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Dear Sirs

FRC Consultation – Auditing and ethical standards implementation of the EU Audit Directive and Audit Regulation

The consultation starts from the presumption that the parallel consultation by the Department of Business Innovation and Skills (“BIS”) will result in aspects of the EU Accounting Directive and EU Accounting Regulation being implemented on behalf of the UK as a member state by the Financial Report Council (“FRC”). LAPFF does not support any further powers being given to the FRC without substantial governance reform of the FRC resulting in demonstrable independence of the FRC from the auditing profession, and has written to BIS accordingly.

LAPFF believes that the FRC is still displaying overly pro-auditor sympathies as a result of the way that the FRC was set up as - at best - a semi-independent body after the “post-Enron” reforms of 2004-2005.

The FRC displays clear “revolving door” relationships with the accounting profession, and some of its key advisers, highly relevant to the risk of regulatory capture. The recent open disagreements between the Competition Commission and the FRC over auditor competition and rotation in LAPFF’s view is merely a manifestation of the fact that the Competition Commission (also under BIS) was properly independent and the FRC wasn’t and isn’t.

LAPFF has consistently argued that the accounting standard regime is defective against the true and fair view requirement of the law. It is also observable and apparent from some of the FRC’s own inspection outputs that there are substantial problems with standards of auditing in practice.

LAPFF can also cite substantial problems with the audits of Royal Bank of Scotland, HBOS, Co-op Bank, each of which had lost all of their capital whilst having had clean audit opinions. Further to that there were also audit problems with Royal Sun Alliance, with accounting problems in the Irish subsidiary missed by group and local auditors which resulted in the need for a large rights issue. Then there are problems with audits outside of financial services, such as Tesco, Betfair (where the accounts were defective and KPMG missed illegal dividends) and latterly Wm Morrison Supermarkets (where KPMG missed illegal dividends and share buybacks). For the FTSE 100 alone the observable failure rate would appear to be between 5%-10% of audits.



In view of the problem with the FRC losing the recent MG Rover appeal from Deloitte, there are clearly problems with the ethical standards of the FRC and ICAEW. It is therefore difficult to support the view in para (vi) of the Introduction to this consultation that *“the FRC consider that it would be most appropriate for the application of the provisions [of the Directive/Regulation] that clearly relate to matters currently covered by the FRC’s standards to be allocated to the FRC to implement via development of the audit and ethical standards framework and revision of the relevant standards”*.

LAPFF also believes that the time it takes for the FRC to pursue cases may well not be related to the complexity of the matters under investigation, but regulatory inertia through a desire to have 6 years expire, coincident with the statute of limitations, so that the FRC findings do not then form the basis for evidence for civil claims by the company itself or liquidators against the auditor. In LAPFF’s view audit quality would benefit if there was more not less successful litigation against auditors, and it should not be the role of the FRC to limit that.

LAPFF believes that the threats and safeguards approach to non-audit services service does not work. LAPFF therefore does not address whether there should be a black list or a white list of non-audit services. LAPFF would like to see no non-audit services attached to audit engagements. LAPFF also believes that the system proposed is overly complex and thus prone to being gamed. Furthermore, placing the safeguards for non-audit services onto audit committees seems to be misplaced. The recent events at HSBC suggest that audit committees have more than enough to be getting on with without this as well.

LAPFF recommends that member funds do not pay the voluntary levy being asked for by the FRC. The FRC seems to have a cumbersome, costly and essentially ineffective standards and disciplinary regime because what the FRC is implementing is largely of the profession’s own making.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Kieran Quinn".

Cllr Kieran Quinn, Chair

Section 1 – Auditing Standards

Question 1 (see pages 11 – 13)

Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

A: LAPFF believes it is essential that auditing standards have additional requirements attached to deal with national law. However, for the reasons set out above LAPFF does not believe that the FRC is an appropriate body to be doing this unless there are substantial governance reforms of the FRC.

Section 2 – Proportionate Application and Simplified Requirements

Question 2 (see pages 14 – 15)

Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

A: It seems apparent from the FRC losing aspects of the MG Rover case that ethics standards are not fit for purpose for large entities, so it is difficult to see how they could be appropriate for smaller entities.

Question 3 (see pages 15 – 17)

When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles 22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available for Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

A: Not answered as outside of the scope of LAPFF investment universe, and given problems in principle indicated in Q2 above.

Section 3 - Extending the More Stringent Requirements for Public Interest Entities to Other Entities

Question 4 (see pages 18 – 25)

With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:

(a) should they apply to PIEs as defined in the Audit Directive?

(b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

A: There seems to be confusion between listed and public interest entities in general in FRC material. If the FRC openly accepted that the purpose of the statutory audit in law is to deal with creditor protection and shareholder protection of limited liability companies, then the need for complicated and overlapping taxonomies would disappear, as the public interest aspects would be more obvious.

The statutory audit model for unlisted limited liability companies is member and creditor protection. That is a corporate governance function. Those companies that are listed then have additional requirements in respect of information for markets. It is the avoidance of dealing with this simple condition that gives rise to more complex taxonomies to deal with listing/public interest.

Question 5 (see pages 18 – 25)

Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

Question 6 (see pages 18 – 25)

Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)?

If yes, which requirements should apply to which other types of entity?

A: Q5 and Q6 as in answer to Q4.

Section 4 – Prohibited Non-audit services

Prohibition of additional non-audit services (see pages 29 – 35)

Question 7

What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

Question 8

If a 'white list' approach is deemed appropriate to consider further:

(a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added?

(b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?

Question 9

Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

Derogations in respect of certain prohibited non-audit services (see pages 35 – 36)

Question 10

Should the derogations that Member States may adopt under the Audit Regulation – to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

Question 11

If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be 'immaterial' sufficient? If not, is there another condition that would be appropriate?

A: Q7-Q11. All of these questions are predicated on there being an acceptable level of non-audit services. LAPFF believes that the time has come to recognise that no non-audit services are acceptable.

Audit Committee's role in connection with allowed non-audit services (see page 36)

Question 12

For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?

Geographical scope of the prohibitions of non-audit services, by the audit firm and all members of its network, to components of the audited entity based outside the EU (see pages 37 – 39)

Question 13

When implementing the provisions of the Audit Regulation in the Ethical Standards,

should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all members of the network whose work they decide to use in performing the audit of the group, with respect to all components of the group based wherever based? If not, what other standards should apply in which other circumstances?

Applying restrictions to other group auditors that are not part of the group auditor's network (see pages 39 – 40)

Question 14

When implementing the provisions of the Audit Regulation in the Ethical Standards, should the FRC require the group auditors of PIEs to ensure the principles of independence set out in the FRC's standards (including the provisions relating to the provision of non-audit services) are complied with by all other auditors whose work they decide to use in performing the audit of the group? If not, what other standards should apply in those circumstances?

A: Q12-Q14. Again, these questions are predicated on there being an acceptable level of non-audit services. LAPFF believes that the time has come to recognise that no non-audit services are acceptable. LAPFF also believes that the system proposed is overly complex and thus prone to being gamed. Furthermore, placing the safeguards for non-audit services onto audit committees seems to be misplaced. The recent events at HSBC suggests that audit committees have more than enough to be getting on with without this as well.

Section 5 – Audit and Non-audit Services Fees

Fees for non-audit services (see pages 42 – 46)

Question 15

Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

Question 16

If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

Question 17

Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms,?

A: Q15-Q17. LAPFF believes that no non-audit services are acceptable and that the cap should be as low as possible, preferably zero.

Question 18

If your answer to question 17 is yes, for a group audit where the parent company is a

PIE, should the audit and non-audit fees for the group as a whole be taken into consideration in calculating a modified alternative cap? If so, should there be an exception for any non-audit services, including the illustrative ‘white list’ services set out in Section 4, be excluded when calculating the modified cap?

Question 19

Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances (see paragraphs 5.3 and 5.15)?

A: Q8-19. These questions are not applicable under the circumstances that no non-audit services are permitted.

Total fees for audit and non-audit services (see pages 46 - 48)

Question 20

Do you believe that the requirements in ES 4 should be maintained?

Question 21

When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

Question 22

Do you believe that an expectation that fees will exceed the specified percentages for at least three consecutive years should be considered to constitute an expectation of “regularly” exceeding those limits? If not, please explain what you think would constitute “regular”.

A: Q20-22. These questions are also not applicable under the circumstances that no non-audit services are permitted.

Section 6 – Record Keeping

Question 23 (see page 49)

Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland) 1)? If yes, what should that period be?

A: LAPFF believes that in order to explain the implications of the question properly the FRC needs to set out the interaction between record keeping and the need for records as evidence in the event there is litigation.

Section 7 – Audit Firm and Key Audit Partner Rotation

Audit firms (see page 50)

Question 24

Do you believe that the FRC's audit and/or ethical standards should establish a clear responsibility for auditors to ensure that they do not act as auditor when they are effectively time barred by law from doing so under the statutory requirements imposed on audited PIEs for rotation of audit firms?

A: It is somewhat remarkable that this question is being asked. The implication is that the existing ethical standards would permit what will be a breach of the law, or that auditors would break the law unless the law was duplicated into auditing standards.

Key audit partners (see pages 50 - 51)

Question 25

Do you believe that the requirements in ES 3 should be maintained?

Question 26

When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

A: Where the requirements of ES 3 are more restrictive, then these should apply.

Consultation Stage Impact Assessment

Question 27 (see pages 52 – 60)

Are there any other possible significant impacts that the FRC should take into consideration?

A: Nothing further to add.

Auditing Standards

Question 1

Do you agree that the FRC should, subject to continuing to have the power to do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, add to the credibility and quality of financial statements)?

A: Yes.

Question 2

Do you believe that the FRC's current audit and ethical standards can be applied in a manner that is proportionate to the scale and complexity of the activities of small undertakings? If not, please explain why and what action you believe the FRC could take to address this and your views as to the impact of such actions on the actuality and perception of audit quality.

Question 3

When implementing the requirements of Articles 22b, 24a and 24b, should the FRC simplify them, where allowed, or should the same requirements apply to all audits and audit firms regardless of the size of the audited entity? If you believe the requirements in Articles 22b, 24a and 24b should be simplified, please explain what simplifications would be appropriate, including any that are currently addressed in the Ethical Standard 'Provisions Available to Small Entities', and your views as to the impact of such actions on the actuality and perception of audit quality.

A: Q2 and Q3: LAPFF is sufficiently concerned about the quality of FRC/ICAEW Ethics standards, in the wake of the MG Rover case, to question their wider application.