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Our ref dvm/mm

9 December 2015

Dear Mr Smith

Consultation on the technical legislative implementation of the EU Audit Directive and Regulation

I am pleased to respond on behalf of KPMG LLP to the Government's discussion document of October 2015 on the implementation of the recent EU audit reforms in the UK.

We trust that this response will be of assistance to the Department of Business, Innovation and Skills (the Department, or BIS) in taking forward the implementation of the Audit Regulation and Audit Directive (AR and AD) at the legislative level, although given the short consultation period for a complex document, it is likely that further detailed points remain to be identified.

We are pleased that the proposals have now settled (a) that the definition of a public interest entity (PIE) will not go beyond the EU minimum; (b) that the option to extend auditor tenure from 10 to 20 years with a re-tender will be taken up; and (c) that tenders taking place before the new law comes into effect will be acceptable under the transitional provision.

Turning to the challenges, one of the most important implementation issues – if not the most important – surfaces in the draft standards being consulted upon by the Financial Reporting Council (FRC). For the reasons given in the following paragraph, we believe that there is an urgent need for the guidance on how the EU requirements are intended to be applied in a number of areas, in particular in relation to the blacklist of non-audit services but also in relation to many of the changes to the International Standards on Auditing (ISAs). The FRC would, as competent authority, seem the most natural body (although the RSBs might do so) to develop such guidance. However, we understand that draft standards lack this necessary clarity because the FRC has been advised that it cannot publish anything in standards that could be seen to be an interpretations of, or adding to, EC law. We do not believe that it was the intention of EC lawmakers that auditors and companies be left with a set of competent authority's rules that allows considerable scope for different interpretations when what all participants – investors, preparers, audit committees, auditors and regulators – wish for is clarity. Feedback received within our network from the European Commission suggests that they expect member states to settle for themselves the fine details in the course of implementation. It would be very helpful if the Department were able to give the FRC the confidence to provide the necessary clarity in its standards.

By way of explanation of this issue, the wording used in the AR itself is often imprecise, making the proposed standards extremely difficult to interpret in many places. By way of example it is not clear what the prohibition of taking "any part in management or decision-making" is intended to mean. At its most extreme this would mean that audit firms could never provide audit clients with advice on any area where management subsequently might need to make a decision. In addition, many of the other service restrictions include vague language such as "services relating to", "services with respect to", "services linked to" etc. Notwithstanding the point about apparent EC legal interpretations, it is very clear that guidance will be needed for audit firms and audit committees and, indeed, for the FRC's own inspection unit to allow it to conduct audit inspections in a consistent way. Without such guidance, which users can confidently apply, we believe that the new standards run the very real risk of damaging (rather than enhancing) audit confidence as individuals will invariably form their own interpretations as to what is meant and this will lead to a plethora of different positions being taken.

We have set out in appendices 1 to 3 our comments in response to the particular questions raised by the Department in its consultation. Among the more significant points that we have identified are:

- It is not yet clear to us how the respective authorities of the Secretary of State, FRC and Recognised Supervisory Bodies (RSBs) fit together.
- The former point, together with the legislation's setting out of a re-iteration of matters that FRC standards etc must achieve, would make the legislation even more complex than before, whereas we had hoped for a refreshed, simplified Part 42 of the Companies Act 2006 (the Act).
- Some aspects of the investigation and sanctions provisions appear to go a little beyond the AD and to be inappropriate. The relationship with the current disciplinary arrangements is unclear.
- The draft legislation appears to enable unlisted PIEs not to carry out tenders and that even listed companies could retain the same auditor for eleven (or 21) consecutive audit appointments in some circumstances. We assume that this is not intended.
- Some of the estimates underlying the Impact Assessment need to be revisited.

Please do not hesitate to contact me if you have any further questions or points of clarification.

Yours sincerely

David Matthews

David Matthews
Head of Quality and Risk Management

cc: Catherine Woods, FRC

Appendix 1 – Question 1

In this appendix we provide our comments in response to question 1, reproduced in the box immediately below. We have arranged our answers according to different elements of the proposals, taking each chapter (or parts of chapter) in the order of the consultation document. For each we have provided comments on the overall approach and / or comments on the draft legislation itself as the case may be.

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

Chapter 5 – Which audits are affected?

Comments on approach

We agree with the proposal not to take the option to extend the statutory definition of a PIE.

Comments on draft legislation

Ref[1]	*Comment*
Reg 2	We note that (b) should end with, "; or". This applies to all instances of the definition in the suite of draft legislation.

Chapter 6 – Competent authority designation and delegation

Comments on approach

FRC – the only body likely to meet the AR / AD criteria

We stated in our March response to the previous consultation (March response) that we are content for the FRC to be the single competent authority, but that the question was over the nature of that authority (see below). We agreed to that because we recognised that the RSBs would not meet the independence and recruitment criteria in AR article 21 and AD article 32(3). It is therefore vital to be sure that the FRC itself in fact meets those criteria. We trust that BIS has or will be carrying out an assessment of the FRC against them.

Nature of the FRC's authority

Turning to the authority of the single competent authority, in our March response we raised the question of whether it was the sole power in a hub-and-spoke model, whereby the RSBs draw their authority from the FRC; or a flat model, whereby the FRC and RSB each draw their authority from statute, with the FRC simply having an extra authority, being to oversee the RSBs. This consultation does not provide a specific answer to that issue.

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[1] References to regulations are to the draft Statutory Auditors and Third Country Auditors Regulations 2016. References to the Act are to the Companies Act 2006.

We also raised in the March response the question of the accountability of the single competent authority in a hub-and-spoke model. We said that we assumed that this would be dealt with at a later stage in the consultation process. It has not been dealt with here. We remain concerned that there should be accountability here. Please refer to our March Response.

Relationship with Secretary of State, and complex legislative structure

In connexion with the flat *vs* hub-and-spoke issue, we note that Part 42 of the Act, which gives the various audit regulatory functions to the Secretary of State, is not proposed to be changed. These functions are then delegated to the FRC by an order[2], which is not proposed to be changed. We had assumed that, going forward, at least some (flat model) or all (hub-and-spoke model) of those functions would have to have been given to the FRC *ab initio* in order that it has the ultimate responsibility as competent authority.

That being so, it seems that the ultimate responsibility still lies with the Secretary of State. We are left unclear as to flat *vs* hub-and-spoke and as to who in fact has ultimate authority (the FRC or the Secretary of State). However, we do consider that, at the least, the legislative architecture is now unnecessarily complex, whereas in our March response we voiced our hope that this was an opportunity to start afresh with a minimalist, straightforward Part 42.

Finally on this theme, regulation 3(9) enables the Secretary of State to give directions to the FRC with respect to the delegation of tasks to the RSBs. It is not obvious to us why, instead, the legislation should not require that delegation directly or indeed itself give the tasks directly to the RSBs.

Reclamation of tasks – the public interest

Related to the above, one of the tests for reclamation, in the draft direction, is the public interest. We note that this has proved difficult to define, ie in the disciplinary case relating to MG Rover Group. If terminology such as this is to be used for an important test, then it is important that it is commonly understood. In this regard, we note that the ICAEW has an extant consultation on the public interest responsibility of accountants which may be of relevance.

Comments on draft legislation

Ref	*Comment*
Reg 3(1)	We are not clear as to what is intended by sub-paragraphs (b) and (c), including how the latter is meant to differ from (g).
Reg 3(3)	We do not understand how the FRC would exercise its duty to consider delegation to the RSBs by having regard to schedule 10, which sets out criteria for recognising RSBs.

2 The Statutory Auditors (Amendments of Companies Act 2006 and Delegation of Functions) Order 2012, SI 2012/1741

Ref	*Comment*
Act sch 10 para 6	Whilst this leaves the matter to the RSBs to decide between an aptitude test and adaptation period (via rather complex drafting), we remain of the view that aptitude test should be required.

Chapter 6 – Register of auditors

Comments on approach

There is copious provision in the draft legislation for the maintaining of the register and all the details to be entered in it. There is much more detail than set out in AD articles 16-20, which are barely changed compared with the 2006 version of the AD, and far more than is currently in the Act. We are not clear why it has been necessary to make such detailed, new provision.

Comments on draft legislation

Ref	*Comment*
Reg 11(2), 12(2)	We agree with regulation 11(2) but note that 12(2) is inconsistent. It requires all RSBs to enter the data, whereas regulation 11 requires that one RSB has sole responsibility.
Reg 12(1)	We assume that the cross reference should be to regulation 10, not 3.
Reg 12(4)	There is no provision for the time of sending in the data with respect to information required by sub-paragraph (3)(a) (*cf*, (3)(b)).
Regs sch 3 para 1(a)	We interpret the reference to "address" as encompassing a service or business address. If that interpretation were to be in doubt, then the drafting should be made clear that it does include a service or business address. For example, we note that paragraph 2(e) refers explicitly to business addresses (of members of a firm in that case – *vs* individual auditors that are the subject of paragraph 1).
Regs sch 3 para 2(c), (h)	This is potentially a very long list of addresses. Further, whilst sub-paragraph (h)(ii) permits a website reference for network firms' addresses, none is permitted at sub-paragraph (c) for a UK firm's office addresses.

Chapter 6 – Quality assurance over auditors

Comments on approach

We recognise the importance of a robust process of quality assurance to a functioning capital market. To this end we believe that consistency of quality assurance is an attribute likely to be valued by the investment community. On this basis we are not convinced by the proposal to

extend the minimum frequency of inspection of certain auditors from at least once every three years to at least once every six years. Whilst we accept that inspections need to be proportionate, we are concerned that the companies audited by those firms often displays more of the characteristics that create a difficult environment in which to deliver high quality audits.

Comments on draft legislation

Ref	*Comment*
Act sch 10 para 13(2)	There should be an "or" before "Article 26".

Chapter 6 –Investigations and sanctions

Comments on approach

Appeals

Article 30d of the AD requires that Member States, "shall ensure that decisions taken by the competent authority … are subject to a right of appeal." This is implemented in paragraph 5 of the Department's draft Regulations. We note that under the present FRC Accountancy Scheme (paragraph 10(12)(i) of the scheme rules), it is provided that an Appeal Tribunal, "may not exercise its powers to impose a greater penalty than that imposed by the Disciplinary Tribunal so that, taking the case as a whole, save as to costs, the Appellant is not more severely dealt with on appeal than he or it was dealt with by the Disciplinary Tribunal." No such provision has been included in paragraph 5, over-turning the current position. The consultation has not put forward a case for such a change and we do not believe that there is a case for doing so. We therefore consider that regulation 5 should be amended to preserve the present position.

Obtaining information

Paragraph 6.22 of the consultation document refers to the requirement in Article 23 of the Regulation that the competent authority with ultimate responsibility should be able to obtain information from third parties in relation to audits of PIEs. The government has proposed that, "the FRC should have powers to obtain this information directly and seek enforcement through the courts where necessary." We do not object to this approach. However, at present paragraph 5(1)(c) of schedule 2 to the draft regulations creates a criminal offence if a person "without reasonable excuse fails to give the competent authority or an officer of the competent authority any other assistance or information which the competent authority or officer may reasonable require for a purpose for which the competent authority or officer may exercise a power under this Schedule." Our view is that the FRC's ability to make an application to Court under paragraph 2 of Schedule 2 should be sufficient to enforce the powers set out in paragraph 1, and that an additional criminal sanction which might also apply to paragraph 1 is unnecessary.

We note that paragraph 1(1)(a) of schedule 2 of the regulations creates a general power for the competent authority to give notice to any statutory auditor requiring it to provide information

specified in the notice (ie, not linked with the statutory audit of a PIE). The FCA has a comparable power, with s165(4) of the Financial Services and Markets Act 2000 making clear that, "this section applies only to information and documents reasonably required in connection with the exercise by the Authority of functions conferred on it by or under this Act." We believe that similar provision is merited in these regulations.

We also note that, with respect to the ability to obtain information from third parties, we are not convinced of the conclusion in the Impact Assessment (paragraph 149) that this, "would not ... result in a significant additional burden as in most cases compliance would previously have followed voluntarily in any case." The FRC's current power is to obtain information from accountancy firms participating in the Accountancy Scheme. We are unsure as to the degree to which third parties who are not participants in the Scheme have complied voluntarily with requests for information from the FRC in the past. We agree that third parties within the UK are highly likely to comply in future if the power is put on a statutory footing, with associated sanctions for non-compliance. We cannot comment, therefore, on the difference in burden that this might involve. However, it seems to us to be far less certain that third parties in other jurisdictions would have previously complied voluntarily, and whether they will comply in future. This could result in extended debate and substantial costs being incurred on all sides.

Publication of sanctions and measures

Article 30c of the AD states that, "competent authorities shall publish on their official website at least any administrative sanction imposed for breach of the provisions of [the AD or AR] in respect of which all rights of appeal have been exhausted or have expired." We note that the government has chosen to exercise the Member State option to continue to permit publication of sanctions which are subject to appeal (paragraph 6.19 of the consultation document).

We are mindful of the fact that this approach is in line with the current FRC publication policy under the Accountancy Scheme. However, given recent experience we ask that this be reconsidered as the policy has the potential to give rise to real and potentially irreparable reputational damage for members of the accountancy profession (both individuals and firms) when sanctions are later substantially reduced or overturned by an appeal tribunal (for example, the case of MG Rover Group, Deloitte & Touche and Mr Maghsoud Einollahi).

We suggest that the default position set out in Article 30c(1)'s first paragraph is appropriate and that sanctions should be published once all rights of appeal have been exhausted or have expired. This will ensure that the publicity of sanctions does not have an unduly punitive effect before those sanctions have been confirmed by the appeal tribunal.

Relationship with the FRC Accountancy Scheme

At present the disciplinary arrangements for auditors comprises the FRC Accountancy Scheme. This is a complete scheme, ie covering all aspects of investigation, appeals, sanctions and so forth. The scheme, and the FRC as its "operator", draws its authority from the fact that firms agree to be bound by it (it is necessary to become a member of the RSB, and the RSB must have rules requiring the same in order to be recognised as an RSB).

Going forward, the FRC, as competent authority, will have certain direct, statutory disciplinary powers. To that extent there will then be double provision as between those and the Accountancy

Scheme. Further, the FRC will be responsible for investigations and sanctions in two personae; as competent authority and as "operator" of the Accountancy Scheme.

It is unclear from the documents currently available how the two sets of powers and different authorities are intended to fit together, and we consider that this needs to be the subject of further thought and consultation.

Comments on draft legislation

Ref	*Comment*
Reg 4(1)(c)	AD article 30a(1)(c) sets the maximum prohibition as three years. This draft legislation sets no limit.
Reg 6(3)	Should these four circumstances be linked by an "or" rather than the "and" as drafted?
Regs sch 2 para 1(2)	Sub-paragraph 1(2) should read, "in a notice under sub-paragraph ~~(2)~~ (1)".
Regs sch 2 para 1(2)(a)	At the end of sub-paragraph (2)(a), it is not specified whether this should be "and" (b) or "or" (b). We trust that it should be "and" (so that a notice requires that both (a) *and* (b) are satisfied); the drafting needs to be explicit to give effect to that.
Regs sch 2 para 4(8)	The definition of the giving of notice (to enter premises at two days' notice per sub-paragraph (3)) is, with one exception, based on the notice being received at the premises, and we agree with that. However, it also includes "sending it there by post"; "sending" connotes merely putting it into the postal system, whereas we consider that receipt of notice is the right principle (and we note that it might anyway take longer than two days in the post). In our view those words should be deleted. Having done so, we think that postal notices would not be ruled out, but that it would be the case that the rule for their taking effect would be on delivery (so the competent authority would simply need to use a recorded delivery service). Moreover, as a more general point, we note that these provisions, which address a very important point of the occasion when regulatory seizure over-turns property rights, are considerably less thorough then the Civil Procedure Rules (https://www.justice.gov.uk/courts/procedure-rules/civil/rules/part06#6.14) on a similar point.

Chapter 7 – Length of audit engagements

Comments on approach

We agree with the approach and conclusions here, in particular:

- the intention to allow continuity and consistency in the application for companies already subject to the CMA Order and then additionally the EU Regulation, as we believe this will significantly reduce complexity and the risk of inadvertent non-compliance;
- the conclusion that the maximum duration of a continuous audit engagement should be 20 years subject to re-appointment following one or more tenders, as we believe this will allow companies appropriate flexibility in determining when to tender within the ten year period; and
- the intention that PIEs that have tendered the audit engagement before the application date should benefit from transitional recognition of that tender, as we believe that is appropriate relief and will avoid significant costs from unnecessary tenders over the short-term.

However, we believe that the draft legislation requires amendment in order that it is consistent with the approach and conclusions set out within Chapter 7 and the requirements of the AR and AD:

- Two particular points that we note in the drafts are that it appears that unlisted PIEs need not carry out tenders and that even listed companies could retain the same auditor for eleven (or 21) consecutive audit appointments in some circumstances.
- We also believe that the legislation requires clarification in a number of respects, including the inclusion of transitional provisions (those explicitly mentioned in the AR as well as the pre-implementation tender approach noted above), which do not appear within the current draft. This is particularly important.

These and other points arising from the proposed legislation are set out in the table below.

We also believe that the question-and-answer guidance will play an important role in enabling the effective application of the new legislation, in particular with respect to the initial transition, and are pleased that this will be updated.

Comments on draft legislation

Ref	*Comment*
Act ss485A, 487(1A), 489A, 491(1A)	We note that the proposed implementing legislation does not include any of the transitional provisions included within Article 41 of the Regulation, nor as proposed within the consultation itself, the previous consultation or the associated Supplementary Information. We trust that these will be included within the final legislation. After all, if it is necessary to implement in the Act the Regulation's ongoing rules with respect to tenure, then it must be equally necessary to implement the transitional rules in respect of tenure within the Act; if not, then there would be no transitional arrangements at all.

Ref	*Comment*
Act ss485A(1), 489A(1)	Having now seen the complete draft legislation on appointment and term limits, it has become apparent that by excluding appointments to fill a casual vacancy from the scope of 485A, a private company PIE need never hold a s485A tender. Is that the Government's intention? This arises because such a company could effect the initial appointment of its auditors by the directors' filling a casual vacancy under 485(3). Each year the auditor's appointment could be allowed to lapse (s487(2)(a)) and the directors re-appoint the firm to the resulting casual vacancy (s485(3) again). The auditors would, of course, to be limited to a ten year term under s487(1A), (1B). The same would apply to public company PIEs through the interaction of ss489A(1), s489(3) and 491. However, since most public company PIEs are listed companies, it is in practice almost inconceivable that the shareholders of a listed PIE would accept that no firm be put forward for appointment at the AGM (ie, in order to create a casual vacancy). There may, however, be some unlisted public company PIEs.
Act s485A(2)(b)	There appears to be a word missing. Should it read: "the directors must propose an auditor for appointment, <u>including</u> the following information in the proposal …" (*cf* s489A(2)(b))?
Act ss485A(3), s489A(3)	We consider that the drafting should clarify that "the auditor or auditors proposed for appointment must ~~be chosen by carrying out a~~ <u>have participated in the</u> selection procedure in accordance with Article 16(3) of the Regulation" and that sub-section (3) should follow after the current sub-section (5). That would reflect the requirements of Article 16(5) of the Regulation, which seems to require not a fresh Article 16(3) procedure, which the draft legislation seems to permit, but an auditor who was involved in the procedure that led to the disregarded proposal of the audit committee.
Act ss485A(4)(a), 489A(4)(a)	We note that the qualifying conditions for the exemption from carrying out a selection procedure in accordance with Article 16(3) are different from that under Article 2(1)(f) of Directive 2003/71/EC. The existing Act thresholds for small and medium-sized companies are aggregate turnover and balance sheet totals of not more than £25.9 million and £12.9 million respectively, and this rule operates on the two-year rolling basis. The equivalent thresholds for small and medium-sized enterprises under Directive 2003/71 are €50 million (approximately £35 million) and €43 million (approximately £30 million) respectively and there appears to be no two-year rolling basis in that directive. We do not object to the simplification

Ref	*Comment*
	being effected here in the UK legislation, if that is intended; but we draw the matter to your attention in case it is not. We also note that strictly sub-section (i) is redundant, since any company qualifying as a small company would also qualify as a medium-sized company under (ii).
Act ss487(1A)-(1D), 491(1A)-(1D)	The structure and drafting of these subsection are based on effecting a *statutory cessation* of appointment (sub-section (1A)) by reference to a period of ten / twenty years of *elapsed time* since *first* being appointed (sub-section (1B)). The Regulation is structured and drafted differently – prohibition on taking up a re-appointment and limits on consecutive financial years as auditor, and the proposed UK legislation causes a number of unexpected outcomes: • It would be possible for an auditor to do eleven (or 21) consecutive audits. This would arise because the auditor is limited to a period of elapsed time, not a number of consecutive audits. So if a firm can do eleven audits in ten years, then that is allowed under this drafting. (Eg, appointed in March 2018 to audit 2017, and then through efficiencies and streamlining of process over the years, the firm is able to complete the audit of 2027 before March 2028.) Is that the Government's intention? • By using as the reference point the "date on which … take office for the first time", it would never be possible to appoint as auditor a firm that had at any point in the past completed a "maximum engagement period" – ie, even after four years had elapsed (making sub-section (1D) redundant). This would clearly be inappropriate, and we assume that this gold-plating is inadvertent. We believe that these matters could be addressed by defining the maximum engagement as the number of consecutive financial years for which the auditor can be appointed (as per Article 17(8) of the Regulation and the Supplementary Information published by BIS earlier this year). Further, since the Act already makes provision for annual cessation of appointment with respect to each financial year, we believe that the effect of completing the maximum engagement would be to prohibit (or make void a purported) appointment with respect to a further financial year.
Act ss487(1B), 491(1B)	We consider that the drafting, which is generally difficult to read, should in particular clarify the definitions and conditions of the maximum engagement period: • If the procedure referred to in s485A(3) is a different application of the Article 16(3) procedure from that of s485A(4) (as to which see our earlier

Ref	*Comment*
	comment), then we consider that s487(1B)(b) should be amended to clarify that meeting s485A(3) is also sufficient. • Sub-section (1B)(c) lacks clarity and the intention is not clear. It could be read as having the same effect as (1B)(b)(ii), in which case it is redundant and should be removed. However, it could also be read as having the effect that the auditor or auditors could be re-appointed only once during a twenty year term (eg, re-appointed after a tender for year 7, so the maximum is 17 years). This is not the conclusion included in the final bullet point of Chapter 7.8, which clearly provides for "one *or more* tender processes". • Sub-section (1B)(b)(i) appears redundant, since meeting the requirements "at least once in that period" would also meet the requirements of "at least once every ten years in that period" under (ii).

Chapter 8 – Non-audit services (NAS)

Comments on approach

We agree with the Government's conclusion not to extend the requirements from those specified in the AR and AD. However, we believe that in order to establish a common understanding between audit committees and firms of what is covered by the blacklist, there is an urgent need for guidance to explain what the blacklist means. The FRC, as competent authority, would be the more natural body to develop such guidance (although the RSBs might do so). However, we understand that the FRC do not feel empowered to clarify the requirements of the EC legislation. Whilst we have an over-arching concern about that, this is a particular example where the wording is very broad and potentially ambiguous. Therefore, we believe that without such guidance there will be multiple interpretations of the requirements in the UK and audit committees will not be confident about when they can and cannot use the company's auditor to provide NAS, and this would overall have a detrimental impact on investor confidence.

We welcome the clarification that the cap on fees for NAS will not be effective until after 16 June 2019 and that services provided under the rules of the FCA and PRA will not be subject to the cap.

Chapter 8 – Standards

Comments on approach

We agree that the detailed provisions on ethics, independence, the conduct of the audit, reporting by auditors, confidentiality, professional secrecy and hand-over to new auditors should be dealt with by FRC standards. (We are, of course, responding to the FRC's related consultation on the detail of those standards.) We are content that at least some small portion of the "operational" provision – as opposed to enabling provision, ie enabling the FRC to set standards – is appropriate in legislation. For example, we concur that Part 16 should continue to specify the opinions to be

given in the audit report (and auditing standards on that topic are traditionally written on the assumption of some such legislative provision).

However, the enabling legislation – the architecture supporting the FRC's standards – does seem rather over-complicated. A simple approach would be to provide that:

- the FRC be empowered to set standards that implement the AD and AR – requiring only a simple cross-reference to the relevant articles of the EC legislation – subject to limits imposed by legislation and any clarifications as to the meaning of the EC legislation; and
- the FRC be required to recognise an RSB only if it has rules requiring its supervised firms to follow the FRC's standards.

The legislation need say little more than this.

The approach as drafted is, first, to embed in the FRC's authorising legislation – eg, in schedule 1 to the regulations – a copy-out of the various aspects of EC law with the invocation that its standards must give effect to this. We are unclear as to why it needs to be copied out at all. Second, schedule 10 to the Act would spell out various specific things that RSBs' rules must include. We are unclear as to why it needs spelling out if it should already be reflected in FRC standards.

We note too that this complex structure has led to restrictions on the FRC's authority being enacted through the RSB recognition criteria: paragraph 10C(3) of schedule 10 to the Act states that the "cooling off" period in RSB rules is a period determined by the FRC but not so as to exceed two years. Whilst we are happy with that limit in the FRC's power, its enactment belongs in the portion of the legislation actually authorising the FRC; this is what schedule 1 to the regulations ought to be used for (instead of copying out). We cite this as an example of the overall complexity: not only have we, reading it cold, found the regulations and the Act's schedule 10 overall difficult to read, but it appears that the same complexity has led to the misplacing a limit on the FRC's authority as an RSB recognition criterion.

Comments on draft legislation

Ref	*Comment*
Regs sch 1 para 2(1)	The phase "management and ... persons charged with the governance ...", typically seen in international auditing literature intended for no specific jurisdiction, is alien to UK company law. It is usually translated into UK standards as "the directors"., and we think that it should be so here.
Regs sch 1 para 9	No case has been made as to how the law of confidentiality falls short of meeting the AD and hence that further provisions is needed in standards. Further, it seems inappropriate to require (per paragraph (5)) that "standards must ensure" that that law is complied with. A document cannot ensure the enforcement of the law. Only a body of persons can do this, and we doubt that the FRC should be seen as a law enforcement agency.

Ref	*Comment*
Regs sch 1 para 15(1)(a)	We cannot identify the source in the AD or AR for this sub-paragraph. Further, it seems inappropriate. The auditor (A-PP) of a parent PIE (PP) is responsible for his / her opinion on PP's group accounts and therefore for any work by another auditor (A-SP) on its subsidiary PIE (SP) for the purposes of A-PP's opinion on the PP's group accounts. However, A-SP's opinion, on SP's accounts, to SP's shareholders is not and should not be the responsibility of A-PP. Yet this sub-paragraph would make it so. Although the foregoing concern is explained in terms of AR article 10 (audit reports) it applies equally to article 11 (report to the audit committee).
Regs sch 1	We did not see any proposed requirement that the FRC's standards must implement AD article 24b(4). That said, our larger concern anyway (see our comments above) is that legislation need not specify what standards must specify, but the FRC should simply bring forward the standards that implement the AR and AD.
Act sch 10 para 9(3), (4), (4A)	The sub-paragraphs within paragraph 9(3) will need to be renumbered following the deletion of sub-paragraph 9(3)(b). Cross references in other sub-paragraph will need consequential amendment.
Act sch 10 para 10	This requires, *inter alia*, that an RSB has rules to implement article 7 of the Regulation. We believe that its operation raises questions about its interaction with the "no tipping off" rule in s333 of the Proceeds of Crime Act 2002. Eg, the Regulation demands that the auditor first ask the audited company to take measures in relation to the suspected irregularity (including but not limited to fraud with respect to the financial statements). This could amount to tipping off. As this is a question about the general law, it seems inappropriate to ask the RSBs to resolve it. It seems more appropriate to be the FRC, as competent authority, or, preferably, to make legislative provision, as part of this implementation, to resolve the matter.
Act sch 10 para 10A(3)	Following the deletion of sub-paragraph 3(b), there is no longer any need for sub-paragraphs.
Act sch 10 para 10C	Sub-paragraph (1) requires an interval of two years between periods as key audit partner (or statutory auditor for individuals), whereas article 17(7) of the Regulation refers to three years.

Ref	*Comment*
	We think too that it would be opportune to clarify the drafting to be clear that (as for firm rotation) the durations referred to are audits with respect to consecutive financial years.

Chapter 8 – Audit reports

Comments on approach

We agree with the proposed approach, ie that the Act be updated only for changes as a result of the AD, with the requirements of the AR included in the FRC's auditing standards. This is because the AR provides more detail about the "surround" to the opinions, and FRC standards seem the right place for that. Building on that, however, we think that there is a case for stripping back the relevant sections of Part 16 to specify just those opinions that the auditor is required to give and the matters that he is otherwise to report upon. To take just one example, this would remove the statutory requirement for an introduction to the report, leaving FRC standards to provide for that (and eliminating the unnecessary double provision that exists now).

Comments on draft legislation

Ref	*Comment*
Act s503(4)	Where two firms are appointed it is not clear whether the "all of them" who sign are the two firms or the two senior statutory auditors in their own names for and on behalf of their respective firms. This might be addressed by adding at the end, "in the manner set out in sub-section (2) or (3) as the case may be." After all, if it is necessary for the first time to make provision for signatures by joint auditors at all, then we think that it necessary to ensure that it covers the territory fully.
Act s505(1A)	A similar point applies here.
Act s506(1)	With specific provision now made throughout Part 16 for the manner of joint auditors' signatures, then unless this section too is in the plural – it has been left unamended in the singular – then it will be the case that this important facility appears to operate only for sole auditors.

Chapter 8 – Report to PIE audit committees and group audits

Comments on approach

As noted in respect of the implementation of standards more generally, we do not find the chosen approach – copy-out of requirements as RSB recognition criteria – to be the simplest, most straightforward way to implement this.

Comments on draft legislation

Ref	*Comment*
Act sch 10 para 10A	Sub-paragraph (4) requires the group auditor to provide "those documents" to the RSB. The documents referred to are copies of other auditors' documentation of their audits that, per sub-paragraph (3), the group auditor handled in order to review the audit work conducted by such other persons. So it is copies of the audit files of auditors of subsidiaries etc. What sub-paragraph (4) requires in relation to "those documents" is that the group auditor makes them available to the RSB on request. Sub-paragraph (5) allows the RSB to make rules that the above does not apply if the group auditor is unable to obtain copies. Whilst this is largely a restatement of the existing paragraph 10A, we notice that it appears to be a mis-implementation (albeit perhaps a long-standing one). Article 27 of the AD *always* accepts that the group auditor may not be able to obtain copies, whereas paragraph 10A does not insist that an RSB accept that the group auditor may not be able to obtain copies. In effect it leaves it up to the RSB to decide whether to implement the last sentence of article 27, or not.

Chapter 9 – Removal of auditor

Comments on approach

We are content with the general approach to the implementation of the new power of removal of the auditor.

Comments on draft legislation

Ref	*Comment*
Act s510A(3)	This refers to an application by "the members". On the face of it, this would appear to require the members as a body to make such an application. We had expected the 5% test to appear here in the conditions for making an application rather than, as drafted, as one of the two tests for the court to make an order.

Chapter 12 – Restrictive clauses

Comments on approach

We agree with the implementation approach here.

Appendix 2 – Question 2

In this appendix we provide our comments in response to question 2, reproduced in the box immediately below. We have arranged our answers according to different elements of the proposals, taking each chapter (or parts of chapter) in the order of the consultation document. For each we have provided comments on the overall approach and/ or comments on the draft legislation itself as the case may be.

2. Do you agree with the Government's proposals on amendments to the Companies Act to reflect Articles 15 and 18 of the Regulation and the amendments to Articles 23, 45 and 47 of the Directive? Do you agree that these are all that is needed to reflect the provisions of the new Directive and Regulation on cooperation, transferring information and confidentiality? Why?

Chapter 10 – information transfer, confidentiality, inter-regulator cooperation

Comments on approach

The conduct of group audits is a complex area. We agree that the group auditor should be able to evidence how the group audit was conducted in accordance with the relevant standards and how the conclusions reached were evidenced. The draft legislation (Act, schedule 10 paragraph 10A(2)) makes reference to "standards for the time being determined by the competent authority". As we have said elsewhere in this letter, we are concerned that there is an urgent need for guidance on how the EU requirements (including as copied out into proposed revised auditing standards are intended to apply). The conduct of group audits, and their inspection, is one such area.

Chapter 11 – ISAs

Comments on approach

We note that there is no proposed implementing legislation with respect to this matter. That is, no provision is made requiring the FRC, as competent authority, to adopt as standards for the conduct of statutory audit work those ISAs adopted by the European Commission (albeit that they have yet to adopt any). However, consistently with our response to chapter 8 regarding standards, we are content with that there is no need for such provisions. As and when the Commission adopts an ISA, then the FRC will need to pick up that ISA as a UK standard and that action will itself implement the AD.

Appendix 3 – Questions 3-9

In this appendix we provide our comments in response to questions 3 to 9, as they are all connected with the effect on costs. We have reproduced each question in a box before providing our comments.

Impact assessment

3. Given the analysis of costs and benefits in the Impact Assessment in general, do you have any comments on how our estimates or underlying assumptions might be improved? Please explain your answer.

Familiarisation with the new framework

We address these cost at question 4 below.

Tendering NAS – one-off costs of £12.1m

This calculation assumes that 50% of NAS will need to be performed by another firm due to independence considerations and applies the threshold across the market place. This suggests £251m of business is to be tendered. It also assumes that all of this volume will be tendered at a cost rate equivalent to 4.8% of sales value, which has been determined based on weighted average audit tender costs. The range of such costs was estimated as 1.9% for large audits, 12% for medium and 26% for small audits.

These estimates ignore the fact that much non-audit work done by auditors today is already tendered. However, the following do not appear to be covered:

- Each element of work will have multiple bidders.
- NAS are, on average smaller than audits. Whilst the tender process may be simpler, we are unable to speculate as to whether it is more or less, as a percentage of the value of the work, than for audit tenders.
- NAS are often a series of one-off projects and hence there will be recurring tender costs, as each one-off project is tendered over the years, not only on transition.

Please also see our comments below on audit tender costs.

Accordingly, it is likely that the costs are significantly understated.

Establishing Audit Committees – one-off costs of £5.0m

This has been determined as £30,000 of recruitment cost for an audit committee chair and one other non-executive, for 167 entities estimated currently not to have an audit committee.

Elsewhere the assumption is that the audit committee would have four members. So this assumes that the companies in question either already have two non-executives that have time to take on the audit committee responsibilities or will operate with an audit committee of two members. We are doubtful of that. Further, the recruitment fee sounds low. Therefore cost per entity could increase, by up to a factor of at least two.

In addition, we are uncertain whether the number of entities should in fact be greater than 167. The Department's research has identified 556 unlisted insurers that will be brought within the PIE regime. It has assumed that only 30% do not already have an audit committee. That 30% is taken as being the same as some 2006 data for listed companies that lacked an independent member on the audit committee. We are concerned that 30% may be an under-estimate of the percentage for unlisted insurers.

Audit committee – recurring annual costs £9.0m

This is estimated as 167 new audit committees of two individuals at a combined cost of £54,000: £49,000 for the chairman and £5,000 for a second member. Elsewhere an audit committee of four has been assumed. Furthermore, it appears that the methodology described on page 36 would lead to higher costs that calculated, ie cost rates should be not £49,00 and £5,000 but £51,000 plus inflation since 2006 (audit committee chair), and £48,000 (base non-executive fee as well as additional audit committee fee) plus inflation since 2006 (second member)[3].

Additional reporting to audit committees – annual cost of £2.0m

This assumes nine additional hours per audit for listed PIEs and between 15 and 24 for unlisted PIEs. These are all costed at £23/hour. This must be based on very junior time with no senior input. Whilst much of the AR article 11 reporting is already done, we think that more senior time will be required and, accordingly, these estimates understate the cost.

On the company's side, it also assumes three hours for each of four audit committee members at £46/hr to read, digest and discuss. On the one hand, this may count a second time the cost of the audit committee, if the recurring annual costs (the £9.0m above) are intended to capture all of the additional non-executive workload. On the other hand, it does not include any allowance for executives (and senior management) all of whom will need to be conversant with the content. After all, the audit committee will be using the report partly as a basis for a conversation with the rest of the board – it is the board as a whole that is ultimately responsible for the accounts and annual report – and management.

Additional audit committee meetings – annual cost of £16.0m

This calculation is based on 1.5 extra meetings at five hours per meeting. Meeting attendance is calculated at one audit partner and manager (at scale rates, ie cost to the company) and four audit committee members at £46/hr and one member of staff of the company at £25/hr.

This may overstate the cost. One the one hand, the rates for audit committee members and company's staff seem on the low side – see earlier comments. On the other hand, we think that many companies with existing audit committees will probably be able to fit within existing meetings schedules with perhaps a time extension of one or two hours, and the cross-over with the £9.0m recurring annual costs is unclear.. So the average used, of 7.5 hours per PIE, may be an over estimate.

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3 Eg, for the chairman: per the table on page 36, 2006 prices are £56,000 for FTSE 250 and £46,000 for smaller companies; and paragraph 99 the cost are assumed to fall between these; so we should expect, before applying inflation, a figure of £51,00 as mid-way between those two figures.

Annual tenders – annual costs of £21.7m

Tender cost

The most part of this is the cost to the bidding firms (£18.2m), which has been determined by assessing the tender cost for the entire population of relevant entities over a ten year period and then annualising it. The base assumptions are £5.5m for a very large tender, £1.0m for large, £146,000 for medium and £31,000 for small. These costs are derived, we presume, from European Commission figures[4] of partner-equivalent hours involved in tenders: 5,000, 1,000, 160 and 6, for very large through to small.

These figures, and the present value calculated from them, appear very low, for a number of reasons:

- They are for all bidding firms in aggregate. Assuming just four bidders, that is only 250 partner-equivalent hours per firm per large tender, whereas far more is likely to be incurred. For a small PIE the assumption of 1.5 partner-equivalent hours per bidder illustrates the point – it's clearly far too low.
- In fact any one bidder is likely to exceed, on its own, the hours figures employed it the assessment for all bidders in aggregate.
- Our comments above apply with respect to hours involved at UK bidding firms. Most of the tenders are multi-national, and so substantial additional hours are incurred in network firms outside the UK. UK audit firms will also incur hours on tenders for multi-national audits of PIEs headquartered elsewhere in Europe (and if European policy sets the agenda elsewhere, then for tenders outside Europe too). No allowance has been made for these matters.
- The tenders are assumed to be spread evenly over a ten-year cycle, whereas tender activity is expected to be very intense in the early years (and already is). That being so, the present value calculation as employed has deferred the costs and therefore diminished the discounted cost.

We also suggest that BIS should liaise with Competition and Markets Authority (CMA), who have also gathered data on these matters.

Familiarisation with the new framework

4. Responses to our Discussion Document suggested that familiarisation and implementation costs to newly designated PIEs and, audit firms that become auditors of PIEs for the first time, would be disproportionately higher. We propose that in the final IA we should uplift the estimated costs for such businesses by a percentage to reflect the additional resource costs to such firms arising from their lack of experience of the requirements of the Regulation

[4] Commission Staff Working Paper Impact Assessment (SEC(2011) 1384 final), Annex 20

and of those provisions of the Directive applying to audits of PIEs. For each category listed above, what do you consider to be a reasonable percentage?

Rather than add a premium to the existing calculations of costs, we recommend that the underlying calculation be revisited. In particular, we have concerns, explained below, that the calculations themselves involve multiple inappropriate assumptions.

Audit firms – one off costs of £33.6m

Audit principals and staff

We note that this component has been based on a range of: 39-57 hours per audit principal at £46/hr; plus 23.5-37.5 hours per auditor at £23/hr; plus 30 auditors per principal. The result is cost per large firm of £4.3m.

The hours per principal and auditors per principal appear high, but cost rates appear low, eg equivalent to about £84,000 and £42,000 per annum costs for principals and auditors respectively (*cf*, from our published 2014 financial statements the average cost of our staff is just over £74,000 per person per annum). We are unable to say whether, overall, the under- and over-estimates balance out.

Non-auditors

This component appears wrong in a number of areas. Firstly, it has an average non-audit work force for the five largest firms of 14,167 people each. This very high. (Eg, our publicly available 2014 financial statements show that we have 8,766 non-audit staff. Data for other firms will also be publicly available.) Secondly it assumes a familiarisation time of seven minutes for each individual. This is far too low. A familiarisation time of perhaps five hours per individual is more likely to be appropriate. Together the assumptions used in the impact assessment give a cost per large firm of only £29,000 for all non-audit personnel. This figure is clearly unrealistically low.

Existing PIEs – one off costs of £30.5m

This has been estimated as one senior manager and 20-30 team members at an average time of 39 hours and average cost of £26/hr (equivalent to annual cost of £53,000).

The mix is probably wrongly skewed away from senior time, and the cost rate too low, but the average hours and number of individuals seems very high.

We speculate that overall this may overstate the cost.

Unlisted, financial sector, new PIEs – one off costs of £8.5m

This assumes that another 21 audit firms (five medium, 16 small) will come into scope as a result of the inclusion of unlisted insurers. The cost data then flow from the firm calculations above. Whilst we have no data on the point, intuitively that is a high estimate of the number of audit firms newly brought within the PIE regime.

5. In the consultation IA we have estimated the direct costs to PIEs of having to tender the audit engagement every 10 years. In our final analysis, we also plan to include an estimate

of the additional costs that would be incurred by a new auditor that has to familiarise itself with the business of a new PIE client. We propose that the additional familiarisation cost to auditors engaged in a new audit could be estimated is an additional 10-30% of the cost of the audit in the first two years. Is this reasonable?

The impact assessment records that one suggestion received was that year-one costs are 10-15% higher than on an ongoing basis. We think that it is unlikely to be as low at 10-15%. Eg, it could easily be 25%. In fact, the CMA found that the additional hours for a new auditor following the year of appointment was 24.3% in Year 1 and 31.5% in Year 2, falling to 14.3% in Year 3 and 8.2% in Year 4[5]. Even assuming that costs for years 5-10 were back to the same level as the prior auditor, this represents a very significant premium cost for changing auditor. Given the aggregate audit fee for the FTSE350 is now approximately £1bn, then assuming an average 15 year tenure, this equates to an annualised £52m of switching costs before taking account of other PIEs.

For new PIEs, which are likely to be smaller, we expect that the costs will tend to be proportionately higher.

Further, this figure does not include the costs of the outgoing auditor in preparing the handover file or otherwise facilitating handover.

We note the point made about future business process improvements bringing down the cost of delivering an audit. That is rather difficult to put a figure on, and in any event applies whether an audit changeover occurs or not. So we consider that it is appropriate to leave that out of account in the assessment of the impact of changing auditors.

Costs to non-PIEs and their auditors

6. Our preliminary analysis suggested that the costs and benefits of the measures in the new Directive affecting audits of non-PIEs would be negligible. This has been assumed in the consultation IA. Is this reasonable? If not, what do you estimate will be the main changes giving rise to costs and benefits for non-PIEs and their auditors? Can you provide quantitative estimates?

7. It is particularly important to assess the costs and benefits arising from the new Directive for non-PIE LLPs and their auditors as the implementation of the new Directive is not required by EU law for these audits. Would your answers to question 6 differ for non-PIE LLPs? How and why?

To assess this would require a detailed identification and analysis of the incremental effect in relation to non-PIEs of the changes to the AD affecting all companies. In the time available in this consultation, we are not able to do that.

Further questions on application to non-PIE Limited Liability Partnerships

8. Do you think that the Government should: implement the changes required by the new Directive for audits of non-PIE LLPs alongside those same changes for entities (such as

[5] Competition Commission Final Report on Statutory Audit Market, Appendix 2(4), table 55

companies) that are required to be audited by EU law; or, implement some or all of the changes required by the new Directive for audits of non-PIE LLPs at a later stage? Please give reasons for your answer.

9. Do you think there would be cost savings from implementing the changes required by the new Directive for non-PIE LLPs at the same time as for entities (such as companies) whose audits are subject to EU law? Please give reasons for your answer. Can you provide any estimate of the extent of these savings?

For reasons similar to those set out at questions 6-7 above, we are unable to offer an answer to this. We can, however, make two observations. First, if the effect of moving LLP audits from the existing Companies Act regime, implementing the old AD, to the new were marginal then there would be merit in having the same, single system for all. That is to say, coping with two systems with only inconsequential differences seems likely to be more costly than a single system.

Second, the current application of the Companies Act regime, itself implementing the old AD, is a voluntary matter, ie not compelled by EC legislation. It may be worth considering whether there is a case for a much simpler system to be devised in respect of LLPs.

For the avoidance of doubt, the exacting standards of governance at our firm with respect to the audit and auditors of our accounts – we are an LLP ourselves – would not change whatever the system is for LLPs. Our comments above are made with other LLPs in mind.