BAKER TILLY

Third Floor, One London Square
Cross Lanes
Guildford
Surrey, GU1 1UN
United Kingdom

T: +44 (0)844 2640300

www.bakertilly.co.uk

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

hugh.morgan@bakertilly.co.uk
20 March 2013

Dear Keith

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

Thank you for the opportunity to comment on the FRC consultation on the implementation of the EU Audit Directive and Audit Regulation.

Our detailed comments to the questions asked in the consultation paper are included in the attached appendix. Our main points are summarised as follows:

- International consistency – we are supportive of internationally consistent auditing and ethical standards and although we support the role that the FRC has in maintaining audit quality in the UK we believe that the FRC should not, other than in exceptional circumstances, be "gold plating" internationally accepted standards by adding more stringent UK requirements. There is little evidence to suggest that additional UK requirements are necessary and whilst we support the FRC having the power to add more stringent requirements this power should only rarely be used and then only after extensive consultation including a high quality qualitative and quantitative impact assessment.

- PIEs – we recommend that the FRC consults on and agrees a definition of UK PIEs that is consistent with the EU definition and does not expand this definition of UK PIEs to include entities that are not included in the EU definition for example AIM listed companies. We further recommend that the FRC applies this definition of UK PIEs consistently to both auditing and ethical standards and does not introduce inconsistences in application that serve no real purpose and are inconsistent with the EU.

- More stringent requirements in existing FRC standards – the introduction of the EU requirements gives the opportunity for the FRC to look again at areas where it has introduced more stringent requirements, for example on rotation in ES 3, and consider whether these are still necessary. In our view there is

little evidence to support the inclusion of more stringent requirements in the areas that the FRC has applied them and these only serve to reduce international consistency and add to costs, making UK auditors less competitive that their EU peers with no tangible benefits. In the light of the new EU requirements we believe that now is the time for the FRC to reconsider whether more stringent requirements are still required in the UK and seek to remove inconsistencies.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

Hugh Morgan
Technical Director
Baker Tilly UK Audit LLP

FRC Consultation: Auditing and ethical standards

Appendix 1

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)?

YES

We agree that the FRC should be able to exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission but only where this necessary to address national law. We accept that there may be cases where, if agreed as appropriate by stakeholders, the FRC may seek to impose additional requirements to add to the creditability and quality of financial statements but in our opinion this should be in extremely rare circumstances and any additional requirements in this area should be kept to an absolute minimum otherwise the FRC would be in danger of "gold plating" UK auditing standards and making UK auditors uncompetitive in the international market.

We believe that one of the main strengths of the ISAs issued by the IAASB is that they are internationally consistent and having been through a lengthy international public consultation process the IAASB ISAs are accepted worldwide. Adding to the IAASB ISA requirements on a national basis has significant cost implications and distorts the audit market by introducing unnecessary differences which make it very hard to perform a consistent international group audit and compete in a global audit market.

If the FRC does want to add to the IAASB ISAs we recommend that the FRC performs a high quality qualitative and quantitative impact assessment, prior to any wider consultation, the outcome of which should be included as part of their consultation process. We further recommend that if, following this impact assessment and consultation process, the FRC still considers that the IAASB ISAs need to be augmented with additional requirements to add to the credibility and quality of financial statements that the FRC work within the existing structures to persuade the IAASB and EU that the internationally accepted ISAs need to be amended to address the UK concerns.

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.

YES

We support the view that there should be one set of standards for all audits and that these standards should be internationally consistent. A principles based approach to standard setting should be able to achieve this goal and be scalable to the audits of smaller undertakings. In practice, the current auditing standards, whilst principles based, still include a number of detailed rules and requirements which make them difficult to apply to audits of smaller undertakings and the attitude of Regulators has not encouraged auditors to adopt the standards in a proportionate manner. Rather than gold plating the rules and requirements that make the existing auditing standards difficult to apply to the audits of smaller entities we would encourage the FRC to work with the IAASB and focus on principles that can be applied proportionately to all audits. We recommend that the FRC consults with auditors of smaller undertakings to get their views as to problems with the scalability of auditing standards.

Whilst we have reservations about the application of auditing standards to smaller undertakings we support the approach that the FRC has taken in applying the ethical standards to smaller undertakings in the ES PASE and it is important that the FRC continues with this approach and works with the IAASB to get this adopted internationally.

Question 3: When implementing the requirements of 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.

NO

In our opinion, because the articles concerned (22b, 24a and 24b) relate to auditor independence, audit firms' internal organisation and maintenance of records in relation to breaches/complaints, we do not consider that simplified requirements should be available in these areas. It is essential that public confidence in the audit regime is maintained and the FRC should avoid creating a two tier system. We also believe that the nature of firms' work will to some extent drive their approach in these areas. For example, the required level of specialist technical knowledge will usually be less at small firms due to the nature of work undertaken and their training needs will reflect this. Whilst we do not agree with simplifying EU requirements in these areas we would recommend that the FRC looks at its own guidance as this presents an opportunity to remove any existing UK gold plating and be more consistent with international requirements.

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?**

NO

We do not recommend that the FRC imposes additional requirements on PIEs beyond those set out in the EU Audit Directive and Audit Regulation. We do not believe that the FRC should be "gold plating" UK auditing and ethical standards except where this is required by national law or, in very exceptional circumstances, is considered necessary to add to the credibility and quality of financial statements. We recommend that the FRC uses this opportunity to review the existing UK standards and remove any UK "gold plating" unless it meets very stringent criteria and also remove the inconsistencies between the ways in which auditing and ethical standards apply to listed companies with AIM companies treated as "listed" for the purposes of ethical standards but not for auditing standards.

We do not believe that the FRC should apply PIE requirements in the EU regulation to listed entities that are not in the EU PIE definition, for example AIM companies. In our opinion the FRC should consult and agree upon a definition of a PIE that is appropriate to the UK market and in doing so we recommend that the FRC follows the approach adopted in the EU and exclude AIM listed and other entities on markets that are not EU regulated markets from the definition of a PIE in the UK. Specific comment on this is included in our further responses below with the term "AIM" used to cover the range of entities concerned.

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?

NO

We believe that the FRC should first consult and agree on a UK definition of a PIE, which should align as closely as possible with the EU definition and in our opinion exclude AIM companies, and then if there any more stringent requirements to be introduced to reflect the provisions of the EU Audit Regulation these should be applicable to UK PIEs on a consistent basis.

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?

NO

As stated above, we do not recommend that the FRC imposes more stringent requirements on other types of listed entity that do not meet the PIE definition set out in the EU Audit Directive and Audit Regulation.

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?

We believe that the establishment of a "black list" of prohibited non-audit services will best reduce perceptions of a threat to auditor independence. The advantage of a "black list" is that it will establish clearly which non-audit services are prohibited but will also mean that audit committees maintain some involvement and discretion in determining whether it is appropriate for the statutory auditor to carry out non-audit services which are not included on the black list. We believe that the "black list" approach is consistent with the current UK system of threats and safeguards which has worked well for many years and allows judgement to be applied when deciding whether non-audit services can be provided allowing for safeguards to be adopted to protect independence. The "black list" approach is consistent with the approaches adopted by IESBA and the SEC and we see no advantage in changing.

Although we see the possibility that the white list may be so widely drafted such that what is left over is effectively what would have been on the black list in reality there would be a large grey area in the middle between the content of the black list and white list where adopting the UK system of threats and safeguards would have produced a more sensible outcome. The creation of a white list also runs the risk that non-audit services will be undertaken by the statutory auditor where, in the specific circumstances concerned, it is not appropriate to do so.

Research has shown that in recent years there has been a steady decline in the proportion of non-audit to audit fees and that audit committees are applying more stringent criteria in this area. We believe that this trend is likely to continue, particularly with the additional provisions in the EU Regulation and therefore do not believe that this is an area where the FRC should be making a radical change in regulation.

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?**

Please see response to Question 7 above – we consider that the establishment of a black list rather than a white list is more appropriate. The "black list" approach is

accepted internationally and we see no evidence that this is flawed or lack clarity or has led to problems in implementation.

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

We are not aware of any further non-audit services which we consider should be prohibited by the Audit Regulation.

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?

YES

We agree in principle that where a non-audit service has no direct impact or an immaterial effect on the financial statements, it could be carried out subject to the other relevant considerations concerning independence. However, we believe that applying this principle in practice will be difficult. For example, in the case of valuation work, the valuation will, in all likelihood, have to be completed before an assessment of materiality can be made.

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?

NO

In addition to the requirement for the impact on the financial statements to be immaterial, we consider that the nature of the work to be performed and the extent of subjectivity that it involves, should be considered. For example, where payroll services are to be provided (which we note are not on the list of prohibited services which may be allowed by derogation), there is minimal, if any, judgement exercised whilst valuations work which does entail a significant level of subjectivity and judgement is on the list of prohibited services which may be allowed by derogation.

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 is adopted?

YES

We believe that audit committee consideration of whether or not non-audit services should be provided by the statutory auditor alongside a "black list" of prohibited services is sufficient.

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

YES

In order to maintain public confidence in the auditing profession, we believe that the group auditor should ensure that the principles of independence set out by the FRC are complied with by all group auditors regardless of where they are based or whether they are part of the same network. Where other group auditors are based in the EU, compliance will be easier to establish than when they are based outside the EU where the IESBA principles apply but this does not mean that the principles of independence should not be complied with across the board. If this approach is to work there should be consistency between the principles of independence set out by the FRC, EU and IESBA otherwise there would need to be a tiered approach with the FRC principles adopted in the UK, the EU principles adopted in the EU and IESBA outside the EU. We see no reason why if differences are kept to a minimum, which should be achievable when dealing with "principles" of independence, that a more internationally consistent approach should be possible. We recommend that when consulting on ethical standards that the FRC make international consistency its goal and work with other ethical standard setter to achieve this.

Question 14: When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of the 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?

Please see our response to Question 13.

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?

YES

We believe that the 70% cap on fees for non-audit services required by the Audit Regulation is sufficient and do not recommend the imposition of a lower cap. We

regard such a cap on fees and the nature of the non-audit services provided to be two separate issues. For example, if, under local legislation, a non-audit service is required to be carried out by the statutory auditor, we consider that it should still be included in the overall calculation of audit fees versus non-audit fees.

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

We consider that the FRC should be able to grant exemptions on an exceptional basis for a period not exceeding two years as set out in Article 4 of the Audit Regulation.

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?

NO

As set out in our response to Question 13, the group auditor should establish whether all other group auditors have complied with the FRC's principles of independence which includes considering the level of audit versus non-audit fees. In the light of this we do not believe that further consideration of audit versus non audit fees is required at network level given the nature of the remuneration structures generally seen in networks.

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?

Please see our response to Question 17 above.

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)?

YES

We believe that the calculation of the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate.