



Governance *in brief*

FRC consultation: Implementation of EU Audit Regulation and Directive, CMA Order and other changes relevant to audit committees

Headlines

On audit reform:

- The FRC proposes to adopt the EU requirements as expected, with a few additions set out in this note, extending the UK's position in the vanguard of audit reform.
- The position on prohibited non-audit services is now broadly clear.
- Whilst the exact timing remains to be finalised, companies should consider the future implications of the 70% non-audit services cap from their first financial year commencing on or after 17 June 2016.

Audit Committees:

- The FRC proposes to strengthen the audit committee's role in relation to corporate reporting, external and internal audit and proposes to clarify the respective responsibilities of the board and the audit committee for risk management and internal control.
- The Audit Committee proposals are likely to be introduced to the same timetable as the EU Audit Regulation and Directive, for financial years commencing on or after 17 June 2016.

Background

This FRC consultation 'Enhancing Confidence in Audit' covers the UK implementation of the EU Audit Regulation and Directive, with proposed changes to the UK Corporate Governance Code and the Guidance on Audit Committees, the Ethical Standards for Auditors and International Standards on Auditing (ISAs). The proposed changes also address those elements of the Competition & Markets Authority's (CMA) final Order that were left for the FRC to address, reinforcing certain aspects of audit committee activities regarding the relationship with the external auditor.

The key topics expected to be covered in a separate BIS consultation paper later in October are:

- Regulation of the audit profession – to include the split of regulatory responsibilities between the FRC and the "Recognised Supervisory Bodies", such as the ICAEW.
- Mandatory audit tendering and audit firm rotation – to include the decision that the UK will be taking the member state option in the Regulation allowing public interest entities to rotate auditor every twenty years, rather than every ten years, provided a tender is conducted at least every ten years.
- The definition of "public interest entity" – to address any differences across the UK regulatory landscape.

The BIS timetable is not clear yet, but responses to the FRC consultation are requested by 11 December 2015.

Provision of non-audit services to PIEs – a new Ethical Standard for Auditors

Entities affected by the proposed FRC changes

The changes described below, arising from the EU Regulation, apply to PIEs only – a "PIE" is a public interest entity as defined in EU law, being an entity with securities (debt or equity) admitted to trading on an EEA regulated market (including LSE Premium or Standard Listing, not AIM), a credit institution (bank or building society in UK terms) or insurance undertaking.

Prohibited services – the changes are as expected

The FRC has adopted the EU “blacklist” of banned non-audit services which cannot be provided to PIEs by their auditors. Incorporated in the proposed final FRC restrictions are additional services already prohibited by current standards, reinforcing the UK’s desire to be seen as having leading standards of independence but allowing Audit Committees a degree of flexibility within certain regulatory constraints.

The proposed list of EU prohibited services is included in the Appendix to this publication.

The “70% cap” on non-audit services – implementation proposals remain as expected

The EU audit regulation contains a 70% cap on non-audit fees to PIEs. To calculate the cap, you average three consecutive years of audit fees to the entity and its parents and subsidiaries – in the fourth year, non-audit fees for services to the entity and its parents and subsidiaries cannot exceed 70% of that average. As a reminder, fees for non-audit services required by EU or member state law or regulation do not count towards the cap. It is not yet clear whether the entity’s “parents” for the purpose of applying the cap are global or EEA only.

In implementing the cap in the UK the FRC has:

- decided not to reduce the percentage level of the cap – it remains at 70%;
- removed the anomaly whereby if no non-audit services are provided in a year, the clock starts again and the cap will not apply until four more years have passed; and
- clarified what is meant by services required by EU or member state law or by a rule issued by a regulator in accordance with powers granted by legislation. For example, this means that the cap will not apply to Reporting Accountant work required by the FCA’s Prospectus Rules and Listing Rules (e.g. public reporting under SIR 2000, 3000 or 4000) but certain related permitted services commonly undertaken as part of transaction execution will count towards the cap as these arise from market practice rather than a regulatory requirement. This may give rise to difficulties for some companies. Examples include the “long form” due diligence reports, the report and comfort letters in respect of working capital and financial position and prospects and SAS 72 comfort letters to underwriters.

This is a slightly unsatisfactory situation regarding the work of Reporting Accountants, which is so fundamental to UK capital markets. At the centre of the debate is the ability of companies to exercise choice for this and other services. In many cases, the company’s preferred option is the statutory auditor, however, the new cap may mean that companies are not able to use their auditors for certain aspects of Reporting Accountants’ work due to the fee ratio. The only solution to this would be for the FCA to make these other services a regulatory requirement. The FRC has done what it can to clarify the situation.

A worked example of the proposed application of the cap is included in the Appendix to this publication.

Provision of non-audit services to non-PIEs – a significant change in relation to tax advocacy

The current requirement in the Ethical Standards prohibits an auditor from acting as an advocate before an appeals tribunal or court but there was no prohibition on acting as an advocate for an entity in its dealings with HMRC *before* the matter reaches a tribunal or court.

To clarify this position, and to align with the new prohibition for PIEs under the EU Regulation, the Ethical Standard will simply prohibit acting as an advocate for an audited entity in relation to tax in any situation (including tribunal, court or with HMRC).

Provision of non-audit services to AIM companies – some reliefs are proposed

As part of its commitment to being a proportionate regulator, the FRC is not proposing to extend the definition of PIE to include AIM companies. In addition, there will be relief from certain of the non-audit services restrictions (see below) set out in the Ethical Standard where the market capitalisation of the entity is below £100 million. The FRC estimates that around three quarters of the entities quoted on AIM will benefit from these reliefs.

AIM companies meeting the size criteria will not be prohibited from using their auditor for the following services: valuations, preparation of tax calculations prior to signing the audit opinion, litigation support, recruitment, distressed restructuring and accounting. These smaller companies are, of course, still required to apply a rigorous threats and safeguards approach to auditor independence but, with fewer finance team resources, they can source support from their auditors.

Provision of non-audit services to “technical listing” companies – some reliefs are proposed

Companies with only a “technical listing” on an unregulated market - where the quoted or listed securities are in substance not freely transferable or cannot be freely traded – will be treated as unlisted. This will be welcome news to many private equity backed entities.

Proposed changes to the UK Corporate Governance Code for Audit Committees

The FRC is proposing the following changes to section C.3 (Audit Committee and Auditors) of the UK Corporate Governance Code:

- The requirement for an audit committee member to have “recent and relevant financial experience” is changed to “competence in accounting and/or auditing”. More fundamentally, the audit committee as a whole will need competence relevant to the sector in which the company operates. This is likely to affect future recruitment policies.
- The FTSE 350 audit tendering provision will be removed as this is superseded by the CMA and EU requirement for mandatory tendering and rotation of the audit firm.
- The audit committee section of the annual report will need to provide advance notice of audit tendering plans. BIS is expected to provide more details in this area.

The FRC is not proposing to take forward the CMA recommendation that there should be an advisory vote on the audit committee’s report, as it believes that shareholders can express views by refusing to re-elect members of the audit committee or can table a specific resolution reflecting their concerns. The FRC is, however, asking for views.

Proposed changes to the Guidance on Audit Committees

The FRC is proposing a number of changes to the Guidance on Audit Committees. In addition to changes which bring the Guidance in line with the proposed changes to the Code, there are the following proposed amendments to audit committee activities and to audit committee reporting.

Activities

Area	Guidance
Key judgements	The audit committee should consider key matters of its own initiative rather than relying solely on the work of the external auditor. It must decide whether the sources of assurance and information are sufficient and objective.
Responsibility for risk management and internal control systems – clarification	The board has ultimate responsibility for an organisation’s risk management and internal control systems. The audit committee should consider what role it can play and what information it requires to assist the board in putting in place sound risk management and internal control systems.
Internal audit process	This section has been updated to reflect existing good practice. The audit committee should ensure the internal auditor has direct access to the Chairman of the Board and is accountable to the audit committee.
External auditor	The audit committee should have primary responsibility for negotiating the fee and scope of the audit, initiating a tender process, influencing the appointment of an engagement partner and making formal recommendations to the board on the appointment, reappointment and removal of the auditors (reflecting the CMA Order). More emphasis is placed on interactions with the external auditor around the areas of significant judgement and risks to audit quality.
Non-audit services	Set and apply a formal policy specifying the types of non-audit service for which use of the external auditor is pre-approved. The guidance reaffirms that such approval should only be in place for matters that are clearly trivial.
Remuneration of audit committees	Remuneration should reflect the responsibility members bear and that a significant extra amount of time needs to be committed.

Additional disclosure proposed for audit committee reports

- A summary of the review of the audit committee's effectiveness, including how the performance evaluation has been conducted.
- The current audit partner's name and for how long the partner has held the role.
- An indication in advance of when the next tender process will be undertaken and an explanation of any changes to the intended timing of the next tender process.
- The committee's policy for approval of non-audit services (N.B. there is currently no option in the proposals for a website cross reference).
- The audit fees for the statutory audit of the company's consolidated financial statements and the fees paid to the auditor and its network firms for audit related services and other non-audit services, including the ratio of audit to non-audit work.
- For each significant engagement, or category of engagements, an explanation of the services provided and why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor.
- The nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team.
- When a company's audit has been reviewed by the FRC's Audit Quality Review team, disclosures about significant findings and the resulting actions they and the auditors plan to take. This disclosure should not include the audit quality category awarded.

The appendix to the current guidance on good practice in audit tendering is being removed and will be published separately, drawing on tender activity to date, probably before the end of 2015.

Other proposed changes to the Ethical and Auditing Standards for Auditors

Ethical Standards

Incorporating the changes to non-audit services described above, the FRC is planning that the existing Ethical Standards for Auditors will be rewritten into one FRC Ethical Standard (plus another for smaller entities). This will bring in the EU reforms as well as some areas where the FRC had fallen behind the Code set by the International Ethics Standards Board for Accountants. This is a principles-based standard, which nevertheless contains a lot of detailed rules. Auditors are required to consider the broad principles even if they think they have complied with all of the rules.

Auditing standards

Over three-quarters of the extensive consultation paper comprises proposed amendments to auditing standards to deal with the EU reforms and IAASB changes in respect of auditor reporting and disclosures. Some of these changes are comparatively minor (for example, where UK standards already substantially covered areas now required by EU law) and will have little practical impact, others are more fundamental.

- The UK has led the way with "enhanced auditor reporting" for companies reporting on their compliance with the Code. This will be extended as a matter of EU law to all PIEs, which will be a change for many companies with only listed debt and also for unlisted banks, building societies and insurers. It will also be extended to entities listed anywhere in the world, whether on a regulated or unregulated market, as part of the IAASB's auditor reporting project. This will also require some changes to existing enhanced auditors' reports – principally because auditors will now communicate "key audit matters" which is a slightly different test to the current requirement for the risks which had the greatest effect on the audit. In practice, it is unlikely the disclosure of audit risks will change for many companies with an existing enhanced auditors' report solely as a result of this change. Key audit matters must include, where relevant, key observations arising with respect to the assessed risks of material misstatement.
- Where the enhanced auditors' report applies, the auditor will now need to report to the audit committee in the same way as to a listed company. Newly formed audit committees might wish to consider an early discussion with their auditors on the form and content of this reporting.

- In line with some firms' current practice (including ours) in enhanced auditors' reports, reporting positively on the appropriateness of going concern and lack of related material uncertainties in the enhanced auditors' report will become mandatory.
- Changes to International Standards for Auditors (ISAs) will be made as part of the IAASB's disclosure project to clarify that the audit of the notes to the financial statements is on an equal footing with the audit of the primary statements. This will complement work by the IASB on disclosures for preparers of financial statements.

Effective date and transitional provisions

The effective date for the EU changes can be no later than periods commencing on or after 17 June 2016 and this is likely to remain the timetable. Some provisions will require transitional arrangements which are currently absent.

Summary status of audit reform implementation

Body	Status	Implementation date
EU	Regulation (EU) No 537/2014 and Directive 2014/56/EU (amending the Audit Directive) were published in the Official Journal of the European Union on 27 May 2014. Member states have until 16 June 2016 to apply the provisions.	Transitional arrangements regarding auditor rotation apply from 17 June 2014
BIS	Consulting on regulation of the audit profession, auditor tendering and rotation, and possible additional matters. October 2015 – responses due in December 2015.	17 June 2016
FRC	Consulting on responsibilities as UK competent authority. Responses due 11 December 2015.	17 June 2016
CMA	"The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014" came into force on 1 January 2015.	Financial years commencing on or after 1 January 2015
FCA PRA	The FCA and PRA are consulting on necessary consequential amendments to their existing rules and guidance on audit committees. FCA CP 15/28 was published on 4 September and PRA CP 34/15 was published on 18 September.	2016

For further information

The FRC's consultation paper can be found at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2015/September/FRC-s-work-to-enhance-justifiable-confidence-in-au.aspx>

Deloitte View

- The changes proposed will further increase the profile and significance of the work of audit committees.
- There is an increased emphasis on audit committees making their own enquiries on key matters rather than placing reliance on the work of the external auditor.
- There is now helpful clarity on ownership of risk management and internal control, reinforcing that the board as a whole is responsible, and the audit committee's role is to provide support to the board to fulfil this function.
- There remains an issue for the UK capital markets. At present, certain Reporting Accountant services that are not a regulatory requirement will count towards the 70% non-audit services cap. We hope that the FCA and the FRC can find a suitable solution.
- There will be transition issues with certain requirements of the EU Regulation and Directive and we hope that proposals will be issued for comment soon.

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Appendix – Additional detail on provision of non-audit services

Summary

The auditor now cannot provide tax services unless they are clearly inconsequential and cannot perform most HR related services. There are some aspects of non-regulatory Reporting Accountant work which need to be looked at carefully as they will count towards the 70% cap. Some IT systems work can still be performed as long as it does not impact the financial statements.

EU prohibited services

The new list of proposed prohibited services for PIEs is as follows. The table also presents the approach the FRC has taken to group situations, including where the subsidiary or parent of the PIE is based outside the European Economic Area (non-EEA).

The FRC will allow those services in italics below (some, but not all, tax services plus valuations) if they have no direct impact, or only a clearly inconsequential effect, separately or in aggregate. In order to take advantage of this derogation, the auditor must document the estimated effect of the service, explain this to the audit committee justifying how the principles of independence have been applied, and the auditor must not place significant reliance on these services as part of their audit. There is no clarification in the consultation of how “clearly inconsequential” differs from “immaterial”.

The following table below summarises the proposals.

Key

No	Prohibited
Restricted	Prohibited unless no direct impact or direct impact is clearly inconsequential
T & S	Threats and safeguards approach

	Can be provided to:		
	EEA PIE, EEA parent of an EEA PIE, EEA subsidiary of an EEA PIE	Non-EEA subsidiary of an EEA PIE	Non-EEA parent of an EEA PIE
A Tax services – note that contingent fees for any tax services will also be prohibited			
<i>preparation of tax forms</i>	Restricted	T & S	T & S
payroll tax	No	T & S	T & S
customs duties	No	T & S	T & S
<i>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</i>	Restricted	T & S	T & S
<i>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</i>	Restricted	T & S	T & S
<i>calculation of direct and indirect tax and deferred tax</i>	Restricted	T & S	T & S
<i>provision of tax advice</i>	Restricted	T & S	T & S
B services that involve playing any part in the management or decision-making of the audited entity	No	No	T & S
C bookkeeping and preparing accounting records and financial statements	No	No	T & S
D payroll services	No	T & S	T & S
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	No	No	T & S
F valuation services, including valuations performed in connection with actuarial services or litigation support services	Restricted	T & S	T & S
G legal services, with respect to			
the provision of general counsel	No	T & S	T & S
negotiating on behalf of the audited entity	No	T & S	T & S
acting in an advocacy role in the resolution of litigation	No	T & S	T & S

	Can be provided to:		
	EEA PIE, EEA parent of an EEA PIE, EEA subsidiary of an EEA PIE	Non-EEA subsidiary of an EEA PIE	Non-EEA parent of an EEA PIE
H services related to the audited entity's internal audit function	No	T & S	T & S
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	No	T & S	T & S
J promoting, dealing in, or underwriting shares in the audited entity	No	T & S	T & S
K human resources services , with respect to			
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	No	T & S	T & S
structuring the organisation design	No	T & S	T & S
cost control	No	T & S	T & S

As can be seen, provision of all of these services to non-EEA parents will be considered on the basis of an assessment of the threat and whether appropriate safeguards can be implemented. This is a practical approach – companies tend to be able to tell their subsidiaries what to do (and hence who to buy services from), but cannot necessarily influence their parents.

The “70% cap” on non-audit services

A worked example

ABC plc is a financial institution and PIE that engages the auditor to perform the statutory audit, the interim review, the regulatory return to the PRA and, in 201X, due diligence on a potential acquisition. ABC plc has paid the same statutory audit fee for the past three years.

	201X £000	Application of 70% cap
Parent company audit fee	20	Statutory audit
Audit fee for subsidiary entities	80	Statutory audit
	100	
Half-yearly review	20	Non-audit
PRA regulatory return	40	Service required by regulation
Due diligence for Project Buy	40	Non-audit
	100	
Total fees to the external auditor	200	

In this case a total of £60,000 of non-audit fees would apply against the 70% cap. With a statutory audit fee of £100,000 for the group, this is at a permissible level. The regulatory return required to be provided by the auditor is excluded from the calculation.

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