Are you prepared for the FRC’s latest proposals on implementing EU audit reforms?

The Financial Reporting Council’s (FRC’s) consultation, Enhancing Confidence in Audit, was issued on Tuesday 29 September 2015. This is the clearest indication yet that the UK, along with 27 other EU member states, is nearing the point where the relationships between audit committee, auditor and non-audit services (NAS) provider will be finalised.

This will have implications for the boards and audit committees of FTSE 350 Public Interest Entities (PIEs), for whom this briefing is written. However, some of the FRC’s proposals (e.g., further restrictions on tax services and appointing audit firm alumni) will affect a broader range of companies. This is because the FRC is taking this opportunity to revisit aspects of its Ethical and Auditing Standards that otherwise fall outside the scope of the EU audit reforms.

The Financial Conduct Authority is also consulting separately on changes to the Listing Rules and Disclosure and Transparency Rules to implement the new EU audit committee requirements – we do not cover these changes in this briefing.

A separate consultation from the Department for Business Innovation & Skills covering tendering, firm rotation and other matters will follow later this month. All of these activities form part of an ongoing process of consultations and discussions to inform the UK’s implementation of the EU’s audit legislation, which came into force on 16 June 2014. We published briefings on these earlier outputs which can be accessed at http://www.ey.com/UK/en/Services/Assurance/EY-european-union-audit-reform.

1 The Prudential Regulation Authority (PRA) is proposing additional audit committee requirements for CRD credit institutions, Solvency II insurance undertakings and UK designated investment firms, which are not included in this briefing. For further details see CP34/15: Implementing audit committee requirements under the revised Statutory Audit Directive.

2 See FCA CP15/28: Quarterly Consultation Paper No. 10
The FRC’s consultation runs to over 1000 pages. It covers a multitude of issues spanning five annexes: Ethical Standards, International Standards on Auditing (UK&I) (ISAs), the UK Corporate Governance Code, the Guidance on Audit Committees, and Provisions available for Small Entities.

Therefore we have limited our comments to three key areas of the FRC’s proposals, signposted below, which are by no means an exhaustive list. We have not commented on the FRC’s proposals to revise the ISAs and the Provisions available for Small Entities.

But before we outline the key areas, it is worth clarifying whether you will be affected by the EU legislation.

You are caught if your company is a PIE. It is a PIE if it is incorporated in an EU member state, with equity or debt listed on an EU-based regulated market (e.g., FTSE). This includes funds (e.g., UCITS or AIF). You are caught if your business is in banking or insurance whether listed or not and subject to the laws of an EU member state.

Key points

As a PIE you must start planning for these changes now, if you have not already begun your preparations, because the legislation takes effect from 17 June 2016 and the FRC previously confirmed that it will apply to financial years beginning on or after 17 June 2016.

Audit committees of PIEs may need to reassess their composition and role. There are new restrictions on appointing audit firm alumni, so the audit committee chair will need to consider how that might impinge on committee succession planning and choice of future auditor. New requirements on the competence of committee members might also have a bearing on the future composition of committees.

New restrictions on NAS will affect PIEs’ procurement strategies for a wide range of NAS, in addition to the audit. PIEs need to make strategic decisions now about which professional services they wish to receive, when, where and from whom. Audit committees also need to enhance their NAS approval policies and procedures to cover the extended restricted services for the PIE and its subs and the 70% cap for the group.

We therefore encourage you to analyse the consultation paper and assess the potential impact on your company. Have your say and engage with the process. The deadline for responses is 11 December 2015.

3 Some requirements take effect sooner e.g., a one year cooling in period for prospective auditors which have previously delivered services related to the design and implementation of the PIE’s financial controls/systems. Requirements on tendering and firm rotation will be subject to transition rules.

Key questions

This section looks at questions covering audit committees (composition and role) and NAS (cap and Tax services).

Audit committee composition and role

► What will your audit committee chair and board need to look out for in the future, when assessing the experience and capabilities of existing and prospective audit committee members?

The current version of the UK Corporate Governance Code 2014 (“the Code”) makes a provision for at least one committee member to possess ‘recent and relevant financial experience’. The proposed replacement of this provision would require at least one member to have ‘competence in accounting and/or auditing’ (C 3.1).

In addition, the revised Code will need to include a new provision stating that ‘the audit committee as a whole shall have competence relevant to the sector in which the company operates’. (C 3.1)

Whereas it would seem that the professional experience requirements are not a substantive change, it is unclear how ‘competence’, ‘sector’ and ‘as a whole’ should be assessed in this context.

► Can you appoint former audit firm partners or employees to positions at your company?

Yes but if, for example, your audit committee is looking to replenish or grow its membership it will face new challenges. It will need a succession plan (looking forward at least two years hence) to take account of the “lead times” required if the board wishes to offer appointments to former partners or employees of the incumbent auditor (connected to the external audit engagement).

It will also have to think twice about offering appointments to partners from other firms (not providing the external audit), if any of those firms are contenders for the next audit tender.

There is also likely to be more competition for candidates as audit committees are being required for the first time for unlisted insurers, unlisted banks and, as proposed by the PRA, unlisted UK designated investment firms.

5 The FCA is also consulting on extending the audit committee independence requirements for UK listed companies (see CP15/28)
What do you have to tell the market about your plans for an upcoming tender?

In response to earlier recommendations from the Competition and Markets Authority, the FRC proposes to add a new provision to the Code requiring an ‘advance notice of retendering plans in the audit committee’s annual report’ (C 3.8). The Guidance adds that changes to an intended date of tender should be explained in the same report.

These changes should help to keep the upcoming dates of audit tenders in the public domain. This should be helpful for companies and audit firms alike, who need to keep a broad perspective on the rate of tenders over a given period of time so they can plan ahead accordingly. Similarly, investors will be interested to know if there are any issues or concerns behind a change in the timing of a tender.

Will your audit committee be expected to be more hands-on than before with the appointment or re-appointment of external auditors?

Yes. Consistent with the new EU legislation, the FRC is seeking to clarify that the audit committee has primary responsibility for the audit tender and appointment process. This change places the emphasis for this activity squarely on the shoulders of the audit committee.

Will your audit committee face closer scrutiny from shareholders and others?

Quite possibly. The Guidance for Audit Committees calls for additional communications with investors including disclosure on the ‘nature and extent of the company’s interaction (if any) with the FRC’s Corporate Reporting Review Team’.

It also adds a requirement that if the company’s audit has been reviewed by the FRC’s Audit Quality Review Team, the Committee should ‘discuss the findings with their auditors and consider whether any of those findings are significant and, if so, make disclosures about the findings and the actions they and the auditors plan to take’.

If the committee makes these disclosures, it is quite possible that investors will ask questions of the company and its audit committee. This added focus on the FRC’s audit quality reviews could also bring into sharp relief the committee’s own role in assessing the effectiveness of the audit process.

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6 Paras 56 and 57 draft Guidance for Audit Committees
7 Para 80 draft Guidance for Audit Committees
Non-Audit Services (NAS)

- Will the FRC be adding to the EU’s list of NAS that you may not procure from your auditor? Will there be a permitted list of NAS and/or further guidance?

No. The FRC proposes to adopt the EU list of restricted NAS and not add further restrictions. It also cannot give guidance on the EU’s list of prohibited NAS because they have direct effect as written in law. It has also dropped its proposal for a permitted list of services.

Audit committees will have to expand their policies and satisfy themselves that NAS are not prohibited as part of their approval process. They will need to enhance their NAS approval policies and procedures to cover the extended restricted services for the company and its subs and the 70% cap for the group. Committees should review their policies and procedures for procuring, approving and recording NAS, and confirm they are adequate for the new regulatory requirements.

A summary of the EU NAS restrictions is attached in Appendix A, and it should be noted that the EU’s NAS restrictions are more extensive than the current restrictions on NAS in the UK.

- Will the NAS restrictions for your auditor apply outside the EU?

Yes. Practically they will have extraterritorial effect because the restrictions are being adopted by the Ethical Standards. The FRC is going further by proposing that where the PIE is UK based, its NAS restrictions apply to all subsidiaries in the group worldwide. It has done this by proposing that the group auditor of a UK based PIE can only rely on the audits of those subsidiaries if the subsidiary auditors (that are part of the group auditor’s network) have complied with FRC’s Ethical Standards. If not the group auditor has to undertake additional audit procedures. The FRC believes this change is necessary to ensure that a consistent approach to objectivity and integrity is adopted by the network firms, where their work is to be used by the group auditor.

The FRC is also extending the NAS cap to cover NAS provided by any firm in a network to a group audit client, not just NAS provided directly by the audit firm.

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8 Page 8 FRC Consultation Paper
9 Page 3 FRC Consultation Paper
10 Page 8 FRC Consultation Paper
11 Page 8 FRC Consultation Paper
12 Page 8 FRC Consultation Paper
Could a firm be prevented from taking up an appointment as auditor, if that firm provides NAS to you?

Yes. The FRC proposals seek to mitigate the risk that an auditor’s independence could be compromised by NAS provided before appointment. Although the onus here is on the audit firm to ensure it is independent when it accepts appointment as an auditor, the audit committee still has a responsibility to review and monitor the external auditor’s independence and objectivity\textsuperscript{13}.

The cap on the provision of permitted NAS

Is the FRC proposing to change the limit of the NAS fee cap?

No. The FRC is not reducing the level of the cap below 70% as set by the EU, but it plans to remove the requirement to reset the three-year calculation period if NAS are not provided in any year\textsuperscript{14}.

The total fees an auditor and its network may earn from providing permitted NAS will be limited to no more than 70% of the average group audit fee paid in the last three consecutive financial years.

Which permitted NAS are exempt from the cap because they are “required by law”?

FRC has confirmed\textsuperscript{15} that the EU exemption from the fee cap for NAS which are “required by law”, will include services required under rules issued by a regulator using powers granted by legislation; whether or not required to be performed by the auditor.

This will exempt services such as those required by the PRA or the FCA or undertaken to comply with the UK Listing Rules. The exemption will not apply to a report under the Standards for Investment Reporting (SIRs) (e.g., Long Form/Working Capital reports for a UK IPO or Class 1 transaction) unless there is a requirement in law or regulation for such a report. In addition, the revised ES refers to “Union or national” legislation only, so it appears that services required under third country law (e.g., US SOX work) may not be exempt.

How will your audit committee’s oversight of NAS, including the 70% cap, be likely to change?

The audit committee may well have to increase its oversight over NAS performed by the auditor. It may be difficult to distinguish between permitted and prohibited NAS, if some NAS are described differently when compared with the EU’s list. In addition, permitted NAS that are required by law will have to be clearly identified and separated from those...
not required by law. Audit committees will also need to be alert to the application of the 70% cap on NAS fees.

The latter issue may be particularly challenging for committees of large group companies (where the group auditor is based in the UK). This is because larger groups may be using a multitude of NAS from various parts of the incumbent audit firm's international network. The committee will need to be absolutely clear about which NAS the firm's network provides: when, where, and for how long. Clearly the committee will require support from the auditor to do this.

Tax services

What are the restrictions on the provision of tax services?

The restrictions on tax services that may not be provided by an audit firm to its PIE audit clients are shown in Appendix A. However, the FRC is seeking to permit certain limited exceptions allowed in the EU legislation, subject to audit committee approval. Therefore, audit committees will need to pay particular attention to the current providers of tax services, and whether these services will need to be delivered by someone else, should the current provider be successful in tendering for the external audit.

The FRC also plans to extend some of the restrictions on tax services to non-PIE audit clients. It has clarified that the prohibition on acting as an advocate for a (non-PIE) audited entity will extend to representing the client in any negotiation or proceedings with HMRC. Also, the FRC is proposing that the provision of tax services on a contingent fee basis should be prohibited.
Want to know more?
If you have any questions, please speak with your usual EY contact or get in touch with one of us:

Hywel Ball
Managing Partner Assurance, UK and Ireland & UK
Head of Audit
Tel: +44 131 777 2318
Email: hball@uk.ey.com

Andrew Walton
Head of Markets Assurance
Tel: +44 20 7951 4663
Email: awalton@uk.ey.com

Jason Lester
Head of Tax
Tel: +44 20 7951 0884
Email: jlester@uk.ey.com

Andrew Hobbs
Partner, Corporate Governance & Public Policy
Tel: +44 20 7951 5485
Email: ahobbs@uk.ey.com
Appendix A: Summary of the EU NAS restrictions

The following information is an extract from the EU Audit Regulations (Article 5, Prohibition of the provision of non-audit services). The list below covers the NAS restrictions and derogations.

(a) tax services relating to:

(i) preparation of tax forms;

(ii) payroll tax;

(iii) customs duties;

(iv) identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law;

(v) support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspections is required by law;

(vi) calculation of direct and indirect tax and deferred tax;

(vii) provision of tax advice;

(b) services that involve playing any part in the management or decision-making of the audited entity;

(c) bookkeeping and preparing accounting records and financial statements;

(d) payroll services;

(e) designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems; valuation services, including valuations performed in connection with actuarial services or litigation support services;

(f) valuation services, including valuations performed in connection with actuarial services or litigation support services;

(g) legal services, with respect to:

(i) the provision of general counsel;

(ii) negotiating on behalf of the audited entity; and

(iii) acting in an advocacy role in the resolution of litigation;
(h) services related to the audited entity's internal audit function;

(i) services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity;

(j) promoting, dealing in, or underwriting shares in the audited entity;

(k) human resources services, with respect to:

   (i) management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve: —searching for or seeking out candidates for such position; or —undertaking reference checks of candidates for such positions;

   (ii) structuring the organisation design; and

   (iii) cost control.

Member states may prohibit services other than those listed above where they consider that those services represent a threat to independence.

By way of derogation, member states may allow the provision of the services referred to in points (a) (i), (a) (iv) to (a) (vii) and (f) above, provided that the following requirements are complied with:

(a) they have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements;

(b) the estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee referred to in Article 11; and

(c) the principles of independence laid down in Directive 2006/43/EC are complied with by the statutory auditor or the audit firm.
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