assessed the prospects of the company; and
- for companies that report on the application of the UK Code, the auditor's report also needs to include additional information to describe the assessed risks of material misstatement, explain the concept of materiality in planning and performing the audit, and providing an overview of the scope of the audit.

If these requirements were not applied this would be seen as a backward step for the UK's corporate governance position, which has been developed to meet the needs of the UK's capital markets. This will maintain public confidence in audit by providing additional information to the investor in the auditor's report for entities applying the UK Code, and providing the audit committees with further information on the audit and audit findings.

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

The AIC **recommends** that the more stringent FRC requirements continue to apply to the auditors of all other Listed entities as currently defined by the FRC. These requirements have been developed by the FRC to meet the specific needs of the UK market.

**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?**

The AIC considers that there is an important distinction to be made between Regulated Markets and AIM. AIM plays a vital role for small and medium sized businesses which require capital to support their growth and development. As such its balanced regulatory framework is specifically tailored to support the needs of smaller companies.

The AIM Rules published by The London Stock Exchange are understood and accepted by market participants. This offers the benefit of a less stringent regulatory regime for companies which choose not to admit their shares to trading on regulated markets, whilst also offering appropriate protection to investors.

The UK Government is committed to providing support for smaller growing businesses. One of the ways in which this can be done is by continuing to provide a differential regulatory framework which can be utilised as appropriate.

Therefore, the AIC **recommends** that the more stringent requirements of the Audit Regulation are not applied to Listed entities as defined by the FRC, which includes AIM companies. Not only would this unnecessarily go beyond the requirements of the Directive, but it would also impose disproportionate regulation on entities that do not fall under the PIE definition i.e. AIM traded companies.

**Question 6 - Should some or all of the more stringent requirements in the FRC's Auditing and Ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?**

As a general policy, the UK's regulatory approach is not to gold-plate EU legislation as outlined in the Department for Business Innovation & Skills' "*Gold-Plating Review*" dated March 2013. The AIC agrees with this approach and **recommends** that the UK should apply the definition of PIEs as defined in the Audit Directive. This would mean that the more stringent new requirements would only apply to PIEs as defined in the Audit Directive.

**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?**

Article 5 of the Audit Regulation requires that a statutory auditor shall not directly or indirectly provide certain prohibited non-audit services to an audited entity, as listed in the Regulation. Member States then have the option to:

- a) prohibit all additional services;
- b) allow the provision of certain prohibited services provided specified requirements are complied with; or
- c) establish stricter rules setting out the conditions under which a statutory auditor can undertake non-audit services other than the prohibited non-audit services.

The AIC **recommends** the UK adopts the derogation set out in option b. We do not consider it necessary or appropriate to prohibit additional non-audit services other than those being required by the Audit Regulation. Nor should the UK impose additional conditions where services are being provided.

The AIC supports the FRC's current approach to apply principles rather than rules in order to maintain good governance. Given that Article 5 of the Audit Regulation sets out a number of prohibited services, we **recommend** this is used to identify a 'black list' of prohibited non-audit services. Construction of the 'black list' should take advantage of the derogation allowing the provision of certain prohibited services where specified requirements are complied with. By establishing a 'black list', the provision of other non-audit services will be allowed, subject to companies evaluating threats and safeguards to the auditor's independence. This is in line with the UK's principles based approach. This will also allow companies to maintain as high a level of commercial flexibility as possible, given the prohibitions required by the Audit Regulation.

The danger of introducing a 'white list', as explained in the consultation paper, is that certain services might be omitted, and therefore services that could have been included are prohibited. Allowing the

audit committee to approve services not on a white list in exceptional circumstances is appropriate. We consider that the perception of the investor is likely to be that the audit committee is going against recommended practice, and therefore it is likely that this will effectively prohibit such services.

**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?**

No. In line with the UK's regulatory approach not to gold-plate EU legislation, the AIC **recommends** that no additional non-audit services should be prohibited other than those that will be required by the new Audit Regulation.

The responsibility for assessing which services the auditor should provide is the responsibility of the audit committee. We agree that further restrictions, either through law or standards in addition to a 'black list', reduces the ability of the audit committee to act in the best interest of the company.

The level of choice available to audit committees to select service providers to provide audit and non-audit services must remain as extensive as possible. Research based on information from Morningstar shows that 91% of investment company audits are conducted by 6 audit firms. To introduce any restrictions that go beyond those outlined in the new Directive and Regulation may reduce the number of audit firms willing or able to tender for particular audit or non-audit work and therefore would serve to restrict further the choice of provider available to companies.

The AIC supports the FRC's current Auditing and Ethical Standards which require safeguards to be put in place where threats to independence are identified. In addition, the audit committee also has responsibility to assess and ensure auditor objectivity and independence is safeguarded as part of the UK Code. We consider this dual responsibility to be operating effectively and consequently ultimate responsibility should continue to lie with the audit committee and the auditor.

**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?**

The AIC **recommends** that the derogation be taken up, to ensure that a proportionate regulatory position is reached and to maintain as wide as possible number of service providers available for the company to choose from so as to ensure that the best provider can be chosen for the service required.

**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?**

The definition of materiality (being "*Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.*") requires the user to consider a wide variety of issues that could impact the decision of users.

The AIC considers this threshold to be appropriate and therefore **recommends** that if the derogations are taken up, the condition that the effect on the financial statements must be "immaterial" is sufficient.

**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?**

For our member companies that comply with the AIC Corporate Governance Code (as endorsed by the FRC), and for those companies complying with the UK Code, the audit committee is responsible for developing and implementing a “*policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.*”<sup>1</sup>

If the external auditor provides non-audit services, the audit committee must also provide an explanation of how auditor objectivity and independence are safeguarded. Therefore there is a clear explanation in the accounts with regard to the provision of non-audit services. The requirement for Listed entities to disclose details of audit and non-audit fees in the annual accounts provides the investor with relevant information.

It is sufficient to require the audit committee to approve such non-audit services having considered any threats to independence and the safeguards applied. The AIC **recommends** that no further conditions are required to be placed on companies to approve 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?**

As stated in our response to question 9, the AIC considers that the responsibility for assessing which services the auditor should provide is the responsibility of the audit committee. Imposing further restrictions, either through law or standards, reduces the ability of the audit committee to act in the best interests of the company. In addition, it is in line with the UK’s regulatory approach not to gold-plate EU legislation. On that basis, the AIC **recommends** that the 70% cap on fees for non-audit services required by the Audit Regulation is sufficient.

**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?**

Yes. The AIC considers it important for the relevant competent authority to be able to grant exemptions on an exceptional basis to allow for specific circumstances that may arise. This will provide the competent authority with a level of flexibility which may be required in certain, limited circumstances to ensure the most appropriate service provider is appointed. As such, the AIC **recommends** that this derogation is taken up.

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<sup>1</sup> The UK Corporate Governance Code September 2014

**Question 24 - Do you believe that the FRC's Auditing 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?**

The AIC agrees with the FRC and **recommends** that auditors should also have a responsibility to ensure that they do not act as auditor when they are effectively barred by law from doing so.

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