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9 December 2015

Dear Sirs

**Response to Consultation – Implementation of EU Audit Directive and Regulation**

BDO would like to thank you for the opportunity to respond to the above Consultation Paper. We would like to state at the outset that we support the approach not to extend the definition of Public Interest Entities (PIEs) and the proportional application of the EU Audit Directive and Regulation (ADR).

Given the time constraints, we have restricted our detailed response to consideration of the draft legislative clauses, Appendix 1. However we would make a number of general comments in respect of the implementation of the ADR and the impact assessment.

**Determination of practical application**

Through attendance at a number of discussion groups it is clear that there is a significant amount of ambiguity within the ADR and interpretation of the provisions is required in order to implement changes within the UK. BDO understands that BIS have advised the FRC, as the standard setter, to include relevant clauses from the ADR without redrafting, to ensure consistent phraseology, interpretation or provision of guidance. It would seem this is not only contrary to BIS's draft clause 3(1)(b) of The Statutory Auditors and Third Country Auditors Regulation, which will require the Competent Authority to determine the manner in which the standards are to be applied in practice but could lead to the undermining of market confidence due to lack of consistency.

If this issue is not addressed, before the ARD comes into effect, the UK will be in a position whereby individuals and firms will have to make their own interpretations as to the requirements in the ADR such as:

- the meaning of playing any part in the management or decision making process, is this to have the same meaning as in the existing standards or does the benchmark change;
- services included in 'financing, capital structure and allocation, and investment strategy;
- the meaning of they 'have no direct or have immaterial a clearly inconsequential effect' it is not evident what 'clearly inconsequential' means compared to immaterial as in the ADR or how one is to determine 'effect', etc.

If no guidance on practical application is provided the first time a firm will know whether their interpretation is consistent with that of the Competent Authority will be following a review by the Audit Quality Review team or following a compliant from a shareholder. Should there be inconsistencies between the two interpretations these will be made public through the audit firm's

Quality Control Reports and transparency report and could lead to an issued audit report becoming invalid which would almost certainly damage market confidence.

In addition to requiring the Competent Authority to issue guidance, BDO would urge BIS to encourage the Competent Authority to adopt terminology and interpretations in line with other EU national standard setters. We understand that it is inevitable, with the number of Member State options, that there will be a patchwork implementation of the ADR across the EU but we consider as a minimum there should be consistency between national standard setters as to the interpretation and practical application of the requirements of the ADR.

**Validity of the Audit Report**

Of particular concern to BDO is the risk that an inability to make an absolute declaration, within the audit report, that no prohibited services have been provided in the period could invalidate audits by preventing the auditor from issuing an audit report or calling into question the validity of an audit report previously issued.

Taking the example of an audit which is completed and the audit report signed in respect of the year ended 30.6.2017, with subsequent review of the audit working papers by the FRC's AQR team. The AQR disagree with the firm's assessment that the tax service provided does not have a direct effect on the financial statements and as such the provision of the tax service is prohibited. This calls into question the validity of the statement within the audit report that no prohibited services have been provided in the period. Clarity is needed whether this invalidates the audit report requiring it to be withdrawn making it necessary for the audited entity to appoint new auditors to re-audit the year ended 30.6.2017 and result in potential delay to the issue of the opinion on the financial year ended 30.6.2018.

Similarly, a situation could arise where the auditor has completed the audit and identifies that a network firm has provided a prohibited non-audit service, to an immaterial unaudited subsidiary, for an immaterial fee. Clarity is needed as to whether the auditor is prevented from issuing an audit report as they are unable to make the declaration that no prohibited services have been provided.

BDO would urge BIS to consider the need for some form of qualification statement, to the declaration, which could be supported by a disclosure requirement regarding any non-permitted services provided. This would enable the audit report to be issued negating the need for the audited entity to go through the expense and delay of commissioning a new audit, which would not be in the public interest and could undermine confidence in the marketplace.

**Non-listed PIEs calculation of tenure**

A particular area that needs clarification is the date from which the definition of PIE applies to those entities previously exempted from the requirements under a Member State option, ie non-listed PIEs. Article 17 (8) states '*the duration of the audit engagement shall be calculated as from the first financial year in the audit engagement letter in which the statutory auditor or the audit firm has been appointed for the first time for the carrying-out of consecutive statutory audit for the same* ***public-interest entity***'[emphasis added]. BIS in their first consultation were clear in their intent that the length of audit tenure of an entity would commence from the time the entity became a PIE or the date the auditor was appointed to the PIE:

*Eg:*

- *a company first appoints their auditors for the year ended 31.12. 2009; and*
- *lists on an EU recognised stock exchange within their financial year ended 31.12 2012*

*the financial period relevant to calculating the tenure of the audit relationship with the PIE would be 31.12.2012.*

However, we are aware that the FRC may interpret the regulations, in respect of non-listed PIEs, as being effective from the implementation of European Union Directive 2006/43/EC. It would appear to BDO that this retrospective application of the law could cause practical and financial difficulties for those non-listed PIEs. These entities are already incurring the costs of complying with the appointment of audit committees; identifying new suppliers of non-audit services and familiarisation costs. It would appear disproportionate, given their previous standing as non-PIEs, to require them to tender their audits in the short term. Clarity is required from BIS as from which date non-listed PIEs must apply the requirements of the ADR in respect of calculation of audit tenure.

**Reporting to Supervisors of PIEs**

BDO would urge BIS when incorporating Article 12 of the EU Regulations into UK legislation that it is made clear to which Competent Authority the auditor/audit firm is expected to report. As drafted in the Regulations it is unclear whether in the case of a listed bank or listed insurer whether the auditor will be required to report to the FRC in addition FCA/PRA. BDO would suggest It would be sufficient to meet the requirements of the EU Regulations to report to the FCA/PRA, as is currently the case, and for those Authorities to report to the FRC is they see fit. The alternative would lead to there being two lines of communication involving an audited entity whose primary authority is not the FRC. That is not to say the FRC should not be the Competent Authority for listed entities who are not otherwise regulated by a Competent Authority.

Furthermore BDO would request that the terminology used be consistent with that in the Financial Services and Markets Act 2000 (Communication by Auditors) Regulations 2001 (SI2587/2001), which would avoid any ambiguity or contradiction.

**Reporting Accountants**

BDO are aware that the FRC have stated that services performed by a Reporting Accountant will be exempt from the non-audit services as they are required by law to be performed by an accountant. Clarity is sought as to whether all aspect of a Reporting Accountants role is exempt from the non-audit services cap or whether the working capital and long form report prepared for the Directors and Sponsors, to enable them to fulfil their regulatory requirements will not be covered by the exemption. It would appear to BDO that the engagement, as a whole supports the fulfilment of legislative requirements and as such all reports produced by the Reporting Accountant should come within the definition of those audit related services that are required by law or regulation and therefore be exempt from the non-audit services cap. This will avoid a common situation where audited entities request, of the FRC, an exemption to the cap on an individual basis to enable them to use their auditors to prepare the working capital and long form reports rather than engaging a separate adviser, against their own wishes.

**CMA Order and Recommendations**

BDO are aware of the efforts already being made by BIS to work with the Competition and Markets Authority (CMA) to incorporate the CMA Order and recommendations into the legislation and where they are not consistent with the ADR seek a resolution. BDO support the efforts in this area and in

particular the calculation of the length of audit tenure and timing of the tendering process for FTSE 350 companies. We would strongly urge BIS to continue their efforts to bring clarity to these listed entities.

**Mechanism for changes**

The requirements of the ADR are complex and lack clarity as to their practical application. It is inevitable when drafting legislation and regulation to incorporate them that there are going to be unforeseen consequences arising. BDO would urge both BIS and the FRC to consider a mechanism for making changes to the UK regulations on a timely basis.

**Impact Assessment**

Given the time constraints for responding to this consultation and the FRC consultation on the Ethical and Auditing Standards it has not been possible to complete a detailed analysis of the Impact Assessment but BDO would make the following general comments:

- The costs for the transparency report appear reasonable in respect of the ongoing costs of reissuing the report however we would suggest the cost of drafting the initial report could be as high as £90,000 although some smaller firms might have lower first year costs where their systems are less complex;
- Familiarisation costs for audit principles and staff appear reasonable in respect of the audit department but will not be sufficient to cover the cost of training and familiarisation of non-audit staff;
- Similarly, the familiarisation costs for Non-Executive Directors (NEDs) appear low and would only cover a half day of their time. Given the complexity of the definition and prohibitions of non-audit services this is likely to be light;
- Account also needs to be taken of the time spent in discussions between the auditor and audit committee clarifying how the requirements relate to their specific entity.

Should you have any queries, arising from our responses, or wish to discuss them further please contact Jane Fowler on 020 3219 4381.

Yours faithfully

BDO LLP

**Responses to Specific Questions**

**Q1 Do you agree with the approach the draft implementing regulations take given the Government's conclusions as set out in these chapters? Why?**

On review of the relevant clauses of the draft legislation and regulation BDO would comment on the following clauses:

## The Statutory Auditors and Third Country Auditors Regulations

**Part 2 - The competent authority**

**Regulation 3**

BDO are supportive of the FRC being the single Competent Authority for PIEs and of the requirement placed on the FRC, as the standard setter, to determine the manner in which the standards are to be applied in practice. We would further urge BIS to require the FRC to issue their determination at the earliest opportunity and no later than the implementation date of the ADR into UK law. BDO consider a consistent approach to interpretation and application of the requirements of the ADR to be central to investors' confidence in the market.

**Regulation 4 – Sanctioning Powers**

It was BDO's understanding of the BIS consultation paper that the FRC were to be the authority responsible for the monitoring and enforcement of regulations as applied to PIEs and the FRC would delegate to the RSBs the task of the monitoring and enforcement of non-PIE auditors /audit firms. As currently drafted this is not clear in the regulation.

The regulation would also benefit from being clear as to whom 'A' is. It would appear that in respect of 1(a) and 1(b) 'A' is an individual connected to an audit but not necessarily the statutory auditor. However, it is unclear whether 'A' relates only to employees/contractors of an audit firm or includes, for example, an individual at the audited entity who makes false representations to the auditor, or an individual who is in some way connected to the audit representations made by an audited entity.

It is also unclear how the powers within the legislation are to work in conjunction with the current Accountancy Scheme. The Accountancy Scheme, operated by the FRC, applies to misconduct which is defined as "*conduct which falls **significantly short** [emphasis added] of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession*". The draft regulations will apply when the FRC considers that a person has "*contravened a relevant requirement*", which would appear to set a lower bar and could therefore operate when the Accountancy Scheme would not apply, if indeed the Accountancy Scheme is to be retained. However the regulations make no provision for how the complaint and investigation process will be conducted in respect of these lesser infringements.

Furthermore there is an apparent lack of due process, in that the regulations afford no protection to the individual 'A', in that there is no provision for 'A' to make representations prior to the determination of a sanction or for the sanction to be reviewed by an independent tribunal.

**Regulation 5 – Right of Appeal**

Although it is clear under regulation 5 that 'A' will have the opportunity to appeal the sanction imposed, BDO are concerned that there is no requirement for the panel to be independent of the Competent Authority. We are not aware of any other disciplinary procedure that would not afford the individual the right to an independent review of the sanction imposed and would urge BIS to align the rights of 'A' under these regulations to those afforded in other disciplinary proceedings.

**Regulation 6 – Publication of Sanctions and Measures**

Again this section conveys rights only to the Competent Authority, with complete authority to determine the procedure to be followed and assess the circumstances when publication should not be made. BDO would strongly urge BIS to incorporate rights, as they relate to the individual or firm, to appeal a decision to publish the sanction.

**Schedule 2**

BDO support giving the Competent Authority formal powers to obtain information and documents from relevant parties as this will assist the Authority to conclude investigations more quickly. However BDO are deeply concerned about the extensive and disproportionate powers of entry granted to the Competent Authority.

In 2014 the government, made a commitment under the Protection of Freedoms Act 2012, that all government departments review their power of entry to ensure the powers were still necessary, proportionate and contained adequate safeguards. One of those departments was HM Treasury who are responsible for the powers of entry granted to FCA, PRA, BoE, OFT and HMRC. BDO would consider it more appropriate that any powers of entry granted to the FRC should be in line with those bodies overseen by HM Treasury, in particular the FCA and PRA who derive their powers from the Financial Services and Market Act 2000, in that:

- The power of entry is only enforceable on issue of a warrant by a justice/sheriff on application by a regulator; and
- The warrant is exercisable by a police constable and any specified person who may accompany him.

As currently drafted the Competent Authority can gain entry to premises with 2 days written notice and remove documents, without the authorisation of a court or being accompanied by a police officer. BDO would question whether this regulation is within the provisions set down in Part 3 of the Protection of Freedom Act 2012.

**Companies Act 2006 – Part 16 AUDIT**

**485A - Appointment of auditors of private company: additional requirements for public interest entities**

BDO can foresee some practical difficulties in implementing this clause:

- Not all private companies, even those defined as PIEs, will be required to have an audit committee and as such the legislation needs to refer to audit committee or those charged with governance.
- There is no legal requirement for a private company to hold an Annual General Meeting (AGM) at which the directors could propose auditors; and
- In respect of private companies it is generally the directors who appoint the auditors rather than the members.

Furthermore, we are unclear as to the requirements of Clause 485A (3), it is our understanding that the audit committee are required to follow the selection procedure in accordance with Article 16(3) of the Regulations for **all** tender processes intended to be valid for extension of auditor tenure, irrespective of any disagreement of the directors with the recommendations made by the audit committee.

**487 - Term of office of auditors of private company**

BDO are concerned that the phraseology used in sub-sub clause (1B)(a) – (c) "*beginning with the date on which the auditor or auditors take office for the first time*" is not necessarily the date required, by the ADR, to calculate tenure being "*the first day of the first financial year*" in which the auditor is appointed and would recommend incorporating the wording applied in the ADR. For instance it is not uncommon for the auditor to be appointed outside the period for appointing auditors ie after the year end or to fill a casual vacancy or in circumstances where there has been a breach by the incumbent auditor providing prohibited services, as set out in our covering letter.

**489A - Appointment of auditors of public company: additional requirements for public interest entities**

BDO would repeat their comment above in respect of private companies, in relation to the application of the tender process. BDO understands that tenders, conducted by PIEs, should always be conducted in line with the Article 16(3) of the Audit Regulation if it is to be valid for extending the tenure in office, as such sub-sub clause (3) is unnecessary and could lead to confusion.

**491 - Terms of office of auditors of public company**

BDO would repeat their comment above. Circumstances can arise where it is not the auditor who is appointed at the AGM who conducts the audit of the relevant financial statements with a new auditor appointed post year end. This situation could be particularly relevant where a network firm has inadvertently provided a prohibited non-audit service preventing the incumbent auditor from issuing an audit report.

**494A - Meaning of "public interest entity" and "audit committee"**

BDO understand that requirements contained in the Audit Regulations are to be incorporated in to Member State legislation without amendment. However, in the instance of the definition of a PIE BDO would recommend the definition be updated to reflect that Article 2(1) of Council Directive 1991/674/EEC of the European Parliament is being repealed on 1 January 2016 and therefore will not be effective legislation when the UK regulations come into force. Reference should instead be made to EU Directive (2009/138/EC).

**497 - Auditor's report on auditable part of directors' remuneration report**

BDO would suggest the inclusion of a further clause setting out requirements in relation to joint audits in circumstances where the respective auditors disagree in their opinion as included in respect of other clauses in this section.

**Companies Act 2006 – Schedule 10 Recognised Supervisory Bodies**

***10 & 10A - Technical standards***

BDO would suggest that given the authority of the Competent Authority set out in Part 2 Clause 3(a)&(b) cannot be delegated to a 'body' it would be more appropriate for the clauses relating to setting technical standards to refer to the Competent Authority and not the Body. We would make the same comments in relation to clauses 10B Public Interest Entity Reporting Requirements and 10C Public Interest Entity Independence Requirements; these responsibilities sit more comfortably with the Competent Authority not the 'Body'.