Quoted Companies Alliance

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Dear Mr Billing,

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

Introduction

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The Quoted Companies Alliance Financial Reporting and Corporate Governance Expert Groups have examined your proposals and advised on this response. A list of members of the Expert Groups is at Appendix A.

Response

We welcome the opportunity to respond to this consultation. We note that we are also responding to BIS' consultation on Auditor Regulation: Discussion document on the implications of the EU and wider reforms.

Our main concern is the intention of the FRC to apply the requirements as set out in the Directives and Regulations as applicable to Public Interest Entities (PIEs), in part or in full, to listed entities as currently defined by the FRC. BIS does not propose to widen the EU definition of PIEs for statutory purposes and will not designate other entities as such. However, the FRC raises this as possibility by consulting on whether to apply the PIE requirements to entities listed on recognised stock exchanges, not just EU regulated exchange, as required by the definition of PIE. If the FRC proceeds on this basis, it will in effect be widening the definition of PIE – something that the Government has openly stated they will not do. We believe that it is crucial that the additional requirements applicable to PIEs are not applied to other entities, as it would not align with Government policy and would impose significant additional regulation on growth companies.

We note that the Audit Directive and Regulation purposely leave outside of their scope companies quoted on growth markets, such as AIM or ISDX. It is up to the Member States of the EU extend the definition of

PIE and thus extend the application of stricter rules to other entities. We find it disproportionate that, in this case, the UK would consider goldplating these rules, going beyond what is deemed fair and necessary.

We believe that over-regulating the audit process would undermine the trust that has been built on audit committees over the years. The focus should be in building market confidence through fair and proportionate rules, which do not hinder small and mid-size quoted companies' abilities to grow.

Our members – small and mid-size quoted companies – do not have the resources to address dramatic changes in regulation. In this case, applying the requirements developed for application to PIEs would be costly and time-consuming, with very little perceived benefit for small and mid-size quoted companies and investors. Audits of small and mid-size quoted companies on AIM and ISDX do not pose a systematic risk to the UK economy. Therefore, we firmly believe that there should be a careful balance between the difficulty of coping with strict regulations and the risks posed to external shareholders.

Leaving companies quoted on growth markets out of the scope of the more stringent rules could help increase the support that these companies need from their auditors when preparing their financial statements, effectively improving the disclosures to the standard encouraged by the FRC.

In addition to the above, extending the application of the EU regulations would also mean increased responsibilities for the FRC, which would translate into increased levies to fund its activities. The costs of this would be inevitably and disproportionately borne by small and mid-size quoted companies. We believe that this should not be the case. The current position of the FRC is to impose regulations on all AIM quoted companies, but only monitor the audit of those with a market capitalisation in excess of £100m. This approach alone has meant that the FRC have imposed costs and greater restrictions on some 1009 AIM listed companies, when only 190 of those companies are deemed of sufficient interest to be monitored by the FRC.

We have responded in more detail below to the questions that we believe would most significantly affect our constituency.

Responses to specific questions

Section 1 – Auditing Standards

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

Other than as required by UK law, the FRC should not impose any additional requirements in auditing standards beyond what is required by the Audit Directive and Regulation. We urge the FRC not to goldplate these rules. The Commission is planning on undertaking a process to adopt International Auditing Standards and we believe that this will be a thorough approach to ensure that these standards are rigorous and appropriate for use on the European capital markets.

We note the comments made in the Consultation regarding the enhanced audit report and agree that this has been well received by investors. We are not aware of any empirical evidence to suggest that this has lowered the cost of capital and made the UK a more attractive capital market. We consider that this change would have been introduced by the IAASB and a mechanism could have been found to introduce it early in the UK outside of changes to auditing standards (for example, through changes to the Listing Rules and the UK Corporate Governance Code). We do not, therefore, consider that this justifies the goldplating of auditing standards.

We believe that over-regulating the audit process would undermine the trust that has been built on audit committees over the years. The focus should be in building market confidence through fair and proportionate rules, which do not hinder small and mid-size quoted companies' abilities to grow. We believe that the Audit Directive and Regulation adequately address auditing standards and requirements and provide sufficient credibility and quality of financial statements.

Continuing to allow further amendment when auditing standards have already been thoroughly reviewed by the Commission is an example of unnecessary red-tape. As mentioned in our introduction, this would translate into increased levies from the FRC to fund its activities. These costs would be inevitably and disproportionately borne by small and mid-size quoted companies. We note that (as we had pointed out in our response to the FRC's Draft Plan & Budget and Proposed Levies 2015/16 in February 2015), the FRC levy for companies with a market capitalisation of less than £1,000m, many of whom are Quoted Companies Alliance members, is proposed to increase by 7%. This means that these companies will bear a disproportionate share of the increased cost, and more so as the FRC's responsibilities expand.

Section 3 - Extending the More Stringent Requirements for Public Interest Entities to Other Entities

Q4 With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation: (a) should they apply to PIEs as defined in the Audit Directive? (b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

There is a danger of confusion regarding the different definitions currently in use. The definition of a 'listed entity' in the audit and ethical standards differs to the definition of a 'PIE' in the Directive and from a 'major audit' within the scope of the Audit Quality Review team. We urge the FRC to consider aligning these definitions to ensure clarity for both companies and auditors. In our opinion, the appropriate definition would be that of a PIE as defined in the Directive and, for the reasons discussed in this response, not extended to cover AIM and ISDX.

We believe that the more stringent requirements should strictly only apply to PIEs as defined in the Audit Directive. To include other entities in the application of these requirements would mean in effect extending the definition of PIEs, which BIS does not propose to do. We believe that it is crucial that the application of the more stringent requirements is not extended to other listed entities as defined by the FRC, specifically those listed on AIM and ISDX.

We note that the Audit Directive and Regulation purposely leave outside of their scope companies listed on growth markets, such as AIM or ISDX. We find it disproportionate that in this case the FRC would consider goldplating these rules, going beyond what is deemed fair and necessary.

When considering whether to retain current UK rules that are an extension of the EU requirements, the FRC should justify why the additional regulation is necessary and how it will be of benefit to those companies affected. This impact assessment should be based solely on empirical evidencing indicating how estimated additional cost of regulation will result in a lower cost of capital and hence an overall benefit.

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

Please see our response to Q4.

We believe that the more stringent requirements should strictly only apply to PIEs as defined in the Audit Directive. To include other entities in the application of these requirements would mean in effect extending the definition of PIEs, which BIS does not propose to do and was purposely not envisaged by the Audit Directive and Regulation.

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

Please see our response to Q4.

We believe that the more stringent requirements should strictly only apply to PIEs as defined in the Audit Directive. To include other entities in the application of these requirements would mean in effect extending the definition of PIEs, which BIS does not propose to do and was purposely not envisaged by the Audit Directive and Regulation.

Section 4 – Prohibited Non-audit services Prohibition of additional non-audit services

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

We believe that the best way to reduce perceptions of threats to the auditor's independence is to encourage greater trust in the Audit Committee and the role that it plays in safeguarding independence. This could be achieved by requiring greater depth of reporting by the Audit Committee concerning non-audit services provided, the safeguards employed and whether the service was subject to external tender.

We do not consider it necessary to introduce a 'white list' or to expand the existing 'black list', as we consider that the Ethical Standards will be clear enough to be interpreted by auditors and Audit

Committees and being more prescriptive could encourage people to focus more on the letter, as opposed to the spirit, of the standards.

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

See answer to Q7 above.

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

There are no other services that we believe should be specifically prohibited.

Derogations in respect of certain prohibited non-audit services

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

As the derogation is de-regulatory, we believe this should be taken up. However, guidance should be given as to how to define 'no direct' or 'immaterial effect'. In our opinion, the derogation would allow for auditors to provide ad-hoc and immaterial tax services where they may be the best placed, and most appropriate, adviser. As noted in our response to Q7, we would expect the Audit Committee to report on this relationship to shareholders.

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

See answer to Q10 above.

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

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

The Audit Committee is the appropriate body to consider and approve non-audit services that are not prohibited, provided this is clearly reported to shareholders, no other condition is necessary.

Section 5 – Audit and Non-audit Services Fees

Fees for non-audit services

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

We believe that the FRC should not apply more stringent requirements than those imposed by the EU Audit Directive and Regulation. That would go beyond BIS' intentions for the implementation of requirements on non-audit services.

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

Whilst such a power should be available, to allow flexibility in the case of unforeseen circumstances, we would expect the power to be exercised extremely rarely and only in conditions of 'emergency' as currently defined in Ethical Standards. There are multiple providers of non-audit services in the UK market and Audit Committees should be capable of ensuring that the cap is not breached by the use of these alternative suppliers.

Our response would be different if the cap is applied to entities listed on AIM and other growth markets, as these smaller companies tend to have smaller audit fees. As such, an acquisitive, high growth company may struggle to apply a cap on non-audit fees bearing in mind it is the auditor that is generally best placed to provide reporting accountant duties.

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

As said above in our response to Q15, we believe that the FRC should not apply more stringent requirements than those imposed by the EU Audit Directive and Regulation. That would go beyond BIS' intentions for the implementation of requirements on non-audit services.

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

Whilst we find the definition a bit complex, we do not consider it appropriate to adopt a more stringent basis than that required in the Regulation.

Total fees for audit and non-audit services

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

Yes, we believe that the requirements in ES 4 should be maintained.

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

We believe that the more stringent requirements should strictly only apply to PIEs as defined in the Audit Directive. To include other entities in the application of these requirements would mean in effect extending the definition of PIEs, which BIS does not propose to do and was purposely not envisaged by the Audit Directive and Regulation.

Section 7 – Audit Firm and Key Audit Partner Rotation Audit firms

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

Yes, we believe that the FRC should establish a clear responsibility for auditors. We would also urge the FRC to ensure the rules, for both auditors and companies, are clear as to how the maximum time permitted should be assessed in the event of a merger of audit firms.

Consultation Stage Impact Assessment

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

We urge the FRC to thoroughly consider, in its impact assessment on extending the more stringent requirements for PIEs to other entities, the effects on extending them to small and mid-size companies quoted on AIM and ISDX. We note that the FRC has not made particular reference to SMEs and namely to assessing the increased costs, which would inevitably be generated for these companies.

If you would like to discuss this in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

APPENDIX A

Quoted Companies Alliance Financial Reporting Expert Group

Matthew Stallabrass (Chairman)	**Crowe Clark Whitehill LLP**
Jonathan Lowe Paul Watts Nick Winters	Baker Tilly
Anna Draper	BDO LLP
Amy Shepheard	Deloitte LLP
David Gray	DHG Management
Shalini Kashyap	EY
Gary Jones	Grant Thornton UK LLP
Anthony Carey	Mazars LLP
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Nigel Smethers	One Media iP Group PLC
Joseph Archer	PKF Littlejohn LLP
Donna Caira	Saffery Champness
Matthew Howells	Smith & Williamson LLP
Jack Easton	UHY Hacker Young
Ian Davies	Vislink PLC
Edward Beale	Western Selection Plc

Quoted Companies Alliance Corporate Governance Expert Group

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Colin Jones (Deputy Chairman)	UHY Hacker Young
Nathan Leclercq	Aviva Investors
David Isherwood	BDO LLP
Nick Graves	Burges Salmon
Nick Janmohamed	Charles Russell Speechlys LLP
David Fuller	CLS Holdings PLC
Nicholas Stretch	CMS Cameron McKenna LLP
Louis Cooper	Crowe Clark Whitehill LLP
Nick Gibbon	DAC Beachcroft LLP
Tracy Gordon	Deloitte LLP
Andrew Hobbs	EY
Eugenia Unanyants-Jackson	F&C Investments
Melanie Wadsworth	Faegre Baker Daniels LLP
Rob Burdett	FIT Remuneration Consultants
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Michael Brown	Henderson Global Investors
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James Hodges	Hydrodec Group PLC
Peter Swabey	ICSA
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Cliff Weight	MM & K Limited
Caroline Newsholme	Nabarro LLP
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