

February 2013

Monitoring the Work of Third Country Auditors

Results of Consultation

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1. Background to the Consultation

Introduction

1.1. The Statutory Audit Directive (SAD) sets requirements for the regulation of the auditors (third country auditors or TCAs) of companies incorporated outside the EU that have securities admitted to trading on regulated markets within the EU, including on the main market of the London Stock Exchange (UK-traded companies). The regulation of third country auditors is one of the responsibilities delegated to the Financial Reporting Council (FRC). As at the end of December 2012 there were 115 third country audit firms registered in the UK. Most of these were members of one of the four largest international 'networks' of accountancy firms.

1.2. The Directive requires that in certain circumstances Member States apply their system for the external monitoring of audit work to third country auditors and the relevant audit engagements. This requirement applies for the most part where there is no equivalent system of audit regulation and external monitoring in the third country, and no plans to introduce such a system.

1.3. The FRC consulted in 2012 on proposals for the system of external monitoring that the FRC should apply to third country auditors. This note reports the results of that consultation.

Background

1.4. Third country auditors (TCAs) are auditors of non-EU incorporated companies that have issued securities on UK regulated markets, principally on the LSE main market¹. The regulation of TCAs under the Statutory Audit Directive ('SAD') is one of the responsibilities delegated by the Government to the FRC. Enforcement is a matter for the UK Listing Authority (UKLA).

1.5. There are some 115 TCAs registered with the FRC from 44 countries with roughly 230 relevant issuers. Most of these TCAs are members of one of the four largest international 'networks' of accountancy firms. There are significantly more third country issuers on UK markets than for any other Member States and they and their auditors come from a much wider spread of countries around the world.

1.6. It is important to understand the structure of the European legislation that governs our responsibilities for TCAs. The SAD and a [Commission Decision](#) of 19 January 2011 classify auditors in three groups: "equivalent" auditors, "transitional" auditors and "Article 45" auditors.

¹ The AIM market is outside the scope of these requirements.

“Equivalent” Auditors

1.7. TCAs are “**equivalent**” auditors where the European Commission and Member States have determined that the relevant country has independent auditor oversight/inspection arrangements equivalent to the requirements for EU Member States and applies in respect of the audits of issuers incorporated in that country. Member States are then allowed to rely on the oversight and inspection by the local independent oversight body and inspection system. The FRC is responsible for setting the requirements in the UK. Equivalent auditors are exempted from routine inspection other than in respect of audits outside the scope of the home country authority. The audit firms are still required to register with the FRC and to cooperate with the FRC, for example on a specific investigation.

1.8. Member States are able to dis-apply regulatory requirements to auditors of issuers in “equivalent” countries, subject to appropriate reciprocity.

1.9. The ten countries that currently have equivalent status are:

- Australia
- Canada
- China
- Croatia
- Japan
- Singapore
- South Africa
- South Korea
- Switzerland
- USA²

“Transitional” Auditors

1.10. TCAs are “**transitional**” auditors where the European Commission and Member States have concluded that the third country is in the process of establishing an acceptable auditor oversight and inspection regime and should be largely exempted from the regulatory requirements for a certain period, whilst the regulatory regime is established. Auditors of companies from transitional countries need to provide specified basic information and register in relevant Member States.

1.11. Under the January 2011 Decision, Member States cannot apply arrangements for routine monitoring to the work of auditors of issuers in the “transitional” countries but require the relevant audit firms to provide specified information.

² Until 1 July 2013

1.12. The twenty countries that currently have transitional status are:

- Abu Dhabi
- Bermuda, Brazil
- Cayman Islands
- Dubai International Financial Centre
- Egypt
- Guernsey
- Hong Kong
- India
- Indonesia
- Isle of Man
- Israel
- Jersey
- Malaysia
- Mauritius
- New Zealand
- Russia
- Taiwan
- Thailand
- Turkey

“Article 45” Auditors

1.13. TCAs are “**Article 45**” auditors where they audit issuers from countries that are not categorised as either equivalent or transitional. Article 45 requires that Member States apply their system of external monitoring to the relevant audit firms and audit engagements. It was the regulation of these audit firms which was the principal subject of the consultation in 2012.

Further Commission Decision

1.14. The European Commission is putting forward proposals that would give equivalent status to a further group of countries and extend the transitional arrangements for some other countries.

Implementation in the UK

1.15. The UK Government implemented the January 2011 decision in September 2011 and the FRC gave statutory directions in December 2011 to complete the detailed legal framework in the UK. The principal effect of the FRC directions is to dis-apply the requirement to have external monitoring arrangements in respect of third country auditors that fall under the “transitional” regime and (provided that the “equivalent” third country does not impose more onerous requirements on UK audit firms) under the “equivalent” regime.

2. Results of Consultation

Number of respondents

2.1. Nine non-confidential responses to the consultation were received and are published on the FRC website. Table 1 shows respondents by the type of stakeholder.

Audit Firms	4
Investors	3
UK Professional bodies	2
Total	9

2.2. A list of respondents is set out in **Annex 1**.

2.3. In addition, we received two informal responses from staff members in fellow EU regulators³

2.4. The FRC was grateful to all respondents for their time and effort in responding to the Consultation.

2.5. The Consultation document sought views on the application of external monitoring to third country auditors in a way that:

- Ensures that the FRC meets its obligations under the SAD
- Is proportionate to the significance of a particular issuer for UK investors and
- Has regard to the likely costs involved in monitoring the quality of the relevant audit work and auditors around the world.

2.6. Respondents raised a range of issues and made a number of helpful comments on the detail. We draw out the main points in this document.

Overview of responses

2.7. All respondents broadly supported the proposals in the paper and were of the view that they offered a measured approach to enabling the FRC to meet its obligations under the SAD without imposing costs that were disproportionate to the benefits and without exposing the FRC to excessive reputational risk. However, one consultee (ACCA), whilst broadly supportive, favoured more direct

³ Both of these were supportive of the approach we proposed, but were not formal responses on behalf of the regulators.

inspections by the FRC rather than placing reliance on alternative, less costly, approaches in lower risk cases.

2.8. A number of respondents underlined some of the difficulties raised in the consultation as likely to be faced by the FRC in trying to carry out external monitoring in widely scattered countries that do not have their own well developed systems of audit regulation. These concerns included problems in accessing audit working papers for review, privacy laws, language barriers and difficulties of operating in some of the countries.

Responses to each Consultation Question

2.9. The following analysis summarises the responses received and sets out the FRC's conclusion.

Question 1

Do you agree with the overall approach set out in the consultation document?

2.10. All the respondents broadly supported the proposals for a proportionate approach to this task. Most agreed that there were wide variations in the significance of the issuers and that a tailored approach was therefore the sensible way forward.

Ernst & Young

We agree the Board's approach to customise the extent of monitoring with the significance of the issuer. We support the Board's multi-step approach of relying on other regulators or other measures to monitor the quality assurance systems of Third Country Auditors

2.11. One respondent, whilst agreeing with the overall approach, struck a note of caution.

ACCA

Generally, we agree with the overall approach. However, care must be exercised, given the widely different business cultures and corporate governance standards in different countries. This means that, even where a country's overall significance is assessed as very low, audit failure in respect of a single issuer would have a significant adverse effect on the reputation of the [FRC] scheme.

2.12. On the other hand, another respondent questioned the significance of the relevant audits to UK investors and another highlighted the practical difficulties in meeting the requirements of the SAD.

Grant Thornton

We agree that the focus of a national audit regulator should be on audits of companies that are significant to investors in that country. In many cases, for example, a company that triggers registration requirements for a TCA will have little significance to UK investors because the listing on the relevant UK regulated market is secondary to the listing on the home country market, and the risk to UK investors, as a whole, will not be substantial.

Fidelity

I think the EU expectation is too onerous. The FRC ask the right questions and come to sensible solutions in the main. I do think it is important that there is some form of QA on auditors outside the EU but I really struggle to see how they do it...I doubt there are any easy or workable solutions.

Conclusion on Question 1

We propose to plan on the basis of the tailored approach set out in the consultation. However, we are mindful of some of the cautionary notes from consultees. In particular we accept that care is needed in assessing the significance for UK investors of the issuers and their auditors.

Question 2

Do you agree with the proposals on "Article 45" auditors set out in the Consultation document? If not, what alternative(s) would you propose?

2.13. All eight respondents who answered this question broadly agreed with the proposal to try to identify the most appropriate approach in a particular case, taking account of the assessment of the risks and the costs.

Deloitte

We support the [FRC's] flexible approach to monitoring a specific firm (or a specific group of firms in a particular country), and the use of a cost benefit analysis which includes potential reliance on a third country regulator, as well as on a global network firm's quality assurance processes, based in part, on the significance for investors in the UK regulated markets of the third country issuers being audited.

2.14. However, there are some cautionary notes about placing reliance on the work of others.

ACCA

...while we believe that these points represent a flexible and proportional approach, care should be taken if relying on another audit regulator or professional body that operates internationally....We would question whether or not the [FRC] may be in a position to judge that a body has the necessary skills in audit monitoring....

2.15. The ICAEW suggested looking to EGAOB or IFIAR to take a regulatory lead and providing a common coordinated inspection programme for small countries that could be relied upon by larger regulated countries.

2.16. One investor advises that the focus should be on issuers of ordinary shares listed on the main London market.

Association of British Insurers

We consider that greater weight should be given to the significance of those examples of companies that have equity securities with a premium listing and which therefore fall to be included in UK market indices. We think the public interest in ensuring equivalence of audit standards is higher than it would be for, say, companies with GDRs.

Conclusion on Question 2

We consider that the consultation provides a high degree of support for the proposed approach to the monitoring of “Article 45” auditors with only one consultee suggesting that we should inspect directly in more cases. We agree with the suggestion that particular priority should be given to issuers of ordinary shares on the main market.

Question 3

Do you agree with the proposals for “equivalent” registered TCAs, particularly for US audit firms set out in the Consultation document? If not, what alternative(s) would you propose?

2.17. All Five respondents who answered this question agreed with the proposal that we do not apply external monitoring to audits of issuers in “equivalent” third countries where the counterpart oversight body does not apply external monitoring to UK audit firms.

Deloitte

...we encourage the continued efforts of the [FRC] and audit regulators from third countries deemed equivalent to forge cooperative arrangements for the appropriate sharing of information.... We support this approach, particularly given the efficiency and consistency that flows from cooperation and reliance among regulators.

2.18. In this case of the US, because there is not full reciprocity, we proposed that the audit firms and audit engagements should fall within the scope of our third country monitoring regime but that we should then rely on the work of the PCAOB to the extent we judged appropriate. In practice we did not expect to initiate an general active programme of inspecting US audit firms and audit engagements, where these were within the scope of the PCAOB and they were willing to share information with us and respond to specific requests, for example to include a particular audit

engagement within their inspection programme.

2.19. There are also a few examples of US companies with a UK listing that are not SEC registrants and the relevant audits therefore fall outside the scope of the PCAOB. We proposed that we should consider undertaking our own review of these specific audit engagements, essentially treating them as “Article 45” auditors in this respect.

2.20. All five respondents who addressed this question agreed with the proposed approach.

Conclusion on Question 3

We consider that there is strong support to proceed as proposed, that is in general we do not inspect audit firms in “equivalent” countries, other than in respect of audit engagements outside the scope of the “equivalent” regulator, or where that regulator is unable to conduct such reviews to our satisfaction.

Question 4

Do you agree that the results of external monitoring should be reported to a regulatory committee of the FRC?

2.21. All six respondents to this question agreed that the results of external monitoring should be reported to a regulatory committee of the FRC. Three of these respondents stated the importance of having review and appeals procedures.

Ernst & Young

We believe it is appropriate that the results of external monitoring of TCAs are provided on a confidential basis to a regulatory committee of the FRC since the TCA firms are registered with the FRC)

2.22. One respondent stressed the importance of having a sliding scale of actions which would be taken in the case of audit issues being found following an inspection

Grant Thornton

...the FRC should undertake a graduating scale of actions, depending on the severity of the issue. We suggest the FRC first try to work with the firm to resolve the issue, which could involve return inspections to identify whether weaknesses have been addressed...

Conclusion on Question 4

We shall report the results of inspections to the Monitoring sub-committee of the FRC’s Conduct Committee. Where we propose to take action, such as removing a registration, the procedures should be similar to those proposed in respect of UK Auditor Sanctions, in particular they would include a formal appeals procedure.

Question 5

What charging structure do you consider provides a sensible and fair basis for recovering the costs of external monitoring?

2.23. We put forward two options for charging without expressing a preference:

- Option 1: Retain the current (modest) registration fees and charge separately to the relevant audit firm the costs of carrying out a specific review.
- Option 2: Restructure the registration fees for those audit firms subject to external review to include a charge per year in respect of each relevant issuer.

2.24. There were mixed views amongst the five respondents on this issue. Those favouring Option 1 argued that this was the fairer approach, was easier to understand, and would enable the audit firm to indicate to the issuer the costs associated with being an issuer. Those favouring Option 2 - spreading the costs over all the relevant firms - considered that it would be easier for the FRC to collect the money and that this would not place too high a burden on any particular audit firm.

EY

With respect to the two options provided, we prefer the first option where there is a separate charge for the costs of carrying out the specific review rather than an annual charge per issuer based on the audit fee...

Grant Thornton

The regime for recovering the costs of external monitoring should not dictate which audit firm is available for appointment by the company...charging each audit firm the costs of the specific review – may prove prohibitively expensive for audit firms in those countries where the hourly rates for conducting an audit are very low compared to the Oversight Board’s inspection costs. In such a case it might be difficult to find an audit firm willing to continue to audit the specific issuer in question.

2.25. One consultee suggested a hybrid system, with a higher registration charge than at present for the “Article 45” audit firms, together with a specific charge for each inspection carried out, somewhat below the full costs.

Conclusion on Question 5

On balance we conclude that Option 1 is preferable for the start of the programme of external monitoring. We think that it is fairer, given in particular our intention to tailor the approach (and the costs) to the significance of the audit firm and issuers. We shall therefore charge the specific costs of quality assurance reviews to the audit firm inspected, though we shall review this in the light of experience.

Question 6

Do you consider that the information we are proposing to publish, as set out in the Consultation document, is adequate for the needs of investors? If not, what do you propose?

2.26. We proposed to publish information on third country issuers, their auditors, relevant reviews carried out. We would make clear where we had encountered barriers to carrying out monitoring. We also proposed to publish an overview of our monitoring work each year.

2.27. The five responses on this question agreed with the proposed approach. Two said that it was important that we did not publish information that identified an individual audit client.

2.28. One investor argued that disclosure was not enough when the FRC for whatever reason could not carry out audit monitoring.

ABI

Where the FRC is unable...to carry out external monitoring that it would otherwise wish...then it is at best questionable whether issuers from such jurisdictions should be eligible to retain UK listings, particularly premium listings of equity securities. We do not think it is sufficient for the FRC simply to disclose where it is unable to undertake the necessary work.

Conclusion on Question 6

There was a good measure of support for the proposals on publication. We plan to publish the names of the relevant issuers and their auditors, provide information on what inspection work we have undertaken or commissioned, though being careful not to attribute findings to individual entities. We also plan to publish an annual report on this work similar to that prepared by the FRC on its inspections of smaller UK audit firms.

We shall also make clear where there have been barriers to our monitoring the work of third country auditors and the reasons for this. We are sympathetic to the point made by the ABI and, we propose to consider case by case, where there is a lack of cooperation with the FRC inspection system, whether to remove the auditors from our register. The issuer would then be in breach of its obligations and subject to enforcement action.

Question 7

Overall, do you consider that these proposals for external monitoring provide the basis for a proportionate and practicable way of meeting the SAD requirements on quality assurance?

2.29. There was general support for this conclusion. One point to emerge was that our proposals place considerable weight on the classification of audit firms and issuers as of high, medium and low significance and that this would need to be done with rigour

Hermes

On the basis that this rigour is applied to classification, and that the classifications disclosed are representative of the assessments carried out now and into the future, we are content to support the Oversight Board's proposals as a rational and proportional response to the requirements it faces.

Conclusion on Question 7

Whilst there is a good level of support for our proposals we recognise the need to take this work forward with rigour, in particular in terms of assessing the significance of issuers and auditors.

Question 8

Do you have any comments on the assessment of costs and benefits in the Consultation document? We should welcome in particular the assessment of UK investors on the value of benefits that might flow from the two options for external monitoring reviews?

2.30. There was broad support for the order of magnitude of the costs and benefits we identified for the two options, though a recognition that a wide range of factors that were difficult to predict underlay the figures. One respondent commented that the estimated cost of £9.5k per annum per issuer (based on inspecting all the auditors) was not material in the context of obtaining and retaining a UK listing and favoured a greater reliance on direct inspection by the FRC.

Conclusion on Question 8

We recognise the difficulties of putting figures to the costs and benefits of different approaches. Overall the responses support the view that the estimates we made were reasonable and of the right order of magnitude.

Annex 1

Respondents to Consultation Document

Association of British Insurers
Association of Chartered Certified Accountants
Deloitte
Ernst & Young Global Limited
Fidelity
Grant Thornton International Limited
Hermes
Institute of Chartered Accountants in England and Wales
KPMG



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