BVCA

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By email: c.wood@frc.org.uk

11 December 2015

Dear Sirs

Re: FRC Consultation: Auditing and ethical standards - Implementation of the EU Audit Directive and Audit Regulation

The British Private Equity and Venture Capital Association ("BVCA") is the industry body for the private equity and venture capital industry in the UK. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. This submission has been prepared by the BVCA's Legal & Technical Committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry.

Our members have invested over £30 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 490,000 people and almost 90% of UK investments in 2014 were directed at small and medium-sized businesses. As major investors in private companies, and some public companies, our members have an interest in reporting matters, the conduct and information presented by such companies, and the burdens placed on the management of such companies.

Development of the Consultation

We have held a number of productive discussions with the FRC over recent months and we would like to thank the FRC for its openness throughout these discussions. In particular, in respect of the Consultation, we welcome the amendment of the definition of a Listed Entity to clarify that an entity whose securities are technically listed but which are not in substance freely transferrable or cannot be traded freely by the public or the entity would not be a Listed Entity.

Further, we welcome the decision of the FRC not to expand the definition of a PIE with respect to the implementation of the EU Regulations. We would ask the FRC not to apply the more stringent requirements over and above the Regulations to non-listed PIEs (such as rotating partners every five years not seven), in order to reduce the administrative and cost burden falling on our members and their investee companies, given that a BVCA member might hold investments in a number of unlisted different credit institution or insurance company PIEs.

We support the objective of seeking to increase quality and independence in the audit market, but we do have a number of concerns with the extent of some of the suggestions in the Consultation. As a result, and given how many people are likely to comment on the Consultation, we have limited our responses to those questions that we believe are of particular relevance to our members.

Background to Private Equity and Venture Capital

Private equity and venture capital firms are long-term investors, typically investing in companies for around 5-7 years. This means a commitment to building lasting and sustainable value in the businesses they invest in. Typically firms will sell their stake in a company by listing on the public markets or selling to a strategic buyer.

Private equity and venture capital firms raise capital to invest from sources such as pension funds, endowments, insurance companies, banks, family offices/high net worth individuals and sovereign wealth funds.

A private equity or venture capital manager manages one or more funds, often set up as limited partnerships. The funds are closed-ended meaning that they have a limited life span, the industry standard being 10 years. The funds will invest in companies in the earlier part of a fund's life until an agreed date (e.g. 5 to 6 years) and exit investments in the run up to the fund's tenth anniversary. The life span of a fund can be extended (if permitted in the fund's constitutional agreement) and this is typically up to 2 additional years.

Private equity and venture capital managers operating in the UK will be authorised and regulated by the Financial Conduct Authority ("FCA") and now (for funds which are in-scope Alternative Investment Funds ("AIFs")) must be authorised and regulated by the FCA as an Alternative Investment Fund Manager.

Question 1. Do you agree that the overarching ethical principles and supporting ethical provisions establish an appropriate framework of ethical outcomes to provide a basis for user trust and confidence in the integrity and objectivity of the practitioner, as described in the introduction to the Ethical Standard?

Yes. However, we can see that the appearance of threats may still remain, and welcome an explicit requirement for the auditor to stand back and consider whether they have complied with the principles and provisions.

In order to mitigate the cost of compliance which might be passed on to audited entities through increased fee levels, we hope that auditors will be permitted to document their assessments, (using their own firms' established protocols) in a proportionate fashion, particularly in respect of privately owned entities which will include the portfolio companies of the BVCA's members.

Question 3: Do you agree with the FRC's proposals for the application of the FRC ES to non-listed PIEs?

On the basis that the definition of a PIE has not been expanded, we do agree with the FRC's proposals for the application of the FRC ES to non-listed PIEs, subject to our responses to questions 10 and 11, below.

As we have previously discussed with you, a number of PE backed businesses are PIEs by virtue of being banks or insurance companies. There is likely to be a disproportionate cost borne by such companies from any alignment of audit engagement partner rotation periods to 5 years for all PIEs because the relatively short hold periods for some companies by PE funds might mean that they would be required to change their audit partner or audit firms more frequently than their competitors.

Question 5: Do you support the FRC's proposal for the group auditor to ensure that any component auditor, whose work they propose to use in the audit and other members of the firm's network, meet the FRC ES or the IESBA Code as set out above?

We understand that other Member States only apply their independence rules within their own countries, relying on the IESBA Code elsewhere. Conversations with those in other Member States suggest that a similar approach is likely once the requirements of EU law have been applied. To be on a level playing field we suggest that you reconsider any extraterritorial application so that UK businesses are not put at a disadvantage when compared to their competitors overseas.

The extension of the application of this Ethical Standard across international groups increases the independence requirements for non EU network firms involved in the audit (in the areas that this Ethical Standard is more stringent than IESBA). This occurs in several places, for example the extension of the chain of command definition, tax advocacy work and tax contingent fee work. The FRC should recognise that this provision could potentially limit choice for international groups as a more restrictive rule set is being applied extraterritorially.

Question 6: Do you support the extension of scope to other public interest assurance engagements, incorporating the requirements of the ESRA into the FRC ES, and do you agree that the restriction of scope of ethical requirements for investment circular work is sufficiently clear in the proposed text?

We have no comments on the extension of scope to other public interest assurance engagements through incorporation of the requirements of the ESRA into the FRC ES.

However, we do have some concerns as to the application of the FRC ES to Reporting Accountant services which are services required by our members relatively frequently. These concerns stem largely from the fact that reporting accountant appointments are in respect of individual transactions, unlike financial statement audits, for instance, which are recurring engagements.

Previously it has been common for private equity backed companies to choose their Auditor to perform Reporting Accountant services, however, the application of new ES4.31 could reduce the choice of providers of these services due to the fee cap in place.

The FRC indicate (pages 8-9 of the consultation) that the exclusion will mean “Entities which engage their statutory auditors to carry out work to comply with regulatory requirements would not be prevented from doing so under the cap, and will not incur any additional burden as a result of having to undertake additional tenders for the provision of such services”.

We understand this to mean that Reporting Accountant engagements would be excluded from the non-audit services cap as the service is required by the listing rules. As you will be aware the listing rules require:

- A short form report prepared by the reporting accountant;
- A declaration by the sponsor; and
- A declaration by the Directors.

In making their declarations the sponsor and directors often require the reporting accountant to prepare a long form report and working capital comfort letter. Could the FRC please confirm that these reports will also be excluded from the non-audit fees cap?

Whilst we acknowledge the FRC’s ability to act in this matter is restricted given the definition provided in the Regulation, we would encourage the FRC to work with the FCA to explore ways in which a company’s auditor could continue to provide the various reports which are currently market practice without reference to the cap on non-audit services.

Question 10: Do you support the FRC’s proposal to make consistent the prohibitions over providing advocacy for an audited entity in relation to tax?

We agree with the principle of the FRC’s proposal – that the advocacy threat may impair an auditor’s actual or perceived independence. However, we believe that a lack of clarity as to what advocacy means in this context could have unintended consequences.

Private equity backed companies frequently do not have dedicated tax resource in-house and rely therefore on the provision of tax services from Accounting Firms, often the same firm as the provider of audit services. The effect of the proposal could be to restrict the choice available to such companies for the provision of tax services in that, once a tax computation has been performed or advice given, the Auditor would be unable to answer any questions from HMRC.

We assume this was not the FRC's intention, not least because this would have a disproportionate impact on medium-sized companies and smaller accountancy practices by forcing many, if not all private equity backed companies, to engage two separate firms and increasing costs to be borne by the companies and PE investors.

We consider that the existing restrictions in paragraph 104 of ES 5 (that the matter cannot be material, nor involve a judgement in relation to the financial statements) are sufficient to manage any actual threat to independence in this area.

It would be helpful to our members to clarify the definition of advocacy such that it does not capture responding to factual inquiries by HMRC and that the change could be limited to listed companies.

Question 11: Do you agree with the prohibition proposed by the FRC in respect of the provision of tax services on a contingent fee basis?

If the FRC believe that the perceived threat is such that a ban is necessary, we suggest that:

- it is restricted to listed entities, to avoid a disproportionate impact on privately held companies including PE backed banks and insurance companies; and

- a transitional provision be introduced (similar to that used re contingent fees in relation to tax services where there was uncertain law) to avoid undue costs falling on businesses.

Question 12: Do you agree with the FRC's proposals to offer targeted reliefs in respect of the audits of smaller listed / smaller quoted entities?

Yes. In particular we are pleased that a more proportional framework will apply to listed entities whose securities are not in substance open to trading by the members of the public.

Question 13: Do you believe that the FRC's proposals are targeted at the right level? If not, what alternative considerations for the application of reliefs would you suggest?

Yes. We agree that aligning with the value used by the FRC's Audit Quality Review team to determine those entities subject to its audit quality inspections is a sensible threshold.

Question 16: Do you foresee any difficulties if the effective date is for audits of financial statements for periods commencing on or after 17 June 2016?

Non-permitted non-audit services are prohibited for the whole of the period from the start of the accounting year for which the audited accounts will be prepared until the filing of those audited accounts. In addition, services advising on accounting, internal control and risk management systems at the audited entity are also prohibited for the year before that for which the audited accounts are prepared. These prohibitions apply to the PIE itself and also to its parent and subsidiary undertakings within the EU.

We are concerned regarding the implications of this in transitional situations around the time of a transaction. The more some of the points we make above are addressed, the fewer the number of situations that will arise where there is a result that seems unnecessarily disruptive. However, the problems will not be eliminated entirely without being specifically addressed. For example:

- A private equity house makes an offer for a listed company and secures over 90% acceptances, at which point it declares the offer unconditional. It then implements a process to squeeze out the minority but which takes time (perhaps 6 months) to complete. Depending on the precise facts, the private equity house could be the parent undertaking of what would be a Listed entity (and hence an entity to which the widened restrictions in the Ethical Standards coming from the Regulation would apply) for the period from when the offer is declared unconditional until the squeeze out is completed (at which point the portfolio company would cease to have any listed shares and hence would cease to be a Listed entity). Hence, there would be an issue if the private equity house were obtaining non-permitted services from the accounting firm that audits the listed entity during that transitional period when the portfolio company was controlled but still listed. Suspending or transferring the service to another provider would be a very unfortunate requirement.

- A portfolio company becomes a Listed entity and the private equity house (which could be the parent as above) has non-permitted services in progress from the accounting firm that audits the relevant portfolio company.

We believe that where it is within the FRC's remit, for example if the UK opts to go beyond the Regulation in its implementation, further consideration is desirable on transitional provisions that could be put into place. This could probably be subject to some time limit and cover services that are in flight but for whatever reason become restricted. This would particularly be the case where those services have no relevance to the financial statements of the actual listed entity. Changing provider mid-way through a project is disruptive and invariably results in additional cost. We believe that, if at all possible, there should be transitional or 'grandfathering' provisions to minimise the incidence of such situations.

Please feel free to contact me if you would like to discuss this submission further.

Yours faithfully

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