Melanie McLaren
Financial Reporting Council
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By email: m.mclaren@frc.org.uk

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Dear Melanie,

Re: EU Audit Reform

The British Private Equity and Venture Capital Association ("**BVCA**") is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital ("**investee companies**") in the UK employ around 385,000 people and almost 84% of UK investments in 2015 were directed at small and medium-sized businesses.

We understand that you may be considering two matters which have arisen in our review of the impact of the implementation of the EU audit reform directive and regulation. We believe these to be unintentional consequences that could have a major impact on the operations of the private equity industry and our investment in British business. The BVCA would be happy to set up a meeting to discuss these with you further and we have therefore set out below an introduction to the issues.

Financing of acquisitions

It is common practice for private equity acquisitions to be partly financed directly by debt normally provided by a number of banks. As part of their due diligence process, the banks wish to read and rely upon the due diligence report, which has been prepared by an accounting firm for the private equity house. To achieve this, they agree with the accounting firm, by way of an access letter, that they can have the report and that the accounting firm will owe them a duty of care which is subject to certain conditions. The services provided to the private equity house would normally be permitted by the new rules as they would be due diligence services.

It is important to note that the engagement agreement, which includes the statement and scope of work, is signed by either the private equity house or one of its investee companies and the accounting firm so the bank is not a contractual party to the scope of work that has been agreed. Indeed, an accounting firm will normally state in its agreement with the bank that they make no representations concerning the adequacy of the scope for the bank's purpose. The private equity house or investee company is normally wholly responsible for the fees.

This sets the situation aside from other similar situations, such as an IPO, where the bank, in this case a sponsor, is party to the engagement agreement and in setting the scope jointly with the company concerned. However, the company pays the fees.

A significant issue which concerns us in respect of typical private equity transactions is when the bank is a PIE, and the accounting firm, who is auditor to the bank, is also the accounting firm providing due diligence services to the private equity house or investee company. In this situation, will the accounting firm providing services directly to the PE house/investee company also be considered to be providing services **indirectly** to the bank, and if so:

- would the service, in respect of the bank, be considered to fall into the category of services linked to financing, capital structure and allocation or **investment strategy** and therefore be prohibited, preventing **any** bank, which is a PIE, from taking part in the financing opportunity? Or would it merely be considered an operational activity and therefore not covered by the prohibitions?
- would the bank's Audit Committee be required to approve the provision of the non-audit service and would this approval be required retrospectively in circumstances where it is not known at the outset which banks will be involved or where a bank within a syndicate is replaced by another bank?
- would the fee, paid by the private equity house/investee company, have to be allocated to those banks to calculate whether the non-audit services cap has been reached? It would be possible to envisage a situation well into the banks' financial years where all the caps of all the parties have been met, especially given the number of financing/syndicated business the banks conduct, which could remove access in a private equity transaction to many advisers, whether they themselves are PIEs or not. Again, as the bank may not be identified at the outset of the engagement, as we understand the position, for the bank to take advantage of the opportunity they would have to gain retrospective approval from the FRC, albeit it may be at the end of the engagement.

We understand that there is currently no guidance on what constitutes an indirect service, but we have been advised that you are considering this question in respect of banking syndicates. Furthermore, we are aware the European Contact Group of accounting firms have considered the issue of what constitutes the provision of indirect service. Following a detailed consideration, the ECG concluded:

'We consider that it is reasonable to interpret 'indirect' in respect of Article 5 (1) as meaning 'the provision of a service to an entity within the EU PIE group via an intermediary' be that another group entity or third party. We consider the mere passing on by an entity of a report or output of a service to a third party is not sufficient to mean that the entity is acting as an intermediary.'

The BVCA considers that the financing situation is akin to a 'passing on' of the report and that the bank has not been 'provided a service', either directly or indirectly. This is on the grounds that they have not instructed the private equity house/investee company to engage the accounting firm and have no liability for fees, nor do they suffer the cost of the fees through any reimbursement arrangements. Moreover, the banks have no input to scoping the engagement, thus the service is not tailored to their needs and it is for them to consider whether it meets their requirements. Therefore, assuming a duty of care to a bank should not be construed as providing a service.

As explained above, this could also become a burden if it is considered that every time a bank is to receive a due diligence report as part of a private equity transaction produced by its auditors, its audit committee has to be convened to approve an indirect service. The uncertainty involved with this process alone could disrupt investments especially as some of the banks may come in late to a deal and have a very short time to make their investment decision. A process which takes even a few days could be problematic.

Audit Committee Approval – impact on confidentiality

A separate issue arising from the implementation of the EU audit reform is where a controlled investee company of a non-PIE private equity house is a PIE itself, then many of the provisions of the reform will apply to both the PIE and its 'parent'.

In this situation if the 'parent' wishes to employ an accounting firm who is the PIE's auditor to provide permitted non-audit services to the parent , the PIE's audit committee will have to give approval. In such a scenario, the private equity house may be considering investing in a company independent to the PIE, where confidentiality is of the utmost importance. Currently this would require approval from the PIE's audit committee. The risk of informing a group of outsiders that this deal is being contemplated would likely make the situation impossible. This would restrict the choice of accounting firm in a situation that actually has nothing to do with the relationship between the PIE and its auditor.

It might be possible to structure the deal so that the accounting firm is employed by a non-parent entity, but that is not necessarily a satisfactory solution as 'structuring' to avoid the rules is not a good answer. Regardless, the 'parent' may still want to have the benefit of the report so the service might be caught as being indirect.

We remain supportive of the effective implementation of the audit reforms, but we consider that both these situations need careful consideration, given their potential impact on private equity investment in the UK. We are grateful to the FRC for engaging with us on such matters. If you have any questions or comments, prior to a meeting, please feel free to contact me.

Yours sincerely,

GKManku

Gurpreet Manku
Director of Policy, BVCA