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By email only to: pauld.smith@bis.gsi.gov.uk

Dear Mr Smith

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

Deloitte LLP is pleased to respond to your consultation on the technical legislative implementation of the EU Audit Directive and Regulation.

We welcome the Government's decisions made as a result of the earlier Discussion Document on the implications of the EU and wider reforms. We believe that your proposed approach has correctly balanced the interests of investors, the public and audited entities, and in particular prioritised the public interest by focussing on the interests of shareholders and prudential regulators of entities with the biggest impact on a broad base of investors or which could give rise to systemic risk.

We also support the decision by the Government to provide for much of the detailed implementation to be done by the FRC rather than in legislation. This will support a "one stop shop", allowing day-to-day reference to the FRC's standards to achieve compliance with the law when executing audits without cross-reference to UK and EU legislation. This will be of particular value to smaller audited entities, less experienced audit committees and smaller audit firms – it is important that needless complexity does not drive firms from the market, harming competition and choice. Reader-friendly standards will help regulators, preparers, auditors and audit committees carry out their respective roles.

In our letter to the FRC on its parallel consultation, we have stressed the importance of law and standards that provide for clear and consistent application. This is in the best interests of shareholders, audited entities (and those charged with their governance), regulators (audit, accounting and prudential) and audit firms.

In that vein we question whether a "copy out" approach is always the most appropriate approach when the FRC is drafting its standards. We understand the steer given by BIS to the FRC is that this approach will avoid unintended gold-plating of EU requirements while allowing for additional requirements to be imposed where called for on grounds of quality. However, the effect of layering these into ISAs (UK and Ireland) and the proposed Ethical Standard that already use very similar language has resulted in drafting that is sometimes confusing. We encourage you to confirm to the FRC that when implementing the Directive it is possible for them to amend existing standards rather than duplicate through "copy out" provided the same end is achieved.

We understand that BIS, the FRC and the Competition and Markets Authority intend to update the questions and answers set out in their publication Auditor Regulation – Supplementary Information, reflecting the final legislative implementation in the UK of the Regulation and the planed removal of the UK Corporate Governance Code requirements on tendering. In many cases, the effect of the Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 ('the CMA Order') is aligned with that of the Regulation. However, there are a small number of cases where this will

force an earlier tender, particularly where an entity lists on an EEA regulated market and immediately joins the FTSE 350. We encourage BIS and the CMA to consider whether it is possible to bring any non-overlapping effects of the CMA Order into the body of the Act so that the law on tendering and rotation is set out in one place rather than two.

We have a number of detailed observations on the technical detail of the implementation which are set out in the appendix to this letter. None of our suggestions are intended to re-open policy decisions taken by the Government.

Finally, your consultation paper notes a number of areas where further legislation is necessary to deal with:

- parallel changes to the law for other types of undertaking, including building societies, friendly societies, Lloyd's syndicates and miscellaneous banks and insurers; and
- consequential amendments to other legislation.

We would be pleased to support you by reviewing drafts of these laws. Given the fact that many of the other types of entity affected by the Directive are in groups containing Companies Act companies, consistent application across these groups will reduce complexity and therefore costs for audited entities, regulators and users of financial statements.

If you have any questions on our comments, please contact David Barnes (020 7303 2888 or djbarnes@deloitte.co.uk) or Richard Gillin (020 7007 0202 or rgillin@deloitte.co.uk).

Yours faithfully

David Barnes

for Deloitte LLP

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Appendix 1: Answers to detailed questions in the consultation paper

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

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

Broadly, yes.

We have a number of detailed comments on the 17 November 2015 draft of the legislation. In each case, our comments are focussed around (a) clarity and therefore the likelihood of consistent application, (b) technical accuracy in the transposition of the Directive and Regulation or (c) internal consistency within the legislation.

Provision	Comment
The Statutory Auditors and Third Country Auditors Regulations 2016 ('the Regulations')	
Reg 2	The definition of "auditor reporting requirements" should also include s498A of the Act.
Reg 3	The current proposal provides that in some instances either the FRC or the relevant RSB(s) could be the appropriate regulator to investigate a potential disciplinary matter. For example, the FRC may conclude that a statutory audit of a non-PIE should come under its auspices due to the 'public interest' in the matter. In the interests of creating certainty for professionals, firms and regulators, we think that the division of powers between the FRC and the RSBs should be more clearly articulated and included in the Regulations or the Minister's Direction. In our view the FRC should focus on the most serious disciplinary matters relating to the statutory audits of PIEs, with other matters delegated to the RSBs.
Reg 4(1)(a)	In order to correctly transpose Article 30d and to preserve the principles of natural justice of the existing FRC disciplinary scheme, proposed Regulation 4 should be amended to give persons the opportunity for a fair hearing by an independent and impartial tribunal. The current clause as drafted gives the FRC the power to determine that a person has contravened a relevant requirement without a hearing. The appeal process set out in proposed Regulation 5 (which implements article 30e of the Directive) does not address the separate right to a fair and impartial hearing in the first instance required by Article 30d. The FRC's current disciplinary scheme, rules and sanctions guidance have evolved to provide for a robust disciplinary regime that enables tough enforcement whilst allowing for natural justice. In implementing Article 30d we suggest that the Regulations should require the FRC to consult on and establish such a scheme, rules and sanctions guidance.
Reg 4(1)(e) and 4(3)	The draft regulation provides for a disciplinary regime whereby auditors could be subject to sanction for any breach of the 'relevant requirements'. The draft regulation does not state whether or not the statutory auditor must have fallen 'significantly short' of the standards to be subject to a sanction, as is presently the case. The present FRC Sanctions Guidance confirms that the primary purpose of imposing sanctions for acts of misconduct is not to punish, but to protect the public and the wider public interest. The proposed regulation should be amended to reflect these overriding objectives. Article 30a(c) of the Directive states that Member States shall provide that the Competent Authority has the following power to sanction for breaches: 'a temporary prohibition, of up to three years' duration, banning the statutory auditor, the audit firm or the key audit partner from carrying out statutory audits and/ or signing audit reports'. Regulation 4(1) when read together with Regulation 4(2) does not appear to require this sanction to apply to the persons and firms listed in Article 30a(c) and only those persons and firms. The draft regulation refers to any person that has contravened a relevant requirement being potentially subject to this sanction. Given the severity of the proposed sanction, we submit that the sanction should only be applicable to those persons set out in the Directive, and provided such persons have direct responsibility for the contravention of the relevant requirement. We believe that the Regulation should replicate the FRC's present approach to disciplinary matters, requiring an independent tribunal to have regard to the reasons for imposing sanctions when imposing them, particularly:

- to deter members of the audit profession from contravening relevant requirements;
- to protect the public where the conduct of the statutory auditor or audit firm has fallen significantly short of the standards reasonably to be expected of the statutory auditor or audit firm;
- to maintain and promote public and market confidence in the audit profession and the quality of statutory audits; and
- to declare and uphold proper standards of conduct amongst statutory auditors or audit firms.

In addition, mirroring the present FRC Sanctions Guidance and approach to disciplinary matters, the independent tribunal should seek to achieve the above objectives by imposing sanctions which:

- improve the behaviour of the statutory auditor or audit firm concerned;
- are tailored to the facts of the particular case and take into account the nature of the contravention and the circumstances of the statutory auditor or audit firm concerned;
- are proportionate to the nature of the contravention and the harm or potential harm caused;
- eliminate any financial gain or benefit derived as a result of the contravention; and
- deter statutory auditors and audit firms from breaching relevant provisions.

Reg 4(4)	We suggest the replacement of 'for example' as used in Article 30b of the Directive with 'including' as used in 4(4) may have a material effect on the interpretation of the provision, to the extent that in all cases the firm's turnover or an individual's personal income is a relevant consideration. We do not believe this is the intention of Article 30b(c), and recommend that the draft regulations mirror the Directive.
Reg 4(5)	The definition of "statutory audit" in s1210 of the Act will be extended to cover other types of entity for which an audit is required by EU legislation. The term "relevant requirement" therefore needs to include the relevant provisions of UK law that enact the audit requirements for these types of entity.
Reg 5	We agree with the inclusion of a right of appeal process, as this is an important factor in providing a fair outcome for all involved parties. We assume that detailed rules as to the applicable appeal process will be included in an updated disciplinary scheme.
Reg 6	Article 30c of the Directive provides that the Competent Authority shall publish sanctions for breaches where all rights of appeal have been exhausted or have expired. In contrast, proposed Regulation 6 requires the publication of sanctions and measures prior to the hearing of an appeal. Regulation 6(3)(a) and (d) provides for certain exclusions to publication of sanctions, but does not provide a route for a statutory auditor or audit firm to challenge publication. We believe that there should be a route to challenge publication in cases that are subject to appeal. Furthermore, the addition of the words 'and the competent authority considers' to Reg 6(3)(a), which do not appear in the Directive, leave the judgement as to whether publication is 'disproportionate' solely at the discretion of the FRC.
Sch 2 para 2(3)(b)	It is unusual for costs orders to be made against an officer personally who might be deemed responsible for failing to comply with a notice to produce information. This provision is not included in Article 23 of the Audit Regulation, and we believe should be deleted, leaving the Courts to decide.
Sch 2 para 5(1)	We are concerned that the proposed criminal sanctions set out in these paragraphs which appear to go beyond the requirement of Article 23 of the Audit Regulation. The draft provision does not accommodate the fact that there may be legitimate reasons for a person or firm to resist a requirement to produce documents or information. In circumstances where there is a refusal to provide information, the appropriate route would be for the Competent Authority to obtain an order from the Court, which would also give the recipient of the request for information the opportunity to raise legitimate objections. Given there is already an established mechanism to obtain an order for production of documents, and applicable sanctions for non-compliance, we do not believe that there is a need for this separate provision.

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Chapter 2 Part 16 Companies Act 2006

ss487 and 491	We understand that you believe the periods of "ten years" and "twenty years" in the Audit Regulation are references to calendar years rather than to financial years. It would be helpful to clarify this point as it will apply to situations where there has been a change of financial year. ss487(1A) and ss491(1A) could also, as drafted, allow an auditor to carry out eleven audits, rather than ten, in a situation where the auditor is appointed after the first year end which they are appointed to audit. Whilst unusual, this is not impossible, and may surprise investors.
s494A	The term "public interest entity" is defined here by reference to EU law. As Part 16 can only apply to a UK incorporated entity, it would be helpful if this could be replaced with a reference to the applicable provisions of UK law for ease of use by companies.
ss495-498A	Most of these sections are amended to deal with joint auditors. We suggest that: • it may be helpful to bring all of these together into a new s498AA "Where more than one auditor is… agree on each of the opinions and statements required by sections 495-498A"; • if not, then (a) there appears to be a gap in that this requirement stems from EU law so should also apply to s498A; and (b) there appears to be no good reason why it should not also apply to s497.
s504	In view of the wider giving of powers directly to the FRC, we assume SI 2012/1741 will be repealed or amended. To simplify the law in this area, s504(b) could be amended to "the competent authority" or "the Secretary of State or the competent authority".
s506	"name" should be changed to "name(s)" throughout to be consistent with the approach taken to joint audits.

Schedule 10A Companies Act 2006

Para 20A	Definition of "auditor reporting requirements" should also include s498A of the Act.

Chapter 4 of Part 16 Companies Act 2006

s510A	The drafting could be simplified by: • moving the 5% requirement in s510(5)(a) to s510(3); • combining s510(4) and (5), which would then read "If the court…. on hearing an application under subsection (2) or (3)…"; and • changing s510(7) to refer to s494A rather than the Regulations. This would avoid needing to amend the Act again if the Regulations were to be updated or replaced.
s519A	The term "public interest company" is amended here to align with the term "public interest entity". It would be simpler for companies, directors and auditors if the terms in this Chapter were just aligned to "public interest entity". If this is not possible, then it would be helpful if the amended definition in s519A simply said "means a public interest company as defined in s494A."

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

Question 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?

We agree with the approach in Chapter 10, with two observations:

- Paragraph 10.1 of the Consultation Paper refers to a proposed amendment to paragraph 10A of Schedule 10 CA06. This change is actually in paragraph 10(2) of that Schedule.

- The law relating to Third Country Auditors and cross-border co-operation is already convoluted, with two sets of regulations and a direction by the FRC. It would be helpful if, instead of making layering further amendments on top of these regulations and direction, one consolidated set of regulations could be prepared, with the FRC retaining the power to amend the list of countries in each category by direction.

In our response to the earlier Discussion Paper, we raised our concerns in respect of the requirement under Article 12 to report to the "supervisor" of a non-financial services PIE (i.e. one which has securities admitted to trading on an EEA regulated market but which is not regulated by the PRA. Our concern was as to:

- whether it would be clear to auditors what the scope of point (a) of that Article ("a material breach of the laws, regulations or administrative provisions which lay down, where appropriate, the conditions governing authorisation or which specifically govern pursuit of the activities of such public-interest entity") would mean. We understand that BIS interprets this to mean breaches of the Listing Rules and Disclosure and Transparency Rules and it would be helpful if this could be confirmed by BIS, the FCA acting as the UK Listing Authority and/or the FRC; and
- whether such reporting would be directed to the body best placed to take action with respect to it.

We suggest that:

- in the case of an entity that is dual-regulated by the PRA and FCA (which would include banks and building societies, plus certain designated investment firms), all reporting under Article 12 should be to the PRA;
- in the case of an entity that is only FCA regulated (for example, a listed insurance broker), all reporting under Article 12 should be to the FCA in its capacity as prudential and conduct regulator; and
- in all other cases, reporting should be to the FCA (or equivalent listing authority in the Home State of the entity).

This would provide for:

- a simple rule, capable of easy application and enforcement;
- avoid duplicate reporting under this rule and SI 2587/2001 for PIEs that are FCA but not PRA regulated;
- reporting to the body who is most likely to need to take urgent time-sensitive action as a result of an auditor having made a report; and
- allowing for information to flow under the statutory gateways to the other bodies who may need it for other purposes.

Impact assessment

Question 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.

Many of the estimates and assumptions relate to others, for example costs of audited entities and regulatory bodies. We believe that the overall analysis of costs and benefits is not unreasonable, recognising that the Government must meet the minimum requirements of EU law, and therefore that the greatest challenge will be the costs and benefits associated with different choices around member state options.

Familiarisation costs

Question 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?

As we fall into neither category, we do not have any data to estimate a reasonable percentage.

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Question 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?

Yes, insofar as this data is consistent with that used in by the Competition and Markets Authority in their recent study.

Costs to non-PIEs and their auditors

Question 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?

Yes, this is reasonable.

Question 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?

No. Our answer to question 6 would be the same for a non-PIE LLP as for a non-PIE company.

Further questions on application to non-PIE Limited Liability Partnerships

Question 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.

We think that the government should implement the changes for non-PIE LLPs at the same time as changes for entities that are required to be audited by EU law. This would:

- reduce the possibility for confusion amongst users of financial statements;
- reduce the possibility for confusion amongst those charged with governance of audited entities; and
- save costs (see question 9 below).

Implementing at a different time would be challenging because:

- audit firms tend to have one set of systems. In practice, any system changes will need to be made effective from 17 June 2016 whether or not the changes for non-PIE LLPs are delayed;
- changes would be needed for some LLPs anyway, as it is MiFID investment firm LLPs are relatively common, meaning that a legislative or regulatory solution would be needed anyway; and
- it is increasingly for common for an LLP to have Companies Act companies as subsidiaries, or vice versa, and consistent application of the law throughout a group is helpful.

Question 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?

Yes. We believe that there would be cost savings from consistency of approach across different types of entity and that therefore BIS should implement the changes for non-PIE LLPs. These savings would arise for:

- standard setters (issuing one set of standards without the need for transitional guidance governing the application of standards to different types of entity from different dates);
- regulators (inspecting one common system of firm-wide controls at audit firms; and

- government (a simple clean break between old and new regimes for Companies House to monitor, savings for BIS not having to draft transitional provisions, and savings for BIS and HMT from not having to develop an alternative solution for LLPs that are MiFID investment firms; and
- auditors (maintaining one set of templates, work programmes and systems; simpler training).