



Department  
for Business  
Innovation & Skills

## AUDITOR REGULATION

Consultation on the technical  
legislative implementation of the  
EU Audit Directive and  
Regulation

OCTOBER 2015

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## 2. Introduction

- 2.1** Effective financial reporting is essential to the functioning of capital markets. It underpins the development of first class businesses – those that others are willing to invest in and to do business with. It provides the basis for sound commercial decision making, and provides trust and confidence.
- 2.2** Audit is an essential safeguard to provide independent assurance that the financial reporting of businesses properly reflects their circumstances, and helps to maintain the integrity of the UK business environment.

### The EU Audit Directive and Regulation

- 2.3** Following on from the earlier Discussion Document<sup>1</sup> we are now consulting on implementation of Directive 2014/56/EU (“the new Directive”<sup>2</sup>) and Regulation 537/2014 (“the Regulation”<sup>3</sup>). Both the new Directive and the Regulation were published in the Official Journal of the European Union in May 2014. The new Directive amends Directive 2006/43/EC (“the 2006 Directive”<sup>4</sup>) and applies to all audits required by EU law. The Regulation applies to all audits of “Public Interest Entities” (or PIEs) as defined in the 2006 Directive as amended and implemented in national law, including credit institutions, insurers, issuers of securities on regulated markets in the EU and other entities designated by the Member State.
- 2.4** The Regulation will apply from 17 June 2016, by which time the new Directive must also have been transposed into national law. The Directive requires minimum harmonisation of requirements at the European level and also gives the opportunity for Member States to exercise derogations and options. The Regulation has a direct effect in law and requires maximum harmonisation at the European level. Unusually for a regulation, it also includes some Member State options.

### This Consultation

- 2.5** This Consultation document sets out the Government’s proposals on the transposition of the Directive into UK law and on legislative provisions needed as part of the application of the Regulation.
- 2.6** The focus remains on identifying legislative, and non-legislative, actions necessary to:
- Strengthen standards for the audit of Public Interest Entities (PIEs);
  - Improve confidence in the independence of auditors;

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<sup>1</sup> The Discussion Document is available at:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/400231/bis-14-1285-auditor-regulation-discussion-document-on-implications-of-eu-and-wider-reforms.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/400231/bis-14-1285-auditor-regulation-discussion-document-on-implications-of-eu-and-wider-reforms.pdf) .

<sup>2</sup> The new Directive is available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32014L0056> .

<sup>3</sup> The Regulation is available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537> .

<sup>4</sup> The European Commission has published a consolidated text of the 2006 Directive as amended by the new Directive at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02006L0043-20140616>

- Avoid excessive concentration in the audit market; and
- Make audit reporting more informative.

**2.7** The Government is committed to a minimal implementation approach, which means applying only the mandatory changes required by the EU reforms and other changes that would result in a benefit to the UK business environment.

## The BIS Discussion Document

**2.8** This Consultation document builds on the Discussion Document on the implications of the EU and wider reforms<sup>5</sup> that was published in December 2014. This was accompanied by options tables on the Directive and the Regulation and followed by supplementary information<sup>5</sup> on the provisions in the Regulation on mandatory retendering and rotation of auditor appointments.

**2.9** Following consideration of the responses to the Discussion Document, Baroness Neville Rolfe made a written statement in the House of Lords<sup>6</sup> on 20 July announcing that the Financial Reporting Council would be the designated UK competent authority with ultimate responsibility for regulatory tasks under both the 2006 Directive as amended, and the Regulation.

**2.10** The Government has also published the responses<sup>7</sup> received to the Discussion Document and will also publish a summary of responses alongside this document.

## Other consultations

**2.11** Related activity is being taken forward by: the Financial Reporting Council (FRC); Financial Conduct Authority (FCA); and the Prudential Regulation Authority (PRA). An update<sup>8</sup> on consultation activity being undertaken by these organisations has been published on the BIS website.

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<sup>5</sup> BIS's supplementary information document is available at:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/412094/BIS-15-180-auditor-regulation-supplementary-information-the-implications-of-the-EU-and-wider-reforms.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/412094/BIS-15-180-auditor-regulation-supplementary-information-the-implications-of-the-EU-and-wider-reforms.pdf)

<sup>6</sup> The text of Baroness Neville Rolfe's written statement is at <http://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Lords/2015-07-20/HLWS137/>

<sup>7</sup> The responses to the Discussion Document can be viewed at <https://www.gov.uk/government/consultations/auditor-regulation-effects-of-the-eu-and-wider-reforms>

<sup>8</sup> The update page on the BIS website is at <https://www.gov.uk/government/publications/eu-audit-directive-and-regulation-implementation-update/update-on-the-implementation-of-the-eu-audit-directive-and-regulation>

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## 3. How to respond

- 3.1** Responses to this consultation or questions about the policy issues raised in the document should be addressed to:

Paul Smith  
Corporate Frameworks, Accountability and Governance Team  
Department of Business, Innovation and Skills  
1 Victoria Street  
London  
SW1H 0ET  
Tel: 020 7215 4164  
Email: [pauld.smith@bis.gsi.gov.uk](mailto:pauld.smith@bis.gsi.gov.uk)

- 3.2** Responses to the consultation must be submitted by close on 9th December 2015.
- 3.3** When responding to this consultation please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear which organisation and, where applicable, how the views of members of the organisation were assembled.
- 3.4** Please note that the Government is seeking to handle and consider responses to this consultation document in line with the principles that it has stated Government departments and other public bodies should adopt for engaging stakeholders when developing policy and legislation. These are set out in the following document:

<http://www.cabinetoffice.gov.uk/sites/default/files/resources/Consultation-Principles.pdf>

- 3.5** You are encouraged to read the confidentiality and data protection information in Chapter 15 of this document.

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## 4. Executive Summary

- 4.1** This is a technical consultation on changes to the regulation of auditors in the UK. The Government is grateful for the helpful debate among the audit and accounting professions, companies, and investors as users of audited accounts. The 43 responses we received to the earlier Discussion Document on *Auditor Regulation* showed a large measure of consensus on the answers, and support for the Government's approach of not making additional unwarranted changes.
- 4.2** This technical consultation includes:
- the Government's intention not to include additional entities in the definition of a Public Interest Entity (PIE). This means that PIEs will only be those entities with securities admitted to trading on a regulated market, banks, building societies, and insurers. Companies traded on AIM will not be PIEs.
  - the requirement that all PIEs put their audit out to tender at least every 10 years and change their auditor at least every 20 years. We have also set out transitional arrangements for PIEs who first appointed their current auditor in the 13 years up to the application date for the Regulation.
  - the underpinning legislation needed for the Financial Reporting Council (FRC) to introduce changes in ethical and technical standards for auditors as part of the implementation of the new Directive and Regulation.
- 4.3** The Discussion Document proposed the FRC should be the competent authority under the new framework. Following consideration of the responses the Government announced in July that the FRC would be designated as the competent authority, and set out how the FRC would delegate tasks to the Recognised Supervisory Bodies (RSBs). This will mean the FRC will only have to conduct audit inspections, investigations and disciplinary cases in relation to PIEs, and oversee the work of the RSBs for other audits. However it would still be open to an RSB to agree the FRC would undertake work that would otherwise have been delegated. As now, the FRC would also have the ability to take over any particular inspection or investigation, if it deemed it to be in the public interest.
- 4.4** The draft implementing regulations and draft amendments to the Companies Act we are publishing now include measures to deliver all of the above changes. They also include measures to make ineffective any agreement with a third party that restricts an audit client's choice of auditor. As well as being required as part of the EU reforms, this measure was recommended by the Competition and Markets Authority.
- 4.5** Further provisions, described in detail in this consultation, will be included in the final implementing regulations. These will cover:
- removal of auditors of PIEs by application to the court by the competent authority or a sufficient minority of shareholders or members; and,
  - application of the implementation of the 2006 Directive (as amended) to additional entities audited under EU law.

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- cooperation between competent authorities, transferring information and confidentiality;
  - the reporting by auditors of PIEs to supervisory authorities; and,
  - the role of competent authorities in relation to the functioning of the audit market for PIEs.

**4.6** This consultation is one of four consultations being conducted in parallel on the implementation, by different regulatory authorities. This includes the FRC's consultation on the detailed changes needed to its ethical standards, auditing standards, UK corporate governance code and guidance on audit committees. Overall the Government supports an approach to implementation that makes full use of non-legislative as well as legislative means.



# 5. Which audits are affected?

*This chapter is about application of the Regulation and Directive. A key element of the EU audit reforms is the definition of a Public Interest Entity (PIE), which determines which businesses are subject to the Regulation. The Discussion Document also considered which organisations should be covered by the 2006 Directive as amended by the new Directive<sup>9</sup>.*

## Summary of changes required

**5.1** The Audit Regulation is directly applicable in law and contains legal provisions specifically for audits of Public Interest Entities (PIEs). A PIE is defined<sup>10</sup> as an entity that either:

- issues transferable securities that are admitted to trading on a regulated market in the EU<sup>11</sup>;
- is a credit institution<sup>12</sup> (a bank or building society, though not a credit union);
- is an insurance undertaking<sup>13</sup>; or,
- is designated by a Member State as a public interest entity (for instance because of its business, size, or the number of its employees).

**5.2** Based on the responses to the Discussion Document and stakeholder feedback, the Government has now concluded that it should not take up the Member State option to define additional PIEs for the purpose of the application of the Regulation and the provisions of the Directive applying to audits of PIEs.

**5.3** Draft implementing regulations, including the definition of a “Public Interest Entity”, are published with this consultation document.

**5.4** This definition is contained in the Directive so must be implemented by Member States. The areas where this definition will be used as part of the BIS implementation include:

- the allocation of responsibility for inspections, investigations and sanctions for PIE audits to the competent authority;
- the application of the framework on mandatory auditor rotation and retendering for PIE audits; and,

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<sup>9</sup> This was all covered in Section 4.1 of the Discussion document.

<sup>10</sup> Article 1 paragraph 2 point (f) of the Directive replaces the definition of “Public Interest Entity” in the 2006 Directive with a new definition, containing updated references to other EU instruments and other minor changes, which applies for the purpose of the new Directive; the 2006 Directive as amended by the new Directive; and the Regulation.

<sup>11</sup> Within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC – the “Markets in Financial Instruments Directive” (MiFID).

<sup>12</sup> As defined in point 1 of Article 3(1) of Directive 2013/36/EU – the “Capital Requirements Directive (CRD IV)”. Credit institutions referred to in Article 2 of that Directive (Credit Unions) are explicitly excluded.

<sup>13</sup> Within the meaning of Article 2(1) of Directive 91/674/EEC – the “Insurance Accounts Directive”.

- the application of the framework allowing the shareholders to secure the removal of the auditor of a PIE.

**5.5** The Financial Reporting Council (FRC) is consulting separately in parallel on amendments to its ethical and auditing standards to apply relevant requirements of the Regulation to the audits of PIEs. Principally, these changes relate to ensuring the independence and objectivity of the auditor through:

- the application of the blacklist of non-audit services, which the auditor is not able to provide to its audit clients;
- the cap on the value of those permitted non-audit services that are provided;
- the content of the auditor's report; and,
- other more technical changes.

#### **Differences between entities covered by the 2006 Directive and the new Directive**

**5.6** The implementation of the 2006 Directive in Part 42 of the Companies Act 2006 applied to all entities whose accounts were, at that time, required to be audited under EU law<sup>14</sup>.

**5.7** Under the new Directive, it is necessary to include in the implementation for the first time all UK entities whose accounts are now required to be audited under EU law<sup>15</sup>. The implementation of the 2006 Directive, as amended by the new Directive will need to be extended to include these entities, which are mainly non-listed entities in the financial sector other than, building societies and insurers.

**5.8** A further change in scope, with the amendments made by the new Directive, results from the removal of the option to exclude non-listed entities from the requirements that applied to PIEs under the 2006 Directive. This means that:

- unlisted insurers and unlisted banks and building societies will have to have an audit committee - the Prudential Regulation Authority (PRA) is currently consulting on new rules on audit committees for PRA regulated entities;
- auditors of unlisted banks and insurers will need to comply with more stringent ethical standards covering independence and objectivity, on which the FRC is now consulting; and,
- auditors of unlisted banks and insurers that do not also audit listed entities will be required for the first time to prepare an annual transparency report – in due course, this will be the subject of consultation by the FRC.

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<sup>14</sup> At the time of implementation of the 2006 Directive undertakings covered by this requirement were companies; qualifying partnerships; banks and building societies; and insurers. Having applied the implementation to companies the UK also applied it to Limited Liability Partnerships (LLPs).

<sup>15</sup> These are: issuers of securities admitted to trading on a regulated market; electronic money institutions; payment institutions; MiFID investment firms; Undertakings for Collective Investment in Transferable Securities (UCITS); and Alternative Investment Funds (AIFs).

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- 5.9** Having considered responses to the Discussion Document, we intend to amend the application of Part 42 of the Companies Act 2006 (“the Companies Act”) to implement these changes. Responses to the Discussion Document agreed with our view that, in practice, a large majority of the entities brought within scope will already be subject to Part 42, because they are incorporated as companies or structured as qualifying partnerships.
- 5.10** On this basis we intend to phase the introduction of changes. As the changes are likely to be minimal, we have not included draft regulations with this consultation. However, draft regulations, including some amendments to entity specific legislation, will be published on the BIS website for informal comment in the coming months. It is our intention to make similar amendments to LLP specific legislation as for those entities that are subject to the Directive in EU law. However this may be on a longer timeframe, as these changes are not required as part of the EU reforms.

# 6. How are audits regulated?

*This chapter is about changes to the regulatory framework and the roles of the Financial Reporting Council (FRC) and Recognised Supervisory Bodies (RSBs)<sup>16</sup> in respect of quality assurance, standard setting, investigations and sanctions, approval, registration and CPD of auditors*

## Single competent authority

### Summary of changes required

- 6.1** The Regulation and the new Directive require changes to the structure of the UK's framework for audit regulation. They set out a regime where the Government must either be, or must designate, a competent authority with ultimate responsibility for all the regulatory tasks provided for in the 2006 Directive (as amended) and the Regulation.
- 6.2** Under the changes, the Government may allow or require the designated competent authority to delegate tasks to other authorities or bodies designated, or otherwise authorised by law, to carry out such tasks. Alternatively the Government may delegate tasks directly to other authorities or these bodies. Any delegation of tasks must specify the conditions under which the tasks are to be carried out.
- 6.3** We understand the European Commission interprets the Directive to mean that the competent authority with ultimate responsibility (and any other designated authority) must be governed wholly by non-practitioners, who are knowledgeable in areas relevant to statutory audit.

### Government Proposals – Single competent authority and delegation of tasks

- 6.4** Following consideration of the responses to the Discussion Document, Baroness Neville Rolfe made a written statement in the House of Lords on 20 July announcing that the Financial Reporting Council (FRC) would be designated as the UK's competent authority with ultimate responsibility for regulatory tasks under the 2006 Directive (as amended) and the Regulation.
- 6.5** The statement went on to explain that legislation would require the FRC to delegate regulatory tasks so far as is possible to the existing Recognised Supervisory Bodies (RSBs), where they meet criteria set out in the legislation. This would mean the FRC would only have to conduct audit inspections and investigations and apply sanctions in relation to audits of PIEs, and would delegate the regulation of other audits to the RSBs and then oversee that work. It would still be open to an RSB and the FRC to agree that the FRC will undertake work that would otherwise have been delegated to the RSB. As now the FRC would also have the ability to take over any particular inspection or investigation if it considered it to be in the public interest.

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<sup>16</sup> These issues were covered in Sections 4.2, 5.8, 5.9 and 5.10 of the Discussion Document.

- 6.6** Finally the statement explained that to minimise the compliance cost for business the FRC and the RSBs will be obliged to cooperate with each other, and the legislation will provide they should be able to rely on each other's work.
- 6.7** This effect is achieved via the provisions in the draft implementing regulations published separately as an annex to this consultation. The draft includes a provision which sets out the areas (listed in Article 32(4) of the Directive) for which the FRC, as competent authority, is responsible. There is also provision for:
- delegating tasks to RSBs (except certain tasks relating to PIEs whose delegation is prevented by Article 24(1) of the Regulation); and,
  - reclaiming such tasks on a case by case basis, and in relation to classes of auditors or audited entities.
- 6.8** This framework is intended to supplement and amend the provisions currently in Schedule 10 to the Companies Act, which set out the conditions bodies must fulfil in order to qualify as RSBs under that Schedule.

<b>Tasks outlined in Article 32(4) of the Directive</b>	<b>FRC role, responsibilities and powers</b>	<b>Roles and responsibilities delegated to RSBs</b>
Audit inspections, investigations and discipline	<p>Ultimate responsibility.</p> <p>Conduct of inspections and investigations and application of sanctions for audits of PIEs.</p> <p>Delegation and reclamation of tasks in relation to non-PIEs.</p> <p>Provision is also made to facilitate agreement between the FRC and the RSBs on delegation and reclamation of tasks and to resolve disputes.</p>	<p>The FRC must delegate the conduct of inspections and investigations and the application of sanctions for non-PIEs.</p> <p>The FRC will be able to retain or reclaim such a task:</p> <ul style="list-style-type: none"> <li>• for a class of auditors or audited entities, where it reasonably considers the RSB is unable to fulfil it;</li> <li>• on a case by case basis where this is justified in the public interest; or,</li> <li>• where the FRC and the RSB agree.</li> </ul>

Tasks outlined in Article 32(4) of the Directive	FRC role, responsibilities and powers	Roles and responsibilities delegated to RSBs
Approval of persons as eligible for appointment as statutory auditors; and registration of approved persons	<p>Ultimate responsibility</p> <p>Determining the criteria for approval as a condition of delegation of the task of approval.</p> <p>Delegation and reclamation of the tasks of:</p> <ul style="list-style-type: none"> <li>- approval of statutory auditors or of EEA auditors to practice in the UK; and,</li> <li>- registration of approved statutory auditors or EEA auditors.</li> </ul>	<p>Operational responsibility for:</p> <ul style="list-style-type: none"> <li>• approval and registration of individuals and firms as eligible for appointment as statutory auditors; and,</li> <li>• approval and registration of EEA auditors to practice in the UK.</li> </ul>
Continuing Professional Development for individual statutory auditors	<p>Ultimate responsibility</p> <p>Approval of rules on Continuing Professional Development for auditors.</p>	<p>Application and monitoring of Continuing Professional Development requirements for auditors.</p>

Note: For Standard setting see chapter 8

**6.9** The draft implementing regulations include provisions on the allocation and delegation of tasks in line with the table above through a combination of amendments to Schedule 10 to the Companies Act and new provisions in stand-alone regulations under the European Communities Act. These are extensive, particularly in respect of inspections, investigations, sanctions and standard setting.

**6.10** Although the practical effect is similar to current UK practice, there is a significant change in that the FRC's responsibilities are set out in legislation and the FRC has ultimate responsibility. This replaces the current regime where the FRC's audit inspection, investigation, sanctions, and standard setting functions are carried out by agreement with the RSBs to meet the requirements of those bodies for recognition under the Companies Act.

**6.11** The overall implementation of this framework would be through a combination of legislative and non-legislative mechanisms. Non-legislative mechanisms would include delegation agreements between the FRC and the RSBs and directions from the Secretary of State.

## Recognition of statutory auditors from another Member State

### Summary of changes required

- 6.12** The 2006 Directive set out the circumstances under which an audit firm approved in one Member State (the home Member State) could provide audit services in another Member State (the host Member State). The new Directive essentially makes the host Member State responsible for oversight of any audit carried out in the host Member State by such an auditor.
- 6.13** The new Directive amends the framework in the 2006 Directive for the approval of an individual already approved in another Member State as a statutory auditor. The amended framework retains the requirement for the individual to register. However it requires the Member States to decide whether individuals should complete an adaptation period, or pass an aptitude test in line with the existing requirement, or whether to allow individuals to decide between these routes.

### Government Proposals – Recognition of statutory auditors from another Member State

- 6.14** The draft implementing regulations provide for the approval and registration of EEA auditors (approved in another Member State) by amending the provisions on eligibility for appointment as a statutory auditor in Schedule 10 to the Companies Act. In our Discussion Document we suggested that the competent authority with ultimate responsibility should be able to determine whether in order to register as eligible for appointment as a statutory auditor, an EEA auditor should be subject to an aptitude test or to an adaptation period or able to choose. The draft amendments take this approach.

## Quality assurance of statutory auditors

### Summary of changes required

- 6.15** The main changes are:
- inspections of all audits of PIEs will have to be conducted by the competent authority with ultimate responsibility;<sup>17</sup>
  - the frequency of inspections of auditors of those PIEs that come within the EU definitions of small and medium sized undertaking for accounting purposes is reduced (from at least once every 3 years to at least once every 6 years);
  - the RSBs will no longer conduct inspections of PIE audits, even where audit firms only have a small number of clients that are PIEs, as is presently permitted under the Companies Act;

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<sup>17</sup> Note that with the removal of the option to exclude auditors only of unlisted PIEs from the previous requirement in the Directive to require inspection of auditors of PIEs every 3 years, the range of entities within the scope of the PIE audit inspection regime and the 3 year PIE inspection cycle is increased to include auditors of unlisted banks, building societies and unlisted insurers.

- those firms that only audit non-PIE undertakings that are small for accounting purposes will no longer be required by law to be subject to the 6 year minimum frequency for inspections – see Article 29 of the 2006 Directive, as amended, which applies to non-PIE audits; and,
- there are additional requirements, in respect of inspections of PIE and non-PIE audits, on the detail of how inspections are to be organised and what they must cover.

## Government Proposals – Quality assurance of statutory auditors

**6.16** The draft implementing regulations disapply the existing audit inspection framework under the Companies Act so that the Regulation can apply directly to inspections of the audits of PIEs. Furthermore for inspections of auditors who only audit small non-PIEs the requirement that the frequency of these inspections must be at least once every six years is repealed. Instead the frequency of these inspections may be determined on the basis of assessment of the risks arising from the auditor’s work. This provides greater flexibility to the RSBs to allow a greater risk-based element to the RSBs’ inspection programmes.

## Investigations, sanctions and powers

### Summary of changes required

- 6.17** Currently, the 2006 Directive requires simply that Member States ensure that there are “*effective systems of investigation and penalties to detect, correct and prevent inadequate execution of the statutory audit*”. The 2006 Directive, as amended, retains this but goes on to specify minimum requirements in terms of sanctioning powers, sanctions guidance, publicity, appeals and reporting of breaches. These requirements apply to statutory auditors and audit firms in respect of all statutory audits, and there are a number of Member State options.
- 6.18** Article 23 of the Regulation grants specific powers to the single competent authority in respect of statutory audits of PIEs. It enables the single competent authority to carry out onsite inspections and investigations, to refer matters for criminal prosecution and request experts to carry out verifications of investigations. These new powers can not only be used in relation to those carrying out statutory audits of PIEs, but also to their affiliates, related third parties and those to whom certain functions in relation to the statutory audit have been outsourced.

## Government Proposals – Investigations, sanctions and powers

**6.19** In relation to the Member State Options in this area, which were considered in the Discussion Document, the Government:

- does not intend to exclude infringements that are already subject to criminal law from the scope of administrative sanctions;
- intends that competent authorities or other authorised bodies retain the ability to apply other sanctions;
- does not consider it is necessary to specify in law “additional factors” that may be taken into account in determining administrative sanctions;



- intends to continue to permit publication of sanctions that are the subject of an appeal; and,
- does not consider there is need to make specific provision on the publication of personal data, as this is covered by legislation of general application on protection of such data.

**6.20** This approach is reflected in the draft implementing regulations. Also reflected in the regulations is the Government's proposed approach in relation to a further option which was omitted from the Government's consideration in the Discussion Document and accompanying options tables. Paragraph (1)(e) of Article 30a of the 2006 Directive as amended makes clear that the competent authority should have powers to suspend directors of PIEs from acting for up to 3 years.

**6.21** However paragraph (2) of the same Article provides that this power may be exercised in collaboration with another authority and / or by application to the courts. We intend that, if ever FRC needs to exercise this power, it should do so in collaboration with the Secretary of State using existing powers under the Directors' Disqualification Act 1986.

**6.22** Finally the regulations provide a framework for the competent authority with ultimate responsibility to obtain information from third parties in relation to audits of PIEs. This is required by Article 23 of the Regulation. Paragraph 4 of that Article contains a similar provision to that in Article 30a(1)(e) of the Directive. We propose that the FRC should have powers to obtain this information directly and seek enforcement through the courts where necessary though there would be nothing to stop it working in collaboration with other authorities.

# 7. Length of audit engagements

*This chapter sets out the Government's position on mandatory rotation and retendering of PIE audit engagements, in particular how often PIEs will be required to put audit services out to tender, and how long the same auditor can continue to be engaged in repeated auditor appointments at a PIE<sup>18</sup>.*

## Existing information

7.1 The changes are outlined in section 4.4, page 28, of the Discussion Document.

7.2 This area was also the subject of supplementary information in the form of “question and answer” guidance. This was assembled jointly by BIS, the FRC and the Competition and Markets Authority (CMA) and published by BIS in March 2015.

7.3 The supplementary information document is available at:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/412094/BIS-15-180-auditor-regulation-supplementary-information-the-implications-of-the-EU-and-wider-reforms.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/412094/BIS-15-180-auditor-regulation-supplementary-information-the-implications-of-the-EU-and-wider-reforms.pdf)

7.4 The question and answer guidance will be updated to reflect the Government's conclusions.

## CMA Order

7.5 When considering how to implement changes, the starting point was to look at the CMA Order, with a view to implementing changes in as consistent a way as possible with the Order.

7.6 This is intended to allow continuity and consistency in application for FTSE 350 companies that are already subject to the Order and will then be subject additionally to the EU Regulation and/or implementing legislation.

7.7 The CMA Order is available at:

[https://assets.digital.cabinet-office.gov.uk/media/54252eae40f0b61342000bb4/The\\_Order.pdf](https://assets.digital.cabinet-office.gov.uk/media/54252eae40f0b61342000bb4/The_Order.pdf)

## Government Proposals

7.8 Following consideration of the responses to the Discussion Document, the Government has reached the following conclusions:

- The maximum duration of an engagement, for which an auditor should be appointed and reappointed annually before a tender process is required, should be ten successive accounting years;

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<sup>18</sup> These issues were all covered in section 4.4 of the Discussion Document.

- A PIE should be permitted to extend the maximum duration of the audit engagement by 10 years on the basis of a tender process for the auditor appointment for any accounting year up to and including that following the conclusion of the 10 year maximum duration;
- Consistent with the proposal in the Discussion Document and the CMA's findings, no provision should be made to enable the maximum duration to be extended by the use of joint auditor appointments, although such appointments will still be possible - This means that a tender would normally be the only way in which a PIE would be able to extend the maximum duration of the audit engagement beyond 10 accounting years; and,
- If the auditor has been re-appointed following one or more tender processes, the maximum duration of a continuous audit engagement (including joint audits) should be 20 years.

Figure 7.1 – illustration of the audit tendering and rotation framework under the UK implementation of the new Regulation



**7.9** The other elements of the process under the new Regulation would apply as envisaged in the Discussion Document. This would be by way of a minimal implementation taking advantage of the flexibilities available under the new Regulation.

- After the expiry of the maximum duration of an engagement, the auditor or any member of their network (within the EU) shall not undertake the statutory audit (either individually or as a joint auditor) of the same PIE within the following four years.
- Following the application of the Regulation, all appointments of new auditors in place of the incumbent auditor will have to be based on a tender. The audit committee (AC) should recommend at least two choices for auditor to the board and state a justified

preference for one of them. Where the board does not accept the audit committee's proposal it must state its reasons in its recommendation to shareholders on the auditor appointment.

**7.10** The remainder of this chapter considers issues where the Government's thinking on the operation of the mandatory retendering and rotation framework under the Regulation has developed since publication of the Discussion Document.

### Alternative systems or modalities for appointment of auditors

**7.11** The Regulation provides an exemption from mandatory retendering of audit engagements where the appointment of the auditor is governed by "alternative modalities" that the Member State has put in place under an option made available under the 2006 Directive.

**7.12** The Discussion Document identified the relevant alternative systems and modalities and respondents agreed that appointments of auditors under these frameworks should not be subject to mandatory tendering. On further consideration we have identified a further case in which mandatory tendering will not be required.

**7.13** The Government therefore intends to provide exemptions from mandatory tendering of PIE auditor appointments where:

- the directors appoint the auditor before consideration of the company's first annual accounts (usually at the first accounts meeting);
- the directors appoint the auditor to fill a casual vacancy in the office of auditor;
- the Secretary of State appoints the auditor because a company failed to do so; and
- the auditor of a private company has been deemed to have been reappointed under the Companies Act.

However, where such an exemption applies, the maximum duration of the resulting audit engagement would be 10 years, at which point the PIE would either change auditors or tender the audit engagement. There is no exemption available from the requirement for a tender to extend the maximum duration.

### Advanced notice to tender

**7.14** The Discussion Document (page 34) proposed linking the maximum duration of the audit engagement to a disclosed plan on retendering in a PIE's annual report. This was intended so that an early retender could still enable a 10 year extension at any time.

**7.15** Responses to the Discussion Document did not favour this approach, in part because there is no EU requirement to provide such advanced notice. We have concluded it is not necessary to create a linkage to advanced disclosure for the maximum duration of the audit engagement to be extended by an early retender, so this requirement will not be included in the implementation.

**7.16** However, the FRC is proposing advance notice of tendering and an explanation of changes on the timing of the proposed tender as good practice. This is set out further in the FRC's

current consultation on the UK Corporate Governance Code and Guidance on Audit Committees.

## Two year extension in exceptional cases

**7.17** In exceptional cases, the Competent Authority may grant an extension of the maximum duration of up to two years “where a public tendering process is conducted”<sup>19</sup>. This could allow reappointment of the incumbent auditor for up to a further two years. This will be a matter for the FRC as the Competent Authority but we consider that these two years may be an extension of:

- a maximum duration of longer than ten years on the basis of a retender that took effect at or before the end of year 10, or of
- the 10 year maximum duration, where a retender will be conducted for the appointment at the end of year 12. This cannot extend the maximum duration for the incumbent auditor to more than 20 years other than in the unlikely event that the Competent Authority grants another extension at the 20 year point.

In no case can an extension be granted which would result in a period of office that exceeds 22 years.

## Transitional provisions

**7.18** Responses to the Discussion Document expressed concern and uncertainty about PIEs that are subject to the transitional provision in Article 41(3) of the Regulation<sup>20</sup>. The supplementary information document published alongside the Discussion Document provided further clarification. However it made clear that guidance on some matters would await consideration of responses to the Discussion Document.

**7.19** Since then, in her written statement to the House of Lords, Baroness Neville Rolfe stated that the Government intended that PIEs that have tendered the audit engagement before the application date for the Regulation should benefit from transitional recognition of that tender where possible. Updated guidance will set out further detail but in summary the intention is that:

- a tender of the audit engagement resulting in the reappointment of the incumbent auditor for an accounting year beginning up to 10 years before the application date for the Regulation should be treated as a tender for the purposes of the transitional provisions. For example a PIE whose auditors were first appointed for the 2004 calendar accounting year and then reappointed on the basis of a tender for the 2013 calendar accounting year would only need to tender again for the 2023 calendar accounting year; but,
- this would only be where the tender met the objectives of the Regulation in this area to secure auditor independence by addressing threats of familiarity<sup>21</sup> and followed a

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<sup>19</sup> Article 17(6) of the Regulation.

<sup>20</sup> The audit engagements affected are those that were first entered into for accounting years beginning on or after 17 June 2004 and that continue for accounting years ending on or after 17 June 2016.

<sup>21</sup> These objectives of the mandatory retendering and rotation framework are set out in recital 21 to the Regulation.

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process broadly equivalent to that specified in the Regulation. We consider this to be a matter of judgement as to the overall effect of the tender process rather than of purely procedural requirements.

# 8. Standards and standard setting

*This chapter is about the amount and types of non-audit services that auditors of PIEs can provide to those clients; the content of audit reports and of new additional reports to audit committees; and other changes in ethical and auditing standards to strengthen the quality and independence of audits<sup>22</sup>.*

## Summary of changes required

- 8.1** The Regulation introduces considerable changes for PIEs in the UK, in respect of auditors that provide additional non-audit services:
- Audit firms are prevented from offering services that are considered to give rise to too great a risk of compromising the auditor's independence. These services are described in a "blacklist" in the Regulation.
  - The fee income from remaining permitted non-audit services is capped at 70% of the average audit fee income from that client over the 3 preceding financial years.
  - Non-audit services required by EU or national legislation, such as those required by rules issued by the FCA or PRA, are not subject to the cap.
  - In exceptional cases the FRC will also be able to waive the application of the cap for up to two years.
  - Certain exemptions are also applicable in respect of the blacklist.
  - Finally, the Regulation sets out the steps that must be taken where the total fee income to an auditor from a PIE exceeds 15% of the auditor's overall fee income. This is not a new issue for auditors in the UK and there are already stringent requirements in the UK's ethical standards for auditors which the FRC proposes to retain.
- 8.2** Separately the new Directive and Regulation include a number of changes in the ethical and auditing standards framework, mostly of limited significance in the context of the existing developed framework of standards that already applied in the UK. These include provisions on the internal organisation of audit firms; the organisation of statutory audit work; engagement quality control reviews for audits of PIEs and handling suspected irregularities.
- The new Directive inserts a revised Article 28 into the 2006 Directive which acknowledges that reporting on whether a company may continue to adopt the "going concern" method of accounting is now a separate requirement under the international auditing standards. Provision is also made for the completion and signing of a joint report where more than one auditor has been engaged, including where the conclusions are disputed between joint auditors.

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<sup>22</sup> These issues were covered in Sections 4.3 (p22), 4.5 (p38), 5.1 (p45), and 5.3 (p50) of the Discussion Document.

- The Regulation includes further provisions on reporting by statutory auditors of PIEs; an additional report by the auditor to the audit committee of the PIE; and a requirement for PIE audits to be subject to engagement quality control review.
- Finally the Directive amends provisions for audits of consolidated accounts. The changes relate to the evaluation of work undertaken by the auditor of a subsidiary undertaking in a group preparing consolidated accounts.

## Government conclusions

- 8.3** Following consideration of the responses to the Discussion Document, Baroness Neville Rolfe's written statement to the House of Lords, and the Government's update on consultation activity set out the intention that the FRC would consult on amendments to ethical and technical standards for auditors to implement these requirements.
- 8.4** The FRC is also consulting on the inclusion in ethical and auditing standards of requirements reflecting the contents of the Directive in this area. This reflects the approach to implementation of the 2006 Directive where the requirements in the Directive are implemented in UK law as requirements on the content of the standards applying to auditors. The draft implementing regulations continue this approach. A copy-out approach for UK law is adopted in respect of the required content of the standards.
- 8.5** As these proposals are the subject of a separate consultation, we are consulting here only on those provisions of the new Directive and Regulation in the area of auditing standards that will require amendments in legislation.

## Audit reporting

- 8.6** To be consistent with the previous implementation of the Accounting Directive<sup>23</sup> the Government proposes to implement the revised Article 28 of the 2006 Directive as amended via amendments to Part 16 of the Companies Act. In fact implementation of the new requirements has already begun with the implementation of the Accounting Directive<sup>24</sup>. To complete the implementation of that Article, the draft implementing regulations include further amendments to Part 16 of the Companies Act.
- 8.7** Amendments are not made to the Companies Act in respect of the application of provisions of the Regulation on the audit report or the additional report to the audit committee. Instead the FRC is consulting on the inclusion of these directly applicable provisions of the Regulation in technical standards for auditors.

## Disclosure of fees paid for non-audit services

- 8.8** The Discussion Document proposed that the Government should amend the statutory framework for disclosure by companies of payments made to their auditors for audit and

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<sup>23</sup> Directive 2013/34/EU previously replaced Article 28 of the 2006 Directive with a revised audit reporting framework. This was implemented in The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015 / 980)

<sup>24</sup> As part of the implementation of the Accounting Directive we also implemented Article 28(2)(e) of the 2006 Directive as it has now been amended by the new Directive.



non-audit services<sup>25</sup>. The Discussion Document sought views on whether the requirements for public disclosure of non-audit services in notes to the accounts should be brought into line with the required disclosure in Article 14 of the Regulation on disclosure to the competent authority.

**8.9** Having considered responses to the Discussion Document, the Government believes that disclosure of non-audit services by large companies, other listed companies and other companies that are excluded from the small and medium sized companies accounting regimes may need to be amended so that services required by EU or national legislation are disclosed under a separate heading from other non-audit services. This information would be needed in part to monitor compliance with the cap on non-audit services, where services required by EU or national legislation are exempt. However, given that the cap on non-audit services will not apply for the first time until the first accounting year beginning on or after 17 June 2019, this amendment is not urgent.

**8.10** However amendments to this framework are needed in any case to complete the implementation of the new Accounting Directive<sup>26</sup> following the Government's consultation on the implementation of chapters 1-9 of the Directive in August 2014<sup>27</sup>. Having considered responses to the 2014 consultation, the Government has concluded that it should:

- revoke requirements for disclosure of audit and non-audit fees by companies that may prepare accounts under the small companies accounting regime;
- revoke the requirement for disclosure of non-audit fees by companies that may prepare accounts under the medium sized companies regime; and,
- require subsidiaries that are audited by an auditor other than the auditor of the consolidated group accounts to make a disclosure in the notes to their own accounts, as their audit and non-audit fees will not have been disclosed in the consolidated disclosure in the group accounts.

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<sup>25</sup> This is in the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (2008/ 489) as amended by the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011 (SI 2011 / 2198)

<sup>26</sup> 2013/34/EU

<sup>27</sup> The consultation is available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/350864/bis-14-1025-implementation-of-eu-accounting-directive-chapters-1-to-9-consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/350864/bis-14-1025-implementation-of-eu-accounting-directive-chapters-1-to-9-consultation.pdf)

# 9. Removal of auditors

*This chapter sets out the Government's position regarding which groups, and the circumstances in which these groups, can seek the dismissal of auditors<sup>28</sup>.*

## Summary of changes required

- 9.1** The new Directive amends Article 38 of the 2006 Directive to enable certain parties to seek the dismissal of the statutory auditor of a PIE. Member States must provide that these parties can bring a claim before a national court for the dismissal of the statutory auditor of a PIE, where there are “proper grounds” for doing so. These parties are:
- shareholders representing five per cent or more of the voting rights or of the share capital;
  - the competent authority (or authorities); and,
  - any other bodies of audited entities, where this is provided in national legislation. The Discussion Document proposed not to take up this option and following consideration of the responses, the Government has concluded it should not do so.
- 9.2** As was explained in the Discussion Document, Article 38 of the 2006 Directive already provides that divergence of opinions on accounting treatments or audit procedures are not “proper grounds” for dismissal. Following consideration of responses to the Discussion Document, the Government does not intend to prescribe what may constitute “proper” or “improper” grounds for dismissal of auditors, other than to state that divergence of opinions on accounting treatments or audit procedures shall not be “proper grounds”.

## Government proposals

- 9.3** Given this decision, we have not included draft legislation on this point in this consultation, although we intend to publish draft regulations that show how the amendments made to provisions in the 2006 Directive will be implemented. These will be made available during the coming months. They will include draft amendments to the Companies Act.

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<sup>28</sup> This area was covered in section 5.7 (p59) of the BIS Discussion Document on auditor regulation.

# 10. Cooperation, transferring information and confidentiality

*This chapter is about the transfer of information between incumbent auditors and their successors; confidentiality requirements on competent authorities; the formation and a new committee as a pan European body to facilitate cooperation between EU competent authorities; cooperation agreements between EU competent authorities and competent authorities in third countries; and requirements on the audit of third country issuers.*

## Transferring information and confidentiality of information

**10.1** The Discussion Document<sup>29</sup> considered four provisions in the Directive and the Regulation on this subject:

- Article 15 of the Regulation requires statutory auditors to keep all the documentation related to a statutory audit of a PIE for a period of at least five years and allows Member States to set a longer period. Therefore, we asked for views on whether provision was needed to make sure breaches of this Article could result in sanctions under the rules applied to statutory auditors. Having considered this further, in the light of responses, the Government intends to amend paragraph 10A of Schedule 10 to the Companies Act for this purpose. The FRC is currently consulting on the introduction of a requirement for retention in the UK for six years.
- Article 18 of the Regulation requires the auditor of a PIE, upon leaving office, to make information available to the successor firm. This extends existing requirements in the 2006 Directive so that information included in the additional report to the audit committee, the transparency report and reports by the auditor to supervisors of PIEs, must also be made available to the successor firm. Having considered this further and considered responses to the Discussion Document, the Government has concluded that the requirement in paragraph 9 of Schedule 10 to the Companies Act should be amended so to make this requirement part of the rules applicable to statutory auditors.
- Article 22 of the Regulation imposes a confidentiality requirement on competent authorities, authorities to which tasks have been delegated and their employees and associates. It reflects a similar provision in Article 36(2) of the 2006 Directive so, having considered this further and considered responses to the Discussion Document, the Government currently considers that no amendment is needed to Section 1224A of the Companies Act.
- Paragraph 17 of Article 1 of the new Directive amends existing provisions in Article 23 of the 2006 Directive, to clarify the position on information transfers in the case of a group audit or of an audit of a company which has issued securities in a third country. The amendments make clear that:

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<sup>29</sup> These areas were covered in section 5.6 (p57) of the Discussion Document.

- (i) the general rules on confidentiality do not prevent the transfer of information to a third country to enable the group auditors to carry out their work; but,
- (ii) any transfer of audit working papers to a third country competent authority must be in accordance with the rules on such transfers in Article 47 of the 2006 Directive.

Having considered this further and considered responses to the Discussion Document the Government has concluded that no further provision is needed in the Companies Act to make it clear that broader confidentiality restrictions do not prevent the transfer of information for the purposes of carrying out a group audit. This is because the obligation of confidentiality that applies to these transfers in section 1224A and B of Schedule 11A to the Companies Act, does not apply to transfers of audit working papers between auditors in the course of their work (e.g. auditing companies in a group).

## Cooperation between competent authorities within EU

**10.2** The Discussion Document<sup>30</sup> sets out the new arrangements that must be put in place under the Regulation for cooperation between the competent authorities of Member States responsible for the tasks in the Regulation and for their cooperation with other European supervisory authorities. The principal change made is to establish a new Committee of European Auditing Oversight Bodies (CEAOB). The European Group of Auditor Oversight Bodies (EAOB) and the European Commission are currently in the process of developing the arrangements for the CEAOB to come into operation upon the application of the Regulation.

**10.3** The Discussion Document then went on to set out the Government's view that no new provisions or amendments to existing provisions in UK law were necessary to provide for the establishment of the CEAOB. However the Discussion Document did acknowledge that some minor changes to the Companies Act might be needed to implement the changes on cooperation in the Directive. Having considered this further and considered responses to the Discussion Document the Government proposes only to make the changes that the Discussion Document identified to enable sharing of information with European financial authorities.

**10.4** The Government is therefore proposing:

- an amendment to section 1253B of the Companies Act to make clear that, in addition to an EEA competent authority, there are several "European Supervisory Authorities" that could also request an investigation by the competent authority; and,
- an amendment to Part 2 of Schedule 11A to the Companies Act to include these authorities so that transfers of information are only possible where the information is for the fulfilment of their functions.

**10.5** For the purposes of these amendments we understand the "European Supervisory Authorities" to mean:

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<sup>30</sup> These areas were covered in section 5.11 (p71) of the Discussion Document.

- the European Securities and Markets Authority;
- the European Banking Authority; and,
- the European Insurance and Occupational Pensions Authority.

## Cooperation of competent authorities with third countries

- 10.6** The Discussion Document<sup>31</sup> explained the changes that will be introduced by the new Directive and Regulation to the framework for cooperation between the competent authorities of Member States and the competent authorities of third countries.
- 10.7** The Discussion Document then went on to set out the Government’s view that no new provisions or amendments to existing provisions in UK law were necessary to provide for the establishment of the CEAOB. However the Discussion Document did acknowledge that some minor changes to the Companies Act might be needed to implement the changes on cooperation in the Directive.
- 10.8** Having considered responses to the Discussion Document , we consider that the following minor changes are needed to the effect of Section 1253A to the Companies Act:
- an amendment to bring inspection and investigation reports within scope of the definition of “audit working papers” in section 1261 to the Companies Act; and,
  - an amendment to the condition in Section 1253E(5)(a) that a transfer of audit working papers can only be made where the staff of the FRC and the third country authority are required to respect obligations of confidentiality in respect of “sensitive commercial information” – we think it will be necessary to include reference to “industrial and intellectual property”.
- 10.9** It will also be necessary to replace regulation 43 of the Statutory Auditors and Third Country Auditors Regulations 2007<sup>32</sup> with a new provision reflecting the revised threshold for a large debt securities issuer.
- 10.10** The Government has not yet prepared draft implementing regulations on the aspects of the Regulation and Directive considered in this chapter. However the proposed implementation is set out in detail here to enable respondents to this consultation to comment as fully as possible on the Government’s proposals.

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<sup>31</sup> These areas were covered in section 5.12 (p74) of the Discussion Document.

<sup>32</sup> SI 2007/3494

# 11. Other audit measures

*This chapter is about the adoption of international auditing standards in the EU; the reporting by auditors of PIEs to supervisory authorities; and the role of competent authorities in relation to the functioning of the audit market for PIEs<sup>33</sup>.*

## Technical standards – International auditing standards

- 11.1** The new Directive and Regulation establish a new framework for the adoption into EU law of international auditing standards (“ISAs”)<sup>34</sup>. This is expected to be used for the adoption of ISAs in the years following the implementation of the Directive and the application of the Regulation.
- 11.2** Any implementation of this framework, including any necessary legislation, must await the adoption of the ISAs, hence no further discussion is included in this consultation.

## Regulatory reporting and information - Report to supervisors of PIEs

**11.3** The Regulation:

- sets out information which auditors of PIEs must report to the competent authority supervising the entity (which we understand to be either the PRA or FCA in the UK);
- confers a duty on auditors to report to supervisory authorities any information concerning a legal breach or breach of administrative rules by a PIE, doubt over the continuous functioning of an audited PIE or the issuing of a qualified auditor’s report to the PIE. This duty extends to auditors of entities with close links to the PIE.

**11.4** As was explained in the Discussion Document, the Government considers the necessary requirements are already implemented for banks, building societies and insurers via:

- The Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 (SI 2587/2001).
- The PRA Code for auditor-supervisor engagement issued under section 339A(2) of the Financial Services and Markets Act 2000.

**11.5** Responses to the Discussion Document suggested that, for those PIEs that have securities admitted to trading on a regulated market and that are not banks, building societies or insurers, the FRC should also be designated to receive information required under the Article 12 of Regulation. We plan to include provision in the final regulations that will exercise the relevant Member State option in the Regulation in this way.

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<sup>33</sup> These areas were covered in sections 5.2 (p47), 5.5 (p55) and 5.13 (p76) of the Discussion Document.

<sup>34</sup> “International auditing standards” are defined to mean International Standards on Auditing (ISAs), International Standard on Quality Control (ISQC 1) and other related Standards issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB) in so far as they are relevant to the statutory audit.

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## **Monitoring market quality and competition**

- 11.6 The Discussion Document set out the obligations arising for the competent authority under this framework in Article 27 of the Regulation. It did not raise any issues for comment from respondents and explained that the framework did not require changes to legislation.
- 11.7 Following the decision that it will become the competent authority under the Regulation, the FRC with the other Member State competent authorities and European Commission are now working on arrangements to enable the initial report to be prepared at EU level on developments in the market for providing statutory audit services to PIEs.

# 12. Restrictive clauses in contracts with third parties

*This chapter sets out the Government's position on implementing the parts of the Directive and Regulation relating to prohibited contractual clauses<sup>35</sup>.*

## Summary of changes required

**12.1** The new Directive inserts the following text into 2006 Directive<sup>36</sup>:

*“Any contractual clause restricting the choice by the general meeting of shareholders or members of the audited entity pursuant to paragraph 1 to certain categories or lists of statutory auditors or audit firms as regards the appointment of a particular statutory auditor or audit firm to carry out the statutory audit of that entity shall be prohibited. Any such existing clauses shall be null and void.”*

**12.2** Article 16(6) subparagraph (1) of the Regulation provides that:

*“Any clause of a contract entered into between a public-interest entity and a third party restricting the choice by the general meeting of shareholders or members of that entity, as referred to in Article 37 of Directive 2006/43/EC to certain categories or lists of statutory auditors or audit firms, as regards the appointment of a particular statutory auditor or audit firm to carry out the statutory audit of that entity shall be null and void.”*

**12.3** Article 16(2) of the Regulation also requires that:

*“...the audit committee shall state that its recommendation is free from influence by a third party and that no clause of the kind referred to in paragraph 6 has been imposed upon it.”*

**12.4** Article 16(6) of the Regulation does not take effect until 17 June 2017, while Article 16(2) of the Regulation and the new Directive takes effect from 17 June 2016. Because the Directive applies to all audits required by EU law, including those of PIEs, in practice the prohibition of the relevant contractual clauses will be from 17 June 2016. This is apart from the requirement on PIEs to inform the competent authority of any attempt by a third party to impose a prohibited clause.

## Government proposals

**12.5** The Directive states that these restrictive clauses “...shall be prohibited” and that “Any such existing clauses shall be null and void”. We have considered what is meant by “prohibited” and “null and void” in this context. The Regulation Article 16(6) only refers to contractual clauses being “null and void” rather than “prohibited”. The Government’s preferred approach is to implement the substance of what the Directive and Regulation

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<sup>35</sup> This area was covered in section 4.4 (p31) of the BIS Discussion document on auditor regulation.

<sup>36</sup> Article 1(30) inserts this new paragraph (3) into Article 37 of the 2006 Directive.



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require by providing that the contractual clauses have no legal effect. The draft implementing regulations reflect this approach.

**12.6** As the Regulation is directly applicable, no implementing provision is needed to reflect this. However it may be helpful to explain our view that:

- the requirement of Article 16(2) of the Regulation - that the audit committee must state that its recommendation is free from influence and no contractual clause has been imposed upon it - applies from 17 June 2016 in spite of the cross reference to Article 16(6) of the Regulation (which is not applicable until 17 June 2017);
- the requirement of Article 16(6) subparagraph (2) that “*the public interest entity shall inform the competent authorities... of any attempt by third party to impose such a contractual clause or to otherwise improperly influence the decision... on the selection of a statutory auditor or audit firm*” is applicable as from 17 June 2017 and is not applicable during the preceding calendar year.

# 13. Discussion - Impact Assessment

**13.1** The consultation stage Impact Assessment (IA) on the implementation of the EU Audit Reforms is published alongside this consultation paper. It is available at:

<https://www.gov.uk/government/consultations/auditor-regulation-effects-of-the-eu-and-wider-reforms>

**13.2** BIS submitted the IA to the Regulatory Policy Committee (RPC) on 10 July 2015. The RPC gave the IA a ‘fit for purpose’ rating on 17 August 2015. We have published the RPC opinion alongside the IA.

**13.3** The IA describes the effect of two options on the implementation: a basic minimal implementation with an Equivalent Annual Net Cost to Business (EANCB) of £41.4 million; and a “preferred option” for the implementation, with an EANCB of £39.61 million.

## Minimum implementation

**13.4** A minimum implementation approach consists of only mandatory changes to the current system. Some of the main elements of this option include:

- (a) increasing in scope the application of the 2006 Directive to additional entities;
- (b) changes to ethical standards relating to the provision of non-audit services by PIEs;
- (c) the requirement of additional content and an additional report to the audit committee for PIEs;
- (d) changes to the framework for the appointment of auditors and the duration of engagement of auditors for PIEs, and;
- (e) changes to the regulatory framework and in particular additional responsibilities of the Financial Reporting Council in the light of its appointment as the ‘single competent authority’.

## The “preferred option”

**13.5** The “preferred option” builds on the minimum implementation required by the new Directive and Regulation. We have identified a small number of areas where we are considering whether the inclusion of additional proposals, including changes to UK company law of domestic origin, will reduce burdens on auditors or their clients or will improve the UK’s audit regulatory framework. The additional proposals are summarised in tabular form on the following page.

Additional measure	Reason for additional measure
We are proposing to provide that retendering of the audit engagement by a PIE before the expiry of the 10 year maximum duration should still enable it to extend the maximum duration by 10 years. <sup>37</sup>	Increased flexibility for PIEs to appoint auditors based on a retender earlier than year 10 could be important, both to facilitate frequent retendering and to make sure the benefits of retendering are maximised compared to the costs.
Applying the implementing measures for the Directive in legislation on Limited Liability Partnerships (LLP), where the LLP is not a PIE. The Directive and Regulation will apply in any case where an LLP is a PIE.	This would increase consistency with the law for company audits.
Amending audit and non-audit fee disclosure requirements to reflect the breakdown of fees in the Regulation.	This would increase transparency to wider stakeholders of compliance with the Regulation and reduce costs of enforcement.
Changes to the framework for oversight by the Financial Reporting Council of the functions of the Recognised Supervisory Bodies (RSBs), including allowing the reclamation of functions by the FRC, if an RSB wishes or if problems arise	The IA explains that It may be necessary to include additional provisions as part of the implementation of the amending Directive in this area to create a regulatory framework that is more adaptable and fit for purpose.

**13.6** On-going discussions with stakeholders have identified these proposals and we welcome further views about them.

## RPC opinion

**13.7** In delivering its opinion the RPC identified a number of areas to be addressed before submission of the final impact assessment:

- clearer explanation of how much of the costs fall on businesses covered by the 2006 Directive for the first time and how much on those that must only respond to the changes;
- distinguish between costs imposed by the amendments to the 2006 Directive and those imposed by the directly applicable Regulation; and,

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<sup>37</sup>The Discussion Document had proposed, as part of an implementation providing this flexibility, that PIEs would need to provide a legally binding statement about when their next tender would take place. As is explained in Chapter 7 we now consider it is possible to provide this without such statement. The IA sent to the RPC, and published alongside this consultation, reflects this change.

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- further work to demonstrate a “zero net cost” of the additional proposals under the “preferred option”.
- 13.8** BIS is therefore seeking to develop its analysis and evidence base further through this consultation exercise to improve the IA in these areas. In particular in relation to the third comment in the summary above we are considering whether the additional proposals for the ‘preferred option’ taken together would be beneficial to business and, therefore, deemed to score as “zero net cost”.
- 13.9** The RPC agreed that taking advantage of flexibility within the regulation to introduce more flexible retendering is beneficial to business, but considered that making use of this flexibility was consistent with a minimal implementation. We accept this.
- 13.10** While it remains true that the implementation of changes to the competent authority’s framework for oversight of the RSBs may need to include some additional measures that are not required by the Directive we now consider these will be very limited. The announcement made by the Government in Baroness Neville Rolfe’s written statement in the House of Lords represents a minimal approach to implementation in this area. That announcement was made after completion of the IA and when it had already been submitted to the RPC. Since completion of the IA we have done considerable work with the FRC and RSBs to determine the most appropriate framework. There are currently no additional measures in the legislative implementation that go beyond those required by the Directive.
- 13.11** As is explained in Chapter 8, the Government is not now proposing to amend the framework on disclosure of auditor remuneration as part of the initial implementation of the Directive and Regulation. This means that the only other additional measure included in the proposals is the application of the implementation of the Directive to LLPs. If it becomes clear that any elements of this part of the “preferred option” impose costs on business overall, the Government is prepared to consider whether they should remain a part of the implementation proposals.

# 14. Consultation questions

General question on the draft clauses prepared to complement the discussion in Chapters 5, 6, 7, 8 and 12

1. Do you agree with the approach the draft implementing regulations take given the Government's conclusions as set out in these chapters? Why?

General question on the proposed legislative approach in Chapters 10 and 11

2. Do you agree with the Government's proposals on amendments to the Companies Act to reflect Articles 15 and 18 of the Regulation and the amendments to Articles 23, 45 and 47 of the Directive? Do you agree that these are all that is needed to reflect the provisions of the new Directive and Regulation on cooperation, transferring information and confidentiality? Why?

**Impact assessment**

3. Given the analysis of costs and benefits in the Impact Assessment in general, do you have any comments on how our estimates or underlying assumptions might be improved? Please explain your answer.

**Familiarisation costs**

4. Responses to our Discussion Document suggested that familiarisation and implementation costs to:

- newly designated PIEs; and,
- audit firms that become auditors of PIEs for the first time...

... would be disproportionately higher. We propose that in the final IA we should uplift the estimated costs for such businesses by a percentage to reflect the additional resource costs to such firms arising from their lack of experience of the requirements of the Regulation and of those provisions of the Directive applying to audits of PIEs. For each category listed above, what do you consider to be a reasonable percentage?

5. In the consultation IA we have estimated the direct costs to PIEs of having to tender the audit engagement every 10 years. In our final analysis, we also plan to include an estimate of the additional costs that would be incurred by a new auditor that has to familiarise itself with the business of a new PIE client. We propose that the additional familiarisation cost to auditors engaged in a new audit could be estimated

is an additional 10-30% of the cost of the audit in the first two years<sup>38</sup>. Is this reasonable?

### **Costs to non-PIEs and their auditors**

6. Our preliminary analysis suggested that the costs and benefits of the measures in the new Directive affecting audits of non-PIEs would be negligible. This has been assumed in the consultation IA. Is this reasonable? If not, what do you estimate will be the main changes giving rise to costs and benefits for non-PIEs and their auditors? Can you provide quantitative estimates?
7. It is particularly important to assess the costs and benefits arising from the new Directive for non-PIE LLPs and their auditors as the implementation of the new Directive is not required by EU law for these audits. Would your answers to question 6 differ for non-PIE LLPs? How and why?

### **Further questions on application to non-PIE Limited Liability Partnerships**

8. Do you think that the Government should:
  - implement the changes required by the new Directive for audits of non-PIE LLPs alongside those same changes for entities (such as companies) that are required to be audited by EU law; or,
  - implement some or all of the changes required by the new Directive for audits of non-PIE LLPs at a later stage?

... please give reasons for your answer.
9. Do you think there would be cost savings from implementing the changes required by the new Directive for non-PIE LLPs at the same time as for entities (such as companies) whose audits are subject to EU law? Please give reasons for your answer. Can you provide any estimate of the extent of these savings?

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<sup>38</sup> One estimate provided in response to our discussion document is that this additional cost would be 10-15% of the cost of doing an audit in the first year. Analysis by the CMA found the additional staff time in the first year of a new appointment to be 24.3% higher than that of the previous auditor. This increases to 31.5% in the second year before reducing.

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## 15. Next steps

- 15.1** The Government will consider responses to this consultation document after the closing date for responses on 9 December 2015.
- 15.2** We intend that responses to the consultation should then be published on the BIS website. Chapter 16 provides further details on confidentiality and handling of personal data in the responses.
- 15.3** Following consideration of the responses the Government will finalise regulations for the implementation of the Directive and to provide for the application of the Regulation. We will also finalise the Impact Assessment on the implementation, which will need to be subject to clearance by the Regulatory Policy Committee.
- 15.4** The Government will lay implementing regulations before both Houses of Parliament, with an Explanatory Memorandum and final cleared Impact Assessment. The Government's intention is that the implementing regulations should come into force for accounting years beginning on or after 17 June 2016.

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# 16. Confidentiality and data protection

- 16.1** We intend that your response to this consultation be made available to the public via the gov.uk website. If this causes you any concern, or if you would like to make a request that all or part of your response should be held by BIS in confidence, please make this clear to Paul Smith (email: pauld.smith@bis.gsi.gov.uk) before the consultation closes.
- 16.2** Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000, the Data Protection Act 1998, and the Environmental Information Regulations 2004). If you want information, including personal data that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.
- 16.3** In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.
- 16.4** Any request for information to be treated in confidence will be taken into consideration in the publication of responses to the consultation. As is explained in Chapter 14 BIS intends to publish all responses following the closure of the consultation period, however we will not publish responses from respondents who request that any of the information in their response, including personal data, should be handled in confidence.



# 17. Navigating policy areas in this consultation

Consultation chapter	Discussion document chapter	Regulation Article	New Directive Paragraph (of Article 1)	2006 Directive Article amended
Chapter 5 - Which audits are affected?	Chapter 4.1 - Audits of Public Interest Entities and application of the Regulation and Directive	1,2	1,2	1,2
Chapter 6 - How are audits regulated?	Chapter 4.2 - Competent authorities - Designation and delegation of tasks Chapter 5.9 - Quality assurance of statutory auditors Chapter 5.10 - Competent authorities - Investigations, sanctions and powers Chapter 5.8 - Recognition of statutory auditors from another Member State	20, 21, 24, 25, 26 26 23	3, 26, 28 4, 10	2, 32 3a, 14
Chapter 7 - Length of audit engagements	Chapter 4.4 - Tendering and duration of audit engagements	16, 17, 41		
Chapter 8 - Standards and standard setting	Chapter 4.3 - Audit fees and non-audit services Chapter 4.5 - Audit reporting and additional reporting to the audit committee Chapter 5.1 - Technical standards for statutory audits Chapter 5.3 - Statutory audits of consolidated accounts	4, 5, 13, 14 10, 11 7, 8	14, 15, 16 23 18, 19, 20 22	22, 22a, 22b 28 24a, 24b, 25a 27
Chapter 9 - Removal of auditors	Chapter 5.7 - Dismissal of auditors	19	31	38

Consultation chapter	Discussion document chapter	Regulation Article	New Directive Paragraph (of Article 1)	2006 Directive Article amended
Chapter 10 - Cooperation, transferring information, confidentiality of information	Chapter 5.6 Transferring information and confidentiality of information	15, 18, 22	17	23
	Chapter 5.11 - Cooperation between Competent Authorities within EU	29, 31, 33	5, 27, 29	5, 34, 36
	Chapter 5.12 - Cooperation of Competent Authorities with third countries	36, 37, 38	33, 34, 35	45, 46 ,47
Chapter 11 - Other measures	Chapter 5.5 Regulatory Reporting and Information – Report to Supervisors of PIEs	12		
	Chapter 5.13 - Monitoring Market Quality and Competition for PIEs	27		
	Chapter 5.2 - Technical Standards - International Standards for Auditing	9	21	26
Chapter 12 - Restrictive clauses in contracts with third parties	Chapter 4.4 - Tendering and duration of audit engagements (page 31)	16	30	37

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## 18. Help with queries

**18.1** Questions about the issues raised in this consultation document, in the accompanying draft implementing regulations and the Impact Assessment should be addressed to:

Name: Paul Smith

Team: Corporate Frameworks, Accountability and Governance

Department of Business, Innovation and Skills  
1 Victoria Street  
London,  
SW1H 0ET

Tel: 020 7215 4164

Email: [pauld.smith@bis.gsi.gov.uk](mailto:pauld.smith@bis.gsi.gov.uk)

**18.2** This is a formal Government consultation. The Government will therefore handle and consider responses in line with the principles that it has stated Government departments and other public bodies should adopt for engaging stakeholders when developing policy and legislation. These are set out in the following document:

<http://www.cabinetoffice.gov.uk/sites/default/files/resources/Consultation-Principles.pdf>

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