

# **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**

**Department for Business, Innovation and Skills**

**RPC rating: Fit for purpose**

## **Description of proposal**

Audit scandals in the USA and Europe and 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 IA explains that the changes to EU legislation consist of two main elements. First, the changes increase the scope of the application of the 2006 directive on audits to now cover additional entities. Second, the changes increase the scope of the requirements of the directive, while moving most of the requirements into the new regulation.

The Department proposes to go beyond minimum implementation by introducing additional requirements to facilitate a more flexible implementation and to ensure consistency with the domestic application of the 2006 directive.

## **Impacts of proposal**

The IA explains that the application of the 2006 directive will now cover entities such as the investment firms covered by the Markets in Financial Instruments Directive (MiFID) and alternative investment funds. The regulation extends the requirement for an audit committee to all Public Interest Entities (PIEs), whether listed or not. Broadening the scope of businesses covered by the existing requirements will impose costs on newly included businesses; for example, unlisted PIEs will have to establish audit committees.

Apart from increasing the range of businesses covered by the 2006 directive and the new regulation, all businesses that fall within the scope of the proposals will have to adjust to the changed statutory audit requirements. The IA provides a detailed breakdown of all individual changes that affect businesses.

The Department estimates total one-off costs of £89.73 million, the vast majority of which are familiarisation costs for audit firms and PIEs. Other elements include the costs to unlisted PIEs of having to establish audit committees as well as the costs to PIEs of obtaining new providers for some non-audit services. This might be necessary as the regulation uses a cap

on fees for non-audit services provided by the auditor to increase auditors' independence and to increase competition for providing non-audit services.

The Department estimates ongoing costs of £51.72 million per year to business. The majority of this cost is caused by two changed requirements. First, businesses will have to retender their auditor appointments every 10 years and the maximum length of an audit engagement is capped at 20 years. This will increase tendering costs for businesses. Second, the proposal introduces additional requirements for audit committees, making more frequent meetings of these committees necessary.

As explained below, the Department intends to go beyond the minimum requirements of the EU legislation. The Department assesses these elements to be net beneficial to business and scores them as 'zero net cost'.

## **Quality of submission**

The IA clearly sets out the rationale and provides comprehensive qualitative and quantitative analysis of the proposals. While the Department provides sufficiently detailed estimates for costs and benefits for this stage, they are to a large extent based on limited information. The Department intends to gather further information on the underlying assumptions and resulting estimates during consultation, and should do so for the RPC to be able to verify the figures at final stage.

As set out above, the impacts appear to be driven by a broadening of the scope of the directive and regulation as well as the introduction of new or changed requirements. It would be beneficial if the IA, at final stage, could provide a clearer explanation about how much of the costs are going to fall on businesses that are newly covered by the directive and regulation and how much on businesses that have been covered before, but have to react to the changed requirements.

The Department has provided a description and costing for all impacts on business, whether derived from the change to the directive or from the new regulation. The RPC welcomes this approach as being helpful to business in understanding the overall impact, but points out that the Department is not required to include figures for directly applicable regulation that does not require UK legislation in its assessment. The IA should explain whether the regulation is directly applicable, or whether all the changes presented require transposition into UK law. The Department should, at final stage, distinguish between those costs imposed by changes to the directive and those imposed by the new regulation.

## **Minimum requirements**

The IA explains that the Department intends to go beyond minimum implementation of the directive in the following ways:

- applying the amendments to the directive to non-PIE Limited Liability Partnerships (LLPs);
- taking advantage of latitude within the regulation to provide more flexible re-tendering requirements for PIEs that would enable them to re-tender the audit

engagement earlier than 10 years without having an additional tendering process at the 10 year point;

- amending the fee disclosure requirements, requiring a business to provide more disaggregated information on fees it has paid for audit and non-audit services; and
- changes to the framework of functions of the Recognised Supervisory Bodies to give the Financial Reporting Council power to impose more focussed sanctions on these bodies.

The Department explains that extending the requirements to non-PIE LLPs would ensure consistency as the 2006 directive was applied to such entities at the domestic level and that increasing flexibility in the tendering process is expected to be beneficial to business. The Department, in its assessment, claims that all four elements above qualify as gold-plating, but that the net effect of all gold-plating taken together will be beneficial to business. The gold-plating elements are, therefore, deemed to score as 'zero net cost'.

The Department's assessment that all these elements can be considered gold-plating and can be judged to be a 'zero net cost' has not yet been demonstrated. The RPC agrees that taking advantage of flexibility within the regulation to introduce more flexible retendering is beneficial to business. However, as presented, making use of this flexibility would appear to be consistent with taking the minimum action required, rather than gold-plating. Since the other elements appear to impose costs on business overall, the gold-plating elements of this proposal, as presented, appear to be more accurately described as an 'IN'. The Department should strengthen its assessment of the gold-plating elements at final stage.

### **Small and Micro Business Assessment**

Although the proposals are European in origin, the Committee welcomes that the Department has undertaken a SaMBA because of the gold-plating.

The Department explains that the majority of small and micro businesses are unaffected by the proposal as they are exempt from statutory audit requirements. However, all PIEs, regardless of size, must be audited. Small or micro PIEs will therefore be affected by the implementation of the directive.

The Department acknowledges that the impact of this measure will be disproportionately greater for smaller audit firms. It explains that 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 inspections. In addition, a new requirement is introduced establishing that the frequency of firm inspections must be based on a risk assessment. This should help to mitigate any disproportionate impact on small businesses.

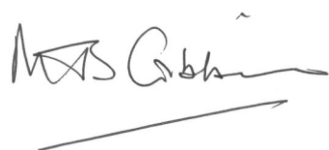
The IA explains that the nature of the business operations of PIEs means that they are likely to have a significant impact on the UK's economy and society. Therefore, it is considered desirable and necessary to apply to them the higher audit standards that are applied to large companies.

### Initial departmental assessment

Classification	Out of scope (EU) / In scope gold-plating elements
Equivalent annual net cost to business (EANCB)	£39.61 million (all of it attributed to the out of scope elements)
Business net present value	£-462.34 million
Societal net present value	£-462.34 million

### RPC assessment

Classification	Out of scope (EU) / In scope gold-plating elements
Small and micro business assessment	Sufficient



**Michael Gibbons CBE**, Chairman