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By email: AAT@frc.org.uk

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Dear Sirs

Re. Post Implementation Review: 2016 Ethical and Auditing Standards Changes to Implement the Audit Regulation and Directive – Call for feedback

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 750 firms, the BVCA represents the vast majority of all UK-based private equity and venture capital firms, as well as their investors and professional advisers. Over the past five years (2013-2017), BVCA members have invested over £32bn into nearly 2,500 companies based in the UK. Our members currently back around 3,380 companies, employing close to 1.4 million people on a full-time equivalent basis ("FTEs") across the world. Of these, around 692,000 FTEs are employed in the UK. Of the UK companies invested in during 2017, around 83% were SMEs.

This submission has been prepared by the BVCA's Legal & Accounting Committee, which represents the interests of BVCA members in legal, accounting and reporting matters relevant to our industry.

Overall, we support the aim of increasing quality and independence in the audit market. However, any increased restrictions (e.g. extension of PIE restrictions to non-PIEs and further restrictions on non-audit services), would significantly increase the administrative burden of monitoring and reduce the choice of accounting firms to provide services to private equity and venture capital (PE/VC) investors. This situation arises because of the structure of PE/VC funds and the way in which they invest in and manage businesses. The restrictions apply in more complicated manner to these types of structures than corporate groups and this in turn can have unintended and unduly burdensome consequences. Any further review of the standards (auditing and ethical) should take into account the output from the other current regulatory reviews (including the CMA, the Kingman and Brydon reviews) and it is crucial that any overall package of reforms is focussed on ethical quality and ensuring the UK remains an attractive place to do business.

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

PE/VC 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.

PE/VC firms typically use a limited partnership to structure funds. Appendix 1 sets out an example fund structure and shows the different firms that may be involved throughout. The general partner of the fund will delegate its power and authority to the private equity manager (often limited liability partnerships with the partners being the PE/VC executives). PE/VC firms will manage one or more funds. The funds are closed-ended meaning that they have a limited life span, the industry standard being 10 years.

PE/VC 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. These investors will be limited partners in the fund and their liability is limited to the capital provided to the fund.

The funds will invest in companies ("portfolio 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 two additional years. The fund's ownership percentage in the portfolio companies will vary depending on the PE/VC strategy (e.g. buyout, minority stake). Private equity acquisitions will often be partly financed by debt, often provided by a number of banks. The portfolio companies will operate independently of each other.

Most PE/VC firms are not themselves PIEs. However, the funds may have investments in companies that meet the definition of a PIE so PE/VC firms do need to consider the impact of the restrictions per the Ethical Standards. For example, there may have been a partial exit through IPO of a portfolio company so the fund has stake in a listed company/PIE.

As the example per Appendix 1 illustrates a number of different audit firms may be involved with the audit of the different entities in the private equity structure. In this example, due diligence services (a permitted non-audit service) have been procured from an audit firm by the fund manager as part of the acquisition of a portfolio company.

There may be other listed securities (debt) that do not meet the definition of an EU PIE. For example:

- The portfolio company has issued high yield bonds (being bonds with a lower credit rating than investment grade bonds and which therefore have a higher yield to reflect the higher risk of default), which are typically listed on the Luxembourg Euro MTF or the Irish GEM exchanges, both of which are 'recognised' but not 'regulated' markets.
- The fund has provided funding through interest bearing loans (often referred to as shareholder loans), which are commonly listed on a stock exchange recognised by HMRC, in particular the Channel Islands Securities Exchange ("CISE"), but which are in fact not traded as the loans are held entirely by the private equity fund. Again, the CISE is a 'recognised' but not 'regulated' market.

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v. Are the ethical principles and supporting specific requirements sufficiently clear? If not, please explain the issues and how you believe they could be resolved.

The provisions in future revisions of the Ethical Standard would benefit from more clarity in certain areas to support a consistent application and approach. For examples, additional requirements introduced into the 2016 Ethical Standard use language or terms which, if clearer, would have assisted with consistency in interpretation, including, the definitions of "significant affiliate", "material subsidiary" and "controlled undertaking." We also understand from our members that debate is on-going regarding the application of a number of significant provisions including:

- the definition of an Objective, Reasonable and Informed Third Party;
- contingent fees; and
- and the definition of "listed", specifically "in substance not freely tradeable.

vi. Based on experience, do you believe the ethical principles and supporting specific requirements are sufficiently proportionate for PIEs and non-PIEs? If not, please explain your view, including what you would consider the proportionate position to be, having regard to the need to address threats to independence, objectivity and integrity viewed from the perspective of an objective, reasonable and informed third party.

vii. Do you believe that user confidence would be strengthened if the FRC required the application of the independence requirements of FRC Ethical Standard to all components of a group audit?

Overall, the ethical principles and supporting specific requirements are sufficiently proportionate for PIEs and non-PIEs. We would be extremely concerned if the requirements were now extended to non-PIEs.

Our concerns focus first on the potential restrictions on choice and quality of service provider that could occur if the scope were to be extended. These concerns arise due to, and are compounded by, the transaction-driven nature of our industry and management of controlling stakes in portfolio companies through fund structures. As discussed in the preceding section, fund structures are very different to typical corporate group structures and there is considerable complexity involved in analysing audit and adviser relationships, also noting that this extends beyond the 'Big 4'.

In addition, the current restriction on providing corporate finance services on a contingent fee basis (as is standard) to audit clients, which is not restricted to PIEs, has had a detrimental impact on the industry. PE/VC firms, particularly in the mid-market, routinely use the corporate finance services of the Big 4 and other large audit firms. The rules, as implemented by the standard, mean that such services can no longer be provided on a contingent fee basis to audit clients. As a result, there has been a tangible reduction for choice to the market and this will inevitably have an impact on quality in due course. Therefore, relieving this condition for PE/VC firms would be advisable.

In contrast to a corporate group which, more often than not, will use one firm for the audit of all its group companies, PE/VC structures (i.e. the manager, fund(s) and its portfolio companies) do not operate in the same way. This is illustrated in appendix 1. In particular, many PE/VC firms do not see it as their role to intervene in portfolio company management's decision as to which firm is engaged as auditors. Hence, it will often be the case that many different firms audit different portfolio companies. As a result, if the PIE restrictions on non-audit services are widened to non-

PIEs, it would be common for PE/VC firms to have several portfolio companies that are audited by different audit firms. The PE/VC firm would then potentially be restricted in using any of these audit firms for services that it itself is looking to procure, for example, in providing advisory services in relation to making new investments. This restriction on choice is a significant issue as it conflicts with another fundamental point for a PE/VC firm, being their obligation (both contractually under the fund documentation and as a fiduciary acting in the best interests of its investors) to seek support and advice from the most relevant and appropriately experienced advisors. This is particularly disproportionate for non-PIEs many of whom are owner managed and will rely on outsider expertise to run their businesses. Anything that restricts choice as to who is most appropriate to provide that support and advice is a significant concern.

In addition, applying auditor rotation rules to limited life funds that are non-PIEs would be disruptive and likely lead to additional costs for investors. Such burden, particularly as many are likely to be SMEs, will be disproportionate and we question whether any such extension would be in the benefit of the public interest in a more general sense.

Secondly, any extension in the application of the ethical principles and supporting specific requirements to non-PIEs will create further inconsistency in how the rules work between the UK and EU Member States. This will just add to the complexity for companies and their directors where so many groups have cross-border considerations, notwithstanding the complexities that Brexit may create (for example, companies incorporated in one country but with securities listed in another).

Where portfolio companies have listed debt on recognised markets, it is worth noting that:

- These debt instruments are not investments held by “the public”;
- In the case of shareholder loans, they are not “traded”; and
- The relevant markets are not “open” but are used solely by sophisticated investors.

It is very difficult to see how the cap for fees for non-audit services would operate, and result in a meaningful answer, in a PE/VC structure if ethical principles and supporting specific requirements are extended to non-PIEs. For example, a firm may have relatively low audit fees for a comparatively small portfolio company. To compare these fees with those for the provision of non-audit services to the PE/VC firm relating to other portfolio companies that may be many times larger than the smaller portfolio company may produce totally anomalous results and would not be achieving the policy aim that the fee cap regime is seeking to address. Furthermore, calculating the fee cap requires the communication of information among members in the private equity structure. By contrast to a corporate group, this is much more problematic and complex in a PE/VC situation. In many cases there are legal restrictions preventing disclosure to other investments being made by the PE/VC firm, but even where there are not, it would not be appropriate or customary for PE/VC firms to explain other business activities to a portfolio company unrelated to that portfolio company. Hence, for the portfolio company that is restricted, there would be significant practical issues in them ensuring compliance with any fee cap. The caps for non-audit services are already expected to pose significant uncertainty and challenge for firms where there is a PIE in the structure when they begin calculating these from June 2019 onwards.

We continue to believe that the use of an “affiliate” in the Ethical Standards rather than that of “parent undertaking” used in the EU Audit Directive and Regulations is disproportionate and captures a much wider group of entities than required by the Directive, which has amounted to

gold plating of the UK's application of the Directive. This is particularly problematic in a PE/VC structure for the reasons noted above.

ix. Do you believe the current restrictions on non-audit services are sufficient to address threats to independence, objectivity, integrity and audit quality, and address stakeholder expectations? If not, please explain why, by providing examples where audit quality has been compromised as a result of non-audit services being provided by the auditor.

x. Do you believe there should be further restrictions, or even an outright prohibition, on non-audit services?

a. Should any further restrictions or prohibitions also apply to "audit related" services, that the auditor is not required to provide? If so, please explain your views.

b. Should any further restrictions or prohibitions also apply to services required by law or regulation (i.e. permitted by the Audit Regulation)? If so, please explain your views.

xi. There is currently a derogation in the Ethical Standard allowing for the provision of certain non-audit services where these have no direct effect or an inconsequential effect (where indirect) on the financial statements. Should this derogation be maintained in the Ethical Standard, and if so why?

xii. Do you believe there could be adverse consequences from imposing further restrictions on some or all non-audit services that may outweigh any actual or perceived benefits? If so, please explain your views.

xiii. The FRC included reliefs from certain FRC ethical requirements for non-PIE audits for the audit of small and medium-sized entities. Should these reliefs be maintained, and if so why?

The current restrictions on non-audit services are sufficient to address threats to audit independence and quality. We would be very concerned if non-audit services were further restricted. Further restriction of non-audit services will significantly restrict PE/VC firms when it comes to choice of service providers due to the number of companies within a fund that will be audited by a range of different audit firms. Further restrictions on services currently permitted could also reduce the quality of service received, as the audit firm will likely have a strong understanding of the business, for services that have minimal threats to audit independence.

We also believe that the reliefs from certain FRC ethical requirements for non-PIE audits of SMEs should be maintained as it is not clear what the public interest benefit is for removing such reliefs. Similarly, the derogation allowing certain non-audit services where these have no direct or inconsequential effect on the financial statements should be maintained, if there is no clear benefit in removing the derogation.

There are currently two permitted non-audit services that are of particular importance to the PE/VC industry.

Due diligence

Given the fact that the PE/VC industry is based on transactions, due diligence is a critical service. We believe this should remain as a permitted non-audit service. Our concerns again centre around

choice and the quality of service available which is key to protecting stakeholders and investors in the fund.

Due diligence services do not conflict with an auditor's independence, but rather require the production of an independent view on a business and its financial information, using the same values of independence and objectivity that you would expect of an auditor. The lack of choice that would otherwise arise is that regulatory restrictions are not the only consideration in deciding who should undertake due diligence. For example, some PE/VC firms have a policy of not using the accounting firm that audits the target business to undertake due diligence; some also have a policy of not using a firm that has undertaken vendor due diligence commissioned by the vendor or target. Hence, other considerations can rule out other audit firms from performing the buy-side due diligence. Imposing another restriction, which we do not believe is necessary, to rule out one or more further firms (especially if restrictions were flowing up from multiple portfolio companies to mean that more than one firm was restricted) could dramatically reduce the choice of which audit firm could be used.

Furthermore, a regular approach to driving growth in portfolio companies is through the making of bolt-on acquisitions. Whilst the PE/VC firm typically initiates such acquisitions, it is the portfolio company that actually commissions any advisory services. It would be an unfortunate and unduly burdensome restriction of choice to prohibit the firm that had undertaken due diligence on the original portfolio company acquisition from undertaking due diligence on a proposed bolt-on because it was the auditor of that portfolio company. Alternatively, it would seem a similarly unfortunate and unduly burdensome consequence to require the portfolio company to change its auditor to avoid such restrictions.

If due diligence were to be made a prohibited service it would encourage a move towards PE/VC firms requiring portfolio companies to change auditors so as to concentrate the related restrictions on one firm so as to preserve the maximum choice of providers for other services. We do not believe that this would be healthy regarding competition to provide the audit services, and also interferes with the principle that exists in many PE/VC firms that choice of auditors is a matter for portfolio company management, not for the PE/VC firm.

Tax advisory services

Tax structuring advice is a critical service for PE/VC firm in order to prevent double taxation for the institutional investors in the fund.

As explained earlier, the restrictions coming from the Regulation will nearly always come from a portfolio company that is restricted rather than from the PE/VC firm itself. However, the tax advice is typically at the PE/VC firm level, either for itself (e.g. its fund structure etc) or in relation to making other investments. Hence, the tax advice in most cases does not have any impact on the financial statements of the restricted entity and we do not see that there is a material risk to the independence of the auditor of the relevant portfolio company.

There is significant benefit in continuity of advice in relation to tax matters. For another adviser to step in and understand all the angles is often extremely difficult and that is when mistakes occur. Ensuring tax advisory services remain permissible is extremely important for the industry to minimise the situations where the PE/VC firm has to either change tax advisers for its own affairs or impose a change in auditors on its portfolio company.

The BVCA would of course be willing to discuss this submission with you further and, if you so wish, please feel free to contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA.

Yours faithfully,

Amy Mahon
Chair, BVCA Legal and Accounting Committee

Appendix 1

The diagram below is a PE/VC limited partnership fund structure for illustrative purposes only.