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9 December 2015

Dear Mr Smith,

Technical consultation: Implementation of the new EU Audit Directive and Audit Regulation

On behalf of the Group A firms and of the Association of Practising Accountants firms, we hereby submit this joint response to the above consultation paper.

We are pleased to offer our submission to this important debate and stand ready to deal with any questions you may have arising from our response.

Yours sincerely,

T M McMorrow
Director of Policy, Regulation and Ethics
Secretary

RSM

BIS Consultation:

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

RSM

Paul Smith Esq
Corporate Frameworks, Accountability and Governance Team
Department of Business, Innovation and Skills
1 Victoria Street
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SW1H 0ET

Dear Mr Smith,

Response to Consultation Paper by the Group A and APA firms

This response is joint between the Group A and the members of the Association of Practising Accountants (we have appended a list of all of the firms which have ascribed to the response[1]), namely the medium sized firms that are active in the mid-tier market, including SMEs[2].

Introductory remarks and key submissions

We recognise and support the policy objectives that the implementation process is intended to deliver:

- proportionality should underscore the approach taken, using the 'gateway test'[3] we referred to when we replied to the original discussion document in March, and the Department of Business, Innovation and Skills (DBIS) confirms its adherence to that approach in para 2.7 of the consultation document[4]. The Audit Regulation and Directive (ARD) implementing legislation should be predicated on the regulatory principle of Proportionality and the governmental objective of supporting Growth, particularly in the systemically important SME sector of commerce.
- the draft Statutory Auditors and Third Country Auditors Regulations 2016 are the UK legislation implementing Directive 2014/56/EU of the European Parliament and Council, and give Member States options in the means of implementing the directive text;
- Articles 30 (a) to (d) on auditor-sanctioning powers and processes are replicated in draft Regulations 4 – 7 and empowers the Financial Reporting Council (FRC) as

[1] **Group A** - Crowe Clark Whitehill, Haines Watts, Kingston Smith, Mazars, Moore Stephens, RSM, Saffery Champness, and Smith & Williamson; **APA** – Armstrong Watson, BHP, Blick Rothenberg, Brebners, Buzzacott, Dixon Wilson, Duncan & Toplis, James Cowper Kreston, Kreston Reeves, Mercer & Hole, Price Bailey, Roffe Swayne, and Shipleys.

[2] In total, we have annual revenues of £1.1bn+, with 12,600 partners and staff in 230+ offices around the United Kingdom.

[3] "*The principle of proportionality should act as a 'gateway' test – regulation and regulatory practice which is not proportionate should be removed or improved as a matter of priority.*" ('Benchmarking best practice for the regulators which govern the Professional & Business Services (PBS) sector' – the Professional & Business Services Council)

[4] 'The Government is committed to a minimal implementation approach, which means applying only the mandatory changes required by the EU reforms and other changes that would result in a benefit to the UK business environment.'

'Single Competent Authority' to impose sanctions on a statutory audit firm which range from the imposition of a financial penalty to the removal of statutory audit licensing rights;

- draft Regulations 4 - 7 carry significant powers, yet there is no specific consultation question addressed to them. Though that may be because such powers and obligations are new to EU Member States in the round whereas the FRC has had in place disciplinary arrangements (now known as 'the Accountancy Scheme') for a number of years, it is not clear whether the FRC intends to take the opportunity to amend the Accountancy Scheme or to amend the Auditor Regulator Sanctions Procedure;
- moreover, given that the FRC is specifically empowered to delegate the disciplinary arrangements and ARSP to the Recognised Supervisory Bodies in respect of non-Public Interest Entities, there will need to be meaningful discussion between the FRC and the RSBs on the conditions of delegation, workability of the arrangements, and how they can be made to work in a proportionate manner;
- DBIS has an opportunity to ensure that the Accountancy Scheme, and all of the other powers and obligations granted under the ARD, are implemented according to deregulatory principles; and
- although the current consultation is a follow-up to the December 2014 discussion document to which we responded earlier this year, and one of the main topics that the discussion document asked for views on was whether the Audit Exemption Threshold should be raised, there is nothing in the current consultation on this important topic, which we find surprising.

We now answer the consultation questions:

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

The intention of the Regulation and Directive is quite clear: to cause users of audited financial statements to have confidence in the process by which audit opinions and conclusions are arrived at, with an explicit emphasis on the audits of Public Interest Entities (PIEs). The principal onus in achieving this objective must, because it has already been designated by Baroness Neville-Rolfe as the UK's Single Competent Authority (SCA), fall on the FRC.

The domestic implementing legislation is subject to the injunction, though, that it must focus on "*identifying legislative, and non-legislative, actions necessary to: (i) strengthen standards for the audit of Public Interest Entities (PIEs); (ii) improve confidence in the independence of auditors; (iii) avoid excessive concentration in the audit market; and (iv) make audit reporting more informative*".

Since these drafting imperatives have to be fulfilled in equal measure, the onus on the SCA will be heavy. No doubt for that reason, the consultation paper makes it clear that the SCA may delegate to the Recognised Supervisory Bodies such tasks as the Regulation and Directive permit, subject to the FRC/SCA retaining an oversight duty and responsibility.

The act and content of delegation are very important, and in our submission, delegation could be accomplished in a manner that achieves the focus and the deregulatory objectives of the Minister at the same time: the new regulatory landscape should replicate the clear distinction between PIE and non-PIE regulation, and assign responsibilities accordingly, something which would itself help bring about a more proportionate regulatory framework. It is believed that the RSBs would support that objective.

As far as is possible, and consistent with the RSBs' preparedness to take the responsibilities on, BIS should try to ensure a 'graduated landscape', with the RSBs retaining the licensing of auditors, and being assigned the monitoring and inspection, and discipline of all non-PIE entities (including all listed ones).

This would be consistent with para 4.2 of the consultation document, which says, *"[T]he Government's intention [is] not to include additional entities in the definition of a Public Interest Entity (PIE). This means that PIEs will only be those entities with securities admitted to trading on a regulated market, banks, building societies, and insurers. Companies traded on AIM will not be PIEs."*

That clear distinction is not, incidentally, followed in the FRC consultation being carried out concurrently with BIS'[5] and nor has the chance been taken to introduce a more coherent set of deregulatory measures across the piece of audit regulation and auditing ethics. Whereas we accept that the FRC, as 'Single Competent Authority', is entitled to settle the detailed arrangements with the Recognised Supervisory Bodies and the regulated population, we have apprised the FRC in terms of the consultation it is currently engaged in that it should not miss the opportunity referred to at the start of this paragraph – we really must make sure that BIS' intention that non-PIE listed entities, of which AIM-listed ones are the most notable examples, are given access to the derogation provisions.

The point about deregulatory measures is not that they lessen the burden on business but that they allow productivity to grow. It is not cumbersome compliance that the SME sector's management dislikes, rather the loss of growth opportunity.

The consultation document reflects the need for a proportionate approach to oversight costs, at paragraph 6.6[6]. The FRC will be obliged (not merely entitled, but subject to a right of recall on cause shown) to *"delegate the conduct of inspections and investigations and the application of sanctions for non-PIEs to RSBs."*.

We regard this as encouraging but it should be made clear that the Accountancy Scheme needs to be amended to ensure that not only non-PIE[7] *investigations* are delegated to the RSBs but any resultant disciplinary process as well. To do otherwise would render the ARD

[5] The definition of 'listed company' in the draft new Ethical Standard in that consultation explicitly *includes* AIM-listed companies, before applying a set of derogations to those companies so far as the application of ethical prohibitions are concerned.

[6] "[Baroness Neville-Rolfe's statement to the House of Lords on 20 July this year] *explained that to minimise the compliance cost for business the FRC and the RSBs will be obliged to cooperate with each other, and the legislation will provide they should be able to rely on each other's work.*".

[7] We include affiliates of PIEs and related third parties within the category of investigation and discipline that should be delegated to the RSBs.

implementation process incoherent and to cause a disproportionate imbalance so far as the auditors of non-PIEs are concerned, and would fail to fulfil the terms and plain meaning of Article 32(4) of the Directive. We understand that the RSBs themselves support the point we have just made.

We support the proposal that the RSBs should retain the right to license audit firms for the conduct of statutory audit and for the application and monitoring of Continuing Professional Development (CPD) requirements.

The act of delegation is one thing but the discretion given to RSBs as to how the delegated acts are conducted is at least as important and there should be further public consultation, jointly by the FRC and RSBs on what delegation will mean in practical terms, and proportionality should underscore the *modus operandi* and be written into delegation agreements.

The act of delegation is important in an audit market concentration context too, especially given that some audit firms will, because they have one PIE client, come under the inspection regime of the Audit Quality Review team at the FRC for the first time. The impact of this change of regime to those firms is likely to be significant (and far greater than they have experienced before) and it is important that the *overall* inspection, investigation and discipline regime to which they will be subject is as fair and deregulatory as possible.

We make a different point, in relation to paras 6.20 and 6.21: it is noted that the FRC will, going forward, have the right to suspend the directors of PIEs from acting as such for up to three years and that the proposal is that it should do so in collaboration with the Secretary of State under the Company Directors' Disqualification Act 1986 (CDDA). There is a lack of specification about this proposal that we believe ought to be addressed. It has been a criticism of the Accountancy Scheme since its inception that it extended only to company directors who are professionally qualified as accountants, leaving out those directors who are professionally qualified. The opportunity should be taken to cause all directors (professionally qualified or otherwise) of PIEs to be subject to FRC jurisdiction, with reference to CDDA action only where a period of suspension over three years is indicated by the director-conduct concerned.

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?

Articles 15 and 18 of the Regulation 23, 45 and 47 of the Directive are about record-keeping, handing over information to successor audit firms, and the disapplication of confidentiality laws. Having examined the implementing text in the draft Statutory Instrument, *The Statutory Auditors and Third Country Auditors Regulations 2016*, it is unobjectionable in principle and amount in the main only to a tightening of existing obligations (in other words, moving professional regulatory requirements into legislation). The latter has been

unhelpfully imprecise in the past so that legislative input now should attempt to provide certainty to audit firms.

Section 519 of the Companies Act 2006 makes it clear that the new law will only apply to PIEs so should not be too onerous for firms which do not have many such audit engagements to comply with. The implementing secondary legislation appears not to go beyond the terms of the ARD and should, on the face if things, not lead to problems in practice.

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.

We support BIS' stated preference for the 'preferred option' and the reasons underpinning it but we stress that the content of the delegation agreements between the FRC and the RSBs needs careful adjustment.

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 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?

Whereas precise calculations are difficult, the degree of familiarisation that newly designated PIEs and firms unused to PIE audit will need should properly be uplifted by 50%.

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?

Again, an accurate assumption is difficult but we would think that the additional cost would be closer to 30% rather than the lower end of the scale.

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?

We concur with the preliminary analysis' conclusion that additional costs of the new regime would be negligible for non-PIEs.

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?

This matter was not trailed in the original consultation earlier in the year but, given that the legislative framework for LLPs is similar to that of private companies, then we do not foresee significant additional compliance costs will be entailed.

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 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.

Our answer to Q7 refers. Para 5.10 of the consultation paper infers that changes so far as the non-PIE LLP population is concerned will be minimal but that bespoke draft regulations will be published by BIS in the coming months. Regulations that are specific to LLPs should be implemented simultaneously with those affecting the private company regime, especially given that company structures often feature LLPs as well as private entities. Failing to have a homogeneous structure covering both types of entity, given effect to at the same time, would make no sense.

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?

Whilst we do not anticipate cost-savings from simultaneous implementation, we could anticipate cost-increases in the absence of it: cost-increases could well result from a failure to deal with changes simultaneously and with each set of changes having had due regard to the other

9 December 2015

T M McMorrow
Secretary