

Consultation: Auditing and ethical standards.
Implementation of the of the EU Audit Directive and Audit Regulation
Invitation to comment: Professor Krish Bhaskar Submission No 2

Reasons for this second submission

At the FRC consultation meeting at the Saddler's Hall on 11 March 2015 a number of statements and comments were made which suggested a second submission.

Prohibited services: Black and White lists

Nick Land (FRC Chair of Codes & Standards Committee) and others vigorously criticised my previous submission on the basis that it was not necessary to have a black list. He argued that it was implicit within the EU regulation and/or was redundant or obvious. I still maintain in the interests of clarity that a black list and white list should be selected in the interests of clarity.

I would make the following points to defend my viewpoint:

- 1) Why ask for a black list approach as one of two alternatives in the consultation document if it is already contained and/or redundant?
- 2) Others at the meeting backed the combination of a black list and a white list.
- 3) Even if you use the actual black list from the EU Regulation, some of the items are non-specific, generalised and/or ambiguous.

Individual audit firms have very different definitions of what certain activities are called. So by defining the black list in an unambiguous way, the FRC could clarify these activities.

Examples for point 3) above include, help in the deriving information that might be used in the preparation of tax forms. Also another area is in the help or actual writing of the annual report including the layout and the derivation of the numbers for the financial statements included in the annual report.

Prohibited services: Flexibility

Article 5 Paragraph 3 of the EU Regulation allows for derogation of certain services. The FRC also states in its consultation document (paragraph 4.35) that any additional items in the black list may be permitted in a similar vein "...if prohibited non-audit services were widened beyond those set out in the Audit Regulation we believe this derogation could also be applied to those additional prohibited services."

This provides a degree of flexibility. My view is that this flexibility is desirable when there is a cost advantage to the audited entity of providing a service by the auditors. This could be authorised by the FRC on an individual basis. If the FRC does not have sufficient resources to undertake this, then the FRC could charge the audited entity or the auditor for this approval process whatever the outcome. This would be, of course, after the audit committee has properly assessed threats to independence and the associated safeguards, and given its approval.

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Where the FRC regulations are tighter than the new EU regulations

This was discussed at the meeting. I think that it would be a retrograde step to move to a less strict regime especially when the media is reporting regularly on such issues as company collapses, ethical concerns, possible audit failures, banking scandals and other issues are being regularly reported in the media.

Scope of the restriction

I answered these briefly previously but further comment seemed appropriate after the meeting.

Specifically in the meeting, the FRC asked the following question: how to reconcile the inconsistency of the following two bullet points (taken from the slides presented at the meeting on the 11 March):

- 1) “The prohibitions on the types of services that can be provided apply to both the auditor and its network firms in so far as those services are provided to group entities based in Europe.
- 2) “The cap on fees for allowed non-audit services applies to the auditor of the audited entity – but not its network firms – on a global basis for services provided to all group entities”.

On reflection, the individual or small practice, without any network, is placed at a possible and potential disadvantage. Many of the top 50 audit firms in the UK already make heavy use of network firms – particularly the larger audit firms. Some have consulting arms that are mainly located outside Europe.

There is the case where the audited entity is mainly a non-UK and non-European firm. It may be that it would be unfair to change the second rule for this type of entity. On the other hand there are some mainly UK/European firms/entities with many overseas operations. In this case rule 2) above might be modified to include all network firms as in rule 1). However, this might, in small measure, make a case for firms to become less UK/European, and this could have other negative ramifications.

That consideration apart I would support rule 2) being applied as:

The cap on fees for allowed non-audit services applies to both the auditor and its network firms of the audited entity on a global basis for services provided to all group entities.

In the second phase of the meeting and consultation process, it might be useful to analyse any negative comments

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Restriction on fees and fees in general: new evidence

Although not part of the consultation experience, my colleagues¹ and I feel it is important to study the effect of both the requirement for rotation and the EU regulations will have on the audit market and audit fees.

Specifically, we are interested in how rotation and the EU audit reform regulation will impact on the audit market in terms of concentration, scope and audit fees (pricing). My guess was that rotation in the UK would lead to an increase in audit fees. My view ran counter to the Chinese experience of audit rotation (post 2012), which saw a drop of 12% and 31% in two cases², although the full findings of Professor Gillis' study are in the same direction but a little more fuzzy.

Informal anecdotal evidence gained from several of the Big Six seemed to indicate that audit fees (strictly defined) are falling and not rising as we had predicted. The Chinese experience, although very different, seems as if it may be relevant for the UK audit market. However, as well as a possible fall in audit fees, there seems to be an increase in concentration. In general, it seems that the cost of the tendering process seems to be greater overall for the audit industry. This evidence is far from scientific and we hope that further work will provide a definite piece of research.

¹ Professor John Flower and Rod Sellers.

² See Accountancy Age 30 January 2014, by Gavin Hinks which refers to two of the 16 case studies. This can be found in <http://www.accountancyage.com/aa/feature/2325939/audit-in-their-hands-what-china-can-tell-us-about-rotation>. The full work can be found in *The Big Four and the Development of the Accounting Profession in China*, by Professor Paul L. Gillis, Emerald Group, Bingley UK, 2014. The background is that the Big Four came to dominate the Chinese market and this was one of several attempts to loosen the Big Four's grip on the Chinese market.