

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

The IA is now fit for purpose as a result of the Department's response to the RPC's initial review. As first submitted, the IA was not fit for purpose.

Description of proposal

The proposal is to transpose an amended EU directive on statutory audits of annual and consolidated accounts into UK regulations. The changes consist of two main elements. First, they increase the scope of application of the 2006 directive on audits to cover additional entities. Second, the EU changes increase the scope of the requirements of the directive, while moving many of the existing and new requirements into a new directly applicable regulation. EU directly applicable regulation automatically takes effect without the need for transposition into UK law or scrutiny by the RPC. However, the impact assessment (IA) does include estimates of the costs of both the directive and the directly applicable regulation.

In addition, the Department proposes to go beyond the minimum implementation required by extending the scope of the directive to the audits of limited liability partnerships (LLPs).

Impacts of proposal

The IA explains that the application of the 2006 directive will now include entities such as the investment firms covered by the Markets in Financial Instruments Directive 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 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 directly applicable EU regulation, all businesses that fall within the scope of the proposals will have to adjust to the changed statutory audit requirements.

The impact assessment provides a detailed breakdown of the costs to business from implementing the directive and, separately, the directly applicable EU regulation.

The IA states that the directly applicable regulation and the directive will together result in familiarisation costs to public interest entities (PIEs) and auditors from understanding the new requirements and changes to the audit standards. The IA uses a combination of data from the Financial Reporting Council, annual survey of hours and earnings (ASHE) and consultation responses to estimate total familiarisation costs of £118.6 million.

In addition, the IA estimates other one-off costs as totalling £31.4 million and ongoing costs totalling £67.16 million as detailed below.

EU directive costs

One-off costs

Familiarisation costs to businesses have been assessed for all the proposed changes taken together, regardless of whether they result from the regulation or the directive or a combination of the two. The IA explains that, as a result, it is difficult to allocate familiarisation costs to each measure and, therefore, to the directive and regulation.

However, based on the total ongoing cost of the directive as a proportion of the total ongoing costs of the directive and regulation combined, the IA estimates that familiarisation with the directive will cost business £36.9 million.

The directive requires the 160 PIEs that do not currently have an audit committee to establish one. The IA uses figures from the 2006 audit directive IA and uprates them for inflation to estimate the cost of recruiting a chairman (£17,972) and one non-executive member (£11,982). The IA estimates these costs to total £4.8 million.

The IA, therefore, estimates the total one-off costs to business to be £41.7 million.

Ongoing costs

The IA states that the ongoing costs consist mainly of two elements.

First, each of the 160 PIEs that would have to establish an audit committee (assumed to be two members) will incur ongoing costs in audit committee fees. The IA uses data from PricewaterhouseCooper's report on non-executive director fees to estimate these to total £100,693 each year. Therefore, the total annual ongoing cost to PIEs of sustaining the audit committees is estimated to be £16.1 million.

Second, the directive also requires additional meetings each year between auditors and audit committee members. The IA estimates that this would require additional meeting time of seven and one half hours for each of 160 PIEs that are now required to establish an audit committee, and an additional two hours for 1,869 PIEs that already have audit committees. Using data from the Financial Services Authority, the

IA assumes an hourly cost of £1,415 and estimates the ongoing costs to PIEs to be £6.99 million.

The IA, therefore, estimates the total ongoing costs to business to be £23.6 million.

Benefits

The IA estimates that there will be annual benefits to audit firms of £0.2 million from the expected reduction in the frequency of inspections by the Financial Reporting Council (from every six years, to every eight).

Additionally, the IA states that the proposal will increase audit quality and ensure that better information is made available to investors. This, in turn, may lead to greater investor trust in financial statements, which could lead to better investment decisions. These benefits have not been monetised.

Gold plating

The Department proposes to go beyond minimum EU requirements by extending the directive to LLPs. The IA explains that auditors of LLPs would have to verify the independence of auditors who provide information for group audits on subsidiaries outside of the EU. There are 87 LLP group audits that are not subject to EU law or UK standards. The IA assumes that this will require five hours of an audit partner's time at an hourly rate of £66.24, giving a total estimated cost of £29,000. The IA estimates that there are likely to be savings from extending the directive to LLPs, however, it states that it is not proportionate to estimate these.

EANCB

The IA estimates the equivalent annual net cost to business (EANCB) for minimum implementation of the directive is £24.7 million. This is a non-qualifying regulatory provision. The IA explains that the only element of the proposal that goes beyond minimum EU implementation is the extension of the directive to LLPs. This imposes an estimated ongoing cost to business of £29,000, which rounds to zero for reporting purposes.

EU directly applicable regulation costs

One-off costs

Based on the total ongoing cost of the regulation as a proportion of the total ongoing costs of the directive and regulation combined, the IA estimates that familiarisation with the regulation will cost business £81.7 million. 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. The IA estimates this cost to PIEs and auditors at £26.6 million for the reallocation of non-audit services.

The total one-off cost is, therefore, estimated to be £108.3 million.

Ongoing costs

Ongoing costs consist mainly of two elements. The regulation requires auditors to provide additional reporting to audit committees of PIEs and to the competent authority. The IA estimates the total cost of this at £5.5 million per annum. The regulation also requires that the auditors of PIEs must be appointed via competitive tendering every 10 years. The IA estimates this to cost PIEs and auditors £45.0 million per annum.

The IA, therefore, estimates the total ongoing costs from regulation to be £50.5 million per annum. The IA does not monetise any benefits as a result of the regulation.

Quality of submission

The IA now provides sufficient analysis for the RPC to be able to validate the EANCB figures.

As initially submitted for RPC scrutiny, the IA was not fit for purpose. This is because, when calculating the costs of an audit committee, the initial IA included a non-executive base fee for the chairman but not the other member of the committee. This meant that the RPC could not validate the EANCB. Following the RPC's initial review, the Department submitted a revised IA that addresses this issue.

The Department has also addressed comments made by the RPC at the consultation stage. The Department has gathered further information during consultation and has adjusted its estimates accordingly. The IA now separates the costs of the directly applicable regulation from those of the directive. However, the IA would benefit from explaining why some of the requirements have moved from the EU directive into new directly applicable EU regulation.

In addition, the IA distinguishes the impacts that will fall on businesses newly covered by the directive and regulation from the impacts on businesses that are already covered.

Small and micro business assessment

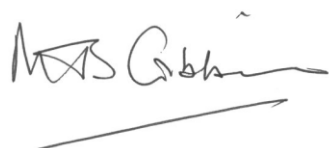
Although not required, the IA provides a sufficient small and micro business assessment for both the non-qualifying EU element and the qualifying gold plating element. The analysis for the gold plating element shows that 82% of the cost will be borne by large auditors. Additionally, there are expected to be savings for small audit firms from the reduction in frequency of inspections.

Departmental assessment

Classification	Non-qualifying regulatory provision (EU) Qualifying regulatory provision (gold plating)
Equivalent annual net cost to business (EANCB)	£17.8 million (initial estimate of non-qualifying regulatory provision) £24.7 million (final estimate of non-qualifying regulatory provision) Zero (qualifying regulatory provision)
Business net present value	-£220.12 million (benefits not fully monetised)
Societal net present value	-£220.12 million (benefits not fully monetised)

RPC assessment

Classification	Non-qualifying regulatory provision (EU) Qualifying regulatory provision (gold plating)
EANCB – RPC validated ¹	Zero (qualifying regulatory provision) £24.7 million (non-qualifying regulatory provision)
Small and micro business assessment	Not required (European origin)
RPC rating (of initial submission)	Not fit for purpose



Michael Gibbons CBE, Chairman

¹ For reporting purposes, the RPC validates EANCB figures to the nearest £100,000.