

# Consultation on Disclosure of Auditor Remuneration

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The Department of Trade and Industry invites your views, by 24th March 2005, on draft regulations requiring companies to disclose information about the types of services they and their associates have purchased from their auditors and their associates, and to ensure that this information is published in one place.

The intention is to give shareholders and others information on which to make a judgment about whether the provision of non-audit services is a threat to a company auditor's objectivity or independence, and to enable users of accounts to make meaningful comparisons across companies.

You are invited to send comments, together with any supporting evidence on any part of this consultation, preferably by email, to:

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**Open Government:** Under the Code of Practice on Access to Government Information, comments may be made publicly available unless consultees state otherwise. Consultees should therefore indicate whether their responses should be treated as confidential. A summary of all responses received will be prepared and circulated to all consultees who respond to the consultative document and anyone else who requests one. It will also be placed on the DTI website. The summary will not identify respondents.

We will handle any personal data you provide appropriately in accordance with the Data Protection Act 1998.

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# Foreword

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## **By Bernadette Kelly, Director Corporate Law and Governance**

Following a number of high profile corporate disasters in the US, including the collapse of Enron, the UK Government decided to review the UK framework of audit regulation and corporate governance, to ensure it operates in a way that promotes long term growth, encourages innovation and ensures stakeholders and others are provided with fair and accurate information.

The Government set up a group, the Co-ordinating Group on Audit and Accounting Issues (CGAA), with a remit to consider key issues which have a bearing on audit and accounting, from the perspectives of corporate governance, professional ethics, regulation and accountability, to ensure a robust underpinning of the financial markets. One particular aim, of specific reference to this consultation, was to find ways of ensuring the independence of the auditor from the audit client, and to address the issue of “non-audit services”.

The Group recommended a package of interlinking measures – both legislative and non-legislative. Legislative measures have been taken through the Companies (Audit, Investigations and Community Enterprise) Act, which received Royal Assent on 28th October 2004.

The Act includes measures to improve the regulation of the audit profession and to strengthen the enforcement of certain aspects of financial reporting. Tightening requirements around the supply of non-audit services by auditors is one element. The Government believes that greater transparency is needed to ensure that the joint provision of audit and non-audit services does not undermine the auditor’s independence. The secondary legislation (“Regulations”) implementing this proposal is the subject of this consultation.

**The consultation seeks views on the most effective ways to disclose amounts paid by companies and their associates to auditors and their associates for audit and non-audit services.**

# Section 1: Executive Summary

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## The purpose of this Consultation

**1.1** In October 2004 the Companies (Audit, Investigation and Community Enterprise) Act 2004 was passed. The Act contains a number of provisions to strengthen the regulation of audit.

**1.2** Section 7 of the Act replaces sections 390A(3) and 390B of the Companies Act 1985 (which deal with disclosure of audit and non-audit fees at aggregate level) with a new section 390B and makes a number of related amendments. The purpose of the section is to enable the Secretary of State, by regulations, to require companies to provide more detail about the types of services they and their associates have purchased from their auditors and their associates and to ensure that this information is published in one place. The intention is to give shareholders and others information on which to make a judgment about whether the provision of non-audit services is a threat to a company auditor's objectivity or independence, and to enable users of accounts to make meaningful comparisons across companies.

**1.3** The draft regulations which are the subject of this consultation set out the Government's proposals for the precise requirements with which companies and their auditors and associates would need to comply.

## Summary of Questions

**1.4** We would welcome your views on all aspects of this consultation and in particular on the following questions.

**Q1. Do you envisage any difficulties that may arise in complying with any aspect of the definition of associates of a company's auditors as set out in the draft regulations?**

**Q2. Should joint ventures and other associates be included in disclosures?**

**Q3. Should the definition of pensions schemes which are associates of a company include those where the company or a subsidiary of the company are a trustee of the pension scheme?**

**Q4. Should there be a “de minimis” exemption? If so what, at what level and by what criteria should it be set e.g. an actual monetary amount, or a percentage of total spend?**

**Q5. Do you envisage any difficulties, including unintended consequences, arising from the proposed categories and sub-categories, which broadly follow the approach adopted by the May 2002 EC Recommendation?**

**Q6. Do you believe the inclusion of narrative explanations would add value for investors and shareholders?**

**Q7. We would welcome your views on the cost and difficulties for companies that also need to follow US SEC requirement, and for users of that information.**

**Q8. We would welcome your views on the difficulties for users of financial statements in the event that our approach and the SEC approach are not completely aligned.**

**Q9. At what level do you believe disclosure should be made (individual company or group accounts) and why?**

**Q10. Where in your view, should disclosure be made: in the notes to the company’s accounts or elsewhere, and what costs or benefits might arise as a result?**

**Q11. What would be the impact on small and/or medium sized companies if they were subject to the full requirements set out in the draft regulations under Section 7?**

**Q12. Will the timing of implementation have any impact in terms of ability to report on costs?**

**Q13. Please comment on the costs and benefits identified in the Partial RIA at Annex B.**

**Q14. Can you identify and quantify any additional costs or benefits resulting from these proposals that have not been identified in the RIA?**

**1.5** Where appropriate, please supply evidence (including details of financial costs) in support of your views.

## How to respond

**1.6** When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of an organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

**1.7** A response can be submitted by letter, fax or, preferably, email to:

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## Confidentiality

**1.8** Your response may be made public by DTI. If you do not want all or part of response or your name to be made public, please state this clearly in the response. Any confidentiality disclaimer that may be generated by your organisation's IT system, or included as a general statement in your fax cover sheet, will be taken to apply only to information in your response for which confidentiality has been requested.

**1.9** Please be assured that we will handle any personal data you provide us appropriately and in accordance with the Data Protection Act 1998.

## 1 Executive Summary

### Help with queries

**1.10** Questions about the policy issues raised in the document can be addressed to:

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**1.11** If you have comments or complaints about the way this consultation has been conducted, these should be sent to:

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[www.dti.gov.uk/consultations](http://www.dti.gov.uk/consultations)

**1.12** A copy of the Code of Practice on Consultation is attached at Annex C.

## Section 2: Policy Background

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### Introduction

**2.1** Since 1967 private companies have been required to file annual accounts at Companies House and to have these accounts audited by a qualified independent auditor. In 1993, the UK took advantage of audit exemptions for small and medium companies offered by the implementation of an EC Directive, permitting these the opportunity to prepare a simpler evaluation, the Audit Exemption Report (AER).

**2.2** In 1997, the regime was simplified by abolishing the AER, and extending the exemption from audit to all companies with a turnover of not more than £350,000. That threshold has subsequently been increased to the maximum allowed under EC law (£4.8m).

**2.3** Throughout, firms of accountants have, in addition to auditing a company's accounts, been permitted to provide it with a range of services (non-audit services) such as tax consultancy, legal services, IT and management services. The ratio of non-audit to audit services has increased rapidly and significantly over the years as major audit firms have developed their range of business and built on the audit relationship.

**2.4** Fees for non-audit services, in many cases, now exceed the fees for the audit itself. This has led to concern that an auditor, whose income from any one audit client derives mainly from non-audit services, might face a conflict of interest which could result in a less robust appraisal of the company's accounts than would otherwise be the case, for fear of losing the lucrative non-audit business.

**2.5** Currently, the law requires companies to disclose in their annual accounts the aggregate remuneration paid to their auditors for non-audit services as well as the amount spend on the audit itself, noting, however, that small and medium sized companies are exempt from the latter requirement.

## 2 Policy Background

**2.6** In recent years, however, a large body of literature has addressed the question of auditor independence in general, and the relationship between audit and non-audit services in particular. For example:

- In May 2002, the European Commission Recommendation “Statutory Auditors’ Independence in the EU: A Set of Fundamental Principles”<sup>1</sup> stated that:

*“The independence of statutory auditors is fundamental to the public confidence in the reliability of statutory auditors’ reports. It adds credibility to published financial information and value to investors, creditors, employees and other stakeholders in EU companies.*

*... Member States’ national rules on statutory auditors’ independence currently differ ... This situation makes it difficult to provide investors and other stakeholders in EU companies with a uniformly high level of assurance that statutory auditors perform their audit work independently throughout the EU.*

*... Where a Statutory Auditor ... has received fees from the Audit Client for (audit and non-audit) services provided during the client’s reporting period, all these fees should be publicly and appropriately disclosed.”*

- In September 2002, the Association of Chartered Certified Accountants (ACCA) carried out a study of non-audit fees paid to auditors by 21 of the largest UK companies. It found that most companies provided more disclosure on non-audit services than was required by law, but that there was such a wide variation in the nature of the disclosure that it was not possible to make meaningful comparisons. It recommended that, to assist investors in reaching their own conclusions on independence, there should be additional disclosure of non-audit fees.
- In January 2003, the Government’s Co-ordinating Group on Audit and Accounting Issues<sup>2</sup> stated in its final report, that:

*“1.31 Joint provision of audit and non-audit services poses a significant problem for auditor independence. ... The ratio of non-audit to audit services supplied to the audit client has increased rapidly in recent years, as the major audit and accountancy firms have developed their range of businesses and have built on the audit relationship.*

*1.32 Whilst there is little clear support for the view that joint provision has in fact compromised auditor independence, it undoubtedly raises significant concerns as to the appearance of auditor independence.”*

<sup>1</sup> <http://www.iasplus.com/resource/euaudit.pdf>

<sup>2</sup> Coordinating Group on Audit and Accounting Issues, Final Report, 29 January 2003, URN 03/567.

**2.7** In broad terms, the conclusions reached in these and other papers is that the provision of audit services is subject to market failure, and on two counts. The first count relates to information asymmetry, i.e. most shareholders are not in a position to gauge the quality of audit services and are unable to observe whether an individual audit firm has cut audit quality. The second count relates to externalities, i.e, the managers who selected the audit firm may have done so on price rather than quality, or may have been implicated in financial wrongdoing.

**2.8** If, as the Government believes, in the event of a poor audit, there are significant negative repercussions for those 'external' to management – shareholders (including pension fund contributors), creditors, potential investors, potential creditors, suppliers, employees and customers, for example – then there is a case for intervention to require companies to disclose the nature and pound value of different services provided by auditors in the company's annual report.

### Previous Consultations on Disclosure of Auditor Remuneration

**2.9** In October 2002, the Institute of Chartered Accountants in England and Wales (ICAEW), supported by DTI, undertook a public consultation on the disclosure of the nature and value of services provided by auditors to UK companies quoted on a regulated market (*'Disclosure of the nature and cost of services provided by auditor'*)<sup>3</sup>. The consultation indicated widespread support for the principle of increased disclosure.

**2.10** In the following year (2003), the Financial Reporting Council's Auditing Practices Board (APB) published a consultation paper *"Draft ethical standards for auditors"*<sup>4</sup>, which included a draft Ethical Standard 5 on non-audit services provided to audit clients. At the time of writing, the APB intends to publish the Standards in early autumn with an effective date of audit periods commencing on or after 15 December 2004.

**2.11** Responses to these consultations have been taken into account both in compiling the list of questions in this consultation paper and in preparing the draft regulations.

### Issues Directly Relating to this Consultation

**2.12** The regulations covering the disclosure of non-audit services are to be made under section 7 of the Companies (Audit, Investigations and Community Enterprise) (CAICE) Act 2004<sup>5</sup>. This section, which is set out below, enables the Secretary of State to require greater disclosure of the types of services purchased from an auditor and its associates.

<sup>3</sup> Technical Note 32/02. [http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I\\_45802](http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_45802)

<sup>4</sup> [http://www.frc.org.uk/images/uploaded/documents/Consultation\\_paper\\_FINAL.pdf](http://www.frc.org.uk/images/uploaded/documents/Consultation_paper_FINAL.pdf)

<sup>5</sup> <http://www.uk-legislation.hmso.gov.uk/acts.htm>

## 2 Policy Background

**2.13** The draft regulations distinguish between services provided by an auditor in his or her capacity as such, and other services (non-audit services). The draft regulations apply to companies from all sectors and break down the services into the categories below, but small and medium companies are required to disclose only the audit fee itself. The categories are:

- The auditing of accounts of associates of the company under the 1985 Act;
- Other services supplied pursuant to any enactment (including any Act of the Scottish Parliament);
- Services relating to compliance with legislation about taxation;
- Other advisory services relating to taxation;
- Further assurance services;
- Services relating to the provision of computer hardware or software to be used for the recording or processing of financial information;
- Internal audit services;
- Valuation services;
- Services relating to litigation;
- Services relating to recruitment;
- Other services giving rise to a self-review threat; and
- All other services.

**2.14** The draft regulations also contain definitions of “associates” in relation to both a company and a company’s auditors.

***Section 7 of the Companies (Audit, Investigations and Community Enterprise) (CAICE) Act 2004***

*Services provided by auditors*

**7 Disclosure of services provided by auditors and related remuneration**

(1) For section 390B of the Companies Act 1985 (c. 6) substitute—

**“390B Disclosure of services provided by auditors or associates and related remuneration**

(1) The Secretary of State may make provision by regulations for securing the disclosure of—

- (a) the nature of any services provided for a company by the company’s auditors (whether in their capacity as such or otherwise) or by their associates;
- (b) the amount of any remuneration received or receivable by a company’s auditors, or their associates, in respect of any services within paragraph (a).

(2) The regulations may provide—

- (a) for disclosure of the nature of any services provided to be made by reference to any class or description of services specified in the regulations (or any combination of services, however described);
- (b) for the disclosure of amounts of remuneration received or receivable in respect of services of any class or description specified in the regulations (or any combination of services, however described);
- (c) for the disclosure of separate amounts so received or receivable by the company’s auditors or any of their associates, or of aggregate amounts so received or receivable by all or any of those persons.

## 2 Policy Background

- (3) The regulations may—
  - (a) provide that “remuneration” includes sums paid in respect of expenses;
  - (b) apply to benefits in kind as well as to payments of money, and require the disclosure of the nature of any such benefits and their estimated money value;
  - (c) apply to services provided for associates of a company as well as to those provided for a company;
  - (d) define “associate” in relation to an auditor and a company respectively.
- (4) The regulations may provide that any disclosure required by the regulations is to be made—
  - (a) in a note to the company’s annual accounts (in the case of its individual accounts) or in such manner as is specified in the regulations (in the case of group accounts),
  - (b) in the directors’ report required by section 234, or
  - (c) in the auditors’ report under section 235.
- (5) If the regulations provide that any such disclosure is to be made as mentioned in subsection (4)(a) or (b), the regulations may—
  - (a) require the auditors to supply the directors of the company with any information necessary to enable the disclosure to be made;
  - (b) provide for any provision within subsection (6) to apply in relation to a failure to make the disclosure as it applies in relation to a failure to comply with a requirement of this Act or (as the case may be) a provision of Part 7.
- (6) The provisions are—
  - (a) sections 233(5) and 234(5); and
  - (b) any provision of sections 245 to 245C.
- (7) The regulations may make different provision for different cases.

- (8) Nothing in subsections (2) to (7) affects the generality of subsection (1).
- (9) Regulations under this section shall be made by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament.”
- (2) In section 390A of the Companies Act 1985 (c. 6) (remuneration of auditors)—
  - (a) subsection (3) (auditors’ remuneration to be disclosed in note to accounts) accordingly ceases to have effect, and
  - (b) in subsection (5) (application to benefits in kind), for the words from “payments in cash” onwards substitute “payments of money.”
- (3) In paragraph 1(1) of Schedule 4A to that Act (form and contents of group accounts), omit “section 390A(3) (amount of auditors’ remuneration) and”.”

## Section 3: The Government's Approach

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### Introduction

**3.1** In determining how best to approach the proposed Regulations, consideration was given to contemporaneous developments on auditor remuneration and disclosure in the EU, e.g. proposed changes to the Eighth Directive on Statutory Audits – as well as third countries including, specifically, the United States, e.g. requirements under the Sarbanes-Oxley Act.

**3.2** The Eighth Directive seeks amongst other things, to clarify the duties of statutory auditors, provide for their independence, introduce a requirement for external quality assurance, and provide for public oversight of the audit profession and improved cooperation between oversight bodies.

**3.3** Article 38 of the Directive addresses the issue of disclosure of auditor remuneration, requiring public interest entities to provide:

*“financial information showing the importance of the audit firm such as the total turnover divided into fees from the statutory audit of annual and consolidated accounts, and fees charged for other assurance services, tax advisory services and other non-audit services.”*

**3.4** The Sarbanes Oxley Act deals with amongst other things, the oversight of accountancy firms that provide audit services to companies that are quoted on a US market (equivalent to the EU's definition of public interest entities).

**3.5** The Act prohibits absolutely the supply of specified services that could conflict with the independence of the audit (including actuarial services, internal audit services and legal services). Other non-audit work (including tax advice) may be provided, but only after prior approval from the company's audit committee.

**3.6** The draft Regulations applying to the UK market are necessarily comprehensive so as to make clear what information must be disclosed and how that relates to disclosure requirements under EU community law and US legislation.

## Items Covered Under Proposed Draft Regulations

**3.7** The items covered by the draft Regulations are:

- Definition of an auditor's associates;
- Definition of a company's associates;
- Services in respect of which disclosure is to be made;
- Disclosure of audit fee by small and medium sized companies in notes to accounts;
- Disclosure of audit fee and non-audit services and their fees by all other companies in notes to accounts;
- Group Accounts;
- Duty of auditors to supply information;
- Enforcement;
- Timing.

A copy of the draft regulations is attached at Annex A.

## Objectives of the Regulations

**3.8** The objective of the draft Regulations is to provide greater transparency about the nature and costs of services provided by auditors to their clients. This is achieved through disclosure of the remuneration paid by companies and their associates for services provided by auditors, or their associates, in the notes to companies' annual accounts. This will enable readers of the accounts to make their own judgments about the appropriateness of those services in the context of the audit work.

**3.9** In producing the draft regulations the DTI has tried to strike a balance between the need to provide information of sufficient quality and quantity to achieve transparency that will enable readers to make their own judgements, yet minimising costs and additional burdens to business.

### 3 The Government's Approach

**3.10** These regulations do not represent the only, or the main, tool for addressing concerns about auditor independence. They are designed to complement a range of other measures (and which are set out in the Coordinating Group on Audit and Accounting Issues (CGAA) report),<sup>6</sup> including independent standard setting and an enhanced role for audit committees.

#### Definition of an Auditor's Associates

**3.11** Schedule 1 to the draft Regulations defines the associates of a company's auditors for the purpose of the disclosures required by the Regulations. The definition includes overseas associates, and covers associates:

- Controlled by the auditors or their associates, except where the auditors are acting as insolvency practitioners, receivers or judicial factors;
- Controlling the auditors;
- In cases where auditors are in a partnership;
- In cases where the auditors are a corporate body;
- In cases of shared use of a trading name.

**3.12** The draft regulations attempt to comply with the proposed EC Directive on Statutory Audit of Annual and Consolidated Accounts, whilst keeping as closely as possible to ICAEW guidance.

**3.13** The May 2002 EC recommendation (see paragraph 2.6 above) refers to any entity controlled by the audit firm, or under common control, ownership or management or otherwise affiliated or associated with the audit firm through the use of a common name or through the sharing of significant professional resources.

**3.14** With regard to ICAEW guidance, the nearest equivalent definition refers to any entity controlled by the audit firm or under common control, ownership or management or otherwise affiliated or associated with the audit firm through the use of a common name or through the sharing of significant professional resources.

**3.15** Terms such as common control, interest, and sharing significant professional resources are difficult to define and quantify. Notwithstanding this, Paragraph 1(d) of Schedule 1 to the draft Regulations attempts to encompass the various definitions as follows:

*"any person using a trading name which is the same as or similar to a trading name used by the company's auditors, but only if the company's auditors use that trading name with the intention of creating the impression of a connection between them and that other person;"*

<sup>6</sup> Coordinating Group on Audit and Accounting Issues, Final Report, 29 January 2003, URN 03/567.

**Q1. Do you envisage any difficulties that may arise in complying with any aspect of the definition of associates of a company's auditors as set out in the draft regulations?**

### Definition of a Company's Associates

**3.16** In the interests of greater transparency the existing definition of "associated undertaking" of a company in regulation 2 of the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991 has been broadened in Schedule 2 to the draft Regulations to include pension schemes and overseas subsidiaries.

**3.17** Although pension schemes are not generally regarded as controlled by the reporting entity (and their accounts are not consolidated), we propose to include pension schemes within the definition of associates in the draft Regulations. The close relationship between companies and their pension schemes make them important for achieving full and transparent disclosure. In addition, the work that an auditor undertakes for a company's pension scheme could have implications for its independence from the company itself.

**3.18** Paragraph 1(b) of Schedule 2 focuses on who appoints pension fund trustees and on who effectively chooses the auditors of the scheme's accounts because this is the area where the risk of conflicts may arise. The definition of "company pension scheme" in paragraph 3 of Schedule 2 is:

*"any scheme for the provision of benefits consisting of or including relevant benefits for or in respect of directors or employees (or former directors or employees) of the company, or any subsidiary of the company; and for this purpose, "relevant benefits" means any pension, lump sum, gratuity or other like benefit given or to be given on retirement or on death or in anticipation of retirement or, in connection with past service, after retirement or death"*

**3.19** ICAEW guidance defines an audit client as the reporting entity and any entity/entities controlled by it alone. This excludes joint ventures and other associates. The draft regulations treat joint ventures and other associates as associates of the company only in cases where they would already be included in the consolidated accounts as subsidiaries.

**3.20** In addition, subsidiaries with severe long-term restrictions that prevent the company from exercising control are excluded from the definition of associates in the draft Regulations.

### 3 The Government's Approach

**Q2. Should the definition of pensions schemes which are associates of a company include those where the company or a subsidiary of the company is a trustee of the pension scheme?**

**Q3. Should joint ventures and other associates be included in disclosures?**

#### The Obligation on Companies Other than SMEs

**3.21** Companies are already required to disclose the total amount of remuneration in respect of non-audit services. These regulations contain a requirement to disclose separately each and every service specified in the regulations and the amount of remuneration paid to the company's auditors and/or the auditors' associates during the period to which the annual accounts relate. Remuneration includes expenses and benefits in kind. There is no de minimis exemption under the draft Regulations (i.e. all amounts, regardless of size, must be disclosed).

**Q4. Should there be a "de minimis" exemption? If so what, at what level and by what criteria should it be set e.g. an actual monetary amount, or a percentage of total spend?**

#### Services in Respect of Which Disclosure is to be Made

**3.22** A range of services may be classified as non-audit services, and different organisations have, in the past, broken them down in different ways. The issue in this consultation is how best to require the information to be broken down in order to help investors and the public to take a view on an auditor's independence.

**3.23** The Government proposes that services should be disclosed broadly in accordance with the categorisation set out in European Commission May 2002 Recommendation.

**3.24** In settling on the proposed classifications in the draft Regulations the Government has also taken into account categories defined by the Auditing Practices Board, in its Ethical Standards for Auditors.

**3.25** The draft Regulations set out the following proposed categories for services in respect of which disclosure is to be made:

- The auditing of accounts of associates of the company under the 1985 Act;
- Other services supplied pursuant to any enactment (including any Act of the Scottish Parliament);
- Services relating to compliance with legislation about taxation;

- Other advisory services relating to taxation;
- Further assurance services;
- Services relating to the provision of computer hardware or software to be used for the recording or processing of financial information;
- Internal audit services;
- Valuation services;
- Services relating to litigation;
- Services relating to recruitment;
- Other services giving rise to a self-review threat; and
- All other services.

**3.26** We believe that the proposed classification will provide investors and the public with the information they need to take a view on independence, without either providing too much information and/or introducing unnecessary burdens. By broadly following the approach adopted in the May 2002 EC Recommendation, investors and the public should be provided with a uniformly high level of assurance both here and throughout the EU.

**3.27** The Government acknowledges that more detailed categorisation could, in theory, improve transparency and allow greater comparisons. It believes, however, that the proposed approach strikes an appropriate balance between information which is too general – and will not give investors and shareholders what they need – too detailed, would impose costs, may not add much value, and could result in confusion.

**3.28** The Government also acknowledges that ICAEW guidance states that narrative explanations should be given of what is included in the various categories where this would be helpful.

**3.29** The Government further acknowledges that respondents to the ICAEW consultation argued that alignment of our approach and the US approach was a priority and would bring benefits to both preparers and users of financial statements. In particular, they argued that preparation of data to meet both UK and US requirements could be burdensome (although no indications of costs were provided).

### 3 The Government's Approach

**3.30** The Government recognises that SEC registrants will be required to provide this information in two separate ways. Our expectation is that, in practice, these difficulties should be capable of being resolved in ways that are not over-burdensome.

**Q5. Do you envisage any difficulties, including unintended consequences, arising from the proposed categories and sub-categories, which broadly follow the approach adopted by the May 2002 EC Recommendation?**

**Q6. Do you believe the inclusion of narrative explanations would add value for investors and shareholders?**

**Q7. We would welcome your views on the cost and difficulties for companies that also need to follow US SEC requirement, and for users of that information.**

**Q8. We would welcome your views on the difficulties for users of financial statements in the event that our approach and the SEC approach are not completely aligned.**

#### Group Accounts

**3.31** Draft regulation 5(1) requires group accounts to comply with the regulations, except where all the companies in the group are SMEs.

Draft regulation 5(2) exempts individual accounts for:

- A parent company required to prepare group accounts in accordance with the 1985 Act; and
- A subsidiary company where its parent company prepares group accounts in accordance with the 1985 Act.

The Government considers that where group accounts are prepared, disclosure need only be given in the group accounts and not in the individual accounts. This is consistent with both ICAEW Guidance and the EC's May 2002 Recommendation (but is inconsistent with the current draft of proposed EC Directive, which requires disclosure in both the individual and group accounts).

**Q9. At what level do you believe disclosure should be made (individual companies or group accounts), and why?**

## Location of Disclosure

**3.32** Section 7 has been drafted flexibly to allow reporting in the notes to the accounts, in the director's report, or in the auditors report. The Government believes that the disclosures should be made in the notes of the accounts, which is in line with the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991. The ability to require disclosure in the director's report has been added in section 7 of C(AICE) Act, because at the time the section was drafted, it was not clear the extent to which it would be necessary to require domestic disclosure in the accounts of a company following international accounting standards (IAS).

**3.33** Article 50 of the proposed EC Directive on Statutory Audit of Annual and Consolidated Accounts requires disclosure in the notes of the accounts. Disclosures additional to IAS requirements are also required in the notes of the accounts.

**Q10. Where in your view, should disclosure be made: in the notes to the company's accounts or elsewhere, and what costs or benefits might arise as a result?**

## Exemptions for small and medium sized companies

**3.34** As with the current requirement in respect of total non-audit service remuneration, the detailed disclosure requirements relating to non-audit services will not apply to companies qualifying as small or medium sized companies (SMEs) under the 1985 Companies Act.<sup>7</sup>

SMEs which are audited will have to continue to disclose the audit fee itself.

**3.35** The current proposals on 8th Directive do not permit exemptions for medium-sized companies and we will continue to press in our negotiations for the possibility of such exemptions.

**Q11. What would be the impact on small and/or medium sized companies if they were subject to the full requirements set out in the draft regulations under section 7?**

<sup>7</sup> A company is considered small if two or more of the following requirements are met in a year: Turnover of not more than £5.6million; Balance sheet total of not more than £2.8million; Number of employees of not more than 50. A company is considered medium-sized if two or more of the following requirements are met in a year: Turnover of not more than £22.8million; Balance sheet total of not more than £11.4million; Number of employees of not more than 250.

### **3 The Government's Approach**

#### **Timing**

**3.36** The consultation process will last 3 months. The intention is that the Regulations will come into force on 1 October 2005 and apply to accounts for periods beginning on or after that date.

Hence the requirement will not bite until after September 2006, although companies will need to be aware of the new requirement ahead of that date. As mentioned above, the ICAEW will be asked to prepare guidance.

**Q12. Will the timing of implementation have any impact in terms of ability to report or costs?**

## Section 4: Costs and Benefits

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4.1 The draft partial Regulatory Impact Assessment (RIA) attached at Annex B seeks comments on the likely costs and benefits of the proposed draft regulations covering disclosure of the nature and costs of services provided by auditors.

**Q13. Please comment on the costs and benefits identified in the Partial RIA at Annex B.**

**Q14. Can you identify and quantify any additional costs or benefits resulting from these proposals that have not been identified in the RIA?**

**2005 No. [ ]**

**COMPANIES**

**The Companies (Disclosure of Auditor Remuneration) Regulations 2005**

<i>Made</i> - - - -	<i>2005</i>
<i>Laid before Parliament</i>	<i>2005</i>
<i>Coming into force</i> - -	<i>1st July 2005</i>

The Secretary of State, in exercise of powers conferred on her by section 390B of the Companies Act 1985<sup>8</sup>, hereby makes the following Regulations:

**Citation, commencement and transitional provision**

**1.**—(1) These Regulations may be cited as the Companies (Disclosure of Auditor Remuneration) Regulations 2005 and shall come into force on 1<sup>st</sup> July 2005.

(2) These Regulations shall not apply to the accounts of a company for any period beginning before 1<sup>st</sup> July 2005; and the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991<sup>9</sup> shall not apply to the accounts of a company for any period beginning on or after that date.

**Interpretation**

**2.**—(1) In these Regulations—

“the 1985 Act” means the Companies Act 1985;

“director” has the meaning given in section 53(1) of the Companies Act 1989<sup>10</sup>;

“parent” and “subsidiary” shall be construed in accordance with section 258 of the 1985 Act<sup>11</sup>;

“remuneration” includes sums paid in respect of expenses and benefits in kind.

(2) For the purposes of these Regulations—

- (a) a company is small or medium-sized in relation to a financial year if it qualifies as small or medium-sized in relation to that year by virtue of section 247 of the 1985 Act<sup>12</sup> and is entitled to the exemptions mentioned in section 246 or 246A (as the case may be) of that Act<sup>13</sup> in its accounts for that year;
- (b) a person is to be regarded as an associate of a company’s auditors if he is a person specified as such by Schedule 1 to these Regulations, and
- (c) a person is to be regarded as an associate of a company if he is a person specified as such by Schedule 2 to these Regulations.

<sup>8</sup> 1985 c. 6; section 390B was substituted by section 7 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.).

<sup>9</sup> S.I. 1991/2128, amended by S.I. 1995/1520.

<sup>10</sup> 1989 c. 40.

<sup>11</sup> Section 258 was inserted by section 21(1) of the Companies Act 1989.

<sup>12</sup> Section 247 was inserted by section 13(1) of the Companies Act 1989 and amended by [ ].

<sup>13</sup> Section 246 was inserted by section 13(1) of the Companies Act 1989 and amended by [ ]. Section 246A was inserted by [ ].

**Disclosure of remuneration: small and medium-sized companies**

3.—(1) In the notes to the annual accounts of a small or medium-sized company, there shall be disclosed the amount of remuneration, if any, received by the company’s auditor for the auditing of the accounts.

(2) Where remuneration includes benefits in kind, its nature and estimated money-value shall also be disclosed in the notes.

(3) Where more than one person has been appointed as a company’s auditor during the period to which the accounts relate, separate disclosure is required in respect of remuneration of each such person.

**Disclosure of remuneration: other companies**

4.—(1) In the notes to the annual accounts of a company which is not a small or medium-sized company, there shall be disclosed the amount of remuneration, if any, received by the company’s auditors and any person who was, at any time during the period to which the accounts relate, an associate of the company’s auditors, for—

- (a) the auditing of the accounts, and
- (b) subject to regulation 5(2), the supply of all other services to the company or to an associate of the company during the period to which the accounts relate.

(2) Where remuneration includes benefits in kind, its nature and estimated money-value shall also be disclosed in the notes.

(3) Separate disclosure is required in respect of the auditing of the accounts in question and of each type of service specified in Schedule 3, but not in respect of each service falling within a type of service.

(4) Where more than one person has been appointed as a company’s auditor during the period to which the accounts relate, separate disclosure is required in respect of remuneration of each such person and his associates.

**Group accounts**

5.—(1) Group accounts shall comply with regulation 4(1)(b) as if the undertakings included in the consolidation were a single company, except where every company included in the consolidation is small or medium-sized.

(2) The notes to the individual accounts of—

- (a) a parent company where the company is required to prepare and does prepare group accounts in accordance with the 1985 Act; and
- (b) a subsidiary company where its parent company is required to prepare and does prepare group accounts in accordance with the 1985 Act and the company is included in the consolidation,

need not disclose the information required by regulation 4(1)(b) if the group accounts are required to comply with paragraph (1) of this regulation and the individual accounts state that the group accounts are so required.

**Duty of auditors to supply information**

6. The auditors of a company must supply the directors of the company with such information as is necessary to enable the disclosure required by regulation 4(1)(b) or 5(1) to be made.

**Failure to make the required disclosure**

7. Sections 233(5) and 245 to 245C of the 1985 Act<sup>14</sup>) shall apply in relation to a failure to make the disclosure required by regulations 3 and 4 as they apply in relation to a failure to comply with a requirement of the 1985 Act.

<sup>14</sup> Section 233 was inserted into the Companies Act 1985 by section 7 of the Companies Act 1989. Sections 245 to 245C were inserted by section 12 of the Companies Act 1989. Section 245 has been amended by S.I. 1994/1935 and S.I. 2002/1986. Section 245B has been amended by S.I. 2002/1986. Section 245C has been amended by sections 10 of and Schedule 8 to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.).

## SCHEDULE 1

Regulation 2(2)(b)

### Associates of a company's auditors

1. Each of the following shall be regarded as an associate of a company's auditors—
  - (a) any person controlled by the company's auditors or by any associate of the company's auditors (whether alone or through two or more persons acting together to secure or exercise control), but only if that control does not arise solely by virtue of the company's auditors or any associate of the company's auditors acting—
    - (i) as an insolvency practitioner in relation to any person,
    - (ii) in the capacity of a receiver, or a receiver or manager, of the property of a company or other body corporate, or
    - (iii) as a judicial factor on the estate of any person;
  - (b) any person or group of persons acting together having control of the company's auditors;
  - (c) a partnership in which the company's auditors are a partner;
  - (d) any person using a trading name which is the same as or similar to a trading name used by the company's auditors, but only if the company's auditors use that trading name with the intention of creating the impression of a connection between them and that other person.
2. Where a company's auditors are a partnership, each of the following shall also be regarded as an associate of theirs—
  - (a) any other partnership which has a partner in common with the company's auditors;
  - (b) any body corporate which is a partner in the company's auditors;
  - (c) any other partner in the company's auditors;
  - (d) any body corporate which is in the same group as any such body corporate as is mentioned in sub-paragraph (b).
3. Where a company's auditors are a body corporate, each of the following shall also be regarded as an associate of theirs—
  - (a) any body corporate which is a director of the company's auditors;
  - (b) any other director of the company's auditors;
  - (c) any body corporate which is in the same group as any such body corporate falling within sub-paragraph (a).
  - (d) any partnership in which a director of the company's auditors is a partner;
  - (e) any body corporate which is in the same group as the company's auditors;
  - (f) any partnership in which any such body corporate as is mentioned in sub-paragraph (e) is a partner.
4. For the purposes of this Schedule—
  - (a) "acting as an insolvency practitioner" shall be construed in accordance with section 388 of the Insolvency Act 1986<sup>15</sup>;
  - (b) "partner" includes a member of a limited liability partnership;
  - (c) "partnership" includes a limited liability partnership and a partnership constituted under the law of a country or a territory outside Great Britain;
  - (d) a reference to "a receiver, or a receiver or manager, of the property of a company or other body corporate" includes a receiver, or (as the case may be) a receiver or manager, of part only of that property;
  - (e) a person able, directly or indirectly, to control or materially to influence the operating and financial policy of another person shall be treated as having control of that other person; and

<sup>15</sup> 1986 c. 45; section 388 has been amended by sections 2(a) to (c) and 4(1) of the Insolvency Act 2000 (c. 39), by section 11(1) of the Bankruptcy (Scotland) Act 1993 (c.6) and by S.I. 1994/2421, S.I. 2002/1240 and S.I. 2002/2708.

- (f) a body corporate is in the same group as another body corporate if it is a parent or subsidiary of that body corporate, or a subsidiary of a parent of that body corporate.

## SCHEDULE 2

Regulation 2(2)(c)

### Associates of a company

1. Subject to paragraph 2, each of the following shall be regarded as an associate of a company—
  - (a) any subsidiary of the company; and
  - (b) any company pension scheme where—
    - (i) a majority of the trustees are appointed by (or by a person acting on behalf of) the company, or any subsidiary of the company; or
    - (ii) the company, or any subsidiary of the company, exercises a dominant influence over the appointment of the auditor (if any) of the scheme.
2. Where severe long-term restrictions substantially hinder the exercise of the rights of the company over the assets or management of a subsidiary, that subsidiary is not to be regarded as an associate of a company for the purposes of these Regulations.
3. In this Schedule, “company pension scheme” means any scheme for the provision of benefits consisting of or including relevant benefits for or in respect of directors or employees (or former directors or employees) of the company, or any subsidiary of the company; and for this purpose, “relevant benefits” means any pension, lump sum, gratuity or other like benefit given or to be given on retirement or on death or in anticipation of retirement or, in connection with past service, after retirement or death.

## SCHEDULE 3

Regulation 4(3)

### Types of service in respect of which disclosure is to be made

1. The types of service referred to in regulation 4(3) are—
  - (a) the auditing of accounts of associates of the company under the 1985 Act;
  - (b) other services supplied pursuant to any enactment (including any Act of the Scottish Parliament);
  - (c) services relating to compliance with legislation about taxation;
  - (d) other advisory services relating to taxation;
  - (e) further assurance services (as defined in paragraph 3(a));
  - (f) services relating to the provision of computer hardware or software to be used for the recording or processing of financial information;
  - (g) internal audit services;
  - (h) valuation services;
  - (i) services relating to litigation;
  - (j) services relating to recruitment;
  - (k) other services giving rise to a self-review threat (as defined in paragraph 3(b)); and
  - (l) all other services.
2. Where a service could fall within more than one type, it shall be treated as falling within that which is mentioned first in paragraph 1.
3. In this Schedule—
  - (a) “further assurance services” means services provided by the company auditor which consist of the evaluation or measurement of a subject-matter against identified criteria and are carried out for the purpose of giving the recipient of the service an assurance about that subject-matter;
  - (b) a service gives rise to a self-review threat if—

- (i) the person providing the service takes decisions that a reasonable person would expect to have been taken by the directors or senior managers of the company to which the annual accounts relate; or
- (ii) the service, or its outcome, will need to be investigated by the company's auditors in order for them to comply with their duties under section 237 of the 1985 Act<sup>16</sup>).

<sup>16</sup> Section 237 was inserted by section 9 of the Companies Act 1989 and amended by S.I. 1996/189 and S.I. 2002/1986.

## EXPLANATORY NOTE

*(This note is not part of the Regulations)*

These Regulations provide for companies to disclose fees received by their auditors and their auditors' associates.

Small and medium-sized companies (defined in regulation 2(2)(a) in the same way as in the Companies Act 1985) must disclose the fee paid to their auditors for the audit itself (regulation 3).

Every other company must disclose both the audit fee and all other fees paid to the auditors for services provided by them and their associates to the company and its associates (regulation 4). Auditors' associates are defined in Schedule 1; companies' associates are defined in Schedule 2. Each type of service specified in Schedule 3 and the fee paid for it must be separately disclosed.

Consolidated group accounts (except where all the group companies are small or medium-sized) must disclose the types of services specified in Schedule 3 and the fees paid for them as if the group were a single company: but if that is done, the individual companies do not need to disclose them (regulation 5).

Auditors must supply their company's directors with the information needed to enable the company to disclose the types of services specified in Schedule 3 and the fees paid for them (regulation 6).

Sections 233(5) and 245 to 245C of the 1985 Act are applied for the enforcement of the Regulations, so that directors who fail to comply commit an offence, they may voluntarily revise non-compliant accounts and the Secretary of State and persons authorised by her may apply to court for an order requiring the preparation of revised accounts (regulation 7).

A Regulatory Impact Assessment has been prepared for these Regulations and a copy has been placed in the library of each House of Parliament. Copies of the Regulatory Impact Assessment can be obtained from [ ].

# Annex B: Draft Regulatory Impact Assessment

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## 1. Proposal

**1.1** Section 7 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 [C(AICE)] gives a power to require companies to give more detail in their annual accounts or reports on types and costs of services bought from their auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided. Under present law, companies are required only to publish the aggregate amount paid to the auditor for non-audit services.

**1.2** The Draft Companies (Disclosure of Auditor Remuneration) Regulations set out the new requirements. A regulatory impact assessment (RIA)<sup>17</sup> for section 7 of the C(AICE) Act was prepared ahead of publication of the Bill which became the Act. This RIA, which deals with the regulations under the section, draws to an extent on that previous RIA. In particular, the draft Regulations require a company to follow a standard categorisation (definition of services) of non-audit services bought from its auditor or associates. They define both the associates of the auditor and associates of the company. Under the regulations disclosure will be required in the notes to the accounts.

**1.3** The regulations will be supplemented by best practice guidance.<sup>18</sup> We will write to the Institute of Chartered Accountants in England and Wales (ICAEW) requesting it to update its guidance, to ensure all the essential information needed is provided for companies to understand, in particular, the principles into which categories and sub-categories a service falls (although in practice we expect the auditors to prepare the information for companies).

**1.4** The full extent of the regulations made under this power will apply to any large company: but small and medium businesses will have to continue to disclose the audit fee itself. This does not represent a change to the present situation.

<sup>17</sup> Companies (Audit, Investigations and Community Enterprise) Bill. Regulatory Impact Assessments. July 2004. URN 04/1354.

<sup>18</sup> Provided by the ICAEW in Tech 24/03: Disclosure of the Nature and Cost of Services Provided by Auditors.

## 2. Purpose and Intended Effect

### (i) Objective

**2.1** The overall objective of section 7 is to increase transparency about the relationship between the company and its independent auditor, so that those with an interest, particularly shareholders, can form a judgement about whether the auditor may be subject to a conflict of interest in forming an opinion on the accuracy of the accounts.

**2.2** This Regulatory Impact Assessment considers the implications of the regulations, which set out the disclosure requirements on the types and amount paid by a company and its auditor and associates. The regulations require a breakdown of the types of services a company's auditor has been supplying, in addition to the statutory audit.

**2.3** The provisions on definition of services take into consideration the broad categorisations specified under the 8th Directive on Statutory Audit of Annual and Consolidated Accounts<sup>19</sup> and the May 2002 EC Recommendation<sup>20</sup>. This level of standardisation is considered desirable as it enables comparisons to be made between companies in the EU, whilst providing sufficient detail to aid transparency and enable judgements to be made. Although the EC Recommendation recommends percentages to be supplied, the Government is of the view that this is unlikely to provide much overall benefit, but could be harmful if looked at and considered in isolation. Any user who is interested can work these out for him or herself, since the data will be supplied.

**2.4** The regulations also set out the definition of both the associates of the auditor and of the company.

**2.5** On the second count, the definition of associates of the company covers the reporting entity and any entity/entities controlled by it. It also includes pension schemes, as work that an auditor does for a company's pension scheme could clearly have implications for its independence from the company itself.

**2.6 Devolution:** Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998. Those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998.

<sup>19</sup> <http://europa.eu.int/eur-lex/en/com/pdf/2004/com2004-0177en01.pdf>

<sup>20</sup> [www.lasplus.com/resource/evaudit.pdf](http://www.lasplus.com/resource/evaudit.pdf)

### (ii) Background

**2.7** The Regulatory Impact Assessment on clause 7 of the Bill which became the CAICE Act explained the policy background. It attempted a preliminary analysis of costs, which it estimated to be negligible on the basis that the proposal merely required companies to summarise (and list) fees paid to auditors during the financial year.

**2.8** Under the Companies Act 1985 companies are already required to disclose the total *amount* paid to their auditors for the statutory audit. (SMEs which have audits are also required to disclose this amount, although they are exempt from disclosing this figure in the accounts which they file in Companies House).

**2.9** In addition, under the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991, companies which are not SMEs are also required to disclose the total amount they have paid to their auditors and their associates for services 'other than those of the auditors in their capacity as such'. In other words, they must disclose the total of what they have spent on non-audit services provided by their auditor (if any). There is currently no requirement to break this down into the types of services and the amounts spent on each one. It has been argued that such information ought to be made public, and that is what these regulations will do.

**2.10** The policy of greater disclosure has support from a large number of regional and international sources. In the US, new legislation was introduced post-Enron. The Sarbanes Oxley Act, passed in July 2002, drew up a list of non-audit services which were proscribed, including financial information systems design and implementation, internal audit, appraisal or valuation services, and legal services. US disclosure requirements require that all companies, which wish to prepare or issue audit reports on US public companies comply with its rules, regardless of where they are incorporated, and thus apply to UK companies that list in the US. The rules require separate disclosure of audit fees; audit-related fees; tax fees and all other fees.

**2.11** In May 2002, the European Commission published a Recommendation on Auditor Independence which recommended such disclosure. The Commission (and most Member States including the UK) see an increase in the mandatory disclosure requirements to be a more proportionate response to the crisis of confidence in the audit function (following the Enron scandal in particular) than an outright ban on other services being provided by the auditor. It relies on transparency and the market to determine the appropriateness of such commercial relationships, rather than heavy-handed regulatory intervention.

**2.12** Since its 2002 Recommendation, the European Commission has brought forward a modernised 8th Directive on statutory audits, which deals with disclosure in Article 50, and which requires disclosure of services to be broken down into four categories:

- Statutory audit (of annual accounts)
- Other assurance services
- Tax advisory services
- Other non-audit services. The EC Recommendation breaks this category down further into financial information technology; internal audit; valuation; litigation; and recruitment.

**2.13** In the UK, the Co-ordinating Group on Audit and Accounting Issues, set up post-Enron, also recommended greater disclosure of non-audit services in summer 2002 (in its Interim report) . Section 7 of the C(AICE) Act was thus drafted to give the Secretary of State a power to require companies to give more detail in their annual accounts or reports on types and costs of services bought from their auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided.

**2.14** ICAEW, in consultation with the DTI, issued its own guidance in 2003 for directors of UK companies on the form and extent of disclosure in their annual reports of the nature and value of services provided by their auditors, anticipating the legal requirement. This Guidance follows the principles of the EC Recommendation, while at the same time aligning with the US Securities and Exchange Commission’s (SEC) approach to the classification of fees, where possible.

**2.15** A number of investment groups support the principles embodied in these various Acts, Directives and Guidance materials. Supportive commentary to this effect includes:

*“the problem is that in the notes to the accounts, shareholders tend not to get enough information about what [non-audit] work is actually being done”<sup>21</sup>*

*“the important thing is that those costs are properly and clearly set out in companies’ annual reports and accounts, allowing shareholders proper scrutiny”<sup>22</sup>*

**2.16** Auditors themselves have also called for more disclosure. Roger Hughes, Head of Audit at PriceWaterhouseCoopers, says that “the more disclosure as to the nature of the work done by the auditors the better.”<sup>23</sup>

<sup>21</sup> David Somerlinck, Pensions Investment Research Consultants, quoted in Accountancy Magazine, Sep 2004 (p 36).

<sup>22</sup> David Gould, National Association of Pension Funds, quoted in Accountancy Magazine, Sep 2004 (p 36).

<sup>23</sup> Quoted in Accountancy Magazine, Sep 2004 (p 35).

**2.17** The business community has also made clear it favours greater disclosure requirements over any direct regulatory intervention into the types of non-audit services that can be supplied, although it would look for these to be proportionate to the risks, rather than “the more the better” (Confederation of British Industry).

**(iii) Risk assessment**

**2.18** Existing disclosure requirements only cover aggregate (total) amounts. As explained above, there is a consensus view that, at present, shareholders and Audit Committees may not be in a position to make fully informed decisions as to the extent of an auditor’s reliance on non-audit fees from the company they are auditing, and hence the appropriateness of the supply of different services in addition to the statutory audit service.

**2.19** The existing aggregate figures do not provide sufficient information to reassure investors and others about auditor independence. The regulations under section 7 of the C(AICE) Act have been drafted to enable a sensible judgement to be made about whether a particular service may lead to a conflict of interest, by requiring greater information through a defined list of categories and establishing the definitions of associates of the company and associates of the auditor.

**2.20** The introduction of legislation requiring non-audit disclosure by type and cost gives greater transparency, in fact and appearance. It could also fulfil future obligations under Article 50 of the 8th Directive, which is still under negotiation but, as drafted, requires detailed disclosure requirements relating to non-audit services. The Directive will require implementation within two years of being adopted, which is expected to be 2005. Although it would be possible to delay the proposed Regulations until negotiations have been completed, in the Government’s opinion this delay would be counter-productive. It would further delay the information shareholders and audit committees need to make judgements and, therefore, fail to provide the necessary public reassurance about the audit-client relationship.

**2.21** At the same time, the Government is aware that requiring intricate details of every service provided could prove costly while bringing about little additional benefit. In some instances it could be counter-productive, or lead to some specific difficulties in relation to price-sensitive or commercially sensitive information (for example if the audit firm had been carrying out due diligence work ahead of an offer, and the name of the target company had to be disclosed).

**2.22** More generally, the purpose and need for such detailed information is currently unproven. Broad categories should be sufficient to enable judgements to be made about auditor/company dependence. In any case, the audit committees of listed companies should be in a position to obtain and pass judgement on such information if it is felt to be relevant. The role of the audit committee as regards the provision of non-audit services is dealt with in some detail in the revised Combined Code Guidance, following Sir Robert Smith's Report into the audit committee role in 2002.

**2.23** As stated above, it is recognised that some UK companies will additionally be required to provide the information in the categories specified by the SEC in the US. There is the risk that this could be confusing for stakeholders and others. The risk is, in part, minimised by the small number of companies likely to be caught by the SEC requirements.

### 3. Options

**3.1** The following options for the Regulations have been identified:

#### Option 1: Do Nothing

**3.2** Retain the existing section 390A(3) and the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991.

#### Option 2: Add on to the existing Regulatory requirements

**3.3** Make only a minor change to the existing requirements in section 390A(3) and the regulations currently in force under 390B of Companies Act 1985, the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991, so that where currently there is a requirement to disclose total fees for non-audit services, this would now require a break-down of the fees, using **existing definitions** for the purpose of disclosure.

**3.4** The existing definitions of associate of the company and associate of the auditor are contained in the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991.

**3.5** Under existing regulations, an associated undertaking in relation to a company means its UK subsidiary. This is a different, (and narrower) definition than the one proposed under option 3 below. It does not include pension schemes.

**3.6** The definition of associate of the auditor in regulation 3 of the Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991 is a narrower definition than in Schedule 1 to the proposed Regulations as it does not extend to persons in the same network as the auditor.

**3.7** Disclosure under section 390A(3) is required in the notes to the accounts, which is what will be required by regulation 3(1) of the proposed Regulations.

### Option 3: Replace the existing requirements with new requirements

**3.8** Option 3 would present an opportunity to build on the existing requirement by **expanding the scope and definitions**, as well as requiring the more detailed breakdown. This is the Government's preferred option. As a result, the Government proposes to:

- Introduce a more detailed breakdown of services. As mentioned already, in the absence of global alignment we propose broadly to follow the disclosure requirements of the draft 8th Directive, which defines non-audit fees as total fees charged for other assurance services, tax advisory services and other non-audit services. These categories will be further broken down into sub-categories.
- Define associates of the auditor and adopt the definition of 'network' used in the EC Recommendation or in the Directive itself if this is finalised. Associates include the Audit Firm which performs the Statutory Audit, together with its Affiliates and any other entity controlled by the Audit Firm or under common control, ownership or management or otherwise affiliated or associated with the Audit Firm through the use of a common name or through the sharing of significant common professional resources.
- Define associates of the company to be the reporting entity and any entity/entities controlled by it *alone*. This generally excludes joint ventures and associates. The Government intends to include pension schemes under the regulations.
- Locate disclosure in the notes to the accounts.

## 4. Benefits

### Option 1

**4.1** This is the status quo option. It would impose no additional costs on companies but deliver no benefits in terms of greater transparency about the auditor/client relationship. It thus does nothing to address the problems which have been identified and which section 7 is designed to address, alongside a number of other complementary measures.

**4.2** The Government has already indicated that it is committed to the principle of greater transparency. And in the longer term, inaction will not be an option if Article 50 of the 8th Company Law Directive is adopted, as we expect. The option would therefore be to delay until we were required to implement the Directive (in some two to three years time). However, the need for greater transparency has also been recognised by the Co-ordinating Group on Audit and Accounting Issues and a range of UK stakeholders. The UK Government would wish act on this issue regardless of the standpoint of other EU countries and the European Commission.

### Option 2

**4.3** This offers a greater level of transparency which goes towards the policy intent.

**4.4** It has the advantage over option 3 of using established definitions. It also requires fewer changes to reporting structures, therefore slightly less work/analysis and possibly slightly fewer costs, as companies would not be required to obtain and disclose additional information, for example, on pension schemes or the wider audit firm network.

### Option 3

**4.5** This option offers the greater transparency which is the policy intent. In addition, it refines some of the definitions so that the most important information is disclosed, not only about the relationship between auditors and the company itself but also, by extending the definition of associate of a company, that between auditors and the company's pension funds. We believe this could be of relevance to the audit-client relationship. And by extending the definition of associate of an auditor to include networks, the new Regulations would require disclosure of a service purchased from another part of the audit firm's network, which might be of relevance to the question of independence.

### **5. Business Sectors Affected**

**5.1** Business sectors that are affected by the draft Regulations are:

- a. Large companies of (any) class;
- b. GB-registered quoted companies; and
- c. Auditors.

### **Companies**

**5.2** The current requirement to disclose the total amount spent on non-audit services applies to all companies which are not SMEs. Analysis conducted since publication of the partial RIA that accompanied the C(AICE) Bill confirms the total number of “live” large private and public unquoted companies at 12,000, with an additional 1,290 GB-registered quoted companies.

**5.3** The proposal is to apply the new disclosure requirement for non-audit services to the same classes of companies. There is no distinction on the basis of the business sector in which the company operates. Any company, regardless of its size, which has its accounts audited, will continue to be required to disclose the audit fee itself.

**5.4** The Regulations are drafted so that small and medium sized enterprises are not covered by the non-audit service disclosure requirements.

### **Auditors**

**5.5** The audit market is characterised by a very high level of concentration, with just four accountancy firms (the ‘Big Four’) and a significant size gap between the fourth and fifth largest firms. The next 20 audit firms are commonly referred to as ‘Group A’ auditors, Most if not all of these firms will be caught by the Regulations.

### **6. Issues of Equity and Fairness**

**6.1** This proposal will not have disproportionate effects on particular sectoral groups. The proposals cover all companies regardless of sector. Clearly the audit firms themselves will be impacted in a different way to the companies that they audit (it is likely that in practice it is the audit firms that will gather and prepare the information for their clients to disclose), but this is entirely equitable since it is their services which are under scrutiny.

## 7. Costs of Options

### Option 1

**7.1** The ‘do nothing’ option would not add to companies’ costs. However this option does nothing to reassure or restore confidence and goes against the Government’s stated intention of increasing transparency. It could add to the cost of capital for companies if – as a result of Government inaction – fears persist about company-auditor relations and the capital markets suffer as a result (as they did in the aftermath of Enron and Worldcom).

### Option 2 and Option 3

**7.2** There will be some small additional costs to business under options 2 and 3. Option 2 costs may be slightly less than those for option 3. The largest cost – that of compiling the information required under the non-audit service categories – is incurred under both options. In any case the cost differential is likely to be so minimal as to be unlikely to be sufficient reason of itself to favour option 2 over option 3.

**7.3** As the RIA to section 7 itself explained, the only cost from this requirement is likely to be the cost of obtaining the information and including it under the required categories in the annual accounts and reports. “If we presume that the requirements would involve 16 hours of staff time, costs will be in the region of £890.”

**7.4** Companies which are also required to provide non-audit service information under US law may incur further costs, as they will be required to conform to two similar, but separate requirements. However the costs are likely to be minimal, especially when seen as a percentage of the turnover of the sorts of companies that choose to dual list in London and New York. In addition, companies with computerised systems should experience minimal additional burdens, as presentation of figures for different markets (or regulators) can be effected electronically.

## 8. Consultation with Small Businesses: The Small Firms’ Impact Test

**8.1** The subject of this RIA is the extension of the requirement for companies to make disclosures about non-audit services. SMEs are not covered by this requirement, although as at present they will be required to disclose the audit fee (if any). It is anticipated that there will therefore be no impact on small and medium-sized businesses (SMEs). We consulted with the SBS on the initial RIA, which is content with the approach.

### **9. Competition Assessment**

**9.1** There is no negative competition impact from this proposal. Any additional cost associated with the disclosure of non-audit services will be very small and will apply to all companies above the SME threshold regardless of sector.

**9.2** Overall, there may be a small gain in market competitiveness from greater transparency about which companies buy which services from their auditors.

### **10. Enforcement and sanctions**

#### **Enforcement**

**10.1** The disclosure requirements of the Companies Act are enforced by Companies House which is responsible for ensuring that all necessary disclosures are made. The Financial Reporting Council's Financial Reporting Review Panel may also take civil remedial action. The new requirements would be enforced in the same way.

#### **Sanctions**

**10.2** Regulation 7 of the draft Regulations applies section 233(5) of the Companies Act 1985 to make it a criminal offence for a director to fail to make the disclosures required. Regulation 7 also applies sections 245 to 245C, under which directors who realise that they have made a mistake may revise the company's accounts and the Secretary of State or a person authorised by her (currently the Financial Reporting Review Panel) may apply to the court for an order requiring revision.

**10.3** Regulation 6 puts a responsibility on the auditors to ensure that companies have all the information they require. This could be enforced via an injunction, but in practice would be enforced by a company making a complaint to the professional body of which the audit firm was a member. Professional bodies have a set of standards of conduct which their members are obliged to follow, and disciplinary action is taken against those that do not. The professional bodies are, themselves, subject to independent public oversight by the Professional Oversight board for Accountancy, part of the Financial Reporting Council.

## 11. Monitoring and review

**11.1** The Government and the CGAA have welcomed work on disclosure of non-audit services already carried out already by the ICAEW and the Association of Chartered Certified Accountants (ACCA). The ICAEW undertook a public consultation on the disclosure of the nature and value of services provided by auditors (see below under Consultation) and produced guidance on voluntary disclosure. The ACCA published a study into existing listed company disclosures. The DTI plans to continue to work closely with the ICAEW, ACCA and other professional accountancy bodies in monitoring the impact of the new disclosure requirements, including compliance levels and costs.

## 12. Consultation

### (i) Within government

**12.1** The DTI has consulted the SBS, OFT and the devolved administrations on this RIA.

### (ii) Public consultation

**12.2** The ICAEW undertook a public consultation on the voluntary disclosure of the nature and value of services provided by auditors in 2002. We have considered the responses to this consultation and discussed them with the ICAEW. The results of the consultation indicated that the principle itself is not controversial, at least among the main stakeholders. Some specific technical issues were raised by some audit firms, and these have been considered when drafting the regulations and raised in the consultation document as appropriate; where disclosure should be made in the accounts, or whether a de minimis exemption should be included, for example.

## 13. Summary and recommendations

**13.1** The regulations require companies to disclose more details in their annual accounts and reports on types and costs of services bought from its auditor or its associates. The policy itself is not in question but there are options as regards the detail of how this should be done. In particular, there is a “minimum” approach which would utilise existing definitions (options 1 and 2 above) and a “maximum” approach which would refine the definitions and extend them in some ways. For example, the criteria for counting as an associate of the auditor could be slightly wider than at present, and definition of a company associate could be extended to include certain pension funds. It is considered that the marginal additional cost of making such changes will be negligible, and that this “maximum” approach is in line with the overall policy objective of enhancing transparency about the auditor-client relationship.

**13.2** The following table indicates the areas where we believe that costs and benefits are most likely to occur in relation to each option.

Description	Additional Benefits	Additional Costs
1. Do nothing	No benefits accrue	No hard costs incurred. Opportunity cost incurred in so far as doing nothing will not aid greater transparency, nor help rebuild confidence in auditor independence.
2. Make as few changes as possible (use existing definitions) whilst still requiring fees to be categorised and sub-categorised	Greater transparency – but limited because the existing definitions are limited in some ways	Marginal costs incurred to collate, list and publish services provided by category. Potential additional costs for dual listed companies to ensure disclosures read-across to third countries. Costs incurred for an estimated 12,000 large private and public unquoted companies, plus 1,290 GB-registered quoted companies.
3. Expand scope and definitions	Greater transparency – more extensive approach which includes audit firm networks and company pension funds.	Marginal costs incurred to collate, list and publish services provided by category. Costs of greater disclosure expected to be minimal, but slightly greater than option 2 (due to wider scope and definitions). Again, applicable to an estimated 12,000 large private and public unquoted companies, plus 1,290 GB-registered quoted companies.

**14. Declaration**

**14.1** I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

**Signed** .....

**[Date]**

***Jacqui Smith MP, Minister of State for Industry and the Regions, Department of Trade and Industry***

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# Annex C: The Consultation Code of Practice Criteria

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1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

The complete code is available on the Cabinet Office's web site, address:  
<http://www.cabinet-office.gov.uk/servicefirst/index/consultation.htm>.