The Statutory Auditors and Third Country Auditors Regulations 2016 and 2017; The Statutory Auditors Regulations 2017

Lead department	Department for Business, Energy and Industrial Strategy
Summary of measure	The regulations include a number of measures aimed at improving audit quality, such as mandatory re-tendering and rotation of audits, restrictions on non-audit services, and provisions in relation to independent audit committees.
Submission type	Post-implementation review (PIR)
Review date	By 17 June 2021
Department recommendation	Keep
RPC reference	RPC-BEIS-5074(1)
Opinion type	PIR
Date of issue	7 July 2021

RPC opinion

Rating[1]	**RPC opinion**
Fit for purpose	Although the Department's recommendation is to retain the regulations, further policy changes are being proposed as part of a new audit reform package to address areas where the regulations are not currently having the intended effects. On this basis, the RPC accepts that the recommendations of the PIR are supported by the available evidence and analysis presented. The Department has provided a clear, transparent and proportionate review of the regulations. However, there are a number of areas, described below, where the PIR could be improved.

[1] The RPC opinion rating is based on whether the evidence in the PIR is sufficiently robust to support the departmental recommendation, as set out in the better regulation framework. RPC ratings are fit for purpose or not fit for purpose.

RPC summary

Category	Quality	RPC comments
Recommendation	**Green**	Although the Department's recommendation is to retain the regulations, further policy changes are being proposed as part of a new audit reform package to address areas where the regulations are not currently having the intended effects. On this basis, the RPC accepts that the recommendations of the PIR are supported by the evidence and analysis presented.
Monitoring and implementation	**Good**	The PIR provides a proportionate review of the impact of the regulations, addressing the key requirements for a 'medium-impact' measure in the RPC proportionality guidance. The PIR uses an appropriate range of evidence, although some additional literature review would be useful. There are some areas, outlined below, where the PIR would benefit from further discussion and justification of the evidence limitations.
Evaluation	**Satisfactory**	The PIR transparently discusses the extent to which policy objectives have been achieved and the unintended effects of the regulations. The PIR would benefit from discussing some areas further. These include opportunities for reducing the burden on business (in particular smaller businesses), re-assessing the estimates for the most significant costs in the impact assessment, and perceptions of auditor independence, innovation and the impact of separation of functions on conflicts of interest.

Summary

The Statutory Auditors and Third Country Auditors Regulations 2016 came into force on 17 June 2016. They implemented: i) Directive 2014/56/EU (“the Audit Directive”) on the audit of limited companies and other undertakings required to be audited under EU law; and ii) Regulation (EU) 537/2014 (“the Audit Regulation”) on the audit of undertakings classified as public interest entities (PIEs), that is, entities whose securities are traded on a regulated market, credit institutions and insurance undertakings.

The Statutory Auditors and Third Country Auditors Regulations 2017 and the Statutory Auditors Regulations 2017 came into force on 1 May 2017 and 1 January 2018, respectively. They continued the implementation of the Audit Regulation and Audit Directive in respect of other entities such as friendly societies and miscellaneous insurance undertakings and improved the clarity of some of the original regulations’ provisions.

The main objectives of the regulations were to:

- improve confidence in the value of audit;
- reinforce the independence and professional scepticism of the statutory auditor;
- increase accountability of independent audit committees of PIEs;
- improve and co-ordinate auditor supervision by competent authorities better, thereby enhancing audit oversight and quality;
- reduce the risk of mis-statement or error in audited accounts, thereby making accounts and audit more credible for shareholders and audit committees; and
- increase competition and choice in the PIE audit market, thereby making the market for large company audits more dynamic.

This PIR focuses on the following key elements of the regulations:

- Extending the scope of the regulations to unlisted banks, building societies, and insurers (unlisted PIEs) and non-PIE limited liability partnerships (LLPs).
- Mandatory retendering and rotation for PIE audit engagements.
- Restrictions on provisions of non-audit services for PIEs.
- Provisions on the appointment and scope of independent audit committees;
- changes to the framework of the statutory regulator.
- Prohibition of “Big Four only” clauses.

Recommendation

The recommendation of the PIR is to ‘keep’ the measures. The PIR provides good evidence that the objectives of the regulations are still highly relevant (pages 13-14). The PIR also presents evidence that the regulations have made small steps towards higher levels of audit quality, although the overall picture is mixed. The Department notes that it is too soon to evaluate fully some of the measures, such as the retendering and rotation periods, and that the effectiveness of the regulations will depend on the changes following the Financial Reporting Council (FRC) review and the audit reform package being consulted on.

The PIR notes that there have been unintended consequences and that this is being addressed separately through the Government's current consultation on audit reforms (see further discussion below). Therefore, although the recommendation is to 'keep' the regulations, there are policy changes being proposed to address areas where the regulations are not having the full desired effect. On this basis, the RPC accepts that the recommendation of the PIR is supported by the evidence and analysis presented.

However, given the mixed evidence of the effectiveness of the regulations in meeting their objectives, and unintended reductions in market choice, the PIR would benefit from setting out in more detail how the findings from the review have informed the Government's latest proposals and how the new proposals would address them. The PIR would also benefit from addressing specifically why these proposals should build upon the existing regulations rather than replace them.

The Department has provided a clear, transparent and proportionate review of the regulations. However, there are a number of areas, outlined below, where the PIR could be improved.

Monitoring and implementation

Proportionate

The RPC considers that the PIR is a proportionate review of the impact of the regulations. The PIR explains that it takes a 'high-evidence' approach to evaluation, which is proportionate to a high-impact measure. The original IA estimated an equivalent annual net direct cost to business of £24.7 million, which falls within the 'medium-impact' category in the RPC proportionality guidance.[2] The PIR addresses the main elements set out in the RPC guidance for a measure with this level of impact.

Range of evidence

The PIR uses an appropriate range of evidence, obtained from several sources:

Evidence review. This includes a review of academic papers and independent reports, including the three major independent reviews of audit (the FRC review, the Brydon review and the Competition and Markets Authority study). This also included the EU's review of the 2016 audit reform package, which assessed the impact of the Audit Regulation and Audit Directive.

Stakeholder survey. The Department conducted an online survey of 102 stakeholders (e.g. companies, investors, audit firms and representative groups). 62 responses were received: 32 from 'businesses/companies that are subject to statutory audit and are a PIE'; 11 from audit firms; 10 from representative

[2] https://www.gov.uk/government/publications/proportionality-in-regulatory-submissions-guidance (page 17)

organisations; 5 from ‘businesses/companies that are subject to statutory audit but are not a PIE’; and 4 individual investors.

Primary research. This included econometric modelling to estimate the impact of the regulations on audit and non-audit services fees.

Gaps in evidence justified

The PIR states that it has been unable to determine the effect on *investor confidence* because of limited survey responses from investors. Given that an increase in confidence is stated as one of the objectives of the regulations, the PIR would benefit from setting out how this will be evaluated.

The PIR would benefit from addressing the impacts of the *auditor dismissal framework* (allowing the regulator, or five per cent of the members of the company, to remove an auditor in specific circumstances).

The PIR states that the two sets of regulations introduced in 2017 continued the implementation of the regulations in respect of other entities such as friendly societies and miscellaneous insurance undertakings. The PIR would benefit from discussing the specific impact of these additional regulations, in particular on the specified organisations.

The PIR would also benefit from referring to the current literature on the general challenges for regulators associated with companies with dominant market power operating internationally.

Evaluation

Policy objectives considered

The PIR provides a good discussion of how the policy objectives are still relevant, and considers transparently the extent to which the regulations have met them. The PIR qualifies the finding that most respondents consider the costs of the regulations to exceed the benefits, with the observation that the many anticipated benefits were positive externalities and societal in nature (for example, a decrease in the expected cost of corporate failures and improvements in the allocative efficiency of investment across companies). The PIR would benefit from addressing this potential societal benefit in more detail and the extent to which the regulations have succeeded in this respect.

The PIR would also benefit from providing further support for its assessment that the regulations have had a positive impact on auditor independence and scepticism, taking account of subjectivity around perceptions of behaviours. The PIR could also focus more on how enterprises can respond to pressures from legislation and public opinion, for example the possibility of a spin out to create new audit firms.

Unintended effects

The PIR provides a good discussion of unintended effects. The most significant unintended effect has been a reduction in market choice. This seems to have been a consequence of the introduction of mandatory rotation of auditors, restrictions on the provision of non-audit services and the added burden of auditing a PIE, reducing the number of available audit firms. This unintended effect is considered to be related to challenger firms not being seen to provide the same breadth of audit services as ‘Big-Four’ firms and the Government are, therefore, consulting on reforms to try to increase capacity and experience of non-‘Big Four’ audit firms.

Original assumptions

The PIR states that it reviewed the assumptions in the IA and usefully includes the key cost figures from the IA at annex E. Although there is some discussion, the PIR would benefit from wider consideration of the accuracy of the assumptions in the IA. The PIR would also benefit from reviewing the figures at annex E, in particular the most-costly measures (mandatory rotation and re-tendering, and restrictions on the non-audit service provisions), or at least providing an indicative revised assessment of overall costs.

Small and micro-businesses

The PIR states that respondents to its survey, particularly those that represent smaller companies, were concerned about compliance costs. The PIR would benefit from exploring this further as part of a section dedicated to impacts on SMBs.

Intervention required

The PIR provides a good and transparent discussion of the mixed impact of the regulations, while providing good evidence that government intervention is still required. The PIR includes a useful annex on implementation of the Audit Directive in EU countries and would benefit from greater discussion of evidence of impact in those countries. The UK went slightly beyond the minimum in implementing the EU requirements, in extending the relevant provisions of the Audit Directive to auditors of non-PIE LLPs. Although the cost of this was estimated in the IA to be insignificant, and there is discussion of this at pages 17-18, the PIR would benefit from addressing more explicitly whether the evidence supports the decision to gold-plate the EU requirements.

Improvements or alternative options considered

The PIR usefully reveals significant concerns from business about compliance costs and higher consequential costs, such as an increase in audit fees, from unintended effects. Findings from the econometric analysis shows that firms brought into the PIE definition by the regulations have faced higher audit fees. The PIR would benefit from addressing more directly the relationship between price and quality (actual or perceived, where higher price is seen as a signal of higher quality); in particular, the recommendations on fees analyses should be extended to firms’ relative prices across the sector. The PIR would benefit from discussing further opportunities for reducing the burden on business.

The PIR would benefit from discussing the opportunities and problems associated with innovation and new technology, including the impact of increased forensic accounting on the quality of audit.

The PIR would also benefit from addressing further the impact of 'people aspects' in the quality of audit. This could draw upon initiatives in relation to changes in recruitment to the profession, improved training and more intensive continuous professional development.

Future evaluation

The PIR notes that a further statutory review will be undertaken in five years' time and usefully sets out the areas on which that review could focus (pages 54-55). The PIR notes that any new regulation from the wider audit reform programme will have an impact on this and states the next PIR should consider these changes appropriately. The PIR would benefit from setting out in more detail how the next PIR might be able to do this.

The areas on which to focus could be expanded to address specifically, conflicts of interest and how any reduction (actual and/or perceived) through separation of functions would be monitored and evaluated, taking account of the potential for re-convergence of service delivery.

The PIR suggests further analysis on the effect on investor confidence and the market effect of audit failures. This could be augmented by analysis of the relationship and interaction between audit committees and their main boards, which will be concerned with share price volatility and consequences of audit failure.

Regulatory Policy Committee

For further information, please contact regulatoryenquiries@rpc.gov.uk. Follow us on Twitter @RPC_Gov_UK, LinkedIn or consult our website www.gov.uk/rpc.