

Title: UK implementation of the EU Directive on statutory audits of annual accounts and consolidated accounts, and of the EU Regulation on specific requirements regarding statutory audit of public interest entities 2014 IA No: RPC15-BIS-2290 Lead department or agency: Department for Business, Innovation and Skills Other departments or agencies: N/a	Impact Assessment (IA)				
	Date: 23/06/2015				
	Stage: Consultation				
	Source of intervention: EU				
	Type of measure: Secondary legislation				
Contact for enquiries: Paul Smith 020 7215 4164					

Summary: Intervention and Options **RPC Opinion:** RPC Opinion Status

Cost of Preferred (or more likely) Option 2				
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Two-Out?	Measure qualifies as
-£462.34m	-£462.34m	£39.61m	YES in part	Zero net cost

What is the problem under consideration? Why is government intervention necessary?
 The financial crash in 2008, led to calls for greater scrutiny of the audit profession. The belief was that the accounts of several financial institutions had been given unjustified clean audit reports and so potentially misled investors and regulators, undermining confidence in the financial system as a whole and affecting the efficient allocation of financial capital. The crisis further underlined the “expectation gap” between the assurance that a statutory auditor is required to provide and that which investors and the public assume. The risk is that the market will underprovide a socially optimal level of rigorous and independent auditing, and hence there is a need for Government intervention. The market failures are due to misaligned incentives, conflict of interests and lack of competition. Companies infrequently tendering audit appointments or changing auditors cause there to be little opportunity for new entrants to compete for contracts, leading to a lack of competition in the market for the provision of audit services. Meanwhile, the emphasis on client retention acts as a disincentive for auditor scepticism which brings into question the independence of the audit. “Professional scepticism” of the auditor could also be compromised when audit and non-audit services are provided by the same organisation (especially where non-audit service revenues from the statutory audit client become substantial; where auditors risk reviewing their previous non-audit work or where the provision of statutory audit services becomes a gateway to the provision of non-audit services..

What are the policy objectives and the intended effects?
 The policy intends to improve confidence in the value of audit through enhanced audit quality and stricter independence requirements on statutory auditors, including on the provision of non-audit services to audit clients. It will also make the audit report more informative for shareholders and audit committees; will extend the regulatory requirements applying to audits of listed companies to unlisted banks, building societies and unlisted insurers, which would now be included in the definition of Public Interest Entities (PIEs); increase accountability to independent audit committees of PIEs, and increase competition in the audit market. This should strengthen investor confidence in audit reports and contribute to a more dynamic audit market in the EU.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

0. Do nothing – this will not address the problems identified by the EU around the quality and scrutiny of audit. In addition, this option would place the UK in breach of its Treaty obligation to demonstrate transposition of the Directive into UK law and implement the mandatory requirements introduced by both the Directive and Regulation. This would impose costs on the Government in fines for infraction, and could also have significant reputational and diplomatic consequences. (see page 20).
1. Take the minimum action required by the Directive and Regulation to address the problems identified. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes (see page 20).
2. Implement the EU baseline, accompanied by additional adjustments to requirements on companies in order to facilitate a more flexible implementation (the preferred option, see page 20).

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** June 2021

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	Micro Yes	< 20 Yes	Small Yes	Medium Yes	Large Yes

What is the CO₂ equivalent change in greenhouse gas emissions?
(Million tonnes CO₂ equivalent)

Traded:

Non-traded:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Date:

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2016	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -644.39	High: -387.05	Best Estimate: -483.19

COSTS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
	1			
Low	63.4		38.3	387.1
High	179.8		55.0	644.4
Best Estimate	89.7		46.5	483.2

Description and scale of key monetised costs by 'main affected groups'

The monetised costs of the proposed measures are:

- One-off familiarisation and implementation costs to auditors and PIEs of approximately £72.66m.
- One-off cost of tendering services of £12.1m that will apply to 1,665 PIEs and their auditors which have non-audit service fees above the threshold, or which have non-audit services which will be prohibited, to arrange for these services to be reallocated to another provider.
- One-off cost of establishing an audit committee of £4.99m that will apply to 556 unlisted insurers.
- On-going costs of £8.99m pa for the audit committee members for the 556 unlisted insurers.
- On-going costs to all 1,665 PIEs to prepare an additional report for the audit committee estimated at £2.02m.
- On-going costs of £15.96m incurred by 1,613 PIEs (listed entities and unlisted banks, building societies and insurers) as a result of additional requirements on all audit committees which will increase the number of meetings per annum
- The requirement for a transparency report will now apply in respect of auditors of all PIEs, not just those that are listed. This will result in additional on-going costs of £1.55m.
- 1,361 PIEs (ie those not in the FTSE350 who are already subject to this requirement) will have to appoint auditors via a competitive tender by the audit committees. This will result in an estimated annual cost of £1m per annum.
- Annual cost of tenders accounting for £21.67m as a result of the requirement to retender auditor appointments at least every 10 years. This will impact 1,361 PIEs (all PIEs excluding those in the FTSE 350 who are already subject to this requirement) and their auditors.
- On-going costs of £0.53m affecting all PIEs to undertake the changes to the audit inspection regime.

Together these costs total £89.73m of one-off costs and £51.72m of on-going costs.

Other key non-monetised costs by 'main affected groups'

- One-off familiarisation costs for audit clients and for auditors of non-PIEs.
- Changes to technical standards and qualifications –auditors already take action on irregularities and quality control so no significant costs are expected. Some smaller PIEs will incur costs of appointing independent quality control reviewer however these costs are expected to be low.

BENEFITS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
	1			
Low	0		0	0
High	0		0	0
Best Estimate	0		0	0

Description and scale of key monetised benefits by 'main affected groups' - None

Other key non-monetised benefits by 'main affected groups'

Benefits are around increase in audit quality and information, which should in turn lead to increased investor trust in the financial statements of companies. This increase in trust could lead to more optimal investment decisions. As audit provides assurance of the veracity of financial statements, increased audit quality reduces risks of misstatement and of resulting corporate crises. This enhances investor protection and reduces the cost of capital.

Increased competition is also expected in the concentrated audit market. Mutual recognition of audit firms across Member States will result in the reduction of the administrative costs of applying for a new licence in each Member State in which the auditor wishes to operate and could open up access to audit markets across the EU, increasing competition.

Key assumptions/sensitivities/risks**Discount rate (%)**

3.5

One of our key assumptions is the number of PIEs in scope. Based on the definitions in the regulations of the entities in scope we have used data from the Bank England, the FAME database and the UK Listing Authority Official List to estimate a total of 1,665 PIEs.

The other key assumptions in terms of costs and benefits are:

- (i) That the Bank of England lists provide full coverage of all credit institutions and insurers which are in scope of this Directive.
- (ii) That audit and non-audit fees are broadly similar across all PIEs as across listed companies.
- (iii) Data on the costs and benefits are limited. Also estimates from the EU Commission's IA, from auditors and from research documents referenced in the main text of this IA on, e.g., the number of hours required to fulfil tasks, may be too high or too low.
- (iv) That transitional costs – familiarisation, tendering for non-audit services and establishing an audit committee – are incurred in 2016 (the UK legislation comes into force in June 2016)
- (v) Ongoing costs will start in to be incurred in 2017 as the UK legislation will apply to accounting years starting after the UK legislation comes into force.

Ranges and best estimates are provided where these risks/uncertainties occur and we will be seeking more information in future consultation to refine our analysis following responses.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: 41.4	Benefits: 0.0	Net: -41.4	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2016	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -623.5	High: -366.16	Best Estimate: -462.34

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	63.4	38.3	387.0
High	179.8	55.0	644.4
Best Estimate	89.7	46.5	483.2

Description and scale of key monetised costs by 'main affected groups'

As Option 1, plus additional costs of measures which may improve the overall operation and reduce the costs of the new EU framework in the context of UK law. This option is still in development and other measures and costs may be identified during the consultation period. We intend to seek views on any costs that arise during the consultation, as well as the impacts of the other measures under consideration.

Other key non-monetised costs by 'main affected groups'

As Option 1.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	2.5	20.9
High	0	2.5	20.9
Best Estimate	0	2.5	20.9

Description and scale of key monetised benefits by 'main affected groups'

As Option 1, plus additional benefits from measures which improve the overall operation of the new EU framework in the context of UK law. At present the benefits of only one of the measures being considered have been monetised. Currently there is uncertainty about whether under Option 1, firms would have the flexibility to tender for audits earlier than year 10 of the last appointment, and be able to re-appoint the existing auditor for another 10 years without needing to tender again. If this is not the case, then we would need to devise a framework that would allow such flexibility to exist, and one such measure is proposed under Option 2. The benefit arises through the increased flexibility for PIEs to appoint auditors based on a retender earlier than year 10 (e.g. to enable multinationals to coordinate audit work across countries) while still extending the audit engagement by 10 years. The best estimate for this benefit is £2.7 million saving per annum.

Other key non-monetised benefits by 'main affected groups'

As option 1, plus increased consistency between companies and LLPs in audit and accounting standards and the level of assurance of accounts provided. Increasing company's accountability to wider stakeholders for their compliance with the blacklist of non-audit services and with the non-audit fee cap. Increased flexibility for Financial Reporting Council (FRC) to impose more focussed and graduated sanctions on the professional supervisory bodies for auditors.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5
As Option 1 above. There is also a possibility that upon clarification with the Commission, it turns out that the flexibility being sought by the additional measure to report on the audit tender position would already be available to firms under option 1 anyway. This would imply that the monetised benefits estimated under option 2 are not additional to option 1 and that options 1 and 2 are equivalent.		

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:	In scope of OITO? Measure qualifies
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Costs:	41.4	Benefits: 1.8	Net: -39.6	YES in part ¹	Zero net cost
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¹ Only the gold plating will be in scope of OITO. The gold plating will result in small net savings for companies of £911,000. However, because it will be an additional requirement for companies, so is scored as an "IN", we are assuming zero net cost.

Contents

Executive Summary.....	8
-------------------------------	----------

Full Discussion of Assessment

A. Background.....	16
B. Problem Under Consideration.....	16
C. Rationale for Intervention.....	16
D. Policy Objectives.....	19
E. Options Considered.....	20
F. Discussion of monetised and non-monetised costs and Benefits of Each Option.....	22
G. Calculations of Costs.....	26
H. Wider Impacts.....	49
- Statutory Equality Duties	
- Competition Impact	
- Small and Micro Business Assessment	
- Environmental Impact	
- Social Impact	
- Justice System	
- Rural Proofing	
I. Summary and Preferred Option.....	51
J. Implementation Plan.....	51
Annex A.....	53
Annex B.....	55
Annex C.....	59

Executive summary

The Audit Directive and Regulation are two associated pieces of EU legislation that reform audit of limited companies and other undertakings.

The legislation will improve the quality of statutory audit by stricter independence requirements on statutory auditors, including on the provision of non-audit services to audit clients; by making the audit report more informative; and by strengthening the regulatory requirements applying to audits of public-interest entities ('PIEs' – i.e. listed companies, banks, building societies and insurers).

1. Problem under consideration and rationale for intervention

Following the Enron and Parmalat scandals it was apparent that there was a need for serious consideration of the state of audit regulation in the European Union. Therefore European legislators adopted the Directive (2006/43/EC) on the audit of accounts.

However, the financial crash in 2008 led to calls for greater scrutiny of the audit profession. The belief was that the accounts of several financial institutions had been given unjustified clean audit reports, and so potentially misled investors, undermining confidence in the financial system as a whole and affecting the efficient allocation of financial capital.

The risk is that the market will underprovide a socially optimal level of rigorous and independent auditing, and hence there is a need for Government intervention. The market failures are due to misaligned incentives, conflict of interests and lack of competition that can arise from the regular reappointment of auditors and the unrestricted provision by them of both audit and non-audit services. Companies infrequently tendering auditor appointments or changing their auditors causes there to be little opportunity for new entrants to compete for contracts, leading to a lack of competition in the market for the provision of audit services. Meanwhile, the emphasis on client retention acts as a disincentive for auditor scepticism which brings into question the independence of the audit. The "professional scepticism" of the auditor could also be compromised when audit and non-audit services are provided by the same organisation (especially where non-audit service revenues from the statutory audit client become substantial; where auditors risk reviewing their previous non-audit work or where the provision of statutory audit services becomes a gateway to the provision of non-audit services).

The proposed changes will provide better information for shareholders and audit committees to lead to more optimal business decisions. Potentially this will reduce the likelihood of problems in the financial sector with its associated systemic risk and generally result in a more open market for the provision of statutory audit services to the largest businesses with greater opportunities for existing competitors and new entrants to win business.

2. Options and policy objectives

The legislation will improve the quality of statutory audit by stricter independence requirements on statutory auditors, including on the provision of non-audit services to audit clients, by making the audit report more informative and by extending the regulatory requirements applying to audits of public-interest entities ("PIEs") to unlisted banks, building societies and unlisted insurers, which would now be included in the definition of Public Interest Entities (PIEs); increase accountability to independent audit committees of PIEs, and increase competition in the audit market. This should strengthen investor confidence in audit reports and contribute to a more dynamic audit market in the EU.

More specifically, the EU and UK's main objectives for this reform are to:

1. Further clarify the role of the statutory auditor;
2. Reinforce the independence and the professional scepticism of the statutory auditor;
3. Increase accountability to independent audit committees of PIEs;
4. Facilitate the cross-border provision of statutory audit services in the EU;
5. Contribute to a more dynamic audit market in the EU; and

6. Improve the supervision of statutory auditors and the coordination of audit supervision by competent authorities in the EU.

• **Option 0: Do nothing.**

Do nothing – this will not address the problems identified by the EU around the quality and scrutiny of audit. In addition, this option would place the UK in breach of its Treaty obligation to demonstrate transposition of the Directive into UK law and implement the mandatory elements introduced by it. This would impose costs on the Government in fines for infraction, and could also have significant reputational and diplomatic consequences.

• **Option 1: Take the minimum action required by the Directive. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes.**

Key elements within this option include:

- Increase in scope of the application of the 2006 Directive to cover the following types of entity: issuers with securities traded on regulated markets; 'Markets in Financial Instrument Directive' investment firms (MiFIDs); undertakings for collective investment in transferable securities (UCITS); alternative investment funds (AIFs); payment institutions and e-money issuers (25 extra entities that are not companies, LLPs or qualifying partnerships).
- Increase in scope of the requirements of the 2006 Directive on audits of PIEs now that most of these requirements have moved to the new Regulation
- Changes to ethical standards relating to the provision of non-audit services
- Changes to technical standards relating to reporting of irregularities and quality control
- Changes to reporting requirements, requiring additional content and an additional report to the audit committee for PIEs
- Changes to the framework for the appointment of auditors and new provisions on the duration of engagement of auditors, requiring the re-tender of audit contracts at least every 10 years, and a change of auditor at least every 20 years
- Changes on dismissal of auditors.
- Changes to enable cross-border provision of audit services
- Changes to regulations on competent authorities and the framework on the responsibilities and operation of the Financial Reporting Council (FRC).
- The frequency of inspections of auditors is now to be determined on a risk basis, with the reduction of previous minimum frequencies of inspections for auditors of some SMEs. However this is combined with the effect of preventing the Financial Reporting Council from delegating any inspections of auditors of PIEs and increasing in the minimum frequency of inspections of unlisted large PIEs

Option 2: Implement the EU baseline – accompanied by additional adjustments to requirements on companies in order to facilitate a more flexible implementation increasing flexibility for companies and other undertakings and their auditors.

In the development of the implementation proposals, we have identified some particular aspects of the changes required by the EU reforms that impose burdens on auditors or their clients or present particular technical difficulties in the context of the UK's audit regulatory framework which can be addressed without preventing the achievement of the EU Directive's and Regulation's objectives. As a result, we have identified a small number of areas where the changes listed above could be improved in their operation via the inclusion of additional proposals. These proposals affect the implementation of the 2006 Directive or other EU instruments, or changes to UK company law of domestic origin.

They cover:

- providing a legislative framework allowing companies that tender at earlier than 10 years to make the reappointment of auditors for the maximum duration of 10 years (rather than having to do another tender at year 10 of the previous term).
- applying the implementation of the Directive to Limited Liability Partnerships (LLP), where the LLP is not a PIE. This will increase consistency with the law for company audits
- amending audit and non-audit fee disclosure requirements to increase the transparency to wider stakeholders
- 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

On-going discussions with stakeholders have identified this small number of proposals and we will seek views on these during the consultation.

Option 2 is our preferred option.

3. Costs and Benefits

We welcome views on the assumptions used below and any additional or improved estimates of the costs and benefits.

Option 0 will not address the problems identified by the EU around audit quality and scrutiny. Also it is not considered feasible. The Directive and Regulation impose changes which are not consistent with the UK's existing legal framework – changes are therefore required to comply with the Directive and Regulation. The Directive and Regulation must be adopted by 17 June 2016, and the Government's objective is to ensure that companies obtain the maximum benefit from the changes, whilst maintaining the integrity of the UK's audit and company law framework. Therefore the focus of the analysis is limited to options 1 and 2.

The **benefits** associated with implementing the Directive and Regulation primarily result from an increase in audit quality, which should in turn lead to increased investor trust in the financial statements of companies and other undertakings, and in particular of PIEs. This increase in trust could lead to more optimal investment decisions as risks to investors/lenders are lessened/more transparent with the increased quality of the audit. The proposals also aim to increase the efficiency and level of competition in the audit market. For the most part we have been unable to quantify the expected benefits due to their intangible nature.

Data on the costs and benefits of the proposed changes are limited and thus there is some uncertainty around the best estimate and we have provided ranges where relevant. Estimates are based on: the EU Commission's assessment of hours taken per activity and at what level of seniority; the FAME database for the number, type and size of PIEs and for audit fees; ONS data on wages; and on public documents and discussions with stakeholders. See main body of the text for risks and assumptions for each proposed requirement. During the consultation period we will ask for views on the costs and benefits presented here.

Option 1

Familiarisation costs

There will be familiarisation costs for auditors relating to the changes for audits and auditors. There will also be familiarisation costs for PIEs in understanding the particular requirements that apply to them on non-audit services, the tendering and rotation of audit engagements, and the requirement to have an audit committee.

There are 1,075 audit principals who work for the 22 audit firms which provide audit services for clients with transferable securities listed on regulated markets. They will need to familiarise

themselves with the revised requirements. We have built a model to obtain the firms' estimates of likely costs and Annex B outlines how we assess familiarisation costs. As yet there is insufficient quantified data available as we have only obtained quantified data from one (large) audit firm.

Based on that response we consider that familiarisation costs for the 5 largest audit firms amount to approximately **£21.59m**. We extrapolated from this information to provide estimates for medium and small auditors of PIEs (including those newly in scope as auditors of banks, building societies and insurance companies) and for the PIEs themselves. At this stage, our best estimate of the total familiarisation and implementation costs across all firms is £72.66m. We intend to seek views on our estimates and their underlying assumptions during the consultation period.

Other one-off costs

There are a number of other one-off costs which are related to the changes being made to the conditions for carrying out statutory audit.

Ethical standards – audit fees

Through the Regulation, PIEs will be subject to a cap applied to the fees for non-audit services provided by their auditor, as well as a complete ban on the provision by their auditor of certain non-audit services. The provisions apply to 1,665 PIEs and their auditors, and will require those companies which have non-audit service fees above the threshold, or which have non-audit services which will be prohibited, to arrange for these services to be reallocated to another provider. The aim of this is to increase “auditor scepticism”, so increasing stakeholder confidence in the services provided, and increase competition in the non-audit service market.

We estimate a one-off cost to those businesses affected by needing to change provider of these services on the assumption that this will involve some form of tender and cost between £3.49m and £84.53m, with a best estimate of **£12.1m** although, due to the fact that a tender is not *required* to be undertaken in order to appoint a new service provider, the costs may be significantly lower.

Appointment of the Audit Committee

The Regulation extends the scope of the requirement for an audit committee to all PIEs, beyond the existing coverage of listed PIEs, and we have assumed that this now includes unlisted insurers. This change aims to clarify to shareholders who is responsible for the company's relationship with the auditor and to increase the audit committee's independence.

Based on data from the Bank of England and assumptions we have made from FAME data, we estimate there are currently 556 unlisted insurers (including Lloyds of London syndicates) which will be brought in scope of the 2006 Audit Directive. From our assumptions on audit fees and that 60-80% of unlisted insurers have an audit committee already, we estimate a one-off cost of establishing an audit committee to be between £3.33m and £6.66m, with a best estimate of **£4.99m**.

On-going costs

Appointment of Audit Committee

As well as the one-off cost to unlisted insurers being brought into scope of this requirement mentioned above, we estimate that there will be an on-going cost of their appointment of between £5.77m and £12.44m, with a best estimate of **£8.99m**, based on the same assumptions.

Additional report to the Audit Committee

This requirement will impact auditors of PIEs, and will involve additional costs to the auditor of preparing the additional report for the audit committee – the information contained within the report is the result of the audit work itself, so there will be no additional costs relating to obtaining and collating the relevant information. This report will increase confidence of stakeholders in the audit committee and its accountability.

Based on the text in the Regulation we assume that all PIEs will be required to have this additional report. We have based our calculation on the assumption that the time taken will depend on the size of the PIE, and the median wage of an accountant (uplifting for non-wage costs). The total annual cost of producing the audit report is estimated at **£2.02m**.

Scope of Audit Committee

The Regulation adds additional requirements on all audit committees, impacting all PIEs requiring additional meetings between auditors and audit committee members on an annual basis. This will increase stakeholder confidence in the effectiveness of the audit committee. This will impact a total of 1,613 PIEs in scope of this requirement (entities listed on an EU regulated market, unlisted banks, building societies and unlisted insurers) and impose an estimated annual cost of £10.64m - £21.28m, with a best estimate of **£15.96m** per annum.

Retaining and disclosing information

The requirement for a transparency report will now apply in respect of auditors of all PIEs, not just those that are listed. The auditor must also report to the competent authority (the Financial Reporting Council, FRC) on audit and non-audit revenues in respect of each PIE. We have estimated that, for reports on all the 1,665 PIEs, the cost is just under **£310k** per annum.

We and the FRC are currently researching how many auditors there are currently engaged in audits of unlisted banks and insurers. We have assumed that the cost of preparation of a transparency report by auditors of unlisted PIEs involves 21 auditors at a total cost of **£1.24m** per annum.

Appointment Requirements - Procedure

This requires that PIE auditors must be appointed via a competitive tender by the audit committee. The aim is to increase “auditor scepticism” and audit quality and hence investor confidence as well as increase competition in the audit market. Additional costs will fall on the audit committee in terms of time taken in monitoring the tender for the selection of auditors as well as validation of chosen audit firms.

Based on ASHE data on salaries and EU Commission data on hours taken by which individuals, and taking into account the expected number of PIEs that would have retendered anyway, we estimate the cost of the audit committee members assessing tenders every 10 years² this leads to an annual average cost of £735 per PIE. Scaled up across all 1,361 PIEs in scope (1665 less the 304 UK incorporated companies in the FTSE 350 that are already subject to this requirement), this results in an estimated annual cost of about **£1m per annum**.

Appointment requirements – Duration of engagement

This sets a maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments after 10 years.

Retendering at least once every 10 years is already a requirement for the FTSE 350 following the introduction of the order by the Competition and Markets Authority (CMA) in 2014 on mandatory retendering of auditor appointments. This aims to increase “auditor scepticism” by reducing the “familiarity” threat of audit firms with their clients, and therefore audit quality, as well as open the audit market up to greater competition. This will impact 1,361 PIEs (all PIEs excluding those UK incorporated companies in the FTSE 350) as well as the auditors of these. We have estimated the annual cost of tenders to be **£21.67m**.

One possible problem with the framework on retendering in the Regulation is that it may not be possible for a company to benefit from an extension of the audit engagement if it tenders the engagement with a view to that tender taking effect before 10 years. This would mean that a company in a group which in practice is required to retender an audit engagement for compliance with the law in another Member State before 10 years, would be unable to benefit from retendering in the UK at the same time because it would be forced to retender again at 10 years.

Option 2 includes a measure to reduce the impact of this interpretation and assesses the potential savings for those companies in groups affected by the Regulation in more than one EU jurisdiction.

² The maximum duration of engagement as set out in the next section.

Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit

Under the Regulation the FRC is required to inspect auditors of all PIEs. This will increase investor confidence in the UK's regulatory framework but reduce flexibility as, at present the FRC is able to delegate inspection of auditors conducting fewer than 10 such audits to the professional bodies.

We expect this to continue to be charged to companies for cost recovery. We consider two effects of changes to the audit inspection regime on the FRC as competent authority with ultimate responsibility for audit regulation:

- The impact of significantly limiting the FRC's use of the current facility to delegate inspections of some auditors³ to the professional supervisory bodies.
- The impact of the wider definition of a PIE, in particular the inclusion of all unlisted insurers within the scope of FRC inspections.

Based on FRC data, it is estimated that the move away from delegating the audit inspections of the 29 auditors which conduct "major audits" of banks, insurers or listed companies to the Recognised Supervisory Bodies will increase costs by **£319,000** per annum. Introducing additional inspections by the FRC of an estimated 18 auditors of unlisted insurers will lead to additional costs of **£210,000** per annum. The total cost is therefore estimated at £0.53m pa.

Other non-monetised impacts

Technical Standards - Reporting Irregularities and Quality Control

This will affect auditors of PIEs and relates to (i) a requirement to report any irregularities first to the audited entity and second to the designated authority in the event that the audited entity does not investigate the matter, and (ii) a requirement that before the submission of the audit report, an engagement quality control review must be carried out by a statutory auditor not involved in the audit to which the review relates, to assess whether the statutory auditor or the key audit partner could reasonably have come to the opinion and conclusions expressed in the draft of these reports.

This should not have an impact on conduct or procedures as it is already part of any audit carried out in accordance with existing ethical and auditing standards. The number of firms that will face additional costs, due to the need for specialist expertise in the quality control reviewer, is low. The cost to those firms which do face additional costs is also low. Responses to the discussion document have confirmed this view.

Educational Qualifications, Professional Competence and Continuing Professional Development - Adaptation period

This measure allows the adaptation of an individual auditor to UK regulatory standards to be assessed, when seeking to establish himself in the UK, either as an alternative to or in place of the auditor having to undertake an aptitude test as is the current requirement. This should not result in direct costs for the auditor seeking to establish in a new Member States compared to the baseline scenario. It may result in costs for the competent authorities if they decide to revise their current aptitude test framework, but this is not mandatory. There are non-monetised benefits arising from the fact that this measure will open new markets to statutory auditors since it will be significantly easier for them to be approved and provide services in other Member States. This will also benefit the statutory auditors employed by audit firms (e.g. possibility of relocation within audit firms).

Qualifications – mutual recognition of auditors and audit firms

³ The FRC may delegate inspections of auditors conducting fewer than 10 "major audits" (that would otherwise be within its remit) to the professional bodies. The class of major audits is required by law to include all listed companies. The FRC also has discretion to include other classes of entity that are subject to statutory audit and can include more entities again by agreement with the professional bodies. At present it includes all banks (whether listed or not) and some unlisted insurers.

There are un-monetised savings from the avoidance of the administrative costs of applying for a full audit licence in each Member State where an audit firm wants to provide services. In addition, this measure will facilitate greater cross-border working and allow existing cross-border firms to operate more efficiently. Audited companies could also benefit from more competition. It is not known to what extent audit firms will wish to take advantage of this.

Option 2

The costs and benefits summarised above would not be significantly affected by the changes discussed under this option. Option 2 assembles together a series of other changes to the legal framework that would apply in addition to those considered under Option 1. These would be intended to complement and improve the implementation of the Directive and Regulation. We would only intend to implement those additional measures which are supported in consultation and improve the overall beneficial impact of the implementation.

For the purpose of this consultation Impact Assessment we have considered a package of additional proposals that would also provide: added retendering flexibility; increased consistency in auditing and accounting standards between companies and Limited Liability Partnerships; increased accountability to stakeholders of compliance with non-audit service requirements; and increased ability for the FRC to apply focussed sanctions to professional supervisory bodies. However, following consultation on these measures we propose to consider in relation to each one whether it should be implemented. A preferred revised option along these lines could then be implemented consisting of some of these measures if considered appropriate, possibly as well as some others not yet identified.

Under this option we also propose to address a possible drawback in the minimum implementation of the Regulation under Option 1. We propose that that a company would be able to retender the audit engagement earlier than year 10 without having then to conduct an additional tendering process at year 10. The earlier retender would extend the maximum duration of the audit engagement beyond that point. As a result of going above the minimum EU requirements, this measure may contain an element of gold-plating. However no additional administrative burdens or costs arise.

There would however also be an associated benefit from this flexibility in terms of additional saving we estimate at £2.74 million per year. This would arise from the ability of a company to retender early (together with another company within its group which has to comply with another Member State's audit rules) without having then to tender again at the end of the 10 year period.

We will seek views on the assumptions and the estimated costs and benefits of the proposed changes to audit requirements or scope, as well as specific elements covered by Option 2 where additional measures are proposed to enable implementation of the Directive and Regulation to be tailored more closely to the UK's audit regulatory framework.

Option 1 is the EU baseline and therefore is out-of-scope of One In, Two Out (OITO).

Option 2 introduces additional measures, allows for a more flexible and lower cost approach to implementation. The gold plating part of this option is in scope of OITO and will result in small net savings for companies. However, because the gold plating will introduce an additional requirement for companies, so is scored as an "IN", we are assuming zero net cost.

Summary of Costs

Matter	LOW ESTIMATE one off cost £'m	BEST ESTIMATE One-off cost £'m	HIGH ESTIMATE one off costs £'m	LOW ESTIMATE on going cost £'m	BEST ESTIMATE On-going cost £'m	HIGH ESTIMATE on going cost £'m
Scope and Application of the Directive and Regulation						
Subject Matter and Scope					Additional costs to unlisted banks, building societies and insurers covered below	
Conditions for Carrying out Statutory Audits						
Ethical Standards - Audit fees	3.49	12.08	84.53			
Technical Standards - Reporting Irregularities and Quality Control		None			No significant costs	
Audit Reporting - Additional Report to The Audit Committee				2.02	2.02	2.02
Appointment of Audit Committee	3.33	4.99	6.66	5.77	8.99	12.44
Scope of Audit Committee				10.64	15.96	21.28
Regulatory Reporting and Information - Report to Supervisors of PIEs						
Regulatory Reporting and Information - Retaining and Disclosing Information				1.08	1.55	1.96
Appointment of Statutory Auditors or Audit Firms						
Appointment Requirements - Procedure				1.00	1.00	1.00
Appointment Requirements - Duration of Engagement				21.67	£21.67	£21.67
Dismissal or Resignation of Auditor						
Educational Qualifications, Professional Competence and Continuing Professional Development						
Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit						
Competent Authorities - Designation and Delegation of Tasks within UK				0.37	0.53	0.70
Competent Authorities - Powers						
Total costs						
Familisation costs	56.57	72.66	88.57			
Other policy costs						
Total	63.39	89.73	179.75	42.54	51.72	61.07

Table 1: Summary of costs in executive summary

Full discussion of assessment

A. Background

1. This Impact Assessment relates to proposals to implement the measures contained within two associated pieces of EU legislation that reform audit of limited companies and other undertakings. These are Regulation (EU) No 537/2014 on specific requirements regarding statutory audit of public-interest entities ('the Regulation') and Directive 2014/56/EU amending Directive 2006/43/EC on statutory audits of annual and consolidated accounts ('the Directive'). The Directive and Regulation entered into force on 17 June 2014, with the Regulation taking effect on 17 June 2016 and the Directive must be implemented by the same date. The Regulation and the implementation of the Directive will apply for accounting years beginning on or after 17 June 2016.

B. Problem under consideration

2. Following the audit scandals in the US (Enron⁴), Netherlands (Ahold⁵) and Italy (Parmalat⁶) it became clear there was a need for reform of audit regulation in Europe. European legislators revised the existing Eighth Directive (84/253/EEC) to strengthen the regulation of statutory auditors. As a result, in April 2006 the Council adopted, in its place, the Directive (2006/43/EC) on the audit of accounts.
3. Subsequently the 2008 financial crisis highlighted further significant concerns as to possible shortcomings in the statutory audit of major listed companies and financial institutions and pointed to the need to take measures to re-establish investor confidence in the audit process which helps to underpin the quality of financial information. This led to calls for further reform of audit and regulation within the EU.
4. As a result, in October 2010 the European Commission looked again at the role of auditors, the governance and independence of audit firms, the supervision of auditors and audit firms, and international co-operation for the supervision of global audit networks.

C. Rationale for intervention

5. The risk that the market will underprovide a socially optimal level of rigorous and independent auditing, and hence the need for Government intervention, arises from market failures around: the misaligned incentives from the combination of audit and non-audit services being provided by the same organisation and the auditors acting for the shareholders but being paid by the audit client; and the lack of competition in the market for the provision of audit services. The proposed changes will provide better information to lead to more optimal business decisions, potentially reduce the likelihood of problems in the financial sector with its associated systemic risk and result in a more open audit market with greater opportunities for winning business and for new entry.

Auditor independence and integrity

6. Confidence in the auditor is fundamental. This includes confidence in the auditor's independence and objectivity.
7. Generally, if investors, trading partners and lenders do not trust the accuracy of financial statements, this can lead to reduced investment and higher cost of capital for companies. Audit is a service provided in the public interest, with a wide range of stakeholders having an interest in the credibility of financial statements, such as lenders, trade partners, employees and credit

⁴ <http://news.bbc.co.uk/1/hi/business/1780075.stm>

⁵ <http://www.economist.com/node/1610552>

⁶ <http://www.worldfinance.com/home/special-reports-home/the-parmalat-scandal>

rating agencies. The audit report on the financial statements is also used by regulators to ensure market stability.

8. Furthermore, following the financial crash, questions were asked as to how the financial institutions affected could have received clean audit reports prior to their failure⁷. Audit regulation requires audit reports to make an assessment about whether the financial statements present a true and fair view of the company's financial situation and the ability of the audited entity to continue to operate as a going concern. It does not have to provide an opinion of the future sustainability of the audited entity. This can create confusion amongst stakeholders about the scope of the audit and explain the expectation gap that can occur.
9. There are a number of specific areas that present a threat to the independence of the auditor, in particular; the provision of non-audit services to audit clients, the fact that the audited entity selects and pays the auditor, and familiarity resulting for example from a company retaining the same auditors for a very long period (e.g. between 2002 and 2010, the average annual switching rate for the FTSE 250 was 4%)⁸.

The provision of non-audit services

10. Providing non-audit services while auditing a company presents a potential source of conflicts of interest. This threat is increased, where non-audit service revenues from the statutory audit client become substantial or where the provision of statutory audit services becomes a gateway to the provision of non-audit services. There is a risk that "professional scepticism" could be compromised, with the auditor feeling unable to question assumptions when providing statutory audit services to the audited entity, because it could be reluctant to scrutinise the findings of non-audit services it also provides, and the potential conflict of interest. The Treasury Select Committee in May 2009⁹ called for the appropriateness of the provision of non-audit services by auditors to the entities that they audit be revisited, believing investor confidence and trust would be enhanced if auditors were prohibited from provided some or most non-audit services to those companies that are audit clients.

The audit client pays and management selects the auditor

11. The auditor's responsibility is to the shareholders and other stakeholders of the audited company but the auditor is selected and paid by the management of the company. In practice, shareholders have little or no say in the selection of the auditor. This undermines at least the appearance of the independence of the auditor and including feedback on the performance of the company's management.

Threat of familiarity

12. The regular re-appointment of audit firms over decades can result in a threat of familiarity. Whilst there are existing requirements to change periodically the audit partners within the same audit firm, the new partners may feel bound by previous decisions and feel unable to question or reopen them¹⁰. Indeed the FRC found that audit firms place considerable importance on client retention and relationship management, which may act as a disincentive for auditor scepticism.

⁷ An examiner of the Lehman Brothers bankruptcy stated that "the investing public is entitled to believe that a 'clean' report from an independent auditor stands for something." Anton R. Valukas, Examiner, Lehman Brothers Bankruptcy, Statement before the Committee on Banking, Housing & Urban Affairs, Subcommittee on Securities, Insurance and Investment, United States Senate, regarding The Role of the Accounting Profession in Preventing Another Financial Crisis, 6 April 2011.

⁸ http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf

⁹ <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf>

¹⁰ James R. Doty, PCAOB Chairman, Rethinking the Relevance, Credibility and Transparency of Audits, speech delivered at the SEC and Financial Reporting Institute 30th Annual Conference, Pasadena (California, US), 2 June 2011.

Lack of competition

13. Evidence presented to the European Commission¹¹ showed that the effective choice in the market for audits of large listed companies and large financial institutions has gradually been limited to the Big Four. This is a consequence of a number of barriers preventing new audit firms from entering the audit market for large public interest entities (PIEs):
 1. There is asymmetric information about the quality of auditors in the market meaning the reputation of the Big Four is an important factor in auditor choice;
 2. Well-developed international networks of the Big Four covering the large majority of countries in which multi-national groups gave a presence;
 3. Contract clauses that effectively require Big Four audits;
 4. Companies infrequently changing their auditor meaning little opportunity for new entrants to compete for contracts, leading to market stagnation; and
 5. Restrictive ownership rules have led to distortions in the market by creating a competitive advantage for audit firms even in non-audit service on one hand, and by creating de facto barriers to the growth of smaller audit firms on the other, therefore protecting large audit firms from competition from medium-sized firms.
14. These barriers contribute to the high concentration in audit markets. In the UK, the Big Four audit 99% of the FTSE 100, 95% of the FTSE 350 and earned 99% of audit fees in the FTSE 350. In some other important sectors in the UK economy, only three of the Big Four provide audit services. This high concentration is leading to the perception that the audit firms are “too big to fail” and that the failure of a large firm would create a disturbance in the market¹².
15. The Competition and Markets Authority (CMA)¹³ found a number of features in the market that give rise to an adverse effect on competition (AEC). They also found that mid-tier audit firms face barriers to entry, expansion and selection in the FTSE 350 statutory audit market. They face experience and reputational obstacles which, combined with infrequency and unpredictability of opportunities to tender, affects their incentives to make the necessary investment to overcome such obstacles. This combined with other factors such as barriers to switching outlined below, have the effect of reinforcing current market positions, and hindering emergence of new or strengthened rivals and so damages potential competition. It also reduces the potential competitive constraints firms can exercise on rivals and weakens companies’ bargaining power since companies may have a lesser range of outside options available to them.
16. The CMA identified a number of barriers to entry:
 - company management face significant opportunity costs in the management time involved in the selection and education of a new auditor;
 - companies and firms invest heavily in a relationship of mutual trust and confidence, which neither will walk away from lightly, as there is a loss of efficiency, and increased risk, in the technical quality in the early years of the engagement of the incoming firm, and
 - companies face difficulties in judging audit quality in advance, meaning companies cannot assess accurately the benefits that tender processes and switching would bring.
17. These barriers, along with other factors can lead to an adverse effect on competition by weakening a company’s bargaining power outside the tender process. The CMA believes that these features are pervasive throughout the FTSE 350 statutory audit market but their effect will be uneven across companies. How a feature or combination of features impacts on an individual company’s strength of bargaining power will vary over time and depend on its particular circumstances.

¹¹ See http://ec.europa.eu/internal_market/auditing/docs/reform/impact_assesment_en.pdf

¹² http://ec.europa.eu/internal_market/auditing/docs/reform/impact_assesment_en.pdf

¹³ CMA, 2013 Statutory Audit Services for Large Companies Market Investigation - Summary of Report

18. As a result of the AECs the CMA concluded that companies are offered high prices, lower quality (including less sceptical audits) less innovation and less differentiation of offering than would be the case in a well-functioning market.

D. Policy objectives

19. The legislation will improve confidence in the quality of statutory audit by stricter independence requirements on statutory auditors, including on the provision of non-audit services to audit clients, by making the audit report more informative and by strengthening the regulatory requirements applying particularly to audits of public-interest entities ('PIEs' – i.e. listed companies, banks, building societies and insurers). For listed companies transparency for shareholders has been a key aspect of a well-functioning equity market. For PIEs in the financial sector, the financial crisis demonstrated the domino effect that the lack of confidence in one financial institution can have on the whole financial system, with investors, regulatory bodies and lenders questioning the veracity of audit reports, particularly when failing financial institutions had received clean audit reports in spite of serious intrinsic financial weaknesses.

20. More specifically, the EU and UK's main objectives of the reform are to:

- (1) Further clarify the role of the statutory auditor;
- (2) Reinforce the independence and the professional scepticism of the statutory auditor;
- (3) Facilitate the cross-border provision of statutory audit services in the EU;
- (4) Contribute to a more dynamic audit market in the EU; and
- (5) Improve the supervision of statutory auditors and the coordination of audit supervision by competent authorities in the EU.

Scope – those who will be affected

21. The changes set out in the Directive and Regulation largely apply to Public Interest Entities (PIEs) and their statutory auditors. PIEs are defined as entities whose transferable securities are admitted to trading on an EU regulated market, credit institutions and/or insurance undertakings. Based on the definitions in the regulations of credit institutions and insurance undertakings we consider that the lists¹⁴ of UK authorised banks, building societies, insurers and Lloyds of London syndicates compiled by the Bank of England and used by the Prudential Regulation Authority (PRA) provide the full coverage of the credit institutions and insurance undertakings in scope.

22. In addition to this we have used the FAME database and the UK Listing Authority Official List to identify those companies which are listed on a UK regulated market (including the LSE Main Market, the Specialist Fund Market (SFM) or on another EU regulated market.

Based on analysis of these sources we have identified:

- **202 credit institutions** (156 banks and 46 building societies) of which **11 are listed** on EU regulated markets
- **609 insurers** (including 505 insurance undertakings and 104 Lloyds of London syndicates) of which **1 is listed** on an EU regulated market
- yielding a total of **811 credit institutions and insurers**, of which **799 are unlisted**
- **866 entities listed on an EU regulated market**

23. This results in an estimate total of **1,665 PIEs**.

¹⁴ The lists of authorised banks and building societies are available at: <http://www.bankofengland.co.uk/pr/Pages/authorisations/banksbuildingsocietieslist.aspx>, while the lists of UK incorporated authorised Insurers and of Lloyds syndicates are available at <http://www.bankofengland.co.uk/pr/Pages/authorisations/fscs/insurance.aspx>

E. Options considered

24. We propose three options, including do nothing. Option 0 would not address the problems identified above and is not considered feasible. The Directive introduces changes which are not compatible with the UK's existing framework. The Directive includes mandatory requirements that must be implemented **by 17 June 2016** for accounting years beginning on or after that date. That implementation must also provide for the application of the mandatory requirements of the Regulation on the same basis.
25. The Government's objective is to ensure that undertakings obtain the maximum benefit from the changes, whilst maintaining the integrity of the UK's audit and company law framework. In order to achieve this, additional measures are proposed alongside implementation, in order to ensure undertakings obtain the maximum benefit and least cost from the proposals. These measures are reflected in Option 2.

As Option 0 is not feasible, the focus of the analysis is limited to options 1 and 2.

- **Option 0: Do nothing.**

26. This option will not address the problems identified by the EU around the scrutiny and quality of audits. In addition, this option would place the UK in breach of its Treaty obligation to demonstrate transposition of the Directive into UK law and implement the mandatory elements introduced by it. This would impose costs on the Government in fines for infraction, and could also have significant reputational and diplomatic consequences.

- **Option 1: Take the minimum action required by the Directive. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes.**

27. Key elements within this option include:

- Increase in scope of the 2006 Directive to cover the following entities, where they were not already included as a result of being a company, LLP or qualifying partnership (QP): issuers of securities admitted to trading on a regulated market; 'markets in financial instrument Directive' investment firms (MiFIDs); undertakings for collective investment in transferable securities (UCITS); alternative investment funds (AIFs); and payment institutions.
 - Increase in scope of the requirements of Chapter X of the 2006 Directive on audits of PIEs now that most of these requirements have moved to the new Regulation
 - Changes to ethical standards relating to the provision of non-audit services
 - Changes to technical standards relating to reporting of irregularities and quality control
 - Changes to reporting requirements, requiring additional content and an additional report to the audit committee for PIEs
 - Changes to regulations regarding appointment and duration of engagement of auditors, requiring the re-tender of audit contracts at least every 10 years, and a change of auditor at least every 20 years, and changes regarding dismissal of auditors.
 - Changes to enable cross-border provision of audit services
 - Changes to regulations regarding competent authorities and the framework for the operation of the FRC.
 - The frequency of inspections of auditors to be determined on a risk basis, with the reduction of previous minimum frequencies of inspections for auditors of some SMEs. However this is combined with the effect of preventing the Financial Reporting Council from delegating any inspections of auditors of PIEs and increasing in the minimum frequency of inspections of unlisted large PIEs
- **Option 2: Implement the EU baseline – accompanied by additional adjustments to requirements on companies in order to facilitate a more flexible implementation**

- The table on the following page sets out an example of elements currently contained within Option 2 which are additional changes building on Option 1. The Government's consultation on the implementation of the Directive and the Regulation will seek views on whether these and other changes would further improve flexibility of the framework for those affected.

Matter within Directive or Regulation to which the measure relates	Details of the additional measure considered for inclusion under Option 2	Reasons for including this measure
<p>What conditions should be set for an extension of the maximum duration of the auditor appointment beyond 10 years. The Regulation requires the retender by the company should take effect at the end of the maximum duration [which is 10 years unless the member state decides otherwise]". Should that maximum duration be able to be less than 10 years where this would be better for the company in question?</p>	<p>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. This will improve flexibility but would not add to administrative burdens or costs.</p>	<p>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.</p> <p>This is particularly valuable for PIEs in a multinational group with member(s) that are subject to other mandatory retendering requirements in other countries.</p>
<p>Whether the scope of application of the implementation of the Directive should be set by reference to EU law only (i.e. only to "audits required by Union law") or whether it should also apply to audits of Limited Liability Partnerships (LLPs).</p> <p>At a domestic level we applied the implementation of the 2006 Directive to auditors of LLPs</p>	<p>We are proposing to continue with the approach of applying the implementation of the Directive to LLPs. The Regulation will apply in any case where an LLP is a PIE. This is for consistency with the law for company audits, where implementation is required as a matter of EU law. In addition some LLPs are required by EU law to be included because their activities put them within the extended scope of the Directive.</p>	<p>For consistency and in order to prevent the emergence of a "part-implementation" of EU audit requirements for LLPs we propose to implement the amendments in the new Directive for the audits of these entities.</p> <p>LLPs would only be subject to the new EU Regulation if they either issue securities on a regulated market or provide banking or insurance services. In these cases EU law would require implementation of both the Directive and the Regulation.</p> <p>The added impact of the measure considered under Option 2 would therefore only be for non-PIE LLPs, which would now be subject to the amendments to the directive.</p>
<p>Whether to update the disclosure of the auditor remuneration framework in light of FRC implementation of Articles 5 and 6 of the Audit Regulation.</p>	<p>The framework for companies' disclosure of the fees it has paid for audit and non-audit services could be amended for PIEs and other companies that the FRC subjects to the same framework to reflect the FRC's implementation when it emerges.</p>	<p>This would increase companies' transparency and accountability to wider stakeholders for their compliance with the blacklist of non-audit services and with the cap on these. It would provide incentives on compliance beyond those provided by the risk of action by the professional bodies and FRC, including via accountability to shareholders.</p>
<p>Whether the FRC should have powers itself to delegate functions in respect of approval of auditors and continuing professional development to the Recognised Supervisory Bodies. The alternative would be that these powers are delegated directly to the professional bodies by the statutory framework.</p>	<p>There are two options under the Directive and Regulation for the allocation to the RSBs of tasks in audit regulation. They can either be delegated by the Member State or by the competent authority (ie the FRC).</p> <p>(For inspections and investigations and discipline FRC delegation is better able to maintain existing flexibilities).</p>	<p>There is potential through the MS Options to increase flexibility for FRC to impose more focussed and graduated sanctions on the professional supervisory bodies for auditors. For instance particular tasks could be delegated on certain conditions or revoked where a problem had arisen.</p>

Table 2: Additional measures included under Option 2

Option 2 is our preferred option.

28. We will invite responses on the additional measures proposed to accompany implementation of the Directive and Regulation during the consultation. These measures are proposed with the aim of enabling a more flexible implementation of the directive which conforms better to the wider UK accounts regulation and which ultimately will create savings for business.

F. Discussion of Monetised and Non-Monetised Costs and Benefits of Each Option

We welcome views on the assumptions used below and any additional or improved estimates of the costs and benefits.

29. Data on the costs and benefits of the proposed changes are limited and thus there is considerable uncertainty around the best estimate and we have provided ranges where relevant. Estimates are based on: the EU Commission's assessment of hours taken per activity and at what level of seniority; the FAME database for the number, type and size of PIEs and for the audit fees; ONS data on wages; and public documents and discussions with stakeholders. The main body of the text sets out the risks and assumptions for each proposed requirement.

Option 1: Take the minimum action required by the Directive. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes.

30. This section focuses on the elements of the Directive or Regulation which are considered to have a significant impact on business. Those elements which are technical or minor changes, or which will not have a material impact on the status quo, have not been included. A summary of all measures are set out in annex A.

31. The areas of primary focus in this Impact Assessment are set out below:

Matter	Brief description of change	Impact - Costs
Scope and Application of the Directive and Regulation		
Subject Matter and Scope – Directive	Increase in scope of Directive to cover non-company/LLP/QP Issuers, MiFiDs, UCITS, AIFs and Payment institutions - see list of changes in the Audit Directive below	Number of new entities now covered is very low (25) due to majority already being covered as a result of being a company, LLP or qualifying partnership
Subject Matter and Scope - Regulation	Increase in scope of some existing requirements on PIEs currently in Chapter X of the Directive but (with the exception of the new Article 39 on Audit Committees) now moved to the Regulation. Chapter X Article 39 used to contain a MS option to exempt unlisted banks and insurers from all the Chapter X requirements on PIE audits. That MS Option has been removed. The main measures affected are those on audit committees, on transparency reporting by auditors of PIEs and on inspections of auditors of PIEs.	All of these costs are covered as the requirements of the new Regulation are discussed individually in this Assessment..
Conditions for Carrying out Statutory Audits		
Ethical Standards - Audit fees	PIEs to be subject to Non-Audit Service fees cap and blacklist	Will apply to all PIEs. No direct on-going impacts expected, but there will be one-off costs associated with reallocation of non-audit services to an alternative provider where necessary.
Technical Standards - Reporting Irregularities and Quality Control	PIE and PIE auditor reporting requirements	Relatively low impact – most auditors will already take action on irregularities and quality control and no significant costs expected. Some smaller PIEs will incur costs of appointing independent quality control reviewer. Responses to our discussion document ¹⁵ indicate that these would be few.
Audit Reporting - Additional Report to The Audit Committee	New additional audit report providing additional information specifically for the audit committee	Moderate costs involved for all auditors of PIEs in preparing an additional report.
Appointment and Scope of Audit Committee	Two changes - first to the requirements on audit committees and second on scope as unlisted banks, building societies and insurers must comply for the first time.	Significant impact of increase in scope of requirement for audit committee to include unlisted insurers. This will involve set up costs and on-going costs. Increase in requirements on audit committees

¹⁵ BIS (2014), 'Auditor Regulation: Discussion document on the implications of the EU and wider reforms', December 2014, 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

		will incur costs for all PIEs principally in the form of remuneration for additional time.
Regulatory Reporting and Information - Report to Supervisors of PIEs	Reporting to Financial Conduct Authority (FCA) on certain matters relating to listed companies	Impact for listed companies only as banks and insurers are already covered by an appropriate framework for PRA. Occurrence of relevant matters is infrequent therefore costs are expected to be low.
Regulatory Reporting and Information - Retaining and Disclosing Information	Auditors of PIEs have various obligations in respect of public reporting and reporting to FRC	Auditors of all PIEs now affected (not just of listed PIEs). Changes between new framework in Regulation and predecessor in Directive of limited impact.
Appointment of Statutory Auditors or Audit Firms		
Appointment Requirements - Procedure	Appointment process for PIE auditors via competitive tender by audit committee. Prohibition of "Big 4 only" clauses of policy significance.	Impact for all PIE audit committees in the form of additional time spent reviewing and processing tender.
Appointment Requirements - Duration of Engagement	Setting maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments at least every 10 years. Half of the work of policy formation already completed with publication of draft CMA Order.	Will impact only non-FTSE 350 PIEs as FTSE 350 have requirement on them through CMA order. Impact of more frequent tendering will create significant burden.
Dismissal or Resignation of Auditor	Dismissal framework for auditors of PIEs where competent authority or 5% shareholders go to court. This will be a significant new proposal in company law terms. Resignation framework much more limited	Impact on PIEs will be low and framework is permissive and voluntary therefore is considered zero cost.
Educational Qualifications, Professional Competence and Continuing Professional Development	Framework for EEA audit firms to provide services cross border; Convergence of MS qualifications; Adaptation period as alternative to aptitude test for individual EEA migrant auditors.	Some impact on audit firms, but not significant.
Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit		
Competent Authorities - Designation and Delegation of Tasks within UK	Shift in the regulatory framework that forms the basis for the operation of the FRC (i) requiring FRC to set some of the audit regulations under schedule 10 rather than Regulatory Supervisory Bodies (RSBs) (ii) setting up the framework in which FRC has some current RSB functions but delegates them to the RSBs (iii) moving away from framework in which independent standards, inspections and investigations and discipline are delivered by unnamed independent body towards a clear FRC framework.	These changes would not result in a significant difference in the operation of the framework in which the FRC and the RSBs work. However the structure of that framework would change and some familiarisation costs might result for the RSBs and the FRC. Given the small number of bodies involved (6) we think these would be minimal.
Competent Authorities - Powers	New powers for FRC to obtain information from 3rd parties. The FRC is currently the body responsible for investigation and discipline of auditors in public interest cases though without statutory powers to obtain information from third parties. These third parties might be the audited company, its staff, companies in the same group, companies with which that company has contracted etc.	These new powers would place on a statutory footing a framework of cooperation with the FRC. As existing levels of cooperation are high we would not expect these powers to be used often. However their availability is a significant enhancement in available powers should they be needed. Where these powers are used, we would not expect this to result in a additional burdens as in most cases compliance would previously have followed voluntarily.
Quality Assurance of auditors	For non-PIEs, the existing requirement that each audit firm must be subject to inspection at least once every 6 years will no longer apply for auditors only of small companies. Instead the frequency of these inspections of auditors would be determined on a risk basis. For PIEs, the minimum frequency for auditors of small and medium sized PIEs is increased from every 3 years to every 6. However this is combined with the effect of preventing the Financial Reporting Council from delegating any inspections of auditors of PIEs and increasing the minimum frequency of inspections of unlisted large PIEs from every 6 years to every 3	Additional cost to auditors of becoming subject to inspection by the Financial Reporting Council where at present the auditors are only inspected by their professional supervisory body. Some costs arising from changes to the frequency of inspections.

Table 3: Costs of principle measures impacting on auditors and audit clients under the new Audit Directive and Regulation

Benefits

32. For most of the measures benefits have not been quantified. The benefits associated with the Directive and Regulation primarily result from an increase in audit quality, which should in turn lead to increased investor and stakeholder trust in the financial statements of companies and other undertakings, and in particular of PIEs. The proposals also aim to increase the efficiency and level of competition in the audit market, giving greater opportunities to existing and new audit entities to compete. This should also increase choice as the Big Four and Mid-Tier audit firms will have incentives to develop and expand their capabilities in order to win engagements. In particular the measures could encourage firms other than the Big Four to invest in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth. This increased choice should lead to more competitive pricing, higher audit quality and more innovation. For the most part we have been unable to quantify the expected benefits due to their intangible nature.

33. The following table sets out in more detail the qualitative assessment of the benefits.

Matter	Brief description of change	Impact - Benefits
Scope and Application of the Directive and Regulation		
Subject Matter and Scope – Directive	Increase in scope of Directive to cover non-company/LLP/QP Issuers, MiFiDs, UCITS, AIFs and Payment institutions - see list of changes in the Audit Directive below.	These audits will now be regulated as statutory audits under Part 42 of the Companies Act 2006 in a way consistent with audit regulation more widely. Closure of potential loophole for audits of providers of financial services in the investment field where these are in a non-company/LLP/QP form. Audits will also be covered by a framework for international cooperation on their regulation should the need arise. We consider these benefits are unquantifiable.
Subject Matter and Scope - Regulation	Increase in scope of some existing requirements on PIEs currently in Chapter X of the Directive but (with the exception of the new Article 39 on Audit Committees) now moved to the Regulation. Chapter X Article 39 used to contain a MS option to exempt unlisted banks and insurers from all of the Chapter X requirements on PIE audits. That MS Option has been removed. The main measures affected are those on audit committees, on transparency reporting by auditors of PIEs and on inspections of auditors of PIEs.	Unlisted banks and insurers are still of considerable systemic importance to the economy. This measure will mean that their audits are regulated on the same basis. We consider these benefits are unquantifiable.
Conditions for Carrying out Statutory Audits		
Ethical Standards - Audit fees	PIEs to be subject to Non-Audit Service fees cap and blacklist	Will apply to all PIEs. Although no direct on-going costs are expected, there will be on-going benefits of auditor scepticism and audit quality, greater confidence of investors, a widened and a more competitive market for non-audit services, in which smaller audit firms could also have the opportunity to compete. We consider these benefits are unquantifiable.
Technical Standards - Reporting Irregularities and Quality Control	PIE and PIE auditor reporting requirements	Independent quality control reviews are already required by standards but this underpins the practice even where a PIE audit is provided by a smaller audit firm that has to outsource the review. This should improve audit quality and assure auditor independence and scepticism. We consider these benefits are unquantifiable.
Audit Reporting - Additional Report to The Audit Committee	New additional audit report providing additional information specifically for the audit committee	Additional information and assurance to the audit committee ensures the audit committee is seen by shareholders and as the focus of the company's relationship to the auditor so that the relevant directors are held accountable accordingly. We consider these benefits are unquantifiable.
Appointment and Scope of Audit Committee	Two changes - first to the requirements on audit committees and second on scope, as unlisted banks, building societies and insurers must comply for the first time.	Clarity for shareholders as to which directors are responsible for the company's relationship to the auditor. Increased investor confidence due to the increased independence of the audit

		committee. We consider these benefits are unquantifiable.
Regulatory Reporting and Information - Report to Supervisors of PIEs	Reporting to FCA on certain matters relating to listed companies	Clarity as to the role for a (limited) direct relationship between the supervisory authority and the auditor. Up to now this has arisen at times but it has been unclear when it is necessary. Much of the information the auditor is now required to pass to the supervisor would have been passed previously but not consistently or in a consistent timely way. We consider these benefits are unquantifiable.
Regulatory Reporting and Information - Retaining and Disclosing Information	Auditors of PIEs have various obligations in respect of public reporting and reporting to FRC	Increased transparency of audit firms is important given that in some cases their filed accounting and reporting information can be very limited. This will now apply in respect of auditors of all banks and insurers, including unlisted banks and insurers. We consider these benefits are unquantifiable.
Appointment of Statutory Auditors or Audit Firms		
Appointment Requirements - Procedure	Appointment process for PIE auditors via competitive tender by audit committee. Prohibition of "Big 4 only" clauses of policy significance.	On-going benefits of auditor scepticism and audit quality, confidence of investors, a widened and more competitive market for audit services in which smaller audit firms could also have the opportunity to compete. We consider these benefits are unquantifiable.
Appointment Requirements - Duration of Engagement	Setting maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments at least every 10 years. Half of the work of policy formation already completed with publication of draft CMA Order.	
Dismissal or Resignation of Auditor	Dismissal framework for auditors of PIEs where competent authority or 5% shareholders go to court. This will be a significant new proposal in company law terms. Resignation framework much more limited	Increased confidence for current and prospective minority shareholders who will be able to secure the removal of an auditor if the need arises. We consider these benefits are unquantifiable.
Educational Qualifications, Professional Competence and Continuing Professional Development	Framework for EEA audit firms to provide services cross border; Convergence of MS qualifications; Adaptation period as alternative to aptitude test for individual EEA migrant auditors.	Reduced costs for audit firms seeking to provide services cross-border or who operate cross-border already in respect of recruitment and deployment of individual audit staff. Adaptation period has potential to increase flexibility for qualified individual auditors. We consider these benefits are unquantifiable.
Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit		
Competent Authorities - Designation and Delegation of Tasks within UK	Shift in the regulatory framework that forms the basis for the operation of the FRC (i) requiring FRC to approve the audit regulations under schedule 10 rather than RSBs (ii) setting up framework in which FRC has responsibility for some current RSB functions but delegates them to the RSBs (iii) moving away from a legal framework in which independent standards, inspections and investigations and discipline are delivered by unnamed independent body towards a framework that clearly designates FRCas that body.	
Competent Authorities - Powers	New powers for FRC to obtain information from 3rd parties in relation to audits of PIEs. The FRC is currently the body responsible for investigation and discipline of auditors in public interest cases though without statutory powers to obtain information from third parties. These third parties might be the audited company, its staff, companies in the same group, companies with which that company has contracted etc.	Increased confidence in UK regulatory framework for investors. We consider these benefits are unquantifiable.
Quality Assurance of auditors	For non-PIEs, the existing requirement that each audit firm must be subject to inspection at least once every 6 years will no longer apply for auditors only of small companies. Instead the frequency of these inspections of auditors would be determined on a risk basis. For PIEs, the minimum frequency for auditors of small and medium sized PIEs is increased from every 3 years to every 6. However this is combined with the effect of preventing the Financial Reporting Council from delegating any	Potential for some quantifiable benefits resulting from reductions in the frequency of inspections of auditors of small companies. Potential for some quantifiable benefits resulting from reductions in the frequency of inspections of auditors of PIEs where these are all only SMEs. Similar reductions for auditors only of small companies. We will seek to establish the extent of any quantifiable benefits during the consultation.

	inspections of auditors of PIEs and increasing the minimum frequency of inspections of unlisted large PIEs from every 6 years to every 3	process. Other unquantifiable benefits result from increased confidence of investors in the UK audit regulatory framework.
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Table 4: Benefits of principle measures impacting on auditors and audit clients under the new Audit Directive and Regulation

G. Cost Calculations

Familiarisation costs

34. There will be costs for auditors in familiarising themselves with the changes to the requirements relating to audits and auditors. There will also be familiarisation costs for all PIEs in understanding the requirements on themselves, in particular relating to non-audit services provided by the auditor, and the requirement to have an audit committee.

- *Familiarisation costs to auditors of entities with securities traded on the UK regulated market*

35. There are 22 audit firms, with a total of 1075 audit principals¹⁶, which undertake audits for clients with securities traded on UK regulated markets¹⁷, and a further 13 smaller firms on which we have no data.

36. Due to the technical aspects required in audits of credit institutions and insurers we would expect these types of entities to require at least a similar level of expertise as required for companies listed on regulated markets, and therefore would expect the audit firms which audit these entities would comprise the large majority of firms which may audit PIEs in general.

37. On this basis, and for the purpose of this consultation impact assessment, we assume that 1,075 audit principals will need to familiarise themselves with the revised requirements. Furthermore we assume these organisations will incur the bulk of familiarisation costs as it is clear they already devote considerable time to familiarising their audit clients with regulatory changes in the area of audit.

38. On this basis we had constructed a model, to obtain estimates of the likely familiarisation costs for auditors. This is based on: three size categories of audit firms according to the numbers of audit principals at the firm; the average numbers of both audit principals and non-audit principals for firms in each category; the person hours they would each be expected to spend in familiarisation; the sizes of audit and non-audit teams in firms in each category and the number of person hours that each team would spend.

39. Finally, we had also sought estimates according to these size categories of audit firms, of the costs that are likely to be involved in updating their internal quality assurance and monitoring systems. These are intended for instance to monitor the provision by the different parts of the firm of non-audit services to audit clients.

40. So far, one large firm has provided data to populate the “person hours” part of the model. This includes the time required for systems updates and adjustments of procedures and is based on our original assumption on the sizes of teams. To estimate the cost of this time, we used median hourly wage data provided by the ONS Annual Survey of Hours and Earnings (ASHE data) uplifted by a factor of 19.8 (to reflect non-wage costs)¹⁸. We intend to consult on how closely this reflects the time costs of personnel. We used this information to calculate a possible estimate of familiarisation costs for the 5 largest firms (those with > 100 audit principals).

- a large audit company has 149 audit principals (each spending 57 hours at £45.90 per hour)

¹⁶ Partners or members of an LLP who hold an audit qualification.

¹⁷ FRC Key Facts and Trends in the Accountancy Profession 2013 <https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profession.aspx>

¹⁸ See Annex C

- each of the 149 audit principals having a team of 30 spending 37.5 hours at £23.26 per hour;
- 1,140 hours spent by non-audit principals and their teams at a weighted average cost of £25.52 per hour.

41. We estimate a preliminary familiarisation cost to one large audit firm of £4.32m. Thus the cost to the five largest audit firms is £21.59m¹⁹. Annex B sets out the calculations in detail.

42. We had data for calculating the average number of audit principals and non-audit principals for the 7 medium sized auditors (with > 30 principals) and 10 of the 23 other (ie small sized) auditors with clients that have securities on regulated markets. However we did not receive any additional information on the time costs for small and medium sized auditors, so we have extrapolated on information given for large firms to provide an estimate for these. We made assumptions about the size of the teams of each audit and non-audit principals (10-30 members, or 20 on average for medium firms, and 5-15 members, or 10 on average for small firms). Using this and extrapolating on time costs given to us on large firms our estimate of the total costs to small and medium sized audit firms is £12.07m. The total cost across all auditors with clients that have securities on the regulated market is therefore £33.65m. We intend to seek views and improve our estimates during the consultation. Annex B sets out the calculations in detail.

- *Familiarisation costs to auditors of unlisted banks, building societies and insurers*

43. In addition to these there would be familiarisation costs to auditors of unlisted banks, building societies and insurers that would be “new in scope” by virtue of the extended definition of PIEs.

44. We and the FRC are investigating how many auditors are currently engaged in audits of unlisted banks and insurers. FRC is aware, from its audit inspection work, which applies to all unlisted banks, that there are 3 audit firms that audit unlisted banks and building societies but no listed companies. This is out of 171 banks and building societies that FRC data shows are neither listed themselves nor have UK listed parents. These firms would have to produce a transparency report for the first time. FRC data on unlisted insurers is less comprehensive given its limited inspection remit in this area.

45. Given the lack of data on unlisted insurers at the time of drafting this IA, we have identified two straightforward methodologies for estimating the number of additional auditors, of unlisted insurers:

- The first is based on the assumption that the proportion of auditors of unlisted insurers that do not audit other PIEs is comparable to that for unlisted banks. A comparable proportion of the 556 insurers that are neither listed nor have UK listed parents suggests that $556 \times (3/171) = 10$ new audit firms could be brought into scope of this requirement.
- The second is based on the assumption that, with the inclusion of unlisted insurers, there will be an increase in the total number of PIE auditors in a proportion to the increase in the number of PIE audits. Currently there are 866 entities with securities admitted to trading on a regulated market audited by 35 auditors. The inclusion of 608 unlisted insurers will represent an increase of $(608 / 866 = 70\%)$. A 70% increase from the current 35 auditors will represent a further 25 auditors.

46. Given the imprecision in these methods, we are base our estimate of the number of additional auditors of unlisted insurers now in scope as ranging from 10 to 25 firms. Therefore we estimate that, in total, between 13 (10 for unlisted insurers+3 for unlisted banks) and 28 (25 for unlisted insurers + 3 for unlisted banks) additional auditors of unlisted PIEs would have to familiarise and adjust themselves for the new requirements. We then proceed with our estimates of familiarisation costs using the same data as for auditors of entities with securities traded on the UK regulated market.

¹⁹ Time costs are estimated based on median hourly pay, excluding overtime, provided by the Annual Survey of Hours and Earnings (ASHE) Data for 2014 (provisional results). Wages are uplifted by 19.8% per cent in line with Eurostat’s estimates of non-wage costs for the UK in 2014. Source: http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Labour_costs_per_hour_in_EUR. See Annex C

47. This analysis requires additional assumptions on how many of the of the additional auditors would be medium sized firms and how many would be small firms (as there are only 5 audit firms with more than 100 audit principals). We assume that of the additional firms that audit unlisted banks, building societies and insurers, the ratio of small and medium auditors would be roughly the same as that of small and medium firms auditing companies with securities on the regulated market. The total number of small and medium auditors with clients on the regulated market is 30 (7 medium and 23 small). We therefore assume that the ratio of medium to small insurers would be roughly 1:3. Our best estimate of the total cost to additional auditors of unlisted banks, building societies and insurers is £8.54m (see Annex B for the calculation).

48. Responses to our discussion document also indicate a general view that the time costs of familiarisation and implementation would be greater for firms auditing less than 10 PIEs, and firms auditing a company that becomes a PIE for the first time under the new definition. We intend to gather more evidence on this and seek views on our current estimates and underlying assumptions through the consultation period.

- *Costs to PIEs*

49. We have not received information on the time PIEs will take to familiarise themselves and implement changes in response to the Directive. We therefore have no data to inform estimates of familiarisation and implementation costs to PIEs. In the absence of data, assumptions have been made for the consultation stage IA. We intend to seek views from firms on how reasonable these assumptions are during the consultation. To reflect the lack of information we provide a range of estimates.

50. We again applied the model used to calculate the time costs of familiarisation and implementation among large audit firms - specifically using the time costs that were envisaged for non-audit principals and their teams. Assuming the same ratios i.e. 1 senior executive to 30 team members in large firms, 1 senior executive to 20 in medium firms and 1 senior executive to 10 in small firms, we estimate a weighted average cost per hour using ASHE data²⁰. We further assume that the time spent by personnel in large, medium and small PIEs would be similar to that spent by non-audit principals and their teams in large, medium and small audit firms. Hence a best estimate of 1200 hours for large firms, 100 hours in medium firms and 20 hours in small firms. Our estimate of the total familiarisation and implementation costs to PIEs is between £17.72m and £43.21m, with a central estimate of £30.46m. Annex B shows the details of the calculations.

51. While responses to our discussion document did not provide specific quantitative information, the qualitative responses received did emphasise that costs to existing PIEs and their auditors would be smaller than those to companies newly in scope as PIEs or as the auditors of PIEs. We will also be seeking further views on this and our estimates of costs during the consultation.

52. The total familiarisation and implementation costs of the changes are estimated at £72.66m. It is assumed that these costs will be incurred in 2016, the year that the UK legislation comes into force.

- *Familiarisation costs to non-PIES*

53. These costs, resulting from the application of the amending Directive to non-PIE entities already covered by the 2006 Directive are considered negligible by comparison to the changes introduced for PIEs. All of the effects of the amending Directive discussed below on non-PIEs are considered to be of negligible impact. We consider the familiarisation costs with these changes are also of negligible impact. This is not just for the non-PIE entities themselves but also for those auditors who only audit non-PIEs. The changes affecting them relate to the introduction of an adaptation period for individual EEA auditors and the introduction of a framework for mutual recognition of EEA audit firms. These have negligible impact on UK non-

²⁰ We used data on the mean hourly wage for chief executives and senior officials and that for managers, directors and senior officials. Each is uplifted to include non-wage costs.

PIEs and on their existing auditors and there is nothing in the framework that they must familiarise themselves with.

54. We have attempted to establish how many non-PIEs would be affected if there were any familiarisation costs arising from these changes. The FAME database suggests that there are 98,618 companies and LLPs required to undergo an audit each year in the UK, This excludes small companies and LLPs who can avail themselves of audit exemption and only undergo an audit by their own choice. Of these 1,665 are PIEs leaving 96,953 non-PIEs. Of these 1,017 are LLPs.
55. The number of non-PIE LLPs is particularly important as these are not actually subject to the 2006 Audit Directive, though the implementation has been applied to them. They are also not subject to the amending Directive. This is discussed further under Option 2 below, as the application of the Directive implementation to non-PIE LLPs is actually part of Option 2 and not a part of Option 1.

Scope and Application of the Directive and Regulation

Subject matter and scope

56. The revised directive will apply to all entities which are required by EU law to have a statutory audit. This includes all companies, LLPs and qualifying partnerships, as well as types of entities which were not covered by the 2006 Directive but, through more recent EU instruments, are now required to have a statutory audit. The types of entity that are now newly covered, even in cases where they are not companies, LLPs and qualifying partnerships are: issuers of transferable securities admitted to trading on a regulated market; 'markets in financial instruments Directive' investment firms (MiFIDs), undertakings for collective investment in transferable securities (UCITS), alternative investment funds (AIFs) and payment institutions.
57. Based on information provided by the Financial Conduct Authority (FCA), and from FAME, we estimate that there are only 25 of these types of entities (all 25 of which are MiFIDs) which are not companies, LLPs or qualifying partnerships, and therefore were not covered by the 2006 Directive but will now be required to comply with the requirements of the 2006 Directive as part of the implementation of the new framework.
58. Having examined the Government's 2007 Impact Assessment²¹ for the implementation of the 2006 Directive and the number of entities affected, we have concluded that the application of the implementation to these entities is unlikely to create additional costs or benefits. This is best explained by reference to the costs arising from the 2006 Directive.
 - The 2007 Impact Assessment identified the largest headline cost applying to all UK statutory audits as that arising from requirements on dismissal and resignation of auditors, which was estimated at £215,000 per annum. (We have since reassessed the impact of this framework under Article 38 of the Directive in practice and consider it to be nearer to £594,000 per annum²²). Though there were other significant costs in relation to audits of PIEs in the 2007 Assessment, the entities to which this older Directive will now be applied will be UK non-PIEs. There are also a number of other smaller and less costly requirements. The estimate of £594,000 relates to notices served of auditors leaving office in 2012, a year in which 103,611 companies had their accounts audited. This means that the cost per audited company was £5.73²³. For 25 additional entities covered by the Directive the total cost would therefore be £143. These costs are considered insignificant in the context of this impact assessment.

Conditions for Carrying out Statutory Audits

²¹ See PDF at <http://www.legislation.gov.uk/uk/si/2007/3495/memorandum/contents> page 6 to 26

²² Unvalidated IA on Notices of Auditors Leaving Office at www.parliament.uk/documents/impact-assessments/IA14-021.pdf . Page 15 states that 13,681 notices were served in 2012. Page 17 identified a best estimate for the cost of serving these as £42.60 each. 13,681 x £42.60 = 583k which when uprated from 2012 to 2013 as the price base year = 594k. Page 4 of the impact assessment explains that in 2012 103,611 companies were audited.

²³ Adjusted for 2014 as price base year.

i. Restrictions on the Provision of Non-Audit Services

59. The Regulation applies both a cap on non-audit services provided to a PIE by its auditor and imposes a complete ban on the provision by the auditor of certain non-audit services. When the statutory auditor provides an audit for a period of three or more consecutive financial years the total fees from non-audit services shall be limited to no more than 70% of the average audit fees paid in the previous 3 years. In addition, specific non-audit services will be prohibited. These include, among others, certain types of tax services, consultancy services relating to management or decision making of the audited entity, bookkeeping and payroll services, and services relating to risk and risk management. These requirements are being brought in to preserve the independence of the auditor and reduce the potential for a conflict of interest arising for the audit firm.
60. These provisions will apply to 1,665 PIEs and their auditors and will require those companies which have non-audit service fees above the threshold, or which have non-audit services which are prohibited from being carried out by their statutory auditor, to reallocate some of these services to another provider.
61. We would not expect there to be any on-going direct costs on either the auditors of the PIEs, or on the the PIEs themselves as a result of these requirements. It is expected that the PIEs would still require the non-audit services. While the auditor would not be able to provide as many such services to that audit client, it would be able to provide them to another non-audit client who is no longer able to obtain some of its non-audit services from its own auditor. If the market for the supply of non-audit services were as restricted as the market for the largest audits, there might be an indirect competition effect resulting in increased non-audit fees because of the further restriction on a company's choice of non-audit services provider. However we think that in fact the market for provision of non-audit services is more competitive than that for audit services, given the number of additional participants.
62. There may be some economies of scale in obtaining non-audit services from auditors who already understand much of the company's business in particular, following the appointment of a non-audit service provider there may be familiarisation costs. We intend to seek further views on this during the consultation and reflect them in the final IA. For the purpose of this consultation stage IA, we are therefore taking the same approach as the European Commission Impact Assessment²⁴, in that we do not anticipate any direct on-going costs.
63. We would however expect there to be transitional costs incurred by those PIEs that will need to reallocate service provision. Our estimates of these costs are set out below.
64. Information on audit and non-audit service fees accessed from FAME indicates that 86%²⁵ of listed companies have non-audit services provided by their auditor. Applying this across the number of PIEs suggests that 1,432 PIEs have non-audit services provided by their auditor. It is normal and acceptable for the auditor to provide services, for example to support capital transactions and regulatory reporting. This is permitted by existing UK standards and allowed by the Regulation, subject to the overall cap.
65. Some of these non-audit services will be the auditing of accounts of associates of the company i.e. the audit of subsidiary accounts. We are able to subtract the value of subsidiary audits from the value of non-audit services provided by the auditor. This leaves other non-audit services, some of which will not be prohibited, for example audit-related assurance, whilst others will be blacklisted.
66. We have considered whether it would be practicable to review the accounts of a sample of PIEs to obtain a better estimate of the proportion of the value of non-audit services provided by the auditor which will be blacklisted. We have concluded however that this may require significant resource and that even then it is not clear the results would be useful. We have therefore applied a range of 20%-80% by value of other non-audit services which will need to be reallocated.

²⁴ http://ec.europa.eu/internal_market/auditing/docs/reform/impact_assessment_en.pdf

²⁵ This is based on a sample of 751 listed companies..

		Low estimate	Best estimate	High estimate
a	proportion of companies having NAS provided by their auditor	86%	86%	86%
b	Total PIEs in scope	1665	1665	1665
c	Total PIEs needing to re-allocate NAS on blacklist (a x b)	1434	1434	1434
d	Average parent NAS cost (excluding subsidiary audit)	91,159	100,687	119,516
e	Total Parent NAS cost (excluding subsidiary audits)	130,761,395	144,427,737	171,436,560
f	percentage of blacklisted NAS	20%	50%	80%
g	Total value of blacklisted NAS to be re-allocated (e x f)	26,152,279	72,213,868	137,149,248

Table 5: Estimating the total value of non-audit services that PIEs will need to obtain from other providers with the application of the black-list

67. Those companies which, after this reallocation due to the blacklisting of certain non-audit services, will still have non-audit services fees from their auditor of above 70% of the audit fees from the previous 3 years will need to reallocate more of their fees. 26% of listed companies have non-audit services fees above the threshold²⁶, scaling to an estimated 378 PIEs. From Fame we have the average value of non-audit services fees above the threshold and therefore can estimate the average remaining value which will need to be reallocated following reallocation of blacklisted services. We then multiply this by the 378 PIEs with non-audit services fees above the threshold.

		High estimate	Best estimate	Low estimate
a	proportion of PIEs that have NAS above 70% of average fees over last 3 years	26%	26%	26%
b	Number of companies needing further reallocation of NAS (1665 x 26%)	378	378	378
c	Average value of total NAS fees above the threshold	522,886	522,886	522,886
d	less: Average value of NAS blacklisted	18,232	50,343	95,613
e	Value of reallocation to meet threshold per PIE (c - d)	504,654	472,543	427,273
	Total value of reallocation to meet threshold (e x b)	190,852,312	178,708,355	161,588,241

Table 6: Estimating the total value of non-audit services that PIEs will need to obtain from other providers with the application of the cap on non-audit services

68. This gives us an estimate of the total value of services which will need to be reallocated. These will not *require* a tender, but some companies will use a tender process to reallocate their

²⁶ Based on information from FAME on audit and non-audit fees

services and in the absence of a tender, they will still incur some costs of finding and appointing a new service provider.

69. On this basis, we use a prudent approach of using the assumptions of the costs of the re-tendering of the appointment of the auditor provided in the EU Impact Assessment and we assume that the cost of tendering is directly related to the audit fee. This data is discussed further under “Appointment of statutory auditors and audit firms” below.
70. The EU impact assessment estimates the cost for each individual PIE based on its own size categories. Applying these categories to FAME data on audit fees it is possible to establish an average audit fee for each category and examine this in combination with the EU Impact Assessment data²⁷, on retendering.
71. Based on the EU size definitions²⁸ used in these cost assumptions we estimate using the FAME database that there are 15 listed companies which are very large, there are 174 companies which are large and 599 companies which are medium sized, leaving 877 which are small.
72. Comparing these estimated costs to the average audit fee for the same size groups²⁹ we find that for large and very large companies the cost of re-tendering is estimated at 1.7% of the average annual audit fee. For medium companies the cost of retendering (£50k) is 2.3% of the audit fees for this size group..
73. Extrapolating on the information we had for the other PIE size bands, we added the “small” category (turnover<50m Euros). This is done by imposing linear relationships between annual audit fee and tender cost to both auditor and PIEs. Our estimate of costs of tendering for small PIEs is £9,524³⁰.
74. Thus for small sized PIEs the costs of tendering are estimated at 25.77% of average annual audit fee.
75. Having established estimates for tender costs as a percentage of the audit fee for each size category, we have then calculated a weighted average percentage for companies overall. The weighted average tender cost as percentage of the audit fee is estimated at 4.81% across the population of PIEs:

Size of company	Number of PIEs	Annual audit fee	EU re-tender cost (or projected)	Tender cost as % of audit fee
Very large ³¹	15	£19,640,652	£365,214	1.86%
Large ³²	174	£3,432,500	£63,912	1.86%
Medium	599	£460,088	£54,782	11.91%*
Small	877	£36,955	£9,524	25.77%*
Weighted average across population				4.81%*

²⁷ EU Impact assessment data was adjusted using an annuity rate to ensure the data was in a consistent year's prices.

²⁸ See footnotes 24, 25, 26

²⁹ Size groups are based on those used in EU IA in estimating tender costs. Very large: turnover >€40bn; Large: turnover of between €2bn - €40bn; Medium: turnover of between €50m - €2bn

³⁰ The equations for the line of best fit (given our three data points) used to calculate the cost for small PIEs was
 $\text{Cost to PIE} = \text{Average Annual Audit Fee} \times 0.0018 + 885.89$

³¹ A very large PIE is defined for this purpose in the EU impact assessment as total turnover more than €40bn

³² A large PIE is defined for this purpose in the EU impact assessment as total turnover of more than €2bn

Table 7: Establishing a weighted average tender costs to PIEs for non-audit services

76. We use these percentage costs to estimate the costs of tendering for the reallocation of the total value of non-audit services we estimated earlier. We use 4.81% as our central assumption of the average costs of reallocating the value of non-audit services across all PIEs. We apply a high estimate of 25.77% reflecting the fact that for the majority of companies the value of reallocation of non-audit services will be lower than the value of their audit services so the proportionate cost of reallocation may be higher due to fixed costs. We apply a low estimate of 1.86% reflecting the fact that many companies will not carry out a formal tender in order to reallocate services and therefore will incur lower costs.

		Low	Best	High
a	Tender cost as a percentage of fees	1.9%	4.8%	25.8%
b	Value of NAS to be reallocated due to blacklisting £m	26.15	72.21	137.15
c	Value of NAS to be reallocated due to 70% threshold £m	161.59	178.71	190.85
d	Total value of reallocations £m (b+c)	187.74	250.92	328.00
e	Total Cost of reallocations (£m) (a x d)	3.49	12.08	84.53

Table 8: Estimating total tender costs to PIEs for reallocating non-audit services

77. This indicates a total **one-off cost** of between £3.5m and £84.5m with a best estimate of **£12.1m** although, due to the fact that a tender is not required to be undertaken in order to appoint a new service provider, the costs may be significantly lower. The cost of this reallocation would recur for any PIE that in subsequent years appoints as its auditor the organisation that is at the time providing its non-audit services. However, it is difficult to estimate the extent to which this would happen given the uncertainty around the incidence of this happening and the value of services that would then need to be reallocated again. In addition, the choice to make such an appointment would be a decision by the individual business, which would presumably only be made in cases where the benefits outweighed these costs.

78. There may also be indirect costs on the audited entities which need to reallocate services as they could face higher costs of either the audit or non-audit services. The indirect costs on specific entities cannot be estimated as they largely depend on the overall restructuring and degree of competition of the market segments of statutory audit and non-audit services.

79. Key assumptions and risks:

- The cost of reallocating non-audit services is largely proportional to the value of the services
- Reallocation of non-audit services will involve costs in line with those estimated for the re-tender of audit services.
- On average between 20% and 80% by value, with a best estimate of 50%, of non-audit services (excl. the audit of associates of the company) will be blacklisted.
- The audit and non-audit fees for listed companies are broadly representative to those for all PIEs.

ii. Technical Standards - Reporting Irregularities and Quality Control

80. This will affect auditors of PIEs and relates to (i) a requirement to report any irregularities first to the audited entity and second to the designated authority in the event that the audited entity does not investigate the matter, and (ii) a requirement that before the submission of the audit report, an engagement quality control review must be carried out by a statutory auditor not involved in the audit to which the review relates, to assess whether the statutory auditor or the key audit partner could reasonably have come to the opinion and conclusions expressed in the draft of these reports.

81. Whilst not explicitly required currently, adding a specific requirement around reporting irregularities in the standards should not have much impact on the conduct or procedures of auditors as it should already be part of good practice within auditors, and therefore is not expected to have significant cost implications.
82. There may be costs to some audit firms associated with the quality control requirements. In most cases the requirement relating to quality control will already be met, however for very small audit firms or larger firms with relatively few 'responsible individuals' with expertise in certain industry sectors, the impact could be greater, as it may be more difficult to identify such partners who are independent of the audit internally within the firm. In these cases, costs would relate to hiring an external statutory auditor for the specific purpose of carrying out quality control reviews, however as this work would be being carried out anyway, the only additional cost will be any premium for consultancy work would represent additional costs over and above the cost of carrying it out internally.
83. We assume that an audit firm with 4 or more 'responsible individuals' will have sufficient capacity to ensure that there is such a partner who is independent of the audit who can undertake the quality control review. Based on data from the FRC³³ we find that, out of the 22 audit firms which audit listed companies, only one has fewer than 4 responsible individuals and is carrying out a total of 3 audits. There may be further firms with very few 'responsible individuals' among those firms which audit other PIEs, and in addition there may a few additional larger firms which may face additional costs due to specific technical or sector expertise, but similarly these are expected to be low. Responses to our discussion document confirm this position.
84. Key assumptions and risks:
- Auditors of PIEs will already be meeting this requirement to a significant extent
 - The number of firms which will face additional costs due to the need for specialist expertise in the quality control reviewer is low.
 - The cost to those firms which do face additional costs is low
- iii. Audit Reporting - Additional Report to The Audit Committee
85. This requirement will impact auditors of PIEs, and will involve additional costs to the auditor of preparing the additional report for the audit committee – the information contained within the report is the result of the audit work itself, therefore there will be no additional costs relating to obtaining and collating the relevant information. Based on the text in the regulation we assume that all PIEs will be required to prepare this additional report.
86. One response to the discussion document provided estimates of time taken for the preparation and discussion of these reports. It suggests that costs are likely to be low for listed companies and high for PIEs that do not currently apply the FRC Corporate Governance Code³⁴. The time taken to draft, review and present an existing UK enhanced audit report is of the order of 10-15 hours. Reports for smaller PIEs are estimated to take up to 5-6 hours of auditor time. Given that many of the existing provisions of Article 11 would already be covered in existing reports to those charged with the corporate governance code, the additional time taken is likely to be single figure hours.
87. We therefore assume 9 hours of additional time would be required by auditors of listed PIEs in preparing and presenting the report. For unlisted PIEs we assume 15 hours (6+9) for small PIEs, 19 (10+9) hours for auditors of medium PIEs and 24 (15+9) hours for auditors of large PIEs.

³³ FRC, Key Facts and Trends in the Accountancy Profession 2013

³⁴ FRC (2014), 'The UK Corporate Governance Code', <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>

88. The response also suggests that audit committees would probably spend an hour or two reading and preparing for the meeting and another hour or two debating the report. In our calculations we assume average time costs of 3 hours for the audit committee.

89. Analysis of FAME data (based on a sample of 822) finds that there are 556 small PIEs, 135 medium PIEs and 974 large PIEs. Based on this we can establish the cost to an audit firm of preparing the report:

	Unlisted			Listed
	Small PIE	Medium PIE	Large PIE	All
Auditor Preparation and Presentation time (hr)	15	19	24	9
Number of auditors	2	2	2	2
Cost of Auditor time at £23.26 per hour	698	884	1,116	419
Debate and discussion time (hrs)	3	3	3	3
Number of Audit Committee members	4	4	4	4
Cost of Audit Committee time (£45.90 per hr)	551	551	551	551
Number of PIEs	300	104	395	866
Ongoing cost (£)	374,019	149,347	659,119	839,574
Total cost across all firms (£)	2,022,058			

Table 9: Estimating total additional costs of producing the additional report to the audit committee

90. The total annual burden of producing the audit report is therefore estimated at **£2.02m**.

91. These estimates may overstate the costs of producing the report, as electronic programmes and sample form reports could reduce the time take to prepare the reports.

92. Key assumptions and risks:

- That ASHE data accurately reflects the cost to the audit firm of the time taken to produce the additional report.
- That the size profile of listed companies is broadly in line with that of unlisted credit institutions and insurers.

iv. Appointment and Scope of Audit Committee

a. Appointment of Audit Committee

93. The Regulation extends the scope of the requirement for an audit committee to all PIEs, beyond the existing coverage of listed PIEs. However, credit institutions whose shares are not listed on a regulated market and if they issue debt securities on a regulated market of a total nominal amount below €100m, have been made exempt from this requirement. Regulatory expectations of the PRA, however suggest that all banks and building societies would already have an audit committee. We therefore assume that the impact of the requirement to set up an audit committee would fall mainly on unlisted insurers.

94. Based on data from the Bank of England and FAME (see discussion above) we estimate there are currently 608 unlisted insurers (including Lloyds of London syndicates) which will be brought in scope of the 2006 Audit Directive. However 52 of these have parents with securities admitted to trading on a regulated market. These are not included in the costs below as they are the subject of an exemption in the Directive from a requirement to have their own audit committee.

95. The remaining 556 unlisted insurers which do not currently have an audit committee with a fully independent member will be required to establish one.

96. Analysis carried out for the 2006 Audit Directive IA based on survey evidence from Grant Thornton and Manifest³⁵ estimated that 60-80% of listed companies already had an audit committee with a fully independent member. We assume a similar figure can be applied to unlisted insurers.
97. This suggests that between 111 and 222 insurers will need to establish an audit committee. For companies not in the FTSE 350 audit committees must consist of at least 2 members³⁶, who must be independent, in order to comply with the regulation.
98. The 2006 IA estimates the cost of recruiting an independent member to be £10,000, with an on-going cost to the company of £15,000 per annum. The PWC 2013 report on non-executive director fees, but also provides more information on the fees for small and medium companies (SMC), finding that the average fee paid by SMCs to their audit committee chairman is £6,000 and to other members is £5,000³⁷. The report also estimates the base fee for a non-executive director at £40,000.

PWC 2013	FTSE 100	FTSE 250	SMC	All listed companies
AC Chairman additional fees £	20000	10000	6000	
AC Member Additional Fee £	15000	5000	5000	
Non executive director base fee £	61000	46000	40000	
2006 Audit directive IA				
Recruitment of independent member fees £				10000
Recruitment of independent chairperson fees £				15000

Table 10: Information on recruitment and retention costs of Audit Committee Member and Chair

99. We assume that the fees paid by unlisted insurers without audit committees fall between those paid by the FTSE 250 companies and those paid by SMCs which have audit committees. We use the PWC figures for these groups as the high and low estimate, a mid-point as the best estimate. We do not have any more up to date information regarding the cost of recruiting an independent member or chair therefore revert to the 2006 estimates, uplifted for inflation between 2006 and 2014. We therefore apply the following costs (PTO):

³⁵ The relevant discussion is on page 23 of the PDF at www.legislation.gov.uk/ukxi/2007/3494/memorandum/contents. A further discussion of the research is at www.frc.org.uk/FRC-Documents/FRC/FRC-Effective-Corporate-Governance.aspx

³⁶ Audit Committee Institute, "A Practical Guide – Shaping the UK audit committee agenda"; Spencer Stuart, "UK Board Index 2013"

³⁷ This re-iterates more recent evidence from KPMG's Guide to Directors' Remuneration 2013, which finds that the average (median) fees paid by the FTSE 100 are £20,000 for an audit committee chairman and £15,000 for other audit committee members, whilst average fees paid by the FTSE 250 are £10,000 for an audit committee chairman and £5,000 for other committee members.

Costs	number of persons	Low	Best	High	Basis
Cost of Appointment of chairperson (£)	1	17,957	17,957	17,957	2006 IA data + uplift for inflation
Cost of Appointment of member (£)	1	11,971	11,971	11,971	We assume that the fees would fall between those paid by FTSE 250 and SMCs, and use the mid-point as our best estimate
Total cost of appointment per entity (£)		29,928	29,928	29,928	
Number of firms now needing to establish an audit committee		111	167	222	
Total one-off cost of appointment across entities (£)		3,328,026	4,992,039	6,656,052	
Ongoing annual cost of chairperson (Non-executive director base fee + Audit Committee Chairman fee) (£)	1	46,785	48,819	50,853	2006 IA + uplift for inflation
Ongoing annual cost of member (£)	1	5,085	5,085	5,085	We assume that the fees would fall between those paid by FTSE 250 and SMCs, and use the mid-point as our best estimate
Total Ongoing annual cost per entity (£)		51,870	53,904	55,938	
Total Ongoing annual cost across entities £s		5,767,928	8,991,182	12,440,629	

Table 11: Total additional costs of appointing Audit Committees

100. Based on these assumptions, we estimate a one off cost of between **£3.33m and £6.66m with a best estimate of £4.99m** and an on-going cost of **between £5.7m and £12.44m with a best estimate of £8.99m** per annum as a result of the inclusion of unlisted insurers being in scope of the 2006 Directive.

101. Key assumptions and risks:

- That the Manifest and Grant Thornton estimate of the proportion of listed companies with an audit committee before the requirement came in for this group, of 60-80%, is broadly representative of the current proportion of unlisted insurers with an audit committee.
- Unlisted insurers without an audit committee have audit fees within the range of those for FTSE 250 companies and those for SMCs.

b. Scope of Audit Committee

102. The Regulation also adds additional requirements on all audit committees, impacting all PIEs, requiring additional meetings between auditors and audit committee members on an annual basis. This will impact a total of 1,613 PIEs (entities listed on an EU regulated market and unlisted banks, building societies and insurers including syndicates³⁸).

103. The additional requirements include monitoring the financial reporting process, the internal quality control and risk management systems, the statutory audit and additional audit report and monitoring and reviewing the independence of the statutory auditors and the appropriateness of the provision of non-audit services to the audited entity.

104. In addition the audit committee will be responsible for the procedure for the selection of statutory auditor(s). This will be dealt with below as part of the cost estimates for the requirement on re-tendering of audit services.

105. The EU impact assessment estimates that the additional requirements on audit committees will result in the need for 2-3 additional meetings per year. However, the reduction in the requirements in the final proposal compared to those set out in the initial proposal on which the

³⁸ We have subtracted the number of PIE subsidiaries that have PIE parents in order to consider each group only once

EU IA was based means the need for additional meetings would be reduced. In addition, they acknowledge that these costs would not arise for those audited entities which already today have robust and efficient audit committees; the UK already has a comprehensive framework on audit committees meaning that for UK companies the additional requirements would be lower. On this basis we estimate that between 1 and 2 additional meetings per year would be required.

106. The FSA³⁹ estimate the charge out rate for an audit partner to be £711 per hour, and for an audit manager to be £400 per hour. We think it is appropriate to use charge-out rates in the calculation of the impact of this particular measure as the burden of these meetings of audit committees with auditors will fall to companies who will have to pay the auditor for their attendance. However the FSA’s estimates are based on auditors’ fees for 72 “very high impact [companies]” and appear to be high. In the absence of other evidence however, we are using these estimates as an upper bound on these costs.
107. For representatives from the audited firm and the audit committee we use hourly wages from ASHE 2014 to represent the resource cost to them of additional staff time. For representatives from the audited firms we use the median hourly wage of corporate managers and directors of £20.74 and uplift for non-wage costs of 19.8% to get an hourly cost of £24.84. For the audit committee itself we use the median hourly wage of chief executives and senior officials from of £38.33 and uplift for non-wage costs of 19.8% to get an hourly cost of £45.90⁴⁰.
108. Audit committees must have between 2 and 6 members⁴¹ and a report by KPMG reports that most have between 3 and 5 auditors⁴². We therefore assume an average of 4 audit committee members. In practice they may not all attend the meeting, but for the purposes of this impact assessment we assume all four attend. This suggests the following costs for each additional meeting:

	Cost per hour	No. of members	Number of hours	Total cost
Audit partner	£711	1	5	£3,555
Audit manager	£400	1	5	£2,000
Audited firm manager	£24.84	1	5	£124
Audit committee member	£45.90	4	5	£918
Total				£6,597

Table 12: Total additional costs of additional Audit Committee work

109. Applying the range of 1-2 additional meetings per annum, this leads to an estimated cost of between £6.6k and £13.2k per annum per firm. Applying this to all 1,613 PIEs in scope of this requirement leads to an estimated annual cost of £10.64m - £21.28m, with a best estimate of **£15.96m** per annum.

v. Regulatory Reporting and Information - Report to Supervisors of PIEs (FCA)

³⁹ FSA “Market s and regulatory failures, benefits and costs” <http://hb.betterregulation.com/external/Market%20and%20regulatory%20failures.%20benefits%20and%20costs.pdf> we transposed the figures of this document to 2014 figures to assure consistency with the other figures in the IA.

⁴⁰ The statistics taken from ASHE are based on the median rather than the mean. This is the preferred measure of earnings as it is less affected by a relatively small number of very high earners and the skewed distribution of earnings. It therefore gives a better indication of typical pay than the mean. The survey takes a sample of employee jobs drawn from HMRC records of gross pay before tax, National Insurance or other deductions. These data were then uplifted by 19.8% to reflect non-wage costs (i.e. National Insurance, pension contributions, other payroll taxes and other non-statutory employee services such as transport and canteen provision). This is in accordance with Eurostat data and forms a standard assumption.

⁴¹ Institute of Internal Auditors best practice

⁴² Audit Committee Institute, “A Practical Guide – Shaping the UK audit committee agenda”; Spencer Stuart, “UK Board Index 2013”

110. This requirement will impact those listed companies which are not banks, insurers or other financial institutions as these entities already have equivalent requirements on them through the Prudential Regulation Authority. Based on information drawn from the FAME database, there are around 744 such companies which are not already covered. The supervisory authority for the companies would be the FCA as the UK Listing Authority. For these entities, we would expect the frequency of events that would need to be reported to the supervisor of the PIE to be low. Also, the eventualities that are required to be reported would currently be brought to the attention of the Listing Authority in any case via a variety of means. The intended effect of this requirement is simply that this information should be brought to the attention of the listing authority at an earlier stage when the auditor is first aware that a problem is likely to arise. For the purpose of this consultation impact assessment we are assuming the costs of this requirement will be negligible and responses to the discussion document confirm this view.

vi. Regulatory Reporting and Information - Retaining and Disclosing Information

111. The requirements on the contents of the transparency report are largely unchanged and we do not anticipate any significant increase compared to the current cost of preparing the report. However, the requirement for a transparency report will now apply in respect of auditors of all PIEs, not just those that are listed. In addition, the auditor must also report to the competent authority on audit and non-audit revenues in respect of each PIE: this is not a current requirement.

Auditors of listed companies and all banks and insurers:

112. The EU impact assessment estimates that preparing a report on the revenues generated in respect of the audit of each PIE would take 8 hours of the auditors' time. As this would be a resource cost to the auditing firm in terms of time of a member of staff, we base our estimate on the median hourly wage of an accountant of £19.42⁴³. Uplifting for non-wage costs of 19.8% gives an hourly cost of £23.26, and we estimate the cost per auditor of preparing the report would be £186.

113. Cost of reporting of information = 1,665 PIEs * 8 hours * £23.26 = **£309,700**

Auditors of unlisted banks and insurers:

114. In the Impact Assessment on the 2006 Audit Directive we anticipated a cost to each auditor of preparing the transparency report to be £59,000⁴⁴. However the evidence backing that estimate is unclear and the reports required for the first time under the 2006 Directive would have included those from auditors of large numbers of PIEs whose reports would have been more complicated as a result. We do not anticipate the additional audit firms now included to perform more than a small number of audits of unlisted banks and insurers. A significant proportion of unlisted banks use existing PIE auditors and we would expect this also to be the case for unlisted insurers. We therefore take the £59,000 cost as an upper bound and will attempt to quantify costs based on a methodology more like that above during the course of the consultation.

115. We and the FRC are researching how many auditors there are currently engaged in audits of unlisted banks and insurers. The requirement for a transparency report will apply where it did not previously for auditors of unlisted banks and/or insurers who do not audit any listed companies.

116. FRC is aware, from its audit inspection work, which applies to all unlisted banks, that there are 3 audit firms that audit unlisted banks and building societies but no listed companies. This is out of 171 banks and building societies that are neither listed themselves nor have UK listed parents. These firms would have to produce a transparency report for the first time.

⁴³ Median hourly pay of chartered and certified accountants (excluding overtime) based on the Annual Survey of Hours and Earnings 2014 provisional results.

⁴⁴ 2014 price base year.

117. FRC's data on unlisted insurers is much less comprehensive given its limited inspection remit in this area. As described under the section on familiarisation costs, we estimate the range of additional auditors of unlisted insurers to be between 10 to 25 firms. This means that in total between 13 (10 for unlisted insurers+3 for unlisted banks) and 28 (25 for unlisted insurers+3 for unlisted banks) additional auditors of unlisted PIEs would have to prepare a transparency report. We therefore anticipate the following costs:

Minimum cost: 13 x £59k = £765k

Maximum cost: 28 x £59k = £1.64m

Best estimate: 21 x £59k = **£1.23m**

Appointment of Statutory Auditors or Audit Firms

i. Appointment Requirements – Procedure

118. This requires that PIE auditors must be appointed via a competitive tender by the audit committee. Additional costs will therefore fall on the audit committee in terms of time taken in monitoring the tender for the selection of auditors as well as validation of chosen audit firms. The EU impact assessment estimates that audit committee members will spend an additional 20 expert days on studying tender documentation, preparation of the opinion of the audit committee on the selection of the audit firm, analysing the reports from auditors as well as any additional input needed to fulfil their tasks.

119. We base cost estimates for audit committee members on ASHE data (2014) on the median hourly wage of chief executives and senior officials of £38.33 uplifted for non-wage costs of 19.8% to get an hourly cost of £45.90. Assuming 8 hours of chargeable time per day, and 20 additional expert days required, this suggests a cost of £7.35k per tender. On the basis that tenders take place no more frequently than the requirement of every 10 years⁴⁵; this leads to a cost of £735 per annum per PIE.

120. Scaled up across all 1,361 PIEs in scope (1,665 less the 304 UK incorporated companies in the FTSE 350 that are already subject to this requirement).

This results in an estimated annual cost of **£1m per annum**.

ii. Appointment Requirements - Duration of Engagement

121. This sets a maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments at 10 years. Retendering at least once every 10 years is already a requirement for the FTSE 350 following the introduction of the order by the Competition and Markets Authority (CMA) in 2014 on mandatory retendering of auditor appointments. This will impact around 1,361 PIEs (ie 1,665 PIEs less the 304 UK incorporated companies in the FTSE 350 who are already subject to this requirement) as well as the auditors of those PIEs.

122. The impact of the directive is the mandatory re-tendering of PIE audits and PIEs every 10 years. We therefore include the cost of this to PIEs (the cost of tendering for an auditor at year 10) and to auditors (the cost of bidding for their existing PIE at 10 years or another PIE at 20 years). Hence, in our estimate of "auditor costs" we include the cost of just one tender per PIE every 10 years (any additional tendering by other audit firms is not considered an impact of the Regulation).

123. As discussed in relation to "conditions for carrying out statutory audits", the EU impact assessment⁴⁶ estimates the cost of retendering to each individual PIE and its auditor based on its own specific size categories⁴⁷. Extrapolating on the information we had for the other size bands, we add the small category (turnover<50m Euros). This is done by imposing linear

⁴⁵ The maximum duration of engagement as set out in the next section.

⁴⁶ EU Impact assessment adjusted for 2013 base price year. <https://www.gov.uk/government/statistics/gdp-deflators-at-market-prices-and-money-gdp-september-2014-quarterly-national-accounts>

⁴⁷ A very large PIE is defined for this purpose in the EU impact assessment as total turnover more than €40bn, a large PIE is defined for this purpose in the EU impact assessment as total turnover of more than €2bn, a medium PIE is defined for this purpose in the EU impact assessment as total turnover of more than €50m

relationships between annual audit fee and tender cost to both auditor and PIEs. On this basis, our estimate of costs to small PIEs tendering for an audit is £9,524 and for an auditor bidding for the tender is £30,708⁴⁸.

Size of Company	Number of PIEs	Annual Audit Fee £	EU IA cost of tender to PIE	EU IA cost of tendering to auditor
Very large	15	19640652	365,214	5,478,204
Large	174	3432500	63,912	976,946
Medium	599	460088	54,782	146,085
small	877	36955	9,524	30,708
Total	1665			

Table 13: Costs of tendering auditor appointments to auditors and PIEs by size

124. -The estimates reflect the likely higher proportionate costs for smaller entities due to the existence of some fixed costs.
125. In order to estimate the additional cost of re-tendering every 10 years, we adjust the costs for the current frequency of re-tendering within the industry as it is. Using the FAME database we can identify those listed companies which have changed their auditor in any year between 2004 and 2011. This finds that 32.5% of companies have changed their auditor within this 8 year period, suggesting a retender rate of 4% per annum. Therefore in any given year, we assume that on average 4% of companies would retender anyway and therefore would not incur the average annual cost of retendering.

	Total Number of PIEs	Number of PIEs on FTSE 350	balance	Of the balance, the number of PIEs retendering each year anyway (4%)	Total number of PIEs affected
Very Large PIE	15	9	6	0	6
Large PIE	174	107	67	3	64
Medium PIE	599	169	430	17	413
Small PIE	877	19	858	34	824
	1665	304	1361	54	1307

Table 14: Total numbers of PIEs tendering auditor appointments each year due to the Regulation

126. Based on the above assumptions we estimate the total cost of the mandatory re-tender every 10 years for firms in each size band. Given that all firms would not be out to tender at the same time, the cost is divided by 10 to get an annual average cost across the industry.

⁴⁸ The equation for the line of best fit (given our three data points) which was used to calculate the cost for small PIEs was: Cost to PIE = Average Annual Audit Fee x 0.0181 + 8858.9. That for cost to an auditor bidding for a small PIE is: Cost to Auditor = Average Annual Audit Fee x 0.2779 + 20435.

	Cost of retender to PIE (EU IA estimate) £	Cost of retender to audit firm (EU IA estimate) £	Total number of PIEs affected	Average annual cost of mandatory tender
Very Large PIE	365,214	5,478,204	6	3,365,809
Large PIE	63,912	976,946	64	6,694,804
Medium PIE	54,782	146,085	413	8,291,810
Small PIE	9,524	30,708	824	3,313,877
Total cost across all firms			1307	21,666,299

Table 15: Total cost of PIEs tendering auditor appointments each year due to the Regulation

127. The annual average cost of tenders across the industry is estimated at £21.67m.
128. Note that the estimated cost of tendering to PIEs may include the cost of audit committee time as a result of their involvement in the tender process (as it may be reflected in the overall estimate). However, given the uncertainties around the estimated costs of the tender process, we make the conservative assumption that the additional cost of audit committee time calculated in the previous section (under the new procedure requirements) is additional to the estimates provided for the overall costs of tendering to PIEs in this section.
129. There will be additional costs to the auditor of needing to familiarise themselves with a new company more frequently, but this will be mitigated by the requirement on the outgoing auditor to provide a handover file for the new auditor including details of their own work. In addition significant familiarisation will be undertaken by the incoming auditor during the preparation of the tender, which has already been taken into account in the costs detailed above. However, responses to our discussion document indicate that there would be significant additional costs in the first year or two of a new undertaking. One respondent suggests that the additional familiarisation costs would be in the range of 10-15% of the total cost of doing the audit in the first year.
130. The costs of familiarisation to the incoming auditor have not been quantified at this stage. We will seek further information on these costs during the consultation to be able to quantify them for the final IA.
131. Finally, given our current interpretation of the regulation under option 1, we consider an additional feature of the requirements in the Regulation that we think presents a problem for PIEs seeking to extend their current audit engagement as part of a group in which other companies are also PIEs incorporated in other Member States. Where these Member States implement the Regulation with a retendering period shorter than 10 years, the whole group will in practice is likely to prefer to retender the audit on this timeframe. It would therefore make sense if the UK PIE could extend the audit engagement by a further 10 years at that stage. For example if a group member is required to tender at 7 years it would make sense for the UK PIE's tender to enable it to extend the engagement, rather than have to tender again at year 10 in order to extend it.
132. The cost can be quantified as it would avoid a PIE in a group which also contains a PIE in a Member State with a shorter tendering period from having to tender its audit appointment twice to meet both the UK's and other Member State's requirements. For instance in Italy, we understand the retendering period may be set at 7 years. Similarly in the Netherlands, it may be 8 years. In each case, during an auditor's 10 year term if the group choses to re-tender at 7 or 8 years, they would still have to tender again at 10 years.
133. However the additional cost being considered here does not arise from the UK framework but from the difference between that and the period chosen in the relevant Member State. It is also a choice as companies do not have to tender along with other companies in the same group that are PIEs in other states. Furthermore, there is an element of uncertainty relating to the current interpretation of the Regulation. We therefore have not included it as a cost of this option. Instead we include it as a benefit under option 2, where the effect of having done so is a quantifiable benefit.

iii. Dismissal or Resignation of Auditor

134. This provides a framework to allow the dismissal of an auditor of PIEs where the competent authority or 5% of shareholders take the auditor to court.
135. Costs incurred by PIEs in dismissing their auditor are not considered as part of this impact assessment as this process is voluntary and the framework is simply enabling rather than mandatory.

iv. Educational Qualifications, Professional Competence and Continuing Professional Development

136. This provides a framework for EEA audit firms to provide services cross-border. Part of this includes convergence of member state qualifications, as well as the potential to allow an adaptation period within the firm as an alternative to the current aptitude test for individual EEA migrant auditors.
137. In terms of the impact on audit firms, there are not expected to be direct costs associated with these measures.

Mutual recognition of audit firms:

138. Savings are expected to result from the avoidance of the administrative costs of applying for a full audit licence in each MS where the auditor wants to provide services. In addition, it will create the potential for access to audit markets in 28 MSs. It is not known how many audit firms would take advantage of this. In terms of indirect benefits, audit firms could more easily consolidate with other firms at cross-border level, thus facilitating the development of stronger and larger actors. Also, for existing groups, the need to keep different legal persons in each Member State is avoided. Therefore, this could lead to some savings in the administrative structure of the audit firm and to a more efficient organisation. Also, it should be easier for audit firms to provide services in a cross-border context, which should lead to increased choice for audited entities regarding audit firms. For instance, it could be easier for an SME to keep its audit firm in case the SME creates a subsidiary abroad.

Adaptation period:

139. This measure should not result in direct costs for the auditor seeking to establish in a new Member State compared to the baseline scenario (aptitude test only). It may result in costs for the competent authorities if they decide to revise their current aptitude test framework. However, this revision is not mandatory and estimated to be a business as usual cost for those authorities. Therefore, no quantification of these costs is provided. Concerning benefits, this measure will open new markets to statutory auditors since it should be easier for them to be approved and provide services in other Member States. This should also make it easier for audit firm relocation statutory auditors within the EU.

Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit

(i) Competent Authority - Delegation of inspections

140. No costs are anticipated in the European Commission's Impact Assessment. However in the UK context we do not think this is reasonable. This is because of two effects of changes to the audit inspection regime of the FRC as competent authority with ultimate responsibility for audit regulation:
- In future auditors of all PIEs will be required to be inspected by the FRC under the Regulation. This will significantly limit the FRC's use of the current ability to delegate inspections of some auditors to the professional supervisory bodies.

- Inspections will also be required for auditors of all PIEs. Currently audits of all listed entities and banks and of some unlisted insurers are subject to FRC inspection. In future audits of all unlisted insurers will be brought within scope.

141. We anticipate that the following costs will arise from these changes:

- The FRC currently delegates inspections of 29 audit firms conducting “major audits” of banks, insurers or listed companies to the professional bodies. Inspection of these is required once every 3 years and FRC estimates each of their inspections to cost between £30k and £40k (best estimate £35k). As these inspections will no longer be done by the professional bodies, there will be a saving to off-set in terms of the cost they have avoided for the inspection by the Supervisory Body which the FRC estimates at £2k per inspection. This gives a total annual cost of:

Minimum: $29 \times (\text{£}30\text{k} - \text{£}2\text{k}) / 3 = \text{£}271\text{k}$ per year

Maximum: $29 \times (\text{£}40\text{k} - \text{£}2\text{k}) / 3 = \text{£}361\text{k}$ per year

Best estimate: $29 \times (\text{£}35\text{k} - \text{£}2\text{k}) / 3 = \text{£}319\text{k}$ per year

142. This cost will be mitigated to some extent by a new provision in the Regulation allowing auditors of PIEs to only be inspected once every 6 years where all of the PIEs audited are SMEs. However this is on the basis that the frequency of inspections should be set in proportion to the risks arising from that auditor’s audits.

143. There are 556 unlisted insurers in the UK that are not part of a listed group. We use the same approach as we did for “Familiarisation costs” and “Regulatory Reporting – Retaining and Disclosing Information” above to estimate the number of additional auditors of insurers affected, giving us from 10 to 25 firms. Some of these auditors may already be within the FRC’s scope because they already conduct other “major audits”, however this will need to be verified, something that might be possible during the consultation process as the relevant auditors are identified.

144. Using the figures above, the cost of additional FRC inspections is therefore:

Minimum: $10 \times \text{£}30\text{k}^{49} / 3 = \text{£}130\text{k}$ per year

Maximum: $25 \times \text{£}40\text{k} / 3 = \text{£}333\text{k}$ per year

Best estimate: $18 \times \text{£}35\text{k} / 3 = \text{£}210\text{k}$ per year

145. This cost is also likely to be mitigated to a significant extent by the new provision in the Regulation allowing auditors of PIEs to only be inspected once every 6 years where all of the PIEs audited are SMEs. Of the 556 unlisted insurers that we have considered for the purpose this assessment we have established that approximately half are SMEs so it would be reasonable to expect some of the audit firms newly brought into scope of FRC inspections to meet the relevant size and risk criteria. We will work with the FRC to improve on the current estimates during the gathering of responses to the discussion document.

(ii) Competent authority – Delegation framework

146. Other changes brought in as part of the implementation of this framework would not be expected to represent a significant cost. They represent a modest shift in the regulatory framework that forms the basis for the operation of the FRC:

- setting up framework in which FRC has some current RSB functions but delegates them to the professional bodies where permitted; and,
- moving away from the framework in which independent standards, inspections and investigations and discipline are delivered by an unnamed independent body towards a clear FRC framework.

⁴⁹ We have not deducted £2,000 from this cost as we have for the calculation above as we consider that saving only to apply where, though the audit is currently within the FRC’s inspection remit, it has previously been delegated to a professional body, incurring an additional regulatory cost. As inspections of audits of most unlisted insurers are not within the FRC’s remit we do not consider that any regulatory costs are saved with their inclusion for the first time.

147. These changes would not result in a significant difference in the operation of the FRC and the professional bodies in the framework in which they work. However the structure of that framework would change. There is a possibility that some specific familiarisation costs might result for auditors but for the purposes of this Impact Assessment we have included those in the general familiarisation costs evaluated above.

(iii) New powers for FRC to obtain information from 3rd parties.

148. The FRC is currently the body responsible for investigation and discipline of auditors in public interest cases, though without statutory powers to obtain information from third parties. These third parties might be the audited company, its staff or former staff, companies in the same group, companies with which that company contract or has contracted etc.

149. These new powers would place on a statutory footing in relation to audits of PIEs a framework of cooperation with the FRC. As existing levels of cooperation are high we would not expect these powers to be used often. However their availability is a significant enhancement in available powers should they be needed. Where these powers are used, we would not expect this to result in a significant additional burdens as in most cases compliance would previously have followed voluntarily in any case.

Summary of costs of Option 1

Matter	LOW ESTIMATE one off cost £'m	BEST ESTIMATE One-off cost £'m	HIGH ESTIMATE one off costs £'m	LOW ESTIMATE on going cost £'m	BEST ESTIMATE On-going cost £'m	HIGH ESTIMATE on going cost £'m
Scope and Application of the Directive and Regulation						
Subject Matter and Scope					Additional costs to unlisted banks, building societies and insurers covered below	
Conditions for Carrying out Statutory Audits						
Ethical Standards - Audit fees	3.49	12.08	84.53			
Technical Standards - Reporting Irregularities and Quality Control		None			No significant costs	
Audit Reporting - Additional Report to The Audit Committee				2.02	2.02	2.02
Appointment of Audit Committee	3.33	4.99	6.66	5.77	8.99	12.44
Scope of Audit Committee				10.64	15.96	21.28
Regulatory Reporting and Information - Report to Supervisors of PIEs						
Regulatory Reporting and Information - Retaining and Disclosing Information				1.08	1.55	1.96
Appointment of Statutory Auditors or Audit Firms						
Appointment Requirements - Procedure				1.00	1.00	1.00
Appointment Requirements - Duration of Engagement				21.67	£21.67	£21.67
Dismissal or Resignation of Auditor						
Educational Qualifications, Professional Competence and Continuing Professional Development						
Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit						
Competent Authorities - Designation and Delegation of Tasks within UK				0.37	0.53	0.70
Competent Authorities - Powers						
Total costs						
Familisarisation costs	56.57	72.66	88.57			
Other policy costs						
Total	63.39	89.73	179.75	42.54	51.72	61.07

Table 16: Summary of costs of Option 1

Option 2: Implement the EU baseline – accompanied by additional adjustments to requirements on companies in order to facilitate a more flexible implementation

150. The benefits and costs set out above for option 1 will also be incurred in option 2. However option 2 will also result in additional impacts from other requirements under consideration..

Allowing a more flexible retendering requirements for PIEs

151. This is intended to take advantage of the flexibility within the regulation of being able to tender for audit at less than 10 years (where it is beneficial to the company).

152. It would provide that a company would be able to retender the audit engagement earlier than year 10 without having then to conduct an additional tendering process at year 10. The earlier retender would extend the maximum duration of the audit engagement beyond that point. This would involve enabling the maximum duration of the audit engagement to be set as the shorter period that the PIE wants in practice to apply so that the retender at the end of that period enables the maximum duration to be extended. As a result of going above the minimum EU requirements, this measure may contain an element of gold-plating. However no additional administrative burdens or costs arise.

Costs

153. The additions to the framework that we have developed in this area would not impose any additional administrative burdens or other costs.

Benefits

154. The benefit of this approach can be quantified as it would avoid a PIE in a group which also contains a PIE in a Member State with a shorter retendering period from having to retender its audit appointment twice to meet both the UK's and the other MS's requirements. For instance in Italy, we understand the retendering period may be set at 7 years. Similarly in the Netherlands, it may be 8 years. In each case, during an auditor's 10 year term a re-tender would be needed at 7 or 8.

155. To monetise the benefit, we estimate the saving to a PIE in a group that also has a group member that is a PIE in the Netherlands or Italy from having to do one additional audit tender in a 10 year period. FAME data indicates that the number of such PIEs is 108. Using the distribution of those across the range of size bands used in "Appointment of statutory auditors and audit firms", we then calculate the retendering costs for these entities and their auditors:

	Number of PIEs with a group member that is a PIE in the Netherlands or Italy	retendering cost to PIE	retendering cost to Auditor	Total cost per annum
Very Large PIE	1	36,521	547,820	584,342
Large PIE	11	6,391	97,695	1,144,945
Medium PIE	39	5,478	14,609	783,383
Small PIE	57	952	3,071	229,326
	108			2,741,995

Table 17: Benefits of resolving technical issue with EY audit tendering framework

156. The benefit is therefore the reduction in cost that results from a PIE, which is part of a group based in part in Italy or the Netherlands, from having to tender the audit again to take effect at year 10. As an annual average, we estimate the saving to PIEs is based on the costs above to be about £2.74m.

Implementing the Directive to Limited Liability Partnerships

157. At a domestic level we applied the implementation of the 2006 Directive to auditors of LLPs. The proposal here is to do the same with the amendments to the Directive. LLPs would

automatically be subject to the new EU Regulation if they fall under the new definition of PIEs (which now includes, apart from those that provide banking or insurance services those that issue securities on a regulated market). In these cases EU law would require implementation of both the Directive and the Regulation anyway.

158. The added impact of the measure considered under Option 2 would therefore be on non-PIE LLPs, which would now be subject to the amendments to the directive. As discussed under familiarisation costs above, we estimate that there are 1,017 non-PIE LLPs in the UK that are required to undergo an audit.

Costs

159. Most of the changes in the new Directive and Regulation are targeted at PIEs and would therefore only apply to LLPs that are PIEs. As discussed under familiarisation costs above, the main change experienced by non-PIE LLPs and their auditors will relate to an adaptation period for individual EEA auditors and mutual recognition of EEA audit firms. These changes that affect non-PIE LLPs are not expected to have a material impact. The additional impact from their inclusion is therefore expected to be minimal, as would any familiarisation costs.

Benefits

160. There would be greater consistency between companies and LLPs in audit and accounting standards and level assurance of accounts provided. This is difficult to monetise.

Amendment of Fee Disclosure Requirements

161. The proposal is to amend the framework for companies' disclosure of the fees it has paid for audit and non-audit services. We are inviting responses on this change here but would expect any change to be made following consultation by the Financial Reporting Council which would establish further the potential costs and benefits.

Costs

162. There would be ongoing time costs for the provision of further disaggregated information that would be required under the proposal. The costs of this measure have not been quantified at this stage. We intend to gather more information during the consultation period to inform the final IA.

Benefits

163. This would increase companies' transparency and accountability to wider stakeholders on their compliance with the blacklist of non-audit services and with the cap on these. It would provide incentives on compliance beyond those provided by the risk of action by the professional bodies and FRC. This includes increased accountability to shareholders. These benefits cannot be quantified.

Changes to the Framework of Functions of the Recognised Supervisory Bodies

164. There are two options under the Directive and Regulation for the allocation to the RSBs of tasks in audit regulation. They can either be delegated by the Member State or by the competent authority (ie the FRC).
165. For inspections and investigations and discipline FRC delegation is better able to maintain existing flexibilities. There is potential for FRC to impose more focussed and graduated sanctions on the professional supervisory bodies for auditors. For instance, particular tasks could be delegated on certain conditions or revoked where a problem had arisen.
166. The proposal under consideration is to make use of this approach. This implementation is a departure from the existing UK implementation where the supervisory bodies for auditors are only "Recognised". It is unclear whether this altered approach is any more than a minimal implementation of the requirements of the Directive and Regulation as there is no approach that provides complete continuity with the existing UK framework. Furthermore, it is not possible to estimate any costs and benefits of this approach compared to a minimal approach as there are no aspects of the framework that lend themselves to monetised estimates. However we include this here for completeness as some stakeholder have suggested that more minimal approaches could have been used of the various alternative options available.

167. Overall, we estimate the total balance of costs per annum of option 2 as being the same as the costs of option 1 with the addition of a further net saving estimated at £2.74m.
168. It should be noted, however, that this is on the basis of costs and benefits that have been monetised so far. Given that there are costs that have not yet been quantified the overall saving may be small.

The overall net cost of option 2 is therefore: £48.98m per annum on-going cost and a one-off cost of £89.73m.

Risks and assumptions

169. The key assumptions in terms of costs and benefits are:

- (i) That the flexibility of being able to tender earlier than 10 years and secure maximum duration of reappointment of the auditor is available under option 1, in which case the savings would not be an additional benefit in option 2.
- (ii) That the Bank of England lists provide full coverage of all credit institutions and insurers which are in scope of this Directive.
- (iii) That audit and non-audit fees are broadly similar across all PIEs as across listed companies.
- (iv) Estimates as to the number of hours required to fulfil tasks may be too high or too low. Though ranges and best estimates are often provided but these risks remain.

Direct costs and benefits to business calculations (following OITO methodology)

170. The direct costs to business are calculated based on the additional burden on PIEs and their auditors, primarily relating to greater internal oversight and ensuring the independence of the statutory auditor. The measure is an EU Directive and falls out scope for OITO. The additional measures included in policy option 2 are in scope of OITO due to the fact it gold-plates the EU minimum. It is however judged to be a zero net cost.

H. Wider impacts

Statutory Equality Duties

171. After screening the potential impact of this proposal on race, disability and gender equality, it has been decided that there will be no impact. It is not expected to have any impact on the Convention Rights of any person or class of persons as the measure regulates incorporated businesses rather than individuals, and applies to all businesses within the stated size threshold.

Economic Impacts

Competition Impact Test

172. This proposal is expected to increase competition in the audit service market.

Small and Micro Business Assessment

173. As the options are European in origin, rather than domestic, a small and micro business estimate is not required by the Better Regulation Framework Manual. However below we provide a high-level discussion of where and how small and micro businesses will be affected by the directive – and why this is desirable to meet the Government’s policy objectives.

174. The majority of small and micro businesses are exempt from being required to have a statutory audit, however all PIEs, regardless of size are required to be audited, therefore any small or micro PIEs will be impacted by the implementation of the directive. The nature of the business operations of PIEs (i.e. listed companies, banks, building societies and insurers), means that PIEs are likely to have a significant impact on the UK's economy and society. Therefore it is considered desirable and necessary to apply to them the higher audit standards that are applied to large companies. The impact of implementing the directive is also disproportionately greater for small PIEs that are currently outside the existing PIE definition. In total there are 130 micro listed companies, and 150 small listed companies. We estimate the total number of small PIEs (which include listed companies, unlisted banks, building societies and insurers) at 556.
175. The impact of the measures will be disproportionately greater for smaller audit firms (carrying out a small number of PIE audits or that have clients that are currently outside the PIE definition and would come into scope for the first time). However, auditors of PIEs, all of whose Public Interest Entity clients are SMEs, can benefit from a reduction in the frequency of audit inspections. Auditors who have no PIE clients or all of whose clients are small, are relieved of any minimum frequency of audit inspections. A new requirement is introduced into EU law that the frequency of all firm inspections must be determined on the basis of an assessment of risk. The risk here is that of insufficient oversight if the frequency of inspections were further reduced.
176. Many audit firms are small for accounting purposes (i.e. they meet 2 out of 3 of the following criteria in the table below and classify as a small company under the Companies Act 2006). There are 6,635 audit firms registered in the UK of which 6,506 (98%) have 10 or fewer "principals" (equivalent to partners active in the firm). These are more than likely to be small businesses.

Criteria	Small company
Annual Turnover	Less than <u>or equal to</u> £6.5m
Balance Sheet Total	Less than <u>or equal to</u> £3.26m
Number of Employees	Less than <u>or equal to</u> 50

Table 18: Summary of audit exemption thresholds

Environmental impacts

177. There are no obvious direct concerns in this area.

Social Impacts

Health and Well-Being:

178. No obvious concerns in this area.

Human Rights:

179. No obvious concerns in this area.

Justice System

180. This will be considered further by legal advisers in the preparation of consultation material. Our conclusions will be reflected in the final Impact Assessment based on responses to the consultation, which will include questions about potential impacts. We do not envisage significant changes to the existing system of criminal sanctions or civil penalties for non-compliance as most of the new or increased requirements can be accommodated in the existing framework. We do not expect any increases in the scope of any current sanctions. Given the

emphasis in the framework on professional disciplinary sanctions, we understand the current impact on the justice system is low. We would not expect this to change.

Rural Proofing

181. No obvious concerns in this area.

I. Summary and preferred option

182. This is a Consultation Stage Impact Assessment and both options are being considered as part of the consultation. We propose that, with further development option 2 is the preferred approach to implementation, subject to establishing the extent of support for the additional measures to be included and the extent of their costs and benefits. We intend to consult on the additional proposals considered under the option, and may, in the light of responses develop further such proposals, as well as obtain further information on benefits and potential costs of all of these.

J. Implementation plan:

Title	<p><i>DIRECTIVE 2014/56/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts</i></p> <p><i>REGULATION (EU) No 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC</i></p>	
EU Legislation Ref.	Directive 2014/56/EU and Regulation (EU) No 537/2014	
Lead Department	<i>Department for Business, Innovation and Skills</i>	
Lead Minister	<i>Baroness Neville Rolfe</i>	
OUTLINE PROJECT PLAN / MILESTONES		
16 April 2014	Date the EU legislation was adopted	
27 May 2014	<p>First published in the Official Journal of the European Union - <i>Regulation:</i> http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537 <i>Directive:</i> http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0056</p>	
Dependencies and Issues	Amendments to primary legislation required for transposition of the Directive and to provide for application of the Regulation will be cleared with the Office of the Parliamentary Council during the course of 2015.	
Method of Transposition / Implementation	<p>Existing legislation <input checked="" type="checkbox"/></p> <p>New primary legislation <input type="checkbox"/></p> <p>New secondary legislation <input checked="" type="checkbox"/></p> <p>Other / Administrative Act <input checked="" type="checkbox"/></p>	<p>- <i>Financial Reporting Council's (FRC's) Ethical and Technical Standards for Auditors</i></p> <p>- <i>FRC Regulations</i></p> <p>- <i>PRA Rules</i></p>

	- <i>FCA Handbook</i>		
Week beginning 24 November 2014	EAC clearance to publish discussion document		
Week beginning 15 December 2014	Publication of Discussion Document		
Summer 2015	Pre-consultation RRC clearance		
Summer 2015	Formal Consultation (Consultation expected to last for a period of less than 12 weeks though not less than 8 weeks due to requests from stakeholders in the audit, and accounting, corporate and investor sectors that the consultation processes should progress from the Government's initial consultation to consultations by the FRC and other independent regulatory authorities.)		
December 2015	Final RRC clearance		
Early 2016	Lay regulations		
26 May 2016	Expected date for implementation in England, Wales, Scotland and Northern Ireland (Company Law and regulation of statutory audit are reserved matters other than in Northern Ireland. Following an agreement with Northern Ireland Ministers, the Secretary of State continues to use powers under the Companies Act 2006 (a UK wide Act), as well as EU implementing powers, to implement secondary legislation in these areas, including to amend primary legislation, on a UK wide basis)		
17 June 2016	Expected date for implementation in Gibraltar		
17 March 2016	Expected date for publication of any guidance		
Late June 2016	Planned date for notifying the Commission of implementation		
17 June 2016	UK legislation enters into force		
17 June 2016	Final transposition deadline (from the EU legislation)		
Summer 2021	Proposed date for Ministerial review (taking into account date of any EU Commission review requirement)		
Lead Official:	Paul Smith	Contact No:	020 7215 4164
Lead Lawyer:	Peter Evans	Contact No:	020 7215 3409

Annex A – Summary of all measures included in the Directive or Regulation

Matter	Regulation Article	Directive Paragraph	Brief description of change
Scope and Application of the Directive and Regulation			
Subject Matter and Scope	1 +2	1 + 2	Increase in scope of Directive to cover non-company/LLP/QP Issuers, MiFiDs, UCITS, AIFs and Payment institutions - see list of changes in the Audit Directive below
Conditions for Carrying out Statutory Audits			
Ethical Standards - Audit fees	4 + 5		PIEs to be subject to Non-Audit Service cap and blacklist
Ethical Standards -Professional Ethics		13-16	Enhanced framework on auditor independence for all audited entities
Technical Standards - Reporting Irregularities and Quality Control	7+8		PIE and PIE auditor reporting requirements
Technical Standards - Organisation of Statutory Auditors		18 + 19	Adoption of ISQC1 framework on audit quality control at EU level
Technical Standards - International Standards for Auditing	9	21	No change until ISAs adopted at EU level
Technical Standards - Scope of Statutory Audits and Consolidated Accounts		20 + 22	Limited changes to harmonise and clarify EU law
Audit Reporting - Procedure for Reporting	10	23	Number of changes to the contents of the audit report largely reflecting current position in UK auditing standards
Audit Reporting - Additional Report to The Audit Committee	6 +11		New additional audit report providing additional information specifically for the audit committee
Appointment and Scope of Audit Committee		32	Two changes - first to the requirements on audit committees - second on scope as unlisted banks, building societies and insurers must comply for the first time.
Regulatory Reporting and Information - Report to Supervisors of PIEs	12		Reporting to FCA on certain matters relating to listed companies
Regulatory Reporting and Information - Retaining and Disclosing Information	13,14 +15		Auditors of PIEs have various obligations in respect of public reporting and reporting to FRC
Regulatory Reporting and Information - Confidentiality and the Transfer of Information	18	17	Changes to provisions on handover files and on transfer to group auditors and competent authorities in third countries of audit information
Appointment of Statutory Auditors or Audit Firms			
Appointment Requirements - Procedure	16	30	Appointment process for PIE auditors via competitive tender by audit committee. Prohibition of "Big 4 only" clauses of policy significance.
Appointment Requirements - Duration of Engagement	17 + 41		Setting maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments at least every 10 years. Half of the work of policy formation already completed with publication of draft CMA Order.
Dismissal or Resignation of Auditor	19	31	Dismissal framework for auditors of PIEs where competent authority or 5% shareholders go to court. This will be a significant new proposal in company law terms. Resignation framework much more limited
Educational Qualifications, Professional Competence and Continuing Professional Development		4,6,10 +12	Framework for EEA audit firms to provide services cross border; Convergence of MS qualifications; Adaptation period as alternative to aptitude test for individual EEA migrant auditors.
Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit			

Competent Authorities - Designation and Delegation of Tasks within UK	20,21,22 +25	3, 26 + 28	Considerable shift in the regulatory framework that forms the basis for the operation of the FRC. (i) requiring FRC to set audit regs under schedule 10 rather than RSBs (ii) setting up framework in which FRC has all current RSB functions but delegates them (iii) moving away from framework in which independent standards, inspections and investigations and discipline are delivered by unnamed independent body towards FRC framework.
Competent Authorities - Powers	23		New powers for FRC to obtain information from 3rd parties
Competent Authorities - Sanctions		25	New framework on the imposition of sanctions by competent authorities
Cooperation Between Competent Authorities Within EU	29,30,31,32,33	5,27,29	Developments of framework on cooperation between EEA competent authorities
Cooperation of Competent Authorities with Third Countries	36,37+38	33, 34,35	Developments of framework on cooperation with third country competent authorities. Technical issues around exchanges of audit working papers with third countries.
Quality Assurance	26, 28,31	24	Technical changes with increased emphasis on risk based approach to frequency of inspections. Enhanced framework on cooperation on inspections.
Monitoring Market Quality and Competition	27		FRC role due to develop in this direction anyway so this may be useful consultation discussion.

Annex B – Familiarisation costs for audit firms with the application of the EU Audit Regulation (and Directive) for Auditors

Table 1: covers all auditors of UK companies with securities admitted to trading on a UK regulated market.												
Size of firm responsible for audits of listed companies[1]	No of firms in this category year end 2013	Average audit principals[2]	Average non-audit principals and teams (457 principals with teams of 30)	Assumed number of accountants in audit principal's team (15-45)	Assumed number of comparable professionals in non-audit principal's team (15-45)	Familiarisation time spent by audit principals and team members (hrs)	Familiarisation time spent by non-audit principals and team members (hrs)	Costs of Audit Principals and teams		Costs of non-audit principals and teams	Total	
Large audit firm (>100 audit principals[3])	5	149	14167	30	30	57 hrs foreach audit principal + 37.5 for each team member	1140	Audit Principals: 57 each (149 x 57 x £45.90). Audit team: 37.5 each (149 x 30 x 37.5 x £23.26)	£4,288,400.23	1140 x £25.52 (weighted average cost of time across personnel, calculated by weighting £45.9 by 457 and £24.84 by (457 x 30). See Annex C for cost data.	£29,090.37	£21,587,452.98
costs per hour		£45.90	£25.52	23.26								
Size of firm responsible for audits of listed companies[1]	No of firms in this category year end 2013	Average audit principals[2]	Average non-audit principals and teams (61 principals with teams of 20)	Assumed number of accountants in audit principal's team (Assumed 10-30)	Assumed number of comparable professionals in non-audit principal's team (assumed 10-30)	Familiarisation time spent by audit principals and team members (hrs)	Familiarisation time spent by non-audit principals and team members (hrs)	Costs of Audit Principals and teams		Costs of non-audit principals and teams	Total	
Medium sized audit firm (>30 audit principals)	7	56	1281	20	20	39 hrs foreach audit principal + 23.5 for each team member	103.08	Audit Principals:57 each (56 x 57 x £45.9) Audit team:37.5 each (57 x 20 x 37.5 x £23.26)	£1,123,340.55	Extrapolating from data on large firms where average time spent by non-audit personnel was (1140/14167)=0.08 hrs. This implies total hrs spent by non audit personnel = 103.08 hrs. Cost = 103.08*£25.84 (weighted average cost of time across personnel calculated using method above in large firms)	£2,663.75	£7,882,030.09
Cost per hr		£45.90	£25.84	23.26								
Size of firm responsible for audits of listed companies[1]	No of firms in this category year end 2013	Average audit principals[2]	Average non-audit principals and teams (23 principals with teams of 10)	Assumed number of accountants in audit principal's team (Assumed 5-15)	Assumed number of comparable professionals in non-audit principal's team (assumed 5-15)	Familiarisation time spent by audit principals and team members (hrs)	Familiarisation time spent by non-audit principals and team members (hrs)	Costs of Audit Principals and teams		Costs of non-audit principals and teams	Total	
Small audit firm firm	23	16	253	10	10	39 hrs foreach audit principal + 23.5 for each team member	20.36	Audit Principals:16 each (16 x 57 x £45.90) Audit team:37.5 each (16 x 10 x 37.5 x £23.26)	181410	Extrapolating from data on large firms where average time spent by non-audit personnel was (1140/14167)=0.08 hrs. This implies total hrs spent by non audit personnel = 20.36 hrs. Cost = 20.36*£26.75 (weighted average cost of time across personnel, calculated using method above in large firms)	£544.66	£4,184,946.47
Cost per hr		£45.90	£26.75	23.26								
Total costs to Auditors with clients on regulated markets	33,654,430											

Table 2: Extrapolating this information to estimated auditors of unlisted banks and building societies and insurers

	Low	High	Best Estimate
Estimate of additional insurers	13	28	21
of which, medium (assuming ratio of 1:3)	3	7	5
of which, small (assuming a ratio of 1:3)	10	21	16
Cost to medium auditors	1,126,004	1,126,004	1,126,004
Cost to small auditors	181,954	181,954	181,954
Total cost	5,197,555	11,703,068	8,541,289

Table 3: Familiarisation and Implementation Costs to PIEs

Familiarisation and Implementation Costs to Large PIEs	Low	High	Best	Assumptions/sources
Number of large PIEs	974	974	974	FAME data
Number of Senior officials and chief executives per team	1	1	1	Assuming a ratio of 1 senior official to 30 team members as in large audit firms
Number of managers and directors per team	30	30	30	
Time across all teams	700	1,700	1,200	Assuming that time costs would be similar to those of non-audit principals and their teams in large audit firms
Average wage	25.52	25.52	25.52	weighted average cost of time across personnel, calculated by weighting £45.9 by 1 senior official and £24.84 by 30 team members. (See Annex C for cost data used).
Total cost	17,391,864	42,237,384	29,814,624	

Familiarisation and Implementation Costs to Medium PIEs	Low	High	Best	Assumptions/sources
Number of large PIEs	135	135	135	FAME data
Number of Senior officials and chief executives per team	1	1	1	Assuming a ratio of 1 senior official to 20 team members as in medium audit firms
Number of managers and directors per team	20	20	20	
Time across all teams	50	150	100	Assuming that time costs would be similar to those of non-audit principals and their teams in medium audit firms
Average wage	25.84	25.84	25.84	weighted average cost of time across personnel, calculated by weighting £45.9 by 1 senior official and £24.84 by 20 team members. (See Annex C for cost data used).
Total cost	174,692	524,076	349,384	

Familiarisation and Implementation Costs to Small PIEs	Low	High	Best	Assumptions/sources
Number of large PIEs	556	556	556	FAME data
Number of Senior officials and chief executives per team	1	1	1	Assuming a ratio of 1 senior official to 10 team members as in small audit firms
Number of managers and directors per team	10	10	10	
Time across all teams	10	30	20	Assuming that time costs would be similar to those of non-audit principals and their teams in small audit firms
Average wage	26.75	26.75	26.75	weighted average cost of time across personnel, calculated by weighting £45.9 by 1 senior official and £24.84 by 10 team members. (See Annex C for cost data used).
Total cost	148,788	446,363	297,576	
Total costs to PIEs	17,715,344	43,207,823	30,461,584	

Annex C: Wage costs

Throughout the IA, staff time costs are estimated based on median hourly pay, excluding overtime, provided by the Annual Survey of Hours and Earnings (ASHE) Data for 2014 (provisional results). They are based on the median rather than the mean because this is the preferred measure of earnings as it is less affected by a relatively small number of very high earners and the skewed distribution of earnings. It therefore gives a better indication of typical pay than the mean. The survey takes a sample of employee jobs drawn from HMRC records of gross pay before tax, National Insurance or other deductions. These data were then uplifted by 19.8% to reflect non-wage costs (i.e. National Insurance, pension contributions, other payroll taxes and other non-statutory employee services such as transport and canteen provision). This is in accordance with Eurostat data and forms a standard assumption. (Eurostat's estimates of non-wage costs for the UK in 2014¹ which report the proportion of non-wage labour costs for the UK at 16.5% in 2014.)

	Hourly Wage	Uplift for non wage costs	Total cost per hour
Auditor	19.42	1.198	23.26
Chief executives and senior officials	38.33	1.198	45.90
Admin and Secretarial	10.12	1.198	12.12
Corporate Managers and Directors	20.74	1.198	24.84

¹ Source: http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Labour_costs_per_hour_in_EUR.