

Explanatory Text

Draft Statutory Auditors and Third Country Auditors (Amendment) Regulations 2011

1. The EU's Statutory Audit Directive (2006/43/EC) introduced the regulation of auditors of companies from outside the EEA, which issue securities on regulated markets in the EEA ("third country auditors"). The Directive also allows these requirements to be disapplied, in whole or in part, where the third country auditor is subject to a system of regulation in the country where the company is incorporated, which is determined to be equivalent to that required by the Directive.
2. The European Commission and Member States have recently agreed a Decision (2011/30/EU) on the equivalence of certain third country regulatory regimes and on further transitional measures for other countries, which will allow Member States to rely on regulation in those countries of audits of companies incorporated there. This continues the European Commission policy of developing mutual reliance on equivalent regulatory regimes, while gradually moving away from transitional measures in a way that avoids disruption to EU securities markets. The Decision can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:015:0012:0016:EN:PDF>.
3. The Decision replaces the previous Commission Decision (2008/627/EC) which, however, still applies in respect of audits of accounts for financial years beginning up to and including 1 July 2010. That decision can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:202:0070:0073:EN:PDF>.
4. The practical implementation of these arrangements in the UK is the responsibility of the Professional Oversight Board (POB) of the Financial Reporting Council. Their broad intention, with the commencement of the revised framework, is to continue the approach they already have in place for the regulation of third country auditors, only making necessary changes at this stage. In particular the differences between the lists of third countries in the two Commission Decisions will mean that some third countries will no longer benefit from transitional status, while one country will benefit from transitional status, having not previously done so.
5. The POB will determine the detailed requirements as to the regulatory regime for third country auditors once the changes have been made to the statutory framework. However, we understand its intention is to require the registration of "equivalent" third country auditors but then to disapply most

other regulatory requirements, provided that the third country does not itself apply additional regulation to auditors of UK companies listed on its markets. In particular the POB is likely to disapply the requirement for auditors of relevant companies incorporated in equivalent third countries to be subject to its own system of quality assurance reviews, to the extent that the relevant audits are within the scope of the regulatory regime of that country, and that the requirement for reciprocity allows. In so far as possible, the POB intends to regulate "transitional" third country auditors as at present. In practice therefore there are unlikely to be major differences between the regime applied to "equivalent" and to "transitional" third country auditors.

6. The existing UK legal provisions for the registration of third country auditors are set out in the Statutory Auditors and Third Country Auditors Regulations 2007 (SI 2007/3494) as amended by the Statutory Auditors and Third Country Auditors (Amendment) Regulations 2008 (SI 2008/499) and the Statutory Auditors and Third Country Auditors (Amendment)(No.2) Regulations 2008 (SI 2008/2639) ("the register regulations"). Continuing the approach under that framework, the POB's registration of third country auditors in the light of the second Commission Decision will be given effect by the disapplication of existing registration and regulation provisions in the register regulations and section 1242 of the Companies Act 2006. The POB already has the powers to disapply these provisions under sections 1239(7) and 1242(4) of the Companies Act 2006.

7. However, because of a technical change in the way in which the second Commission Decision takes effect compared to the first one, section 1242(4) has to be amended. The amended power will enable the POB to disapply requirements on the regulation of third country auditors in relation to particular audits of companies or of classes of company, while other audits, by the same auditor, may be unaffected. This will be necessary because the second Commission Decision gives transitional (or equivalent) status to a country for the purposes of audits of companies incorporated there. This differs from the first Decision, which granted transitional status to a country for the purposes of auditors domiciled or registered there. Most "transitional" (or equivalent) third country auditors should experience little change as a result of this, though in fact their continuing registration status will be based on slightly different criteria.

8. In other respects, the legal approach of the Commission Decision is unchanged. However, as it is possible that a registering or registered auditor in practice audits companies from equivalent third countries, transitional third countries and / or other third countries, further amendments are needed to the provisions in the register regulations to ensure that the registering auditor provides and updates all the necessary information. The draft regulations do this by removing the current definition in the register regulations of an "exempt third country auditor". The information which is currently only required for registration of "exempt third country auditors" would in future be required from all registrants. However this will be subject to directions issued

by the POB under section 1239(7) of the Companies Act 2006. We understand the POB intends to disapply requirements for information from registering and registered auditors, as appropriate under the new Commission Decision, given the companies for which the auditor provides an audit report. The draft regulations include a new requirement for registering and registered third country auditors to notify the POB of the listed companies for which they provide audit reports. This is intended to allow directions issued by the POB to disapply information requirements as appropriate.

9. The draft regulations are also intended to provide the POB with sufficient flexibility for the future. The amendments proposed to section 1242(4) and to the register regulations are intended to provide sufficient flexibility, should the POB wish to put in place specific arrangements for particular equivalent third countries.

10. The draft regulations make certain other minor changes to the register regulations. First, they remove the requirement for third country auditors to provide the POB with information on arrangements they have entered into for the purpose of quality assurance (inspections) and investigations for disciplinary purposes. In practice these arrangements are determined by the POB and there is no need for registration information on them to be sought or maintained. Secondly, they clarify that the registration numbers of individuals conducting audits for registered third country audit firms are not the registration numbers on the third country auditor register, but those of the individuals' registration with their own professional institutions. Finally, as well as adding a definition of "the second Commission Decision" the regulations continue to include a definition of "the first Commission Decision". This is because we intend to include certain transitional provisions in the final regulations, which are yet to be drafted. Some transitional provision comparable to regulation 3 of SI 2008/2639, is likely to be needed to ensure applicants for registration, who submit applications under the new framework before the commencement date, can be registered after that date. Similar provision is likely to be needed for applicants under the current system, whose applications fall to be processed after the commencement date. Finally, provision is likely to be needed for existing registered "exempt third country auditors" and other third country auditors, whose registrations will need to have an appropriate status under the new framework. Some of these provisions may need to be included in the revised direction by the POB under sections 1239(7) and 1242(4), rather than these regulations.

11. These regulations will also need to include certain additional provisions on issues where the Department for Business Innovation and Skills is yet to finalise a policy approach. These relate to third country audits conducted by statutory auditors and EEA auditors. Currently, the Financial Services Authority's Disclosure and Transparency Rules¹ require each UK-traded non-EEA company to be audited either by: a registered third country auditor; a UK

¹ DTR4.1.7R(4) - see <http://fsahandbook.info/FSA/handbook/DTR/4/1.pdf>

statutory auditor; or an EEA auditor. The FSA intends, in so far as possible, that this will continue, though we intend to provide in the final regulations that such a company can only be audited by a statutory auditor or EEA auditor, who has not registered as a third country auditor, where the system of regulation in the UK or EEA state covers the audit in question. This is because, following the technical change in the way the second Commission Decision takes effect, EEA auditors and UK statutory auditors who conduct third country audits will be subject to regulation under the Directive according to where the audited company is incorporated. It is anticipated that UK statutory auditors will satisfy this requirement because of other amendments we intend to make to the Companies Act 2006. It should be possible to make amendments extending the UK statutory audit regulatory regime to cover all relevant third country audits by UK statutory auditors. However, for EEA auditors, this will depend on whether, in practice, regulation in the EEA-state in which they are registered extends to the regulation of audits of companies incorporated in third countries, which are listed in the UK. During the consultation process we will examine how these exemptions might rely on a combination of the UK regulatory regime, that in other EEA states and/or that in certain third countries, as appropriate.

12. If you have any comments on the draft Statutory Instrument, or the proposals explained in this explanatory text, please send them by 19 May 2011, preferably by e-mail to: auditdirective@bis.gsi.gov.uk. If you wish to comment by letter, please write to Paul Smith, Audit and Accounting Policy, Department for Business, Innovation and Skills, Spur2 3rd Floor, 1 Victoria Street, London SW1H 0ET. If you have any questions about the regulations, please contact Paul Smith on 020 7215 4164.

13. Confidentiality: Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want information, including personal data that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

14. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.