Department for Business Innovation & Skills

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

Summary of responses and Government response

MAY 2016

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Introduction

The consultation document

In October 2015 the Department for Business, Innovation and Skills (BIS) published "*Auditor Regulation: Consultation on the technical legislative implementation of the EU Audit Directive and Regulation*".

The consultation page is available at the following link: https://www.gov.uk/government/consultations/eu-audit-directive-and-regulation-implementing-the-requirements

An Impact Assessment and draft regulations were published alongside the consultation document and are available on the consultation page.

The consultation closed on 9 December 2015 and over recent months BIS has been analysing the responses and undertaking further discussion with respondents on specific aspects.

The EU Directive and Regulation

The consultation sought views on the technical implementation of the EU Audit Directive (2014/56/EU) and Regulation (537/2014). Further information, including the text of the Directive and Regulation is available on the Europa website at the following link: http://ec.europa.eu/finance/auditing/reform/index_en.htm

The Directive amends the existing Directive 2006/43/EC and applies to all audits required by EU law. The Regulation only applies to the audits of 'Public Interest Entities' (PIEs), i.e. entities with securities admitted to trading on a regulated market, banks, building societies and insurers.

The transposition date of the Directive and application date of the Regulation is 17 June 2016.

Related BIS publications

Previously, BIS published a Discussion document to gather stakeholder views on our approach to implementation and to inform the technical consultation. It is available, along with a summary of responses, via the following webpage: https://www.gov.uk/government/consultations/auditor-regulation-effects-of-the-eu-and-wider-reforms

BIS has also published supplementary guidance about auditor rotation and retendering. The guidance was developed in collaboration with the Financial Reporting Council and Competition and Markets Authority and can be accessed via the following link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/412094/BIS-15-180-auditor-regulation-supplementary-information-the-implications-of-the-EU-and-wider-reforms.pdf

Executive Summary

There were 25 responses to BIS's consultation on the *legislative implementation of the EU Audit Directive and Regulation*. Overall there was support for BIS's minimal implementation approach, which is intended to ensure that the legislative changes allow maximum flexibility for auditors, their clients and the relevant regulatory bodies.

What are the Government's key legislative changes and regulatory effects?

The Regulation introduces a framework for mandatory rotation and retendering of audit engagements. It also introduces significant new controls on the provision of non-audit services by statutory auditors to their audit clients.

The Regulation only applies to the audits of 'Public Interest Entities' (PIEs). The definition of a PIE will be restricted to entities with securities admitted to trading on a regulated market, banks, building societies, and insurers.

All PIEs will be required to put their audit out to tender at least every 10 years and change their auditor at least every 20 years.

The Directive requires all Member States to identify a Competent Authority for the regulation of statutory audits. This will be the Financial Reporting Council (FRC) in the UK. The FRC will be required to delegate tasks as much as possible to Recognised Supervisory Bodies (RSBs). The FRC will continue to be the standard setting body for auditors, and will have to conduct audit inspections, investigations and disciplinary cases in relation to PIEs.

Limited Liability Partnerships

Our final Impact Assessment considers applying the amended Directive framework to audits of LLPs. This would continue the current approach of making LLPs subject to the same audit regulatory framework that applies to companies and other business entities, noting that those LLPs with listed debt or that offer banking or insurance services will have to be covered by the Directive and the Regulation anyway.

Our Impact Assessment indicates there would no significant additional costs resulting from applying the updated framework to LLPs, so we propose that this should be undertaken on a longer timeframe to avoid distracting from delivery of the necessary changes in the light of the nearing implementation deadline.

Responses received

(25 respondents listed below)

Association of Chartered Certified Accountants (ACCA) Association of Investment Companies (AIC) Association of Practicing Accountants (APA) BDO Blackrock British Private Equity & Venture Capital Association (BVCA) Chartered Accountants Ireland (CAI) Chartered Institute of Management Accountants (CIMA) Competition and Markets Authority Crowe Clark Whitehill Deloitte Ernst & Young (EY) Financial Reporting Council (FRC)	Grant Thornton Institute of Chartered Accountants in England and Wales (ICAEW) Institute of Chartered Accountants of Scotland (ICAS) Investment Association (IA) KPMG London Society of Chartered Accountants (LSCA) Mazars National Audit Office PriceWaterhouseCoopers (PwC) Quoted Companies Alliance (QCA) RSM Taylor Wessing

Analysis

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

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

There were twenty five responses to this question.

The majority of respondents, including all four Recognised Supervisory Bodies (RSBs), the largest six accountancy firms, three mid-tier accountancy firms, and four investor bodies, agreed with the Government's view that the definition of a PIE should not be expanded beyond the definition provided for in the Directive.

Fifteen respondents agreed that the Financial Reporting Council (FRC) is the most suitable body to be the competent authority, including three RSBs and five of the largest six accountancy firms. The other respondents did not provide a clear view about this.

Eleven respondents, including two RSBs, five of the largest six accountancy firms, and four investor bodies, supported the Government's proposal to allow a ten year maximum extension for audit engagement following a retender and a twenty year maximum duration for auditor engagement.

In assuming that the FRC will be the competent authority, a number of respondents including ICAEW, LSCA, PwC, KPMG and Mazars commented on the appropriateness of the FRC's current constitution and governance arrangements. In particular they wondered whether these would need to be changed to fully comply with the EU requirements. The ICAEW noted in particular that FRC would need to ensure it complied with Article 21 of the Regulation. PwC suggested there should be a separate consultation on the appropriate future governance and oversight model for the FRC. KPMG considered it was vital for the FRC to meet the independence and recruitment criteria in particular. Mazars suggested that the changes in the FRC's powers would need to be accompanied by a thorough review of its governance.

All of the RSBs as well as Deloitte and BDO indicated that, as the competent authority, the FRC should focus on Public Interest Entities (PIEs) and delegate other matters to the RSBs, as set out in a written ministerial statement by Baroness Neville-Rolfe on 20 July 2015. Taylor Wessing stated that it was sensible in their view to have a single competent authority for PIEs. All of the RSBs also requested more clarity on this delegation framework and some other respondents stated that they would welcome more clarity generally about the remit and powers of the FRC and RSBs. For instance, Deloitte said that the division of powers between the FRC and RSBs should be more clearly articulated.

Six respondents – BDO, KPMG, Grant Thornton, The Association of Practicing Accountants (APA), Mazars and Taylor Wessing – wanted clarity about the relationship between new and current disciplinary arrangements. Some of these respondents expressed concerns about whether procedural safeguards in the existing scheme will apply to the new process, noting the existing safeguards are important. For instance, BDO supported the right to an independent tribunal. Deloitte said regulation should replicate the FRC's present approach to disciplinary matters and people should have the opportunity for a fair hearing by an independent and impartial tribunal. In relation to this issue some respondents said they would welcome further detail in relation to the provision of sanctions.

Two respondents questioned the Government's proposed implementation of provisions in the Directive on the publication of sanctions imposed on auditors by the competent authority or the RSBs. They queried whether legislation should require the withholding of information on the imposition of sanctions until all avenues of appeal are exhausted.

With regards to the FRC's auditing standards and ethical standards, some respondents raised concerns about using a 'copy out' approach as they considered the language used in the Directive and Regulation imprecise and at times difficult to interpret. For instance, among others, BDO said they had concerns about the approach of copying text from the Directive and Regulation straight into the standards without an attempt at interpretation.

The Chartered Institute of Management Accountants (CIMA), the Investment Association and KPMG supported the approach of a clear and understandable blacklist of services that audit firms are prohibited from providing to their audit clients.

Government response to the general question on the draft clauses

Baroness Neville-Rolfe made a written ministerial statement on 20th July 2015,[1] setting out that:

- The Government will require all PIEs i.e. listed companies, banks, building societies and relevant insurers to put their audit out to tender at least every 10 years and change their auditor at least every 20 years.

- The Government intends that the Financial Reporting Council (the FRC) should be the UK competent authority for the regulation of auditors, but that legislation will require it to delegate regulatory tasks so far as is possible to recognised supervisory bodies that meet criteria set out in the legislation. Overall this would mean the FRC would only have to conduct audit inspections, investigations and disciplinary cases in relation to PIEs, and would oversee the work of the recognised supervisory bodies for other audits.

Responses to the consultation indicated strong support for this policy approach. As a result the Government is continuing to take forward their implementation as proposed.

[1] http://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Lords/2015-07-20/HLWS137/

This will include clear provision on the division of responsibilities between the competent authority and the RSBs, through the use of a revised direction by the Secretary of State setting out when the FRC should delegate tasks to the RSBs.

The definition of a PIE will be restricted to the definition provided in the Directive and will not include companies traded on AIM.[2] The Secretary of State's direction will require the FRC to delegate inspections and investigations of audits of non-PIEs to the RSBs unless the FRC and RSBs agree otherwise.

The Government will require the FRC to fulfil the independence requirements of the Regulation in order for it to become the Competent Authority.

With regards to disciplinary arrangements and the right of appeal, the Government will require the FRC to ensure its processes are compliant with Article 6 of the European Convention on Human Rights.

The Government has considered the comments made on the publication of sanctions. Having considered the various alternatives, we think the original proposed implementation is appropriate. We consider that it is clear from the FRC's practice under its publication scheme where a sanction is subject to appeal. This approach is also consistent with the Government's preference to use "copy out" of EU Directives as much as possible.

The Government has also considered how the underlying framework for enforcing sanctions should work. The FRC have pointed out that it is not logical that the range of sanctions against auditors available to the Competent Authority should be narrower than those that a professional body could apply under delegated arrangements. This is because if tasks are delegated the Competent Authority may have to reclaim them from a professional body – and the Competent Authority will need to have the same range of enforcement powers. The Government can see the logic in this approach, and we conclude that the FRC, in its capacity as the designated Competent Authority, will need a statutory right to seek enforcement of sanctions determined by the disciplinary tribunal.

In so far as the implementation of provisions in the Directive and the Regulation is via the FRC's auditing standards and ethical standards, the preparation of the standards is a matter for the FRC. The FRC has consulted through a separate parallel process on the assembly of the standards. BIS has shared the responses it has received to its consultation with the FRC to assist it with the development of its own conclusions.

The Government also received a number of specific drafting comments on individual implementing provisions. We have considered these carefully and, where appropriate, the draft provisions have been amended.

[2] AIM (formally the Alternative Investment Market) is a sub-market of the London Stock Exchange, allowing smaller companies to float shares with a more flexible regulatory system than is applicable to the main market.

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

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

This question was answered by fewer than ten respondents. In general, there was support for the Government's proposals, with only a few respondents voicing concerns. A summary of those views on each of the five proposals is provided below.

Article 15 on record keeping – two responses were received. One said that it is reasonable to have sanctions for breaches of the keeping of records. The other respondent expressed support for a six year retention period, in line with current practice.

Article 18 on a handover file – two responses were received. One said that it would be reasonable to expect there to be provision to ensure that there is a handover file available to a successor firm; the other expressed concern about lack of guidance on what compliance should look like.

Article 23 on confidentiality – of the five provisions, this was of the lowest level of interest, with only one firm seeking clarification on this. This was due to concerns that the competent authority should not go beyond the specifications of the Directive and Regulation.

Articles 45 and 47 on third country issues – three respondents expressed support in principle, noting that this is probably best addressed in the rules for auditors set by the FRC, which would also assist in minimising the need for detailed future legislative change.

Government response to the general question on the proposed legislative approach

During the course of the consultation period between October and December 2015, BIS prepared draft amendments to UK law to implement most of the changes described in Chapters 10 and 11 of the consultation paper. These additional draft clauses have not prompted significant comment and will be taken forward into the final implementation. In taking the drafting further forward, we will continue to make sure that the implementation of the provisions does not elaborate unnecessarily the requirements in this area.

Impact assessment and estimating costs

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

Twelve respondents answered question three. This included two RSBs, five of the largest six accountancy firms, four mid-tier firms and one representative body. Two respondents stated they believed the analysis was broadly reasonable.

Detailed comments relating to specific costs and benefits in the Consultation Stage Impact Assessment were provided by seven respondents (including both audit firms and representative bodies).

In terms of benefits, one mid-tier audit firm noted that the proposals for more frequent re-tendering of PIE auditors had the potential to boost competition in the UK audit market.

In respect of analysis of the costs, detailed consultation responses cover the following topics:

- Reporting costs related to the transparency report;
- Familiarisation costs for audit principals, non-audit staff, non-executive directors and for non-PIEs;
- Costs relating to the audit committee;
- Costs relating to the tendering of non-audit services;
- Costs for smaller companies affected by the changes; and
- The analytical assumptions relating to wage costs and audit and non-audit fees.

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

• newly designated PIEs; and,

• audit firms that become auditors of PIEs for the first time…

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

Ten respondents provided answers to question four. Five respondents suggested that they were unable to provide data to answer this question. Two large audit firms provided detailed comments on the nature of the familiarisation costs arising to affected entities. One audit firm stated that they believed these costs would be higher than for other affected entities, though they did not quantify this.

Three respondents (all audit firms) provided quantitative estimates of the percentage uplift to apply to estimate the familiarisation costs for newly designated PIEs and audit firms that become auditors of PIEs for the first time. Two respondents suggested that 50 per cent was a reasonable uplift for both new PIEs and first- time PIE auditors, while another suggested that they viewed 20 per cent was a reasonable uplift for the costs for these organisations.

5. In the consultation IA we have estimated the direct costs to PIEs of having to tender the audit engagement every 10 years. In our final analysis, we also plan to include an estimate of the additional costs that would be incurred by a new auditor that has to familiarise itself with the business of a new PIE client. We propose that the additional familiarisation cost to auditors engaged in a new audit could be estimated as an additional 10-30% of the cost of the audit in the first two years. Is this reasonable?

Eleven respondents gave an answer regarding the familiarisation costs in the first two years for auditors taking on the audit of a new PIE client, providing a range of views. Two organisations stated that they were unable to provide a view. Eight out of the eleven respondents agreed that the additional costs would fall somewhere in the range of 10-30% of the cost of the audit. Two organisations disagreed. One (a large audit firm) suggested that the additional familiarisation costs could be above this range, at 30-40% of the cost of the audit, while one investor said they believed that the cost would be 'significant', though they did not quantify the additional costs. Therefore given the majority of respondents agreed with BIS's preliminary analysis, the Government's Final Stage Impact Assessment estimates that the additional familiarisation costs will be in the range of 10-30% of the cost of the audit. Additionally one respondent suggested there may be some costs to the outgoing auditor of handing over the audit client.

6. Our preliminary analysis suggested that the costs and benefits of the measures in the new Directive affecting audits of non-PIEs would be negligible. This has been assumed in the consultation IA. Is this reasonable? If not, what do you estimate will be the main changes giving rise to costs and benefits for non-PIEs and their auditors? Can you provide quantitative estimates?

Eleven respondents provided answers to question six. Eight respondents (two RSBs, two of the largest audit firms, and four mid-tier audit firms) agreed with BIS's Consultation Stage Impact Assessment that the costs and benefits of the measures in the new Directive affecting audits of non-PIEs would be negligible. Two respondents suggested costs would arise if the audit requirements for LLPs and companies were not the same. Two organisations were unable to provide an answer to this question. One respondent stated that there would be learning costs for auditors, tentatively estimated at £2,000 per affected firm. One mid-tier audit firm stated that they believed that limitations on auditors providing tax services to non-PIE clients could be costly to firms who would have to change their tax advice provider.

7. It is particularly important to assess the costs and benefits arising from the new Directive for non-PIE LLPs and their auditors as the implementation of the new Directive is not required by EU law for these audits. Would your answers to question 6 differ for non-PIE LLPs? How and why?

Ten respondents answered this consultation question. Six of the responses received (including responses from RSBs, large and mid-tier audit firms) agreed that their answers to question 6 would not differ for LLPs, and stated that LLPs would not face any additional costs compared to other affected corporate entities. Two respondents noted that they were unable to answer this question. One RSB suggested that there would likely be learning time for auditors, and tentatively estimated at around £2,000 per affected firm. One respondent believed that this extension to LLPs should be the subject of a separate consultation and Impact Assessment.

Government response on questions related to the Impact Assessment and estimating costs

The Impact Assessment has been revised to reflect the input received from stakeholders during the consultation period.

This has resulted in changes to the assumptions used in the analysis, although on some occasions changes in the assumptions have not necessarily resulted in significant changes in estimated costs. For example, we have revised down our estimate of the number of audit principals working as part of an audit team – because respondents deemed this figure to be too high. However, we have increased our estimate of the number of hours that an audit principal spends working as part of an audit team – because respondents deemed this figure to be too low. These two changes in costs counteracted one another. On other occasions more significant changes in costs have resulted, for instance where we used data from the Competition and Markets Authority to estimate the familiarisation costs to an auditor learning about a company for the first time.

Overall, the changes have led to a more accurate assessment of the impact of the Directive on business.

Further questions on application to Limited Liability Partnerships

8. Do you think that the Government should:

• implement the changes required by the new Directive for audits of non-PIE LLPs alongside those same changes for entities (such as companies) that are required to be audited by EU law; or,

• implement some or all of the changes required by the new Directive for audits of non-PIE LLPs at a later stage?

… please give reasons for your answer.

Seven respondents (one RSB, two of the largest six accountancy firms, and four mid-tier firms) said that the changes for LLPs should be made alongside the same changes for those entities that are required by EU law to be covered by the reforms. Four of the largest six accountancy firms and three mid-tier firms said there would be cost savings for doing the implementation at the same time.

Four respondents (one RSB, two of the largest six accountancy firms, and one investor body) answered that some or all of the changes required by the new directive for audits of LLPs should be made at a later stage.

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

Nine respondents provided views on the potential savings from implementing the changes required by the Directive for LLPs at the same time as other entities. However no quantitative estimates of the extent of savings were received.

The majority of the respondents (seven out of nine) believed implementing the changes simultaneously would result in cost savings or that costs would arise if the changes were not implemented simultaneously. However, one respondent suggested that implementing the changes for LLPs should be postponed, until after that changes for other entities were made.

Respondents in favour of simultaneous implementation suggested that consistent audit requirements would avoid costs for audit firms, because it would mean these firms would not need two different sets of audit guidance, templates, IT systems, and training materials. One large audit firm suggested that consistent audit requirements for non-PIE LLPs would also give rise to savings for audit standard setters, regulators, and the Government. This firm also believed a single set of requirements would be simpler for users of financial statements; those who govern non-PIE LLPs; and for non-PIE LLPs with subsidiaries that are affected by the Directive requirements. Another respondent believed the impact of simultaneous implementation for non-PIE LLPs would have a negligible impact on these entities.

Government response regarding application of the Directive to non-PIE LLPs

In line with the responses to the consultation document the Government is committed to the application of the Directive to LLPs. The Government agrees with the reasons that some stakeholder have provided, in particular that applying the Directive to LLPs will lead to

consistency and resulting simplification gains.

Furthermore, responses indicate there would be no significant additional costs resulting from applying the updated framework to LLPs. The Government's final stage impact assessment includes a discussion of the impact of applying the Directive to LLPs, drawing on evidence received from the consultation responses.

The changes to Part 42 of the Companies Act, and in particular Schedule 10 to the Act, will apply to LLPs as from the commencement date. Similarly the changes in the new implementing regulations will affect LLPs as from the commencement date. However, some amendments on appointment and removal of auditors, requiring amendments to LLP specific legislation will follow at a later stage. The mainly affect LLPs that are PIEs, of which there are very few if any in existence.

The Government's priority is to implement the Directive on time. We will seek to make the remaining corresponding changes on appointment and removal of auditors of LLPs as soon as possible. We propose to apply the remaining changes to LLPs to the same financial years and therefore keep costs and complexity to a minimum.

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