Audit Reform and Regulation Team
Department for Business, Energy & Industrial Strategy
1st Floor, Victoria 1,
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By email: FRCConsultation@beis.gov.uk

11 June 2019

Dear Sirs

Re. Independent review of the Financial Reporting Council – responses on initial consultation

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital ("PE/VC") industry in the UK. With a membership of over 770 firms, the BVCA represents the vast majority of all UK based PE/VC firms, as well as their professional advisers. Our members have invested over £32 billion into nearly 2,500 UK companies over the last five years (2013-2017). 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 people are employed in the UK. Of the UK companies invested in during 2017, around 83% were SMEs. Between 2013 and 2017, BVCA members rescued 91 companies experiencing trading difficulties, helping safeguard over 37,000 jobs.

This submission has been prepared by the BVCA's Legal & Accounting Committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry. We support the objectives of this review and would welcome further clarification on some of the definitions used within the response, especially when determining the application to Public Interest Entities ("PIEs").

We have limited our responses to those questions 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.

Response to consultation questions

Q1 What comments do you have on the proposed objective set out in Recommendation 4?

We would expect the definition of 'wider public interest' to be clarified by the new regulator to avoid the possibility of conflicting objectives, because different stakeholders will have different views on financial reporting and governance, as well as holding to account the companies and professional advisers responsible for meeting the high standards expected.

Q2 What comments do you have on the duties and functions set out in Recommendations 5 & 6?

We note the potential conflict between the duty of the regulator to "promote competition in the market for statutory audit services" and the functions of the regulator "to set and apply high…..audit standards and monitor and report on…..the extent of any cross-subsidy from non-audit work and the implications for the quality of audit". This is because there are often potential restrictions on choice of professional service providers by our members, particularly in relation to transaction related non-audit work where one or more audit firms will often be conflicted by virtue of acting for another party to the transaction, or in an EU PIE environment, because of an audit relationship. See response to Q11 for further considerations.

Q5 How will the change in focus of CRR [Corporate Reporting Review] work to PIEs [Public Interest Entities] affect corporate reporting for non-PIEs

The impact on non-PIEs will depend on the definition of a PIE. We highlight this because Recommendation 18 suggests that the Government should review the UK's definition of a PIE. We have previously responded on the definition of PIEs, most recently in response to the FRC's Post Implementation Review of the 2016 2016 Ethical and Auditing Standards Changes to Implement the Audit Regulation and Directive[i]. See response to question 11.

Assuming that the definition of a PIE remains consistent with the current definition, it is unclear whether there will be a significant impact of this recommendation as we understand that the FRC currently undertakes little active enforcement for non-PIEs, other than for certain AIM companies. Widening the definition to include companies listed on AIM or ISDX or those companies with purely technical listings would create an administrative and reporting burden that could outweigh the benefit of such companies falling within the remit of the CRR.

We highlight that there are certain other voluntary best practices adopted by a number of our members such as the Walker Guidelines that promote strong corporate reporting and governance. Further, the UK Corporate Governance Code provides guidance on narrative reporting which can be used by non-PIEs to enhance narrative reporting disclosures. Such avenues will remain open to non-PIE companies. We would recommend that the new regulator promote the benefits of such frameworks to increase their usage by non-PIE entities rather than seeking to bring more entities within the PIE definition.

Q7 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We note that Recommendations 35 and 36 refer to 'Public Interest Entities'. We would again seek clarity on this definition given the possibility of change in the future as mentioned above.

Q8 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

With reference to Recommendation 45, we note that duties to report concerns around the going concern status of an audited company already exist. We agree this could be broadened out to include situations where the auditor identifies poor governance or concerns around viability.

With reference to Recommendation 51 when looking to determine the extent of a UK equivalent to Sarbanes-Oxley, we would agree that special consideration would need to be given to proportionality in relation to the size of the company in order to properly scope the requirements and ensure that the benefits outweigh the costs that would be borne by companies within the scope of the regime.

Q11 Are there specific considerations you think should be borne in mind when taking forward the recommendations in this chapter? Are there other ideas we should consider?

With reference to Recommendation 72, we refer you to our response to FRC's Post Implementation Review of the 2016 2016 Ethical and Auditing Standards Changes to Implement the Audit Regulation and Directive. We raised concerns on the restrictions on choice that occurs in limiting the level of non-audit work for PIEs, which would be compounded if the scope of PIEs was 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 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, it is common for PE/VC firms to have several portfolio companies that are audited by different audit firms. The PE/VC firm is then potentially 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.

We would be happy to discuss the contents of this response with you; please contact Gurpreet Manku (gmanku@bvca.co.uk).

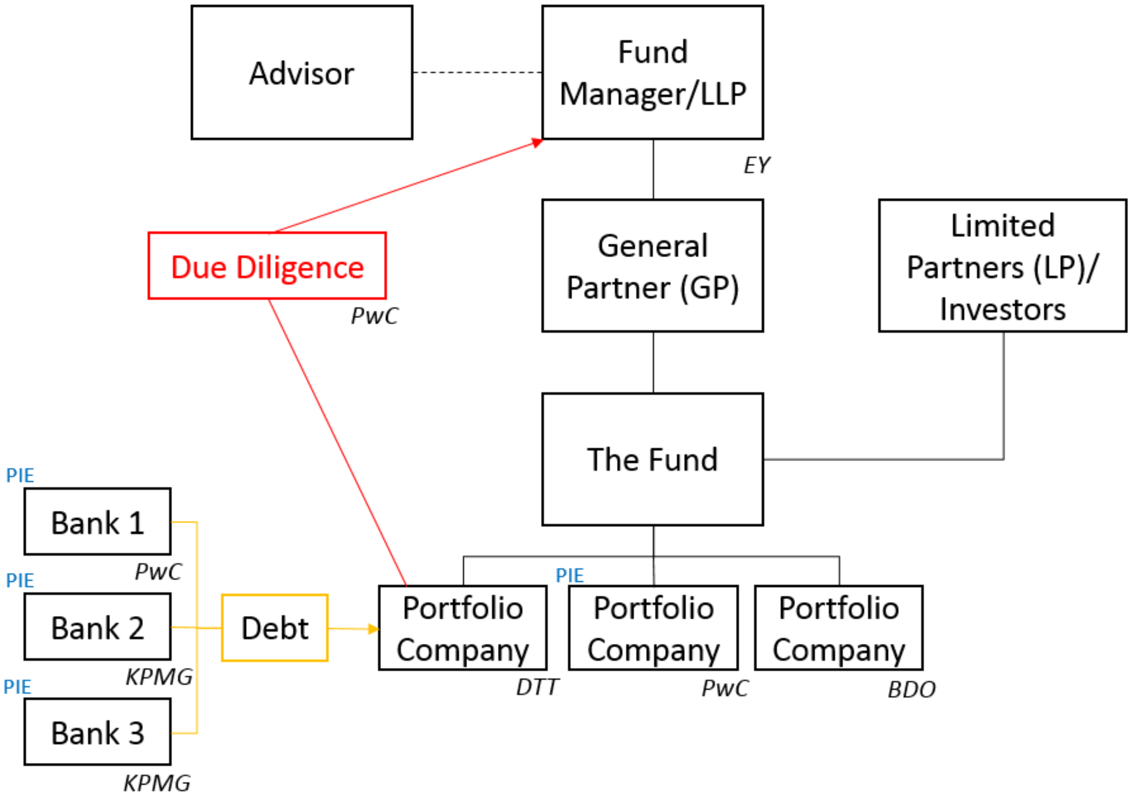
Yours faithfully,

Amy Mahon
Chair, BVCA Legal and Accounting Committee

[i] BVCA response to the FRC's Post Implementation Review: 2016 Ethical and Auditing Standards Changes to Implement the Audit Regulation and Directive – Call for feedback (February 2019)

Appendix 1

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



Appendix 2

For clarity, we have listed below the recommendations that have been referred to in our response.

Recommendation 4
The Review proposes that the new regulator should have the following strategic objective:

"To protect the interests of users of financial information and the wider public interest by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards."

Recommendation 5
The full set of duties that the Review proposes be placed on the new regulator are below, requiring that it should act in a way which:

- Is forward-looking, seeking to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term;
- Promotes competition in the market for statutory audit services;
- Advances innovation and quality improvements;
- Promotes brevity, comprehensibility and usefulness in corporate reporting;
- Is proportionate, having regard to the size and resources of those being regulated and balancing the costs and benefits of regulatory action;
- Is collaborative, working closely with other regulators both in the UK and internationally; and
- Prioritises regulatory activity on the basis of risk, having regard to the Regulators' Code

Recommendation 6
The Review recommends that the new regulator's duties will guide the new regulator in carrying out its core functions on audit and corporate reporting. The Review proposes that its functions should also include:

- To set and apply high corporate governance, reporting and audit standards;
- To regulate and be responsible for the registration of the audit profession;
- To maintain and promote the UK Corporate Governance Code and the UK Stewardship Code, reporting annually on compliance with the Codes;
- To maintain wide and deep relationships with investors and other users of financial information;
- To monitor and report on developments in the audit market, including trends in audit pricing, the extent of any cross-subsidy from non-audit work and the implications for the quality of audit; and
- To appoint inspectors to investigate a company's affairs where there are public interest concerns about any matter that falls within the Authority's statutory competence.

Recommendation 18
The Government should review the UK's definition of a PIE.

Recommendation 35
The Review recommends that enforcement action against accountants in relation to apparent wrongdoing in Public Interest Entities should be undertaken by the regulator on a statutory basis. The current voluntary scheme should be discontinued and replaced with a new statutory regime

with tests and powers aligned and similar to those in the AEP. Those in scope would be judged against the requirements that already apply to them (legislative requirements, financial reporting standards and professional ethical standards).

Recommendation 36

The Review recommends that the Government, working with the new regulator, should task the regulator to develop detailed proposals for an effective enforcement regime in relation to Public Interest Entities that holds relevant directors to account for their duties to prepare and approve true and fair accounts and compliant corporate reports, and to deal openly and honestly with auditors. The Review recommends that this should apply to: a company's CEO, CFO, chair, and audit committee chair.

Recommendation 45

The Review recommends that the Government introduces a duty of alert for auditors to report viability or other serious concerns. The regulator should also take a close interest, and engage with the auditor, in situations where a PIE auditor has parted company with its client outside the normal rotation cycle.

Recommendation 51

BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from operation of the Sarbanes-Oxley regime in the US. The pros and cons of options for change should be analysed and consulted upon, giving special consideration to the importance of proportionality in relation to the size of the company.

Recommendation 72

In addition to a competition duty, the Review also recommends that the regulator should be given a specific statutory function to keep the statutory audit market under review and to report regularly on market and competition developments. This will need to include reporting on trends in audit pricing, the extent of any cross-subsidy from non-audit work and any implications for the quality of audit.