



**EUROPEAN COMPANY LAW AND
CORPORATE GOVERNANCE**

Implementation of Directive
2006/43/EC on Statutory
Audits of Annual and
Consolidated Accounts
(8th Company Law Directive)

A CONSULTATIVE DOCUMENT

MARCH 2007

EUROPEAN COMPANY LAW AND CORPORATE GOVERNANCE

IMPLEMENTATION OF THE DIRECTIVE ON STATUTORY AUDIT OF ANNUAL AND CONSOLIDATED ACCOUNTS

The Department of Trade and Industry invites your views on the implementation of the Directive on statutory audit of annual and consolidated accounts (replacing the 8th Company Law Directive).

The Directive clarifies the duties of statutory auditors and provides for their independence and ethical standards; introduces a requirement for external quality assurance; provides for public oversight of the audit profession, including third country auditors, and improved cooperation between oversight bodies in the EU. It also provides a basis for international cooperation between regulators in the EU and with regulators in third countries.

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

Mailbox: AuditDirective@dti.gsi.gov.uk

Or by post to: Jim Bellingham
Corporate Law and Governance Directorate
Department of Trade and Industry
1 Victoria Street
London SW1H 0ET

Or by fax to: 020 7215 0235

The deadline for responses is **1 June 2007**.

Additional copies of this document may be made without seeking permission or downloaded from the Department's website on:
www.dti.gov.uk/cld/current.htm

Confidentiality: Your response may be made publicly available by the DTI. If you do not want all or part of your response or name made public, please state this clearly in the response. A summary of all responses received will be included in the Government's response to this consultation.

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

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FOREWORD

Good corporate reporting is one of the cornerstones of efficient capital markets and the wider economy. It promotes trust and confidence in business, encourages investment and provides the basis for sound commercial decision making. It is important that the reporting and auditing framework operates in a way that supports long-term growth and innovation and ensures stakeholders and others are provided with fair and accurate information.

The potential impact of a loss of investor confidence across Europe and globally is immense. This was made all too real with the significant decline in stock market prices that followed from a number of corporate scandals earlier this decade. Many of us - whether through lost jobs or falls in value in our pension, endowment or other investment products – suffered directly.

It was important there was a concerted response, both from the EU and national Governments, to reduce the risk of similar events in the future. The measure on which we are now consulting, in strengthening the EU auditing framework, is a part of that response.

The new Audit Directive seeks to enhance confidence in the financial statements and annual reports published by companies across the EU. The Directive aims to achieve its objective by strengthening the EU framework of standards and public oversight for the audit profession, in particular for the audits of larger, publicly listed companies, as well as introducing new provisions for auditors from non-EU countries.

Many of the provisions of the Audit Directive are already in place in the UK, and will require little, if any, change to existing practice. However there are a range of new provisions including measures extending for the first time to auditors from third countries, provision allowing for the adoption of International Standards on Auditing under EU law and new provisions on audit committees applying to listed UK companies.

We invite your views on the policy proposals to implement this Directive in the UK. We are determined to ensure that the UK continues to have the very best corporate reporting standards within a regulatory framework which avoids unnecessary burdens. To this end, we have engaged with many of our stakeholders to seek their views on these issues, and as we continue to do so

your views would be extremely welcome and would guide us in making the right choices in implementation of this Directive into UK law.

A handwritten signature in black ink, appearing to read "Ian McCartney". The signature is written in a cursive, slightly slanted style.

Rt. Hon. Ian McCartney MP

Minister for Trade, Investment and Foreign Affairs

Chapter 1

EXECUTIVE SUMMARY

Purpose of this consultation

1.1 The Directive on the Statutory Audits of Annual Accounts and Consolidated Accounts was published in the Official Journal on 9 June 2006 and came into force on 29 June 2006. This consultative document seeks your comments on the UK Government's proposed approach to implementation of the EU Directive on statutory audits of annual accounts and consolidated accounts, including the likely costs and benefits of the implementation proposals as indicated in our draft Regulatory Impact Assessment (RIA) at Annex A. Your views will inform the implementation of the Directive in the UK and the drafting of regulations.

1.2 The formal consultation period will end on 1 June 2007. The Government will consult on draft regulations in due course.

About the Directive

1.3 The Directive clarifies the duties of statutory auditors and provides for their independence and ethical standards; introduces a requirement for external quality assurance; provides for public oversight of the audit profession, including third country auditors, and improved cooperation between oversight bodies in the EU. It also provides a basis for international cooperation between regulators in the EU and with regulators in third countries, such as the US Public Company Accounting Oversight Board (PCAOB).

1.4 On the whole, this is a 'minimum harmonisation' Directive intended to establish a set of basic principles for the conduct and oversight of statutory audits conducted in the EU. There are, however, restrictions in some areas, which prevent Member States going beyond the requirements of the Directive, such as on International Standards on Auditing.

1.5 Unlike in some Member States, the existing UK framework for statutory audits already provides for a significant proportion of the areas covered by the Directive. There are, however, some new provisions, such as the requirement for some entities to have an audit committee and the provisions for co-operation with third country authorities. The Government

proposes to build on the existing UK audit framework in its implementation of these provisions.

Related consultations

1.6 The Professional Oversight Board, a body of the Financial Reporting Council, has published a consultation document on the implementation options for the transparency requirements in Article 40. The consultation document can be found at www.frc.org.uk/POB/press/pub1162.html. The consultation is now closed, and the Professional Oversight Board plan to publish the results shortly, along with their plans for the next steps.

1.7 The European Commission published a consultation document on the provisions in Articles 45 to 47, concerning third country auditors and cooperation with third country authorities, on 11 January 2007. The consultation, which closed on 5 March 2007, can be found at http://ec.europa.eu/internal_market/auditing/relations/index_en.htm

1.8 The European Commission also published a consultation document on the effect of current national provisions on auditor liability, as required under Article 31 of the Directive, on 18 January 2007. The consultation, which closes on 15 March 2007, can be found at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/60&format=HTML&aged=0&language=EN&guiLanguage=en>

1.9 European Directive 2006/46/EC, amending the Fourth, Seventh, Bank Accounts and Insurance Accounts Directives, was published on 16 August 2006 and must be implemented by the 5 September 2008. The Department of Trade and Industry is consulting on the implementation of this Directive in parallel with the Audit Directive. The separate consultation, which closes on 1 June 2007, can be found at: <http://www.dti.gov.uk/consultations/index.html>

1.10 The Department of Trade and Industry is also consulting on the wider implementation of the Companies Act 2006. This consultation, which closes on 31 May 2007, can be found at: <http://www.dti.gov.uk/consultations/index.html>

What happens next?

1.11 The Government will issue a summary of responses within three months of the closing date of this consultation. It is intended that the Government response to this consultation, which will include draft regulations, be issued at the same time.

How to respond and help with queries

1.12 Comments are welcome on all aspects of the proposal. In particular, we invite your views on the specific issues highlighted in this consultation document (a summary of the consultation questions is attached at Annex B). In relation to the draft Regulatory Impact Assessment at Annex A, any relevant data or other supporting evidence would be especially useful.

1.13 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.

1.14 Responses should be submitted, preferably by email, to

Mailbox: AuditDirective@dti.gsi.gov.uk

Or by post to: Jim Bellingham
Corporate Law and Governance Directorate
Department of Trade and Industry
1 Victoria Street
London SW1H 0ET

Or by fax to: 020 7215 0235

Confidentiality & Data Protection

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

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

1.17 The Department will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Help with queries

1.18 Questions about the policy issues raised in the document can be emailed to AuditDirective@dti.gsi.gov.uk or discussed with Jim Bellingham on 020 7215 3858.

1.19 A copy of the Code of Practice on Consultation is at Annex D.

Chapter 2

OVERVIEW OF THE DIRECTIVE AND IMPLEMENTATION PROCESS

Introduction

2.1 This consultative document seeks your comments on the Government's proposals for implementation of the Audit Directive, including the likely costs and benefits of the proposals as indicated in the draft Regulatory Impact Assessment (RIA) at Annex A.

2.2 In preparing this consultation document, we have been in regular contact with a range of stakeholders to gain informal feedback on the practical issues involved in implementation. We will continue to work with stakeholders throughout the implementation process.

Background to the Directive

2.3 On 16 March 2004 the European Commission presented a proposal for a Directive of the European Parliament and of the Council on the Statutory Audit of Annual and Consolidated Accounts, and amending Council Directives 78/660/EC and 83/349/EC. This proposal was, in part, a response to the Enron and WorldCom financial scandals of the early 2000s. This document can be found at:

www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52004PC0177:EN:HTML

2.4 On 23 August 2004 the DTI published a consultation paper asking for comments on the UK's negotiation strategy during consideration of the proposed Directive by Expert Working Groups. A copy of the consultation document, including a draft regulatory impact assessment, is available by contacting the DTI Publications Order line on 0870 1502 500, or by e-mail publications@dti.gsi.gov.uk quoting reference URN 04/1382.

2.5 The Government published its report on the responses to consultation in February 2005. The majority of respondents were supportive of the position the Department was taking during the negotiations. This document, as well as an updated draft regulatory impact assessment, can be found at: www.dti.gov.uk/files/file22807.pdf

2.6 Once the consideration of the proposed directive had been finalised amongst Council members 'agreement on the general approach' was given by Ministers of the Economic and Financial Council (ECOFIN) on 7 December 2004. Members of the European Parliament also considered the proposed text under the co-decision process laid down by Article 251 of the Treaty establishing the European Community. Consideration of the proposed Directive culminated in a first reading approval being given to the proposed Directive by the European Parliament on 27 September 2005.

2.7 The Directive was adopted on 25 April 2006 and published in the Official Journal on 17 May 2006. A copy of the Directive can be found at Annex C of this consultation or online at: www.europa.eu.int/eur-lex/lex/JOhtml.do?uri=OJ:L:2006:157:SOM:EN:HTML The provisions of the Directive came into force on the 29 June 2006 and the majority of the requirements will have to be implemented by 29 June 2008.

Existing UK framework for statutory audits

2.8 This Directive replaces the 8th Company Law Directive of 1984 (84/253/EC), which is implemented in the UK through a combination of provisions including the Companies Act 1989, the delegation of some powers to the Professional Oversight Board, the standards set by the Auditing Practices Board and the Audit Regulations of the Recognised Supervisory Bodies.

Approach to implementation

2.9 The UK audit framework already meets most of the requirements in the Directive. Our approach to implementation is intended to build on that existing framework. It is the Government's view that this approach will minimise any new burdens on business. Responses to this consultation will inform Ministers' decisions on the content of the implementing regulations.

2.10 The Directive is in part an EU response to the Enron and other scandals of earlier this decade, with provisions requiring public oversight of, and systems of investigations and penalties for the audit profession, as well as oversight of third country auditors. Other parts are a restatement and updating of the 8th Company Law Directive. The provisions of the Companies Act 2006 reflect many of these changes, and these will therefore be implemented as part of the Companies Act 2006 implementation. However, there are some new provisions, including on audit committees, and co-operation with third country authorities, which are not completely covered by the Companies Act 2006. Implementation of these provisions will need to be taken forward by other means, as explained in the following

paragraphs, in conjunction with commencement of the relevant parts of the Companies Act 2006.

Process of implementation

2.11 The implementation of the Directive will require a range of provisions to be made in regulations, either by the DTI or by the Professional Oversight Board; amendments to the Companies Act 2006 to provide statutory underpinning for (and updating where necessary) existing Ethical Standards and Recognised Supervisory Bodies rules; and comitology procedures at EU level.

Via the Professional Oversight Board

2.12 The Professional Oversight Board is the body to which the Secretary of State has delegated a number of his functions with respect to the regulation of the audit profession. The Government proposes to continue to delegate to the Professional Oversight Board those powers to make regulations that are delegated to it under the Companies Act 1989. These powers will be delegated by way of a Delegation Order under the Companies Act 2006. These functions currently include, for example, the power to make regulations requiring a register of auditors to be kept. The new Delegation Order will also include the delegation of some powers relating to the new requirements of the Directive. An example is the power to require those eligible for appointment as a statutory auditor to make specified information available to the public (one of the requirements of Article 40 of the Directive).

Via Ethical Standards and Audit Regulations

2.13 In some cases (for example, in relation to professional ethics), the provisions will be implemented by giving statutory underpinning to the relevant rules of the Recognised Supervisory Bodies, usually in conjunction with standards of the Auditing Practices Board, in Schedule 10 of the Companies Act. In the case of a number of the requirements, this will require amendments to Schedule 10 of the Companies Act 2006 and, in some cases, also to the Recognised Supervisory Body rules and Auditing Practices Board standards. A general alternative to this approach would be to make freestanding regulations for new provisions but it is the Government's current view that this would not generally be an efficient method of implementation. The Government's general preference is to follow the approach under the existing framework in which the detailed standards and rules are made by expert bodies, within the statutory framework.

Via DTI regulations

2.14 The remainder of the regulations will be made by DTI, using powers in the Companies Act 2006 or section 2(2) of the European Communities Act 1972. Where entities coming into the scope of the Directive are not companies, as described in paragraph 2.17 below, separate regulations may be required to amend the relevant UK legislation relating to the audits of those entities.

Via comitology

2.15 Other parts of the Directive provide for the European Commission to make decisions under various comitology powers, including in relation to the third country oversight provisions.

Timetable for implementation

2.16 It is our intention to publish draft regulations at the same time as the Government response to this consultation. The Directive must be implemented by 29 June 2008. The Government plans to bring into force the majority of implementing regulations in April 2008. The provisions would apply to reporting periods beginning on or after the date when the regulations come into force. The timing of implementation of the third country provisions in Articles 45 to 47 may be slightly later, and will take into account the timetable for implementing any decisions taken under comitology (these are discussed in paragraphs 3.85 – 3.86).

Scope of the Directive

2.17 This Directive will affect statutory auditors, audit firms and their professional bodies. It applies, with the exception of some specific optional exemptions, to audits of all entities already required to have an audit of annual accounts or consolidated accounts under Community law (as required by Article 2.1). This includes:

- companies¹;
- credit institutions² (i.e. banks and building societies);
- and insurance undertakings, which may be companies, friendly societies or industrial and provident societies³. This includes Lloyds⁴.

¹ As defined by Directive 78/660/EEC on the annual accounts of certain types of companies ("the Fourth Directive") and Directive 83/349/EEC on consolidated accounts ("the Seventh Directive").

² As defined by Article 4.1 of Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions.

³ As defined by Article 2.1 of Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings ("the Insurance Accounts Directive").

⁴ Lloyd's is covered by Part 42 of the Companies Act 2006 (s1210 (1)(e)). The present situation is that there are the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2004 and in those, Part II of the Companies Act 1989 is applied for the appointment and duties of auditors. We will need to form a view as to implementation of articles 28, 37, 38, 41, and 42 of the Audit Directive. The Government will consult with Lloyds to determine the most effective way to implement the relevant provisions of the Directive.

2.18 There are also additional requirements for companies (and mutuals) classified as public interest entities and for public interest entities' audit firms.

Application to audited entities

2.19 Application of the Directive to the statutory audits of UK companies is provided for in the Companies Act 2006. To apply the requirements of the Directive to the other entities to which it applies, it may be necessary to amend the legislation applicable to those entities. While the majority of credit institutions and insurance undertakings are companies, a significant group of them are constituted as building societies, friendly societies or industrial and provident societies. These entities are governed by their own legislative framework⁵. HM Treasury is responsible for this legislation and for the application of the Directive to mutual credit institutions and insurers. Where possible, the Government proposes a similar approach to implementing the provisions for these mutual entities as that proposed for companies.

2.20 When implementing accounting directives, the Government has in the past considered parallel amendment for Limited Liability Partnerships (LLPs). It will do so in this case as part of the broader consideration of how to reflect implementation of the Companies Act 2006 in amendments to the law on LLPs.

Application to auditors

2.21 Part 42 of the Companies Act 2006 makes equivalent provision for the statutory auditors of companies and the mutual entities covered by the Directive. The implementation of the provisions⁶ of the Directive that apply to statutory auditors will therefore require no further specific provision for mutuals.

2.22 The Directive is applicable to the United Kingdom. This consultation covers the implementation of the Directive in Great Britain and Northern Ireland.

Key provisions of the Directive

2.23 The key provisions of the Directive are as follows:

- An updated educational curriculum for auditors, which must now include knowledge of international accounting standards (IAS) and international standards on auditing (ISA) (Articles 6 to 13);

⁵ The applicable legislation is the Building Societies Act 1986, the Friendly Societies Act 1992, and the Industrial and Provident Societies Acts 1965 to 2003.

⁶ Articles 1 to 27, most of 28, 29 to 36, 40, most of 42, 43 and 44 of the Directive.

- Opening up the ownership of audit firms to individuals who are statutory auditors and to audit firms in any member state (Article 3);
- An updated registration system for auditors and audit firms (Article 15);
- Defined, basic professional ethics principles (Article 21);
- A legal underpinning for auditor independence principles including a duty for the statutory auditor or audit firm to document factors which might affect his/its independence and safeguards adopted (Article 22);
- An obligation for Member States to set rules for audit fees that ensure independence (Article 25);
- Requirements to use international standards on auditing for all EU statutory audits once those standards have been endorsed under the EU comitology procedure. Member States will only be allowed to impose additional standards for financial years ending before 29 June 2010 (Article 26);
- The possibility of a common audit report for financial statements that have been prepared on the basis of ISAs (Article 28);
- The introduction of a requirement that Member States have an audit quality assurance system that complies with defined principles (Article 29);
- Common rules concerning the appointment and the resignation of statutory auditors and audit firms (Articles 37 and 38);

2.24 In addition, the Directive imposes further requirements on the statutory audit of public interest entities. These include:

- The introduction of an annual transparency report for audit firms to cover, for example, information on their governance (Article 40);
- The rotation of key audit partners at least every seven years, some requirements to report certain matters to audit committees, and a restriction on auditors taking up key management positions in entities they have audited (Article 42);
- A quality assurance review, at least once every three years, of audit firms who audit public interest entities (Article 43);

- The introduction of a requirement for some public interest entities to have in place an audit committee or a body performing equivalent functions (Article 41).

2.25 The Directive also aims to reinforce public oversight of the audit profession and to encourage regulatory cooperation both within the EU and third countries. The following elements have been included:

- Common criteria for Member State public oversight systems, in particular a predominance of non practitioners (Article 32);
- Cooperation between Member States regulatory bodies on the basis of 'home country regulation' of statutory auditors and audit firms approved by them (Article 34);
- Mutual recognition by Member States of one another's regulatory arrangements in cases where audits cover more than one jurisdiction (Article 34);
- The establishment of procedures for the exchange of information between Member State oversight bodies carrying out investigations (Article 36);
- Rules on the registration, approval and supervision of third country auditors or for reliance on home country arrangements for regulation of third country auditors (Articles 45 and 46); and
- Regulation of the passing of audit working papers to competent authorities in third countries (Article 47).

Chapter 3

PROPOSED IMPLEMENTATION

3.1 The sections below set out options and proposals for the implementation of the requirements of the Directive. Discussion of related Articles has been grouped where this assists clarity and understanding.

3.2 As noted earlier, we have developed these options following informal discussion with a range of stakeholders. This process has also helped to identify specific issues on which we particularly invite respondents' views and supporting evidence. A summary of the consultation questions is included at Annex B.

Education and Qualifications - Articles 3 to 14, and 44

3.3 The requirements in Articles 3 to 14 largely repeat the provisions in the 8th Company Law Directive and are, therefore, already reflected in UK law. These provisions are also reflected in Part 42 and Schedules 10 and 11 of the Companies Act 2006. There are, however, a small number of new provisions, which will require some changes and are discussed here. Apart from these, we believe that the current UK provision complies with the Directive's requirements, and we therefore do not currently propose to make any further changes to, for instance, the provisions for exemptions from the various requirements.

Withdrawal of approval

3.4 Article 5.3 requires the competent authorities to notify other Member States in which an auditor is registered if the approval of that auditor is withdrawn for any reason. We propose to make the transmission of this information to other Member States the responsibility of the Professional Oversight Board, while it will be the duty of the Recognised Supervisory Bodies to provide the Professional Oversight Board with the necessary information.

Test of theoretical knowledge

3.5 Article 8.1 lists those subjects that will be examined in the test of theoretical knowledge which auditors are required to sit. Currently, these subjects are set out in a regulation based on the earlier Directive, but this will need to be updated to include the additional subjects (parts (c), (f), (i)

and (j) of Article 8.1). We propose to repeal the old regulation (SI 1990/1146) and to allow the Professional Oversight Board, to whom this power is now delegated, to make a new regulation. Although our understanding is that the current syllabi are in fact already compliant with the new requirements, there is a question as to exactly when the new requirements should come into force. We are considering this issue further in consultation with the Recognised Supervisory Bodies and the Professional Oversight Board, who would need to consult on draft regulations.

Approval of statutory auditors from other Member States

3.6 Article 14 limits the additional requirements that can be imposed by the Recognised Supervisory Bodies on statutory auditors from other Member States who wish to practice in the UK. They can be required to do no more than pass an aptitude test on their knowledge of UK laws and regulations applying to audit. While we do not expect this limitation to make a substantive difference to the current practice of the Recognised Supervisory Bodies in respect of auditors from other Member States, it will require a change in the law, as the Companies Act 2006 (in Schedule 10, paragraph 6) currently expressly permits the Recognised Supervisory Bodies to impose additional requirements.

Approval of auditors from third countries

3.7 Article 44 sets out the requirements for the arrangements for recognition of auditors from third countries who wish to register as statutory auditors in the UK. Provision has been made for these arrangements, and for the requirement of reciprocity, in section 1221 of the Companies Act 2006. The Secretary of State's power to recognise overseas qualifications that meet certain requirements will continue to be delegated to the Professional Oversight Board. The Companies Act 2006 may require some amendment to cover the requirements of Article 44.2, parallel to the amendments needed in respect of Article 14.

Q1 Do you have any comments on the Government's proposals for implementation of the requirements on education and qualifications?

Registration - Articles 15 to 20

3.8 The revised Directive contains a number of new requirements for the public register, which go beyond those in the current UK regulations (Companies Act 1989 (Register of Auditors and Information about Audit Firms) Regulations 1991, SI 1991/1566). This will require new regulations to be made under the Companies Act 2006 to require the Recognised Supervisory Bodies to maintain a register that meets the new requirements.

Public register and registration of statutory auditors

3.9 Specifically, under Article 16, the register will have to include individual registration numbers for all statutory auditors; under Article 15, it must be available electronically to the public; and it must also list the other Member States in which each auditor is registered as a statutory auditor.

3.10 Article 15.1 provides an exemption to protect information on the register from disclosure, to mitigate a threat to personal security. The Government proposes to delegate the power to use this exemption to the Professional Oversight Board.

3.11 Under Article 16.2, a register must be kept of third country auditors who sign reports of third country companies whose transferable securities are admitted to trading on Member States' regulated markets⁷. They must be clearly marked as such in the register. We propose that the Professional Oversight Board should be responsible for maintaining this part of the register, while the third country auditors or audit firms will be responsible for providing accurate and updated information as necessary.

Registration and updating of information

3.12 For audit firms, much of the information specified in Article 17, with the exception of parts (a), (b), (f), (g), and to some extent (e), will be a new requirement. Articles 18 and 19 of the Directive also introduce new requirements whereby auditors and firms will be responsible for the accuracy of the information in the register and for providing updates to it. This will need to be provided for in the new regulation; they will be required to provide updated information to their Recognised Supervisory Body in order to maintain their registration.

Proposed implementation

3.13 In order to put these arrangements in place, the Government currently envisages two sets of regulations, one made by the Professional Oversight Board under their delegated powers to cover UK auditors, and another by DTI to cover the arrangements for third country auditors. This need not mean, however, that there will need to be two separate registers. Nor is there any intention of imposing any changes to the existing practical arrangements for maintaining the register of UK auditors, beyond what is required by the Directive.

Timetable

3.14 The Directive requires that the register be fully operational by June 2009, one year later than most of the provisions in the Directive. The

⁷ The definition of a regulated market applied by the Directive is based on the Markets in Financial Instruments Directive. Under Article 16 of the Investment Services Directive (Directive 93/22), the FSA is responsible for maintaining the list of regulated markets for which it is the Home Member State.

Government has yet to form a firm view on whether to use this additional year, and views are invited. The Government does not, at this stage, see any particular reason why it should be necessary to bring the revised UK audit register and the provisions of Article 45 and 46 for the register for third country auditors, into force at the same time. The timetable for the implementation of the third country provisions in Articles 45 to 47 also needs to take into account the timetable of any decisions taken under comitology.

Q2 Do you have any comments on when the revisions to the UK auditor register should come into effect?

Q3 Do you have any other comments on the Government's proposals for implementation of the register requirements?

Ethics - Articles 21 to 25

General approach

3.15 Many of the requirements in this chapter of the Directive are already substantively covered by either the Ethical Standards issued by the UK Auditing Practices Board or by the Audit Regulations of the Recognised Supervisory Bodies. The Government's view is that detailed provision of such matters should continue to be dealt with in the Auditing Practices Board's Ethical Standards or by the rules of the Recognised Supervisory Bodies. The alternative in relation to any particular requirement would be to make regulations that set out the requirements in a way that binds auditors directly. However, the Government's general preference, subject to consultees' responses, is to follow the current approach for new requirements under the Directive.

3.16 The Government therefore proposes only to make the minimum amendments to the UK legal framework necessary to provide legal underpinning to the relevant requirements under the Directive. This would be effected by amendments to Schedule 10 to the Companies Act 2006 to reflect the minimum required under the Directive, with any more detailed rules to give effect to this requirement being provided for under the Recognised Supervisory Bodies' regulations in conjunction with the Auditing Practices Board's Ethical Standards.

Access to relevant information

3.17 The requirement in Article 23.3 for the outgoing auditor to provide all relevant information to the incoming auditor is not established in existing UK law. Neither is it covered by the Auditing Practices Board's Ethical Standards or the Audit Regulations. The Government therefore proposes to

amend Schedule 10 to the Companies Act 2006 to require these obligations to be provided for under the rules of the Recognised Supervisory Bodies. It would then be for the Recognised Supervisory Bodies to consider what might be the most appropriate minimum requirement in relation to access to relevant information.

Confidentiality and professional secrecy

3.18 The requirement in Article 23.4 regarding confidentiality and professional secrecy is met by the Recognised Supervisory Bodies' existing rules. Members of the Recognised Supervisory Bodies are bound by these rules whilst they are members of the bodies and appropriate sanctions for breaches of these rules are in place. Former members also continue to be bound by these terms of their membership of the Recognised Supervisory Bodies and a case may be brought, and a fine imposed, against individuals who are no longer members. As for other parts of Article 23, the Government proposes to amend Schedule 10 to the Companies Act 2006 to provide the statutory underpinning to the existing rules. The Government is considering whether it is necessary to make any further provision to ensure these fines are enforceable.

Audit fees

3.19 Under Article 25, fees for statutory audits must not be influenced or determined by the provision of additional services to the audited entity and neither can they be based on any form of contingency. The requirements in Article 25 are addressed only in part by the existing Ethical Standards set by the Auditing Practices Board. The Government's view, subject to consultation responses, is that these requirements should continue to be dealt with in the Ethical Standards and the Auditing Practices Board will, therefore, be reviewing these in the light of the requirements in the Directive. We propose to amend Schedule 10 to the Companies Act 2006 to provide the necessary statutory underpinning to the standards in this respect.

Q4 Do you have any comments on the Government's proposals for implementation of the requirements on ethics?

Standards and Reporting - Articles 26 to 28

Auditing standards

3.20 Article 26 requires statutory auditors and audit firms to carry out statutory audits in compliance with the International Auditing Standards (ISAs) adopted by the Commission. The timetable and procedure for adopting the ISAs referred to in Article 26 are currently under discussion in the EU. The European Commission has established an Audit Regulatory

Committee, for the purpose of making decisions under comitology, and a technical advisory group of Member State national experts called the European Group of Audit Oversight Bodies. The Commission is likely to issue a consultation in the first half of 2007 on the adoption of ISAs in the EU.

Statutory audits of consolidated accounts

3.21 Article 27 sets out provisions for statutory audits of the consolidated accounts of a group of undertakings. The existing standards set by the Auditing Practices Board cover the provision in point (a), which requires that the group auditor bears the full responsibility for the audit report in relation to the consolidated accounts, and section 495(3)(a)(iii) of the Companies Act 2006 ensures that the group auditor reports on the group accounts. The requirement in point (b), relating to the documentation of the group auditors review of the audit work, is also partly covered by Auditing Practices Board standards but not wholly. The expectation is that the revised ISA 600 will cover the outstanding requirements, but that standard is not yet finalised and is unlikely to be adopted in time for the implementation of this Directive. Transitional arrangements, which may be required, are the subject of discussions between the Auditing Practices Board and the Recognised Supervisory Bodies. The Government proposes to amend Schedule 10 to the Companies Act 2006 to provide the necessary legal force to the Auditing Practices Board standards or to the Recognised Supervisory Bodies' rules relating to (a) or (b).

3.22 Point (c) of Article 27, which covers requirements where a component of a group of undertakings is not covered by arrangements under Article 47 (on cooperation with competent authorities from third countries), is not likely to be covered by the revised ISA 600. The Government's current preference, in line with the general approach set out in paragraph 2.13, is that this requirement should also be implemented through the rules of the Recognised Supervisory Bodies and given statutory underpinning by way of a further amendment to Schedule 10.

Audit reporting

3.23 The requirement in Article 28.1, for the audit report to be signed by at least the statutory auditor(s) carrying out the audit on behalf of the audit firm, is provided for in section 503 of the Companies Act 2006. There is also provision, in section 504 of the Act, for the Secretary of State to issue guidance on who should be the senior statutory auditor, if the European Commission has not issued standards that cover the point. It is proposed to delegate this power to the Professional Oversight Board, as provided for under the Act. Article 28 also makes provision for the auditor's signature not to be disclosed in exceptional circumstances, and this is provided for in the Act at section 506. The Government will consider whether to make

equivalent provision for non-disclosure of the auditor's details in respect of entities that are not companies.

Q5 Do you have any comments on the Government's proposals for implementation of the requirements on standards and reporting?

Public Oversight, Investigations and Discipline - Articles 29 to 36

Quality assurance, investigations, and public oversight

3.24 Articles 29, 30 and 32 set out the requirements of the Directive for the systems of quality assurance, investigations and penalties, and for public oversight. At present in the UK, quality assurance inspections are undertaken by the Professional Oversight Board in respect of major audits, and by the Recognised Supervisory Bodies in respect of all other audits. Public oversight of the Recognised Supervisory Bodies is the responsibility of the Professional Oversight Board.

Proposed implementation

3.25 The Government's view is that the existing system of quality assurance and investigations reflects the requirements of the Directive. However, it will be necessary to give statutory underpinning to the requirements of Articles 29 and 30 of the Directive. The Government would propose to do this by amending those parts of Schedule 10 of the Companies Act that set out the functions of the regulatory systems. It is the Government's intention to do this in a way that provides for maximum flexibility in the way the regulatory systems work, consistent with a proper implementation of the Directive.

3.26 The Government is considering, with the Professional Oversight Board and the Recognised Supervisory Bodies, whether any further marginal adjustments to the framework may be needed.

Auditor liability

3.27 Member States are not required to implement Article 31. Article 31 requires that the European Commission produce a report on the effect of current national provisions on auditor liability. The Commission has done so in the form of a public consultation document, which was published on 18 January 2007 and is available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/60&format=HTML&aged=0&language=EN&guiLanguage=en>

Cooperation between public oversight systems

3.28 Article 33 requires that the UK designate one entity responsible for ensuring co-operation with other Member States in respect of public

oversight activities. The Government proposes to designate the Professional Oversight Board.

Mutual recognition of regulatory arrangements

3.29 Article 34 sets out the requirements for mutual recognition of regulatory arrangements in other Member States and the principle of home-country regulation and oversight. The existing UK system, and the arrangements being put in place to implement this Directive will be in line with this Article, and no further specific provision is necessary.

Designation of competent authorities

3.30 Article 35 is the requirement to designate competent authorities for the various roles set out in the Directive. In the UK, the Professional Oversight Board is responsible for the effective operation of the overall oversight system, and for the quality assurance of larger audits; while the Recognised Supervisory Bodies are responsible for smaller audits, and for registration and qualifications of auditors. The Government plans to designate these bodies in respect of their existing roles.

Professional secrecy and regulatory cooperation

3.31 Under Article 36, UK competent authorities must be subject to a duty to fulfil the various obligations to co-operate with other Member States' competent authorities. The Government's approach to implementation of these provisions is not to seek to regulate all contacts with other Member States but to allow for the most pragmatic and efficient approach to co-operation between UK bodies and their counterparts elsewhere in the EU, while providing a legal framework as a fallback to ensure that this happens in line with the requirements of the Directive. The Government considers that the least burdensome approach would be to impose a duty on the Professional Oversight Board along with their delegation order. The Government does not propose to impose separately on Recognised Supervisory Bodies the duty to co-operate. Recognised Supervisory Bodies would be required to provide information to the Professional Oversight Board in support of the Professional Oversight Board's duty of co-operation. This can most simply be done by an amendment to Schedule 10 of the Companies Act. In this way, the Professional Oversight Board would generally be the main focus of co-operation between the UK and other member states, with the Recognised Supervisory Bodies providing information and support on any cases for which they have lead responsibility, and working directly with overseas bodies where this is the most pragmatic approach.

3.32 Under Article 36.2, there is a requirement to ensure the obligation of professional secrecy is imposed on the staff of competent authorities. The Government proposes to implement this by setting out restrictions on the

disclosure of information in a parallel way to that which is set out for the Financial Services Authority in sections 348 and 349 of the Financial Services and Markets Act 2000 or for the Takeover Panel in sections 948 and 949 of the Companies Act 2006. As this sort of prohibition protects the information, rather than binding a particular body, it would cover the requirement for all the competent authorities.

Q6 Do you have any comments on the Government's proposals for implementation of the requirements on public oversight, investigations and discipline?

Appointment and dismissal - Articles 37 and 38

Appointment of statutory auditors or audit firms

3.33 Under Article 37, the statutory auditor or audit firm must be appointed by the general meeting of shareholders or members of the audited entity. Member States may provide for alternative appointment methods provided that the independence of the auditors is not compromised. The Government considers that, in relation to companies, the requirements in Article 37 have been provided for fully in Part 16 of the Companies Act 2006. The requirements are also met in relation to building societies, friendly societies, and industrial and provident societies in the relevant UK legislation⁸.

Dismissal and resignation of statutory auditors or audit firms

3.34 Under Article 38, Member States are required to ensure that statutory auditors (whether individual or firms) shall only be dismissed where there are proper grounds. This provision relates to the need to provide protection of the independence of the auditor in, for example, the situation where they might come under undue pressure from company directors.

3.35 The present position in UK law, which will be unchanged by the Companies Act 2006, is that the auditor can be removed from office for any reason, but only by ordinary resolution (simple majority) at a meeting of shareholders. Provision is set out for that resolution in sections 510 and 511 of the Act. While this partly implements the Directive, it is not sufficient to implement Article 38.1, as there is no provision against dismissing the auditors without good reason. Sections 522 and 523 of the Companies Act 2006 provide for the requirement under Article 38.2 that both the company and the dismissed auditor inform the appropriate audit authority. The appropriate authority would be the Recognised Supervisory Body for the auditors of most companies, and the Professional Oversight Board (acting

⁸ The applicable legislation is the Building Societies Act 1986, the Friendly Societies Act 1992, and the Industrial and Provident Societies Acts 1965 to 2003.

under its powers delegated by the Secretary of State) in respect of the auditors of public interest entities.

3.36 In considering how best to implement the provision in Article 38.1, the Government is concerned to identify arrangements which are not unduly burdensome; which sit well with the existing structure of UK Company Law; do not constrain unduly the freedom of shareholders to dismiss an auditor where there is good reason to do so; and ensure the auditor's ability to protect the interests of minority shareholders.

3.37 The Government does not propose to go beyond the terms of the Directive, or to set out in an unduly prescriptive way, what may constitute improper grounds for the dismissal of auditors.

3.38 The Government has identified three options for enforcement:

➤ Option 1

Part 30 of the Companies Act 2006 already provides for any shareholder to seek a court order on the grounds that the company's affairs are being conducted in a way that is prejudicial to their interests. The application of this principle here could provide that the dismissal of auditors without proper grounds is unfair prejudice; shareholders could therefore make an application to the court; and the court could order the re-appointment of the original auditors, the appointment of new auditors, or any other remedy which it deemed appropriate.

➤ Option 2

Create a new prohibition: this could provide either (i) that the company may not dismiss an auditor without proper grounds (civil unlawfulness only) or (ii) that the company would commit an offence if it dismissed an auditor without proper grounds. The aggrieved shareholders could apply for a court order that the dismissal was void, or (under (ii)) the company and possibly directors in default could be prosecuted.

➤ Option 3

Under section 1248 of the Companies Act 2006, the Secretary of State has powers to require a second audit of a company where the appointed statutory auditor was either not qualified or not independent. We propose to continue to delegate these powers to the Professional Oversight Board, as is already the case under the Companies Act 1989. Regulations could be made to provide that a second audit may also be required where an auditor has been dismissed without proper grounds.

If this option were pursued, it might be necessary to provide a power for the Professional Oversight Board to require information from companies, shareholders or directors.

3.39 On balance, the Government's current preference is for Option 1. This would avoid the creation of a new offence and would use an existing system for enforcement. It would also allow the court to choose the most effective and appropriate remedy for the situation. Separate provision would need to be made for entities that are not companies. In the case of mutual entities, where option 1 is not feasible, the Government is considering what other options might be more appropriate for implementation of the provisions in Article 38.

Q7 Do you have any comments on the Government's proposed approach to defining improper grounds for auditors? Do you have any views on a more detailed and prescriptive approach than that proposed?

Q8 Which of the three options:

- Option 1: Use of the existing provision on unfair prejudice;**
- Option 2: Creating a new prohibition; or**
- Option 3: Use of the Secretary of State's powers to require a second audit**

do you think would be the best approach for enforcement of the provisions on the appointment and dismissal of auditors?

Q9 Do you have any other comments on the Government's proposals for implementation of the requirements on appointment and dismissal?

Public Interest Entities - Articles 39 to 43

3.40 Chapter 10 of the Directive (Articles 39 to 43) sets out special requirements for the statutory audits of Public Interest Entities. These are entities that are deemed to have a higher visibility and/or are economically more important, and it is considered that investors require a higher degree of protection when investing in these entities. The Directive therefore imposes stricter requirements on the statutory audit of their annual or consolidated accounts. The definition of public interest entities as applied by the Directive in Article 2.13 covers the following:

- Entities which have issued transferable securities admitted to trading on a regulated market governed by a Member State⁹;
- Credit institutions (i.e. banks and building societies)¹⁰; and
- Insurance undertakings, which may be companies, friendly societies or industrial and provident societies¹¹. This includes Lloyds¹².

3.41 The Directive allows Member States also to designate other entities as public interest entities if they are of significant public relevance because of the nature of their business, their size or the number of their employees. The Government does not propose to go further than the definition provided in Article 2.13 for the reasons set out in the next paragraph in relation to Article 39. The Government's view is that the requirements in the implementing legislation should not apply to foreign incorporated entities listed on UK regulated markets. Entities incorporated in other Member States will of course be subject to those states' requirements.

Application to non-listed public interest entities

3.42 Article 39 provides that Member States may, subject to certain conditions, exempt some types of public interest entity from one or more of the requirements in Chapter 10 of the Directive. Entities trading on regulated markets may not be exempted from the requirements of Chapter 10, except as provided for under Article 41.6 (see paragraph 3.43). The Government supported the approach in Article 39 during the negotiation of the Directive as it considered that this would provide the most appropriate balance between investor protection and the regulatory burden on business. Public interest entities that are not listed on regulated markets are known to attract more sophisticated investors, with a greater awareness of the level of risk related with these alternative markets. The Government therefore proposes to exempt from the all the requirements in Chapter 10 all entities that are not listed on regulated markets. This exemption will of course apply to mutuals that do not issue listed securities. It is expected that using the exemption will mean that the majority of mutual insurers and credit institutions are not caught by the provisions of Chapter 10. (However, the exemption is subject to the limitation imposed by Article 41.6(d) in relation to certain unlisted credit institutions, as discussed in paragraph 3.73 below.)

⁹ In the UK, "regulated markets", for the purposes of Directive 2004/39/EEC, are the six markets operated by the London Stock Exchange plc (including the LSE main market), the two markets operated by virt-x Exchange Ltd, one operated by EDX and one operated by Liffe Administration and Management. Under Article 16 of the Investment Services Directive (93/22), the FSA is responsible for maintaining the list of regulated markets for which it is the Home Member State.

¹⁰ Credit institutions as defined by Article 4.1 of Directive 2006/48/EC.

¹¹ Insurance undertakings as defined by Article 2.1 of Directive 1991/674/EC.

¹² The Government will consult with Lloyds to determine the most effective way to implement the relevant provisions of the Directive.

3.43 Article 41.6 provides for Member States to apply exemptions in specific circumstances. With the exception of the provision in 41.6(d), these exemptions are in addition to those provided in Article 39 and are relevant only to entities which have issued transferable securities admitted to trading on a regulated market governed by a Member State. The provisions in Article 41.6 are discussed in paragraphs 3.69 - 3.73.

Transparency Reports

3.44 Article 40 requires that audit firms who audit public interest entities publish annually on their websites the specified information about the operation of the firm. The Professional Oversight Board, to whom the Government proposes to delegate the power to enforce the requirement in Article 40, has consulted on the content of the transparency report, and intends to publish shortly the results of that exercise and its plans for the next stage.

Audit Committee

3.45 Under Article 41.1, Member States must require public interest entities to have an audit committee, which meets the compositional and functional requirements set out in Article 41.1 to 41.3.

3.46 The scope of the definition of public interest entities is explained in paragraphs 3.40 to 3.43. Certain classes of public interest entity may be exempted wholly or partly from the requirements of Article 41. The Government's proposed approach to these options is discussed in further detail in paragraphs 3.68 to 3.73. In addition, under Article 41.5 Member States may disapply the requirement to have such an audit committee, providing specified conditions are met.

3.47 Article 41.1 and 41.3 set out specific compositional requirements for audit committees. In particular, at least one member of the committee must be independent and have competence in accounting and/or auditing. In addition, Member States are required to determine whether such audit committees are to be composed solely of non-executives, and how they are to be appointed. Article 41.2 sets out specific functional requirements for audit committees (without prejudice to the responsibilities of others). These requirements are that the audit committee shall, inter alia:

- Monitor the financial reporting process;
- Monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- Monitor the statutory audit of the annual and consolidated accounts;

- Review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

3.48 Article 41.5 enables Member States to choose not to apply the compositional requirements for audit committees specified in Articles 41.1 to 41.3, to entities which have a body performing equivalent functions which is established and functions in accordance with national provisions. The Government proposes to take up this option. For the purposes of this provision, the relevant functions are those listed in Article 41.2. In such cases, the entity must disclose which body carries out these functions and how it is composed. The alternative body must obviously be composed in such a way as to enable it effectively to perform these functions and, in the Government's interpretation, this means it should in particular have within its composition sufficient independence and relevant expertise. However, the Government does not consider the Directive requires that the national provisions prescribe rules as to what would constitute such independence and expertise. Those are matters appropriate to be judged in the individual circumstances of the company and in relation to the nature and complexity of its business.

3.49 The Government is considering options for setting out the requirements in national provisions, and for ensuring adequate enforcement. In doing so we are seeking to provide the maximum flexibility available under the Directive for public interest entities to determine the composition of their audit committee, or other body performing equivalent functions, to help enable companies to establish arrangements which best suit the interests of their shareholders in the company's particular circumstances.

3.50 The Companies Act 2006 includes two powers which could be used for this purpose:

- section 1269 inserts section 890 into the Financial Services and Markets Act 2000, which enables the Financial Services Authority (FSA) to make rules relating to corporate governance in connection with the implementation of EU obligations;
- section 1273 enables the Secretary of State to make regulations for similar purposes.

3.51 The Combined Code on Corporate Governance, promulgated by the Financial Reporting Council (FRC), already contains provisions in relation to

audit committees¹³. These provisions are well established, regularly reviewed by the FRC in consultation with stakeholders, and form an important plank of the corporate governance framework in the UK.

3.52 The provisions in respect of audit committees under the Combined Code are more extensive and specific than the minimum requirements under Article 41.5. For example, they recommend that all members of the audit committee be independent directors, and that the committee undertake other functions in addition to those set out in the Directive. The Government's view is that it should therefore remain for companies to determine whether to comply with the specific recommendations of the Code in respect of audit committees. Equally, the Government considers that the provisions of the Combined Code as currently promulgated meet the requirements in respect of audit committees set out in Article 41.1 to 41.3.

3.53 The current FSA rules require listed companies to make disclosures in relation to their compliance with the provisions of the Code¹⁴. However, these disclosure requirements are not in themselves sufficient to implement the Directive, because the Listing Rules leave open the option of having in place no arrangements in relation to these matters at all, under the comply or explain approach.

➤ Option 1

3.54 One option for implementation would therefore be for the FSA to make rules to require companies either to:

- have an audit committee complying with the relevant provisions of the Combined Code; or
- have in place alternative arrangements meeting the minimum requirements for exemption under Article 41.5 (which would need to be defined in the rules), and provide an explanation of how they do so.

3.55 An alternative to referencing the Combined Code in this way, but still relying on FSA rules for implementation, would be to set out specific obligations under the rules reflecting the requirements on audit committees under Article 41.1 to 41.3, together with the alternative of explaining how any differing arrangements met the minimum requirements for exemption under Article 41.5.

¹³ A copy of the Combined Code is available from the FRC website at: <http://www.frc.org.uk/corporate/combinedcode.cfm>

¹⁴ A copy of the relevant listing rules are available from the FSA website at: <http://fsahandbook.info/fsa/html/handbook/LR/9/8>

3.56 The FSA is responsible for monitoring compliance with the Listing Rules and would therefore be responsible for monitoring substantive compliance with these new obligations: that is, monitoring of whether issuers actually comply with the obligations, as opposed simply to monitoring whether they disclose that they do comply. Such general monitoring of substantive compliance by issuers would be a departure for the FSA. It currently only monitors compliance with disclosure requirements in relation to the Combined Code, and the Listing Rules more generally. The FSA would apply its normal risk-based approach to monitoring compliance. Present FSA sanctions for failure to comply with the Listing Rules include fines and the added possibility of delisting companies that fail to comply with the listing rules.

3.57 Separate provision may need to be made for public interest issuers which do not have securities admitted to trading on a regulated market, in order to apply the requirements of Article 41. However, Article 39 provides Member States with the option to exempt the majority of such entities from these requirements altogether (see paragraph 3.40 above).

3.58 In addition, separate provision may need to be made either in the Listing Rules or in separate regulations to apply the requirements to debt issuers, as the current disclosure requirements in the Listing Rules in relation to the Combined Code apply only to UK companies which have a primary equity listing. However, Article 41.6 also provides an option for certain debt issuers to be exempted from the requirements of Article 41 (see paragraph 3.73 below).

➤ Option 2

3.59 Alternatives to the Financial Services and Markets Act rules approach would involve regulations made under section 1273 of the Companies Act 2006. Section 1273 enables regulations to be made by reference to any specified code on corporate governance that may be issued from time to time. Such regulations could introduce a requirement on public interest entity companies to include a new statement in the Directors' Report either:

- that the company has an audit committee complying with the relevant provisions of the Combined Code; or
- that the company has in place alternative arrangements meeting the minimum requirements for exemption under Article 41.5 and explaining how they do so.

3.60 Again, an alternative to referencing the Combined Code would be to set out specific obligations in the regulation reflecting the requirements on audit committees under Article 41.1 to 41.3. As with other mandatory elements of the Directors' Report, failure to include such a statement, or making a false statement, would be an offence. The Financial Reporting Review Panel has responsibility for reviewing Directors' Reports for compliance with relevant provisions of the Companies Act 1985. The Panel would consider the statement made in respect of a company's audit committee in accordance with its Operating Procedures. If the Financial Reporting Review Panel brought civil proceedings against a company for restatement of its directors report it would be open to the company to establish an audit committee or appropriate body so that it could make the required statement in the revised report. Separate provision would need to be made for listed entities which are not companies.

➤ Option 3

3.61 A third alternative approach would be to make regulations imposing obligations on companies and other entities separate from the requirements on contents of the Directors Report. Such regulations would set out a freestanding obligation on entities to have in place an audit committee, or alternative body, meeting the same minimum requirements as described for the other options above. Failure to meet this obligation would be an offence. Neither the Financial Services Authority nor the Financial Reporting Review Panel would have a role in the monitoring or enforcement of this obligation. Separate provision would need to be made for listed entities which are not companies.

➤ Option 4

3.62 An alternative option combining some elements of the various approaches described above would be to leave the listing rules relating to the Code as they currently stand as the basis for implementation of the requirements of the Directive, and to provide separately for the additional elements required¹⁵. This approach would avoid having to amend the listing rules provisions which provide the essential support for the Combined Code.

3.63 In relation to companies whose shares are listed, the additional elements required would be provisions, which could be achieved by regulations under the Companies Act 2006, to ensure:

¹⁵ Subject to the application of the exemptions provided in Chapter 10 of the Directive, it may be necessary to make additional provisions for those entities not bound by the FSA Listing Rules.

- that a company which is unable to make a statement under the listing rules that it has complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code in relation to the audit committee, has in place alternative arrangements meeting the minimum requirements for exemption under Article 41.5; and
- that the company explains how these arrangements do meet the requirements. This could be achieved by regulations under the Companies Act 2006.

3.64 Under this approach there would be no change to the requirements for companies complying with the provisions on audit committees in the Combined Code, or to the current role of the Financial Services Authority in connection with disclosures relating to the Combined Code required by the Listing Rules. Separate provision would need to be made for entities which are not companies.

Directive amending the to the Fourth and Seventh Company Law Directives: Annual Corporate Governance Statement

3.65 The Government is also consulting on options for implementing related provisions under Article 1.7 of European Directive 2006/46/EC, amending the Fourth, Seventh, Bank Accounts and Insurance Accounts Directives. This inserts a new requirement into the Fourth Directive requiring companies whose securities are admitted to trading on a regulated market to produce a corporate governance statement in their annual reports.

3.66 The annual corporate governance statement has to refer to the corporate governance code applied by the company and explain whether, and to what extent, the company complies with that code. It will also have to include a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process and information on:

- Certain matters related to the company's share and control structures (already required by the Takeovers Directive¹⁶);
- The composition and operation of the board of directors and its committees; and
- The general meeting and shareholder rights.

3.67 There is clearly scope for combining the implementation measures for these requirements with those for Article 41, in the interests of simplicity and clarity for business. The Government has been mindful of this in

¹⁶ EU Directive on Takeover Bids (2004/25/EC).

identifying the range of implementation options. The Government's separate consultation document on the implementation of the amending Directive can be found at <http://www.dti.gov.uk/consultations/index.html>

Exemptions

3.68 Article 41.1 enables Member States to make a specific but limited exception for public interest entities that are also small or medium sized companies¹⁷ from some of the requirements under Article 41 on the composition of audit committees. The Government is not proposing to take up this specific option, given that we are proposing to take up the wider exemption provided for in Article 41.5. The latter provision was added to the draft of the Directive at a relatively late stage in negotiations, whereas the specific exception for small or medium-sized entities was included in the text at an earlier stage before the wider exemption under Article 41.5 was available.

3.69 As noted above, Article 41.6 permits Member States to exempt certain classes of public interest entity from the obligation in Article 41.1 to have an audit committee. These entities are:

- (a) subsidiaries¹⁸ of groups that are already subject to the requirements of Article 41;
- (b) collective investment undertakings¹⁹;
- (c) issuers of asset backed-securities²⁰; and
- (d) credit institutions which issued only debt securities with a value of less than Euro 100 million and have not published a prospectus²¹.

The Government is not currently persuaded that imposing a requirement for these entities to have an audit committee would be a justifiable burden. Where applicable, we therefore propose to exempt these entities from the requirement to have an audit committee. The specific exemptions are discussed below.

3.70 Article 41.6(a) allows an exemption for public interest entities which are subsidiaries that are subject to the requirements in Article 41.1, if those requirements are also applicable at the group level. The Government invites views on whether this exemption should be applied.

¹⁷ As defined by Article 2.1(f) of the Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

¹⁸ As defined by Article 1 of the Seventh Company Law Directive concerning consolidated accounts of companies with limited liability (83/349/EC)

¹⁹ As defined by Article 1.2 of Directive 85/611/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

²⁰ As defined by Article 2.5 of Commission Regulation 809/2004/EC implementing Directive 2003/71/EC as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

²¹ Prospectus not published under the Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

3.71 Article 41.6(b) allows an exemption for all collective investment undertakings. The Government proposes to exempt these entities from the requirement to have an audit committee since the financial reporting and related risks are not comparable to those of other public interest entities and these entities already operate in a strictly defined regulatory environment and are subject to specific governance mechanisms such as controls exercised by their depositary.

3.72 Article 41.6(c) allows an exemption for public interest entities whose sole business is to act as issuer of asset backed securities, providing that they explain to the public their reasons for not having either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee. The Government proposes to exempt such entities on this basis, as the risks in such cases are different to those in relation to other public interest entities.

3.73 Article 41.6(d) allows an exemption for credit institutions whose shares are not admitted to trading on a regulated market of any Member State, subject to their only issuing debt securities, of a total nominal amount which remains below EUR 100,000,000, and without publishing a prospectus. The Government proposes to exempt such entities. Holders of debt are in a different position, as regards protections, from shareholders in public companies and the same rationale for minimum audit committee requirements do not apply.

Obligations on auditors

3.74 Article 41.4 requires Member States to ensure that statutory auditors and audit firms carrying out audits of public interest entities are under certain obligations in respect of matters they should report to audit committees. The Government considers that this requirement is covered by ISA 260 (UK and Ireland) and existing Auditing Practices Board ethical standards and proposes simply to give statutory underpinning to those standards by amending Schedule 10 to the Companies Act 2006, in line with the general approach described in paragraph 2.13.

Q10 Do you have any comments on the Government's proposal to exercise the option provided for in Article 41.5?

Q11 Do you have any preference between the four options identified?

Q12 Do you have any views on the option of referencing the Combined Code as described under any of these options, or the alternative of setting out specific requirements in rules/regulations?

Q13 Do you have any comments on the use of the specific exception for public interest entities which are also small or medium-sized companies?

Q14 Do you have any comments on the options to exempt certain classes of public interest entity under Article 41.6?

Q15 Do you have any other comments on the Government's approach?

Independence

3.75 Article 42.1 requires that the auditors of public interest entities make disclosure of various matters to the audit committee around their independence. Our current analysis is that the substance of these provisions is covered in the Auditing Practices Board's Ethical Standards for listed companies. On that basis, the Government proposes to amend Schedule 10 to the Companies Act to provide the statutory underpinning needed for implementation of this requirement, as proposed for the implementation of Article 41.4.

3.76 The requirement in Article 42.2 requires that key audit partners responsible for carrying out a statutory audit of public interest entities rotate from the audit engagement within a maximum period of seven years, and that they only be allowed to take up the engagement again after a period of at least two years. This requirement is based on the EU definition of "key audit partner" and would therefore bind those auditors referred to in UK Ethical Standards as "key audit partners" as well as "audit engagement partners." Ethical standards in the UK currently set a period of five years for the audit engagement partner and seven years for the key audit partner.

3.77 The Government proposes to implement the requirement under Article 42.2 - that the standard must insist on rotation within a maximum period of up to seven years - by giving statutory underpinning to the existing ethical standard through amendment of Schedule 10 to the Companies Act 2006.

Prohibition on auditors taking up management positions

3.78 Under Article 42.3, the statutory auditor or the key audit partner who carries out the audit on behalf of the firm may not take up a key management position in the audited entity before a period of at least two years has elapsed since they resigned from the audit engagement. This will require additional provision to implement. There are two questions about the way this prohibition could work; the first is exactly who the provision would be applicable to, and which positions they would be barred from

taking up; the second concerns the way in which the prohibition would be enforced.

3.79 The Government proposes to bar key audit partners from taking up a position as a director of an entity they have audited, for a period of two years after they have ceased to be auditor. In the UK, the definition of the term “key audit partner” includes those currently described as audit engagement partners and key audit partners.

3.80 There are two options for the enforcement of the provision under Article 42.3:

➤ Option 1

A Companies Act offence that would be committed by the former key audit partner were they to take up a directorship of the audited entity. Offences could be prosecuted by the DTI. If this were the preferred option, the Government would consider any additional provisions needed for entities that are not companies.

➤ Option 2

Provision could be made (in Schedule 10) that the Recognised Supervisory Bodies are required to have rules to this effect. These could then be enforced under the usual disciplinary procedures. There would also be the question of how this would be enforced in the case where an auditor might resign their membership of the Recognised Supervisory Body. This option would be feasible for all types of entity.

Q16 Which of the two options:

Option 1: A new offence created under the Companies Act; or

Option 2: Provision in the rules of the Recognised Supervisory Bodies’ rules

do you think would be the better approach for the enforcement of the prohibition on auditors taking up management positions? Do you have any other comments on the Government’s approach to this prohibition?

Quality assurance

3.81 Article 43 requires those audit firms who audit public interest entities to be subject to more frequent quality assurance inspections than those

who do not. We propose to implement this by a provision in Schedule 10 of the Companies Act 2006, alongside the statutory underpinning needed for Article 29.

Third Country Auditors - Articles 45 to 46

3.82 This part of the Directive introduces new requirements applicable to the auditors of companies incorporated outside the European Union whose securities are admitted to trading on an EU regulated market. (These auditors are described as third country auditors below.)

3.83 These provisions on third country issuers and on their auditors are particularly important from the UK perspective because of the large and growing number of non-EU listings in London, and because for the first time these companies will be required to engage auditors who meet some EU regulatory requirements.

3.84 The rationale underlying the requirements is that auditors should be subject to an equivalent minimum level of regulation, regardless of whether the issuer is incorporated within or outside the EU. The Directive therefore requires the imposition of the UK audit regulatory regime on third country auditors, unless they are subject to regulatory systems in their home country which are assessed as equivalent to those applied in the EU, in respect of quality assurance, public oversight, and discipline.

3.85 The determination of equivalence is to be made by the Commission under comitology in the first instance. Once equivalence is established, subject to reciprocity, Member States may disapply their own regulatory systems. The Commission can also allow transitional arrangements for auditors from third countries where regulatory systems are being developed. The Government, and the Financial Reporting Council through the European Group of Audit Oversight Bodies (referred to in paragraph 3.20), is working with the Commission and Member States on the development of policy under these provisions.

3.86 The Commission issued a consultation document on its approach to the provisions relating to third country auditors on 11 January 2007. A copy of the consultation, which closes on 5 March 2007, can be found at http://ec.europa.eu/internal_market/auditing/relations/index_en.htm

3.87 The basic framework for the implementation of these provisions in the UK is provided in SS1241-1247 of Companies Act 2006. The Government proposes to delegate to the Professional Oversight Board the duty of approving auditors, maintaining the register and, where necessary,

applying elements of the UK regulatory system. The Government also proposes to delegate to the Professional Oversight Board the power in s1242(4) to disapply the requirements to certain groups of auditors, although the Government intends to retain the power to act concurrently in this respect. This will allow, subject to reciprocity, the Professional Oversight Board not to regulate auditors from countries that have been deemed to have an equivalent regulatory system.

3.88 Article 45.4 requires Member States to ensure that annual accounts signed by unregistered third country auditors should have no legal effect. The Government proposes this requirement should be implemented by an amendment of the Financial Services Authority's listing rules so that they require entities covered by these provisions to have an audit report signed by an auditor who is registered with the Professional Oversight Board as a third country auditor or a statutory auditor in a EU member state.

Q17 Do you have any comments on the Government's approach to the implementation of the provisions for third country auditors?

Co-operation with third country authorities - Article 47

3.89 Article 47 requires control of the passing of audit papers to the authorities of non-EU countries. We have no such restriction in the UK so, in order to implement the Directive, we will need to impose new restrictions with appropriate exemptions for the circumstances in which the Directive provides for information to be transferred.

3.90 The Directive provides that transfers can generally only take place:

- From one competent authority to another;
- Where the papers relate to a company which is part of a group issuing accounts in the third country or which issues securities there;
- Where the competent authorities regulate the audit profession in a way which meets requirements broadly similar to those required in the EU. This is to be determined by the Commission by comitology.
- Where there are reciprocal working arrangements between the competent authorities for the transfer of papers; and
- Where the transfer of personal data is in line with the EU's Data Protection Directive.

3.91 As a derogation from these arrangements, the article permits (paragraph 4) Member States to allow the direct transfer of papers from an audit firm to third country authorities in exceptional cases. The Commission may, by comitology, define what those circumstances may be.

3.92 The Government's view is that implementation therefore requires:

- a) A prohibition on auditors passing papers to third country authorities except via the UK competent authority, or as allowed under Article 47.4; and
- b) A duty on the UK competent authority (which will be the Professional Oversight Board) only to do so in line with the conditions set out in the Directive.

3.93 The Government proposes to impose such a duty on the Professional Oversight Board. With regards to the prohibition applying to auditors, we have identified the following options:

➤ Option 1

A new offence created under Companies Act 2006. This would allow for a prosecution or a civil action;

➤ Option 2

A requirement on the Recognised Supervisory Bodies to have appropriate rules to bind their members, which would mean that any breaches could be dealt with under the normal professional disciplinary system; or

➤ Option 3

Regulations providing for any such transfer to be unlawful. This would mean that an aggrieved party could pursue the auditor for damages in the civil courts.

3.94 The Government has not yet come to a firm view on which of these options is to be preferred and comments are invited.

3.95 A number of issues also arise in the definition of the extent of the prohibition:

- Article 47.4 provides an option for Member States to permit direct transfer of audit working papers from audit firms to 3rd country authorities in certain circumstances: the Government's current view is that the implementing arrangements in the UK should provide for this flexibility. We are considering how best to frame this within national provisions.

- The definition of a third country “competent authority”: the obvious approach would be to restrict the scope to those authorities that have a parallel role to those in the UK which oversee the audit profession. The Government proposes to restrict the definition to those third country authorities that have responsibility for regulation of the audit profession.

3.96 Article 47.1 provides little flexibility on the definition of the papers covered: the provision clearly applies to all audit working papers and other documents relating to the audit. The Government therefore proposes to cast the implementing regulations in similar terms.

Q18 Which of the three options:

Option 1: A new offence created under the Companies Act;

**Option 2: Provision in the Recognised Supervisory Bodies’ rules;
or**

**Option 3: Regulations providing for any such transfer to be
unlawful**

**do you think is the best approach to implementing the prohibition
applying to auditors?**

**Q19 Do you have any other comments on the Government’s proposed
approach to the prohibition?**

Article 49 – Disclosure of auditor remuneration

3.97 The effect of this article, which provides for amendments to the Fourth and Seventh Company Law Directives, is to make requirements on the disclosure of auditor remuneration. Existing provision in UK law is made in the Companies (Disclosure of Auditor Remuneration) Regulations 2005.

3.98 Article 49.1(a) requires entities falling within the scope of the 4th Directive (public or private companies limited by shares or guarantee, partnerships, limited partnerships or unlimited companies) to specify separately in the notes to the annual accounts the fees paid to the statutory auditor for:

- the statutory audit
- other assurance services
- tax advice
- all other services

This need not be applied to subsidiaries, where they are included within the consolidated accounts of the group and the appropriate information is given in the notes to those accounts.

3.99 As small companies are not caught by the EU's statutory audit regime, Article 49.1(b) allows Member States to disapply the requirement for small companies. Article 49.1(c) allows Member States to disapply it for medium companies, provided the information can be provided on request to the public oversight system. Article 49.2 requires an equivalent disclosure in group accounts.

3.100 The provisions of the existing UK regulations largely comply with the Directive, although some amendment will be necessary in respect of small and medium companies. At present in the UK, medium sized companies, as well as those small companies who have an audit,²² must all declare their audit fees in the annual accounts. The Government would propose to maintain this requirement, and amend the regulations so that medium-sized companies must supply the additional information on non-audit services in response to a request from the Professional Oversight Board. The alternative approach would be to apply this requirement in respect of non-audit services additionally to those small companies who have an audit. Although this would maintain the approach of treating medium-sized and (audited) small companies in a similar way, it would go beyond the requirements of the Directive, and the Government is not minded to take this course.

3.101 The thresholds for small and medium companies are those set out in the accountancy directives, and in part 15 of the Companies Act 2006. The question of whether to take up the option of raising the thresholds defining small and medium companies is discussed in the parallel consultation on the implementation of the latest amendments to the Fourth and Seventh Company Law Directives. This consultation document can be found at <http://www.dti.gov.uk/consultations/index.html>

Q20 Do you agree with the Government's proposed approach to implementing Article 49?

RESPONSES

3.102 Please send all responses by 1 June 2007. Details of how to respond are set out in paragraph 1.14 of the Executive Summary.

²² The UK audit exemption works differently to that in EU legislation. Under EU legislation, all small companies are exempt, where a small company is defined as one which meets two out of the following three conditions: balance sheet less than 4.4 million Euros; turnover less than 8.8 million euros; fewer employees than 50. In the UK, conditions on turnover and balance sheet must BOTH be met.

3.103 Any supporting evidence that you are able to supply would be particularly helpful in the development of our implementation decisions. Comments also requested on costs and benefits, particularly as between the options identified, for the Regulatory Impact Assessment (a draft assessment is attached at Annex A).

Thank you for participating in this consultation.

UPDATED DRAFT REGULATORY IMPACT ASSESSMENT

THE EUROPEAN DIRECTIVE ON THE STATUTORY AUDIT OF ANNUAL AND CONSOLIDATED ACCOUNTS (2006/43/EC)

Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

1 Background

1.1 On 16 March 2004 the European Commission presented a proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual and Consolidated Accounts.

1.2 On publication of the proposal the Commission omitted to prepare and publish a cost impact assessment. In the absence of this assessment, the Department of Trade and Industry (DTI) produced a partial impact assessment that was attached to its consultation document of 10 September 2004. After consideration of the responses to that consultation the Department published an updated regulatory impact assessment (RIA) that can be found at: www.dti.gov.uk/files/file22807.pdf

1.3 After consideration by the European Parliament, the European Commission and Member States, political agreement was reached on the Directive. This was published by the Commission on 9 June 2006. The full text of the Directive can be found at: www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52004PC0177:EN:HTML

1.4 Background information on the Directive can be found in the consultation document (paragraphs 2.3 to 2.7).

The current UK framework

1.5 Following the recommendations of the Co-ordinating Group on Audit and Accounting Issues, the Government made a number of changes to audit and accounting regulation. Many of these changes were implemented by the Companies (Audit, Investigations and Community Enterprise) Act 2004.

1.6 In addition, the Companies Act 2006 sets out provisions (in parts 16 and 42) for the audit of companies and those carrying out statutory audit. These Parts include restatements and modification of earlier company law and some of the new provisions contained in this Directive. Part 42 provides that auditors of banks, building societies and insurers are also subject to the statutory auditor regime. This UK regime therefore covers all statutory audits within the scope of the Directive.

1.7 The effect of this is that the UK framework for statutory audit already meets a significant number of the requirements of the Directive. However, not all Member States are as far advanced. As recent financial scandals have shown, confidence is a European, not just UK, concern. A harmonised approach is therefore desirable.

Impact of the Directive

1.8 In assessing the impact of the Directive, the Department has considered the extent to which it differs from the measures that have been introduced by the UK Government. The Directive is one of a number of EU measures aimed at creating an efficient and harmonised EU capital market. These include:

- (a) The adoption of International Accounting Standards (Regulation EC1606/2002);
- (b) The Directive on Market Abuse (Directive 2003/71/EC on Insider Dealing and Market Manipulation);
- (c) The Prospectus Directive (Directive 2003/71/EC on the Prospectus to be published when securities are offered to the public or admitted to trading);
- (d) Amendments to the 4th Company Law Directive 78/660/EEC of 25 July 1978 (Annual Accounts of certain types of companies) and the 7th Company Law Directive 83/349/EEC of 13 June 1983 (on consolidated accounts);
- (e) Directive 86/635/EEC on the Annual Accounts and Consolidated Accounts of Banks and other financial institutions; and
- (f) The Insurance Accounting Directive 91/674/EEC on the Annual Accounts and Consolidated Accounts of Insurance undertakings.

2 Scope of the Directive

2.1 The Directive's requirements affect the statutory audit of the following entities:

- Companies required to produce annual accounts under the Fourth Company Law Directive (78/660/EEC);
- Companies required to produce annual and consolidated accounts under the Seventh Company Law Directive (83/349/EEC);
- Banks and other financial institutions required to produce annual and consolidated accounts under Council Directive 86/635/EEC;
- Insurance undertakings required to produce annual and consolidated accounts under Council Directive 91/674/EEC.

2.2 Chapter 10 of the Directive (Articles 39 to 43) sets additional requirements for companies who are defined, in the Directive, as public interest entities²³. Whilst it is an option in the Directive, the Government does not intend to specify any other entities as ‘public interest entities’ for the purposes of Chapter 10 of the Directive. The Government proposes, as set out in the discussion of them in Chapter 3 of the consultation document accompanying this draft RIA, to apply most if not all of the exemptions provided in Articles 39 and 41. This would narrow the scope of the requirements in Chapter 10 largely to those entities that are listed on the London Stock Exchange’s main market.

2.3 There are around 1,100²⁴ companies registered in the UK whose shares are traded on the London Stock Exchange’s main market. These companies cover a diverse range of sectors and operate in a variety of EU and non-EU competitive environments. The following table provides an indication of the scope of the provisions applying to those companies:

Companies covered by the Government’s proposed implementation of Chapter 10 of the Directive

UK registered companies trading on the LSE (SEAQ and SETS)*			
	By turnover (in millions)	By assets (in millions)	By no. of employees
Smallest company	£0.002	£0.013	1
Largest company	£152,618	£683,573	402,375
Average size	£1,358	£4,568	9491
Median size	£170	£138	1240

*Information from FAME database, 2004 figures. Data does not include stocks from the Alternative Investment Market.

²³ ‘Public Interest Entities’ are currently defined as entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC, credit institutions within the meaning of Article 1(1) of European Parliament and Council Directive 2000/12/EC and insurance undertakings as defined in Article 2 of Council Directive 1991/674/EEC. The UK may also designate other entities as public interest entities, for instance entities that are of significant public relevance because of the nature of their business, their size or their number of employees).

²⁴ LSE Main Market statistics, August 2006: 1,161 companies registered in the UK. FAME database, August 2006: 1,066 companies registered in England, Scotland and Wales.

2.4 There are an additional 300 overseas companies²⁵ with a total market capitalisation of £2000 billion.

2.5 Small companies make up around 20%²⁶ of the companies coming into the scope of this part of the Directive. We do not consider that the Directive's requirements will add a disproportionate burden upon them, as they would already be expected to meet UK requirements associated with their listing.

3 Small Firms Impact Test

3.1 The Audit Directive applies to those entities that are already subject to statutory audits under the requirements of existing Community law. Under the 4th and 7th Company Law Directives, small companies are exempt from the requirement to have a statutory audit. In the UK companies that qualify as 'small'²⁷ and meet the turnover and balance sheet thresholds can be exempt and will not, therefore, be subject to the requirements of the Audit Directive.

3.2 There are, however, some exceptions to this exemption. For example, public companies cannot qualify as small. Where a small company is considered, under the definition in Article 2.13 of the Directive, to be a Public Interest Entity, it may also be subject to the requirements in Chapter 10 of the Directive.

3.3 Some small companies, which are not required by law to have their accounts audited nonetheless elect to do so because they see economic benefits in doing so.

3.4 European Directive 2006/46/EC, published on 16 August 2006, amends the 4th, 7th, Bank Accounts and Insurance Accounts Directives. The Directive must be implemented by 5 September 2008. The Department is consulting separately on the implementation of this Directive including on the question of whether to take up the option of raising the thresholds defining small and medium companies. A consultation document can be found at: <http://www.dti.gov.uk/consultations/index.html>

4 Risk Assessment

4.1 This Directive seeks to reduce the risk of future corporate scandals such as those at Worldcom, Enron and Parmalat and the subsequent

²⁵ LSE Main Market statistics, August 2006.

²⁶ FAME database, August 2006.

²⁷ In the UK small companies are defined as: a balance sheet total of up to £2.8 million; and/or an annual turnover of up to £5.6 million

collapse of Andersens, by setting out provisions to ensure regulation of and transparency in the statutory audit function. The Directive aims to establish minimum levels of investor protection across the EU. Whilst these measures cannot guarantee the prevention of another financial scandal, they will further mitigate the risks of such corporate malpractice occurring in the future.

4.2 It is difficult to quantify the risk of poor investor confidence across Europe and globally. Companies involved in corporate scandals lose significant market value and are often forced to restructure, with consequent job losses. It has been estimated that the loss in stock market wealth in the US, as a result of the Enron and Worldcom scandals, has been at least 9% or 0.36% of Gross Domestic Product (GDP) - \$38.2 billion in the first year.²⁸

5 Options

5.1 The attached consultation document notes a number of provisions in respect of which the Government identifies that there are choices to be made as to the way in which the requirements of the Directive are to be implemented. These options fall into two categories:

- Optional exemptions as provided for in Articles 39, 41 and 46; or
- Alternative mechanisms for implementing, as identified in relation to Articles 21 to 25, and 37 to 49.

5.2 Recognising these choices, we have identified three broad alternative options for implementation:

Option 1

Do nothing to implement the Directive, continuing with the current UK regime, which already reflects many but not all of the provisions in the Directive;

Option 2

Implement the Directive by building on the existing UK framework and adopting the implementing options as proposed in the attached consultation document; or

²⁸ See Graham, Carol/Litan, Robert/Sukhtankar, Sandip (2002) 'The bigger they are, the harder they fall: an estimate of the costs of the crisis in corporate governance.'

Option 3

Implement the Directive by building on the existing UK framework but adopting some or all of the alternative implementing options identified in the attached consultation document.

6. Cost-Benefit Analysis

OPTION 1 – Do nothing to implement the Directive, continuing with the current UK regime, which already reflects many but not all of the provisions in the Directive

6.1 As identified in the revised draft RIA published in February 2005, it is not feasible to 'do nothing further' as the UK Government is under a legal obligation to implement this Directive. Whilst there will be no implementation costs associated with this option there will be potential costs for the UK economy. These include:

- (a) Lack of confidence in UK's capital markets;
- (b) Potential increased costs for investors associated with different regimes and the need for 'greater due diligence checks';
- (c) Potential increased costs for UK business in dealing with different auditing regulatory regimes and standards across the EU; and
- (d) Potential disadvantages for UK auditors seeking business in other Member States.
- (e) Risk of infraction proceedings brought against the UK Government by the Commission.

OPTION 2 – Implement the Directive by building on the existing UK framework and taking advantage of the flexibilities provided in the Directive, where these are considered to be the preferred policy choice

6.2 The aim of the Directive is to raise the standard of, and public confidence in, the audit function across the European Internal Market. Greater confidence should reduce investor costs and have a favourable impact on the cost of capital. It should also restore faith in corporate reporting systems that underpin capital markets.

6.3 Attached at Appendix A is a table identifying the estimated costs of implementing the Directive by means of Option 2. This table is based on our current analysis and on the figures supplied by stakeholders in response to the Government's earlier consultation on the draft Directive, which can be found using the link in paragraph 1.2 above. The main costs are:

- Updating the current register of auditors to include additional information (Article 15);
- Submission of a dismissal notice in cases where the auditor has been dismissed (Article 38);
- Publication of a transparency report by audit firms who perform the statutory audit of public interest entities (Article 40);
- Supply of information by Third country auditors to the oversight body required under Articles 45 and 46;
- Changes required to ensure that proper systems are in place to meet requirements on the cooperation between third country competent authorities (Article 47); and
- Provisions for Public Interest Entities to have audit committees or bodies performing equivalent functions.

6.4 The Directive provides optional exemptions from some requirements and allows flexibility in the approach adopted by Member States in the implementation of others. The Government's objective is to maintain the benefits of the existing UK framework whilst avoiding unnecessary costs in implementing the additional requirements in the Directive. **Option Two represents the Government's current assessment of the best means of implementation within these flexibilities and is, therefore, the Government's preferred option.**

OPTION 3 – Implement the Directive without taking up optional exemptions and/or through a less efficient and more complex means of implementation

6.5 This option is similar to option 2 except that we would not seek to use as many of the flexibilities provided for in the Directive and identified in the consultation document and would adopt some or all of the alternatives to the preferred options identified. On the basis of our current assessment of the issues to date, we have not identified significant overall cost differentials between options 2 and 3. The choice between them is, therefore, primarily policy based and will depend on what is likely to be the most appropriate balance of protections and regulations, and the most efficient and least complex means of implementation. However, respondents are invited to submit further information on potential cost differentials between the various options.

7 Business Sectors Affected

7.1 This Directive will affect all companies and financial institutions, such as banks and Insurance undertakings, which are required to have a

statutory audit. There are additional requirements on companies classified as public interest entities and for public interest entities' audit firms. This Directive will affect statutory auditors, audit firms and their Recognised Supervisory Bodies. There are also some new requirements for the Financial Reporting Council.

7.2 The Financial Reporting Council is funded by the Government, companies (via listing fees) and the accountancy profession. For Recognised Supervisory Bodies, costs will be met on a cost recovery basis via increases in membership fees and, therefore, falls on auditors and audit firms.

8 Issues of Equity and Fairness

8.1 The Government considers that the measures introduced by the Directive will not bring disproportionate benefits or have a disproportionate effect on particular groups.

9 Competition Assessment

9.1 The Directive's requirements will affect all accountancy companies, which carry out statutory audits, all medium sized and public interest entity companies and financial institutions, such as bank and insurance undertakings. It is not anticipated that the Directive will: affect any of these businesses more than others; affect market structure; change the number or size of those businesses; lead to higher start-up costs for those businesses; or lead to higher on-going costs.

10 Consultation

10.1 The Government is committed to working closely with UK stakeholders during the consultation process to ensure the effective implementation of the provisions in the Directive to ensure that each element of the Directive brings economic benefits that justify legislation. The DTI will endeavour to ensure that the final implementation proposal offers business flexibility that keep burdens to a minimum.

10.2 The DTI published a consultation document on the proposed Directive on 10 September 2004. The report on the responses received and an updated RIA, published in February 2005, can be found at the link identified in paragraph 1.2 above. Prior to publication of this consultation document, the Department held meetings with a range of stakeholder

representatives. Since then, we have continued to maintain regular contact with our key stakeholders for assistance in developing the proposals in the attached consultation document and to gain informal feedback on the practical impact of these proposals. We will continue to work with stakeholders throughout the implementation process.

Department of Trade and Industry
March 2007

BREAKDOWN OF COSTS

The following table shows the best estimate of costs, based on responses to the Government's consultation during negotiation of the Directive and updated in places with additional data from stakeholders relating specifically to the implementation proposals set out in this consultation. The Department would be grateful for any further information on costs from respondents to this consultation.

Article	Subject Matter	Cost	Comment
3,4 and 5	Auditor Approval	No additional cost	The Directive's requirements will not impose any additional cost.
6, 7, 8, 9, 10, 11, 12 and 13	Auditor Education	No additional cost	The Directive's requirements will not impose any additional cost.
14	Approval of Auditors from other Member States	No additional cost	The Directive's requirements will not impose any additional cost.
15, 16, 17, 18, 19 and 20	Public Register	Up to £4.5 million as one off policy cost.	There will be costs associated with obtaining and storing information that is not currently held on the public register and making the information available electronically. These costs will, however, be offset against savings relating to stakeholders' search costs (see note 1 below).
21 to 24	Ethics, Independence and Confidentiality	No additional cost	The Directive's requirements will not impose any additional cost. Any future proposals from the Commission for comitology provisions might have cost

			implications (see note 2 below).
25	Auditor Fees	No additional costs	The Directive's requirements will not impose any additional cost.
26	Standards	No additional costs	The UK has already adopted International Standards on Auditing.
27	Consolidated Accounts	No additional costs	The Directive's requirements will not impose any additional cost. (see note 3 below).
28	Audit Reporting	Up to £10,000 cost per annum (split between policy and admin costs).	The changes required to the current UK system should largely be cost neutral. The figure of £10,000 per annum represents the cost of exemptions (see note 4 below).
29 and 43	Quality Assurance	No additional costs	The Directive's requirements will not impose any additional cost. (see note 5 below).
30	Investigations	No additional costs	The Directive's requirements will not impose any additional cost.
32	Public Oversight	No additional costs	The Financial Reporting Council (FRC), Professional Oversight Board (POB) took the oversight of statutory auditors from April 2005.
33, 34, 35 and 36	Co-operation between oversight systems	Up to £30,000 per annum in policy costs	There are likely to be increased costs for the POB (see note 6 below).
37	Auditor Appointment	No Additional costs	The Directive's requirements will not impose any additional cost.
38	Dismissal and Resignation	Up to £215,000 administrative cost per annum	Instances of auditor dismissal will be notified to the POB. The figure of £215,000 per annum covers the preparation and

			transmission of dismissal letters (see note 7 below).
40	Transparency Report	Up to £1 million per annum in administration costs	The requirement for published annual transparency reports are likely to apply in the UK to only a small number of audit firms, 30 or 40 at most. Many of these already prepare annual reports and the additional costs for those firms are likely to be low. Firms within this requirement that do not at present prepare an annual report will have more significant costs – see note 8.
41 and 42(1)	Audit Committees	Up to £14.2 million policy cost per annum	The figure of £14.2 million relates to changes required to companies' audit committees. Not all UK public interest entities currently have an audit committee. In addition, not all audit committees currently have an independent member. As the pool of potential independent members is relatively small the cost of hiring will likely rise (see note 9 below).
40(2) and (3)	Auditor Rotation/Auditor 'cooling off	No additional costs	The Directive's requirements will not impose any additional cost.
44, 45 and 46	International Provisions	Under Article 46, up to £2 million to set-up and £1 million on-going costs. Third country auditor	Responsibility for the approval of third country auditors under Article 45 is proposed to be delegated to the POB. Responsibility for the assessment of the equivalence of third countries' systems of oversight, quality

		registration £650 administration cost per instance.	assurance, investigations and sanctions under article 46 falls to the Commission and to the POB (see note 10 below). The costs comprise the following elements: <ul style="list-style-type: none"> • Costs of inspecting non-EU audit firms (costs would be passed to non-EU auditors and thus to issuers); • Costs of setting up a system of registration of third country audit firms; and • Costs to the audit firms of registering and of any inspection (e.g. management time).
47	Co-operation between third countries	Possibly £100,000 per annum of administration cost (based on 50 cases per annum)	The figures relate to cost of transferring information between competent authorities. The 'on going' costs will depend on the number of requests (see note 11 below).
49	Disclosure	No additional costs	The Directive's requirements will not impose any additional cost.

Notes:

1. There are approximately 9000 audit firms. Additional information will be required from those firms to allow for the recognised supervisory bodies (ICAEW, ICAS, ICAI, ACCA and AIA) to comply with the public register requirements. Audit firms are already expected to complete annual returns with respect to the register. Based on information provided by the POB we do not now consider that the costs identified in the report on responses to the consultation on negotiation are accurate. We consider the costs on audit

firms will be substantially lower. The cost of updating and implementing the register are estimated as follows:

5 supervisory bodies (at £150,000 each*)
= £750,000

Top 12 audit firms (50 hours each for completion of annual return at £200 per hour) = £120,000

8986 Firms at average of £400 (2 hours for annual return completion at £200 per hour) = £3.6 million

(* This cost is based on the amount incurred to update a similar computer system by a supervisory body).

Once the register has been updated to include the additional information the directive requires we do not consider that there will be any further cost on auditors or audit firms to ensure that information is accurate as that requirement already exists.

2. The Directive allows audit firms to provide non-audit services to audit clients in accordance with the existing UK 'threats and safeguards approach'. The implementation of the requirement should, therefore, have no cost impact and it is important to emphasise that costs would only occur if the Commission decided, under comitology provisions, to set restrictions on the provision of non audit services.

Costs would depend on the restrictions imposed but would be likely to result from efficiency losses. For example, excluding the auditor from the provision of some non-audit services would add cost since it is more efficient for some services to be provided by the auditor who already knows the business. Excluding the auditor may also decrease the choice of non-audit service providers for the company.

One estimate from audit firms puts costs at £30 million and is based on the following assumptions:

- (a) Large companies are audited by large audit firms which would – if a ban was introduced - separate their audit and non audit services teams;
- (b) Businesses would not incur new costs following the separation of their audit and non audit service providers;

- (c) The separation of audit and non audit service providers would cost, on average, £3000 per business; and
- (d) Some 95,000 businesses are required by law to have a statutory audit and could, therefore, be affected by a more restrictive approach.

This figure is at odds with the figure provided by the Recognised Supervisory Bodies. They estimate a one off cost of up to £100 million. This divergence demonstrates the difficulties in assessing potential additional costs in this area.

The Government considers that this range of estimates is very high and that a more restrictive approach under comitology would be an issue only for the largest firms and audits of listed companies. Though there may be some one-off costs for larger audit firms, the Government considers that most costs would result from the loss of efficiency savings resulting from the on-going separation of services.

3. Although we do not envisage any additional costs, it is possible there could be additional activity for the Professional Oversight Board associated with reviewing the work of overseas subsidiaries. Any costs would depend on factors, such as: (a) the decision when to carry out the review; (b) the location of the subsidiary; (c) the ability for documentation to be transferred electronically, or in hard copy.

4. The Directive provides exemptions from disclosure where the requirements would give rise to imminent and significant threats to an auditor's personal security. Utilising the exemption, while probably unusual, would have associated costs. We have estimated that these will be £1000 per instance. This exemption was one identified by the Audit Profession and those entities affected. This exemption imposes in part a policy and administrative cost (we estimate the admin cost is £200 per instance). However, it will provide for companies to appoint an auditor where otherwise it might be impossible.

5. No significant changes to the UK system are envisaged.

6. The POB will be responsible for co-ordinating requests (under Article 34) from other Member States authorities. There are likely to be increased costs for the POB if, as expected, these provisions result in significantly greater coordination and cooperation between and amongst Oversight Bodies within the EU. It is difficult to put a figure on this but it might be of the order of £30,000 a year.

7. The Directive will require companies to notify the POB when they dismiss their auditors. (This is currently not a requirement under UK

company law but will be upon enactment of provisions in the 2006 Companies Act). Our cost estimate is based on the number of dismissals and resignations during the years 1990 to 1999. During this period, on average, 2138 firms were dismissed each year. Assuming each dismissal and resignation notification costs some £100 the per annum cost of the new requirement will be £213,800. Whilst this is an administrative cost it will provide for greater transparency into the reasons why a company dismisses auditors. We consider that this transparency will allow investors to make informed choices.

8. Costs based on up to 20 firms having to prepare a report for the first time at an estimated cost of £50,000 per firm. The POB will have responsibility for ensuring that auditors and audit firms comply with the new requirement. Its costs have not been included.

9. Based on data from the London Stock Exchange there are 1461 listed companies. Whilst all of the FTSE 100 companies currently have an audit committee only 80% of the FTSE 350 have a committee. Of the remaining listed companies we estimate that around 80% currently either do not have an audit committee or have an audit committee that does not meet the Directive's requirements. We also estimate that the cost to a company of hiring an independent member will be some £15,000 per annum.

10. The Companies Act 2006 makes provision for POB costs of assessments under Article 45 to be charged to third country auditors. Costs will depend on the number of applications dealt with under Article 45, which in turn will be influenced by the Commission's assessment under Article 46.

The scale of costs depends on a range of factors, in particular (i) the extent to which we can disapply the Article 45 regime using the exemptions under Article 46 (the Commission is consulting in this area); (ii) the numbers and geographical spread of third country issuers with securities traded on UK regulated markets, and the number of third country auditors (POB estimates 600 issuers and 200 audit firms in 50 countries); and (iii) how we apply any system in practice.

The POB estimate costs of setting up a registration system and carrying out an inspection programme, assuming equivalence for only a relatively small number of countries under Article 46, to be £1.5 to £2 million in the set-up phase and £1 million in steady state. At the other extreme, assuming equivalence for all, the cost would be almost zero.

In the draft RIA published with the Government's report on responses to the consultation document on the negotiation on the Commission's proposal

we estimated that third country auditors costs would be £650 per instance. As identified above, the assessment of how many third country auditors will be required to register is dependent upon the application of the provisions in Article 46.

11. As the implementation of this article is likely to involve increased restriction on audit firms passing papers to third country authorities, it is unlikely to result in increased costs to business. It may, however, result in increased cooperation and transfer of papers between regulatory authorities. It is extremely difficult to estimate the costs which may result from this provision. However, we would expect the number of such cases to be relatively small. If there were 50 cases a year, with an average cost of transferring information of £2000, we estimate an annual cost of £100,000.

We do not expect that this will involve the setting up of expensive IT systems but we welcome views on this.

SUMMARY OF CONSULTATION QUESTIONS

Questions relating to education and qualifications (Articles 3 to 14, and 44)

- Q1 Do you have any comments on the Government's proposals for implementation of the requirements on education and qualifications?

Questions relating to registration (Articles 15 to 20)

- Q2 Do you have any comments on when the revisions to the UK auditor register should come into effect?
- Q3 Do you have any other comments on the Government's proposals for implementation of the register requirements?

Questions relating to ethics (Articles 21 to 25)

- Q4 Do you have any comments on the Government's proposals for implementation of the requirements on ethics?

Questions relating to standards and reporting (Articles 26 to 28)

- Q5 Do you have any comments on the Government's proposals for implementation of the requirements on standards and reporting?

Questions relating to public oversight, investigations and discipline (Articles 29 to 36)

- Q6 Do you have any comments on the Government's proposals for implementation of the requirements on public oversight, investigations and discipline?

Questions relating to the provisions for appointment and dismissal (Articles 37 and 38)

- Q7 Do you have any comments on the Government's proposed approach to defining improper grounds for auditors? Do you have any views on a more detailed and prescriptive approach than that proposed?

Q8 Which of the three options:

Option 1: Use of the existing provision on unfair prejudice;

Option 2: Creating a new prohibition; or

Option 3: Use of the Secretary of State's powers to require a second audit

do you think would be the best approach for enforcement of the provisions on the appointment and dismissal of auditors?

Q9 Do you have any other comments on the Government's proposals for implementation of the requirements on appointment and dismissal?

Questions relating to public interest entities (Articles 39 to 43)

Q10 Do you have any comments on the Government's proposal to exercise the option provided for in Article 41.5?

Q11 Do you have any preference between the four options identified?

Q12 Do you have any views on the option of referencing the Combined Code as described under any of these options, or the alternative of setting out specific requirements in rules/regulations?

Q13 Do you have any comments on the use of the specific exception for public interest entities which are also small or medium-sized companies?

Q14 Do you have any comments on the options to exempt certain classes of public interest entity under Article 41.6?

Q15 Do you have any other comments on the Government's approach?

Q16 Which of the two options:

Option 1: New offence created under the Companies Act; or

Option 2: Provision in the rules of the Recognised Supervisory Bodies' rules

do you think would be the better approach for the enforcement of the prohibition on auditors taking up management positions? Do you

have any other comments on the Government's approach to this prohibition?

Questions relating to third country auditors (Articles 45 to 46)

Q17 Do you have any comments on the Government's approach to the implementation of the provisions for third country auditors?

Questions relating to co-operation with third country authorities (Article 47)

Q18 Which of the three options:

Option 1: A new offence created under the Companies Act;

Option 2: Provision in the Recognised Supervisory Bodies' rules; or

Option 3: Regulations providing for any such transfer to be unlawful

do you think is the best approach to implementing the prohibition applying to auditors?

Q19 Do you have any other comments on the Government's proposed approach to the prohibition?

Questions relating to the disclosure of auditor remuneration (Article 49)

Q20 Do you agree with the Government's proposed approach to implementing Article 49?

Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 44(2)(g) thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Economic and Social Committee [1],

Acting in accordance with the procedure laid down in Article 251 of the Treaty [2],

Whereas:

(1) Currently, the Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies [3], the Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts [4], Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions [5] and Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings [6] require that the annual accounts or consolidated accounts be audited by one or more persons entitled to carry out such audits.

(2) The conditions for the approval of persons responsible for carrying out the statutory audit were laid down in the Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents [7].

(3) The lack of a harmonised approach to statutory auditing in the Community was the reason why the Commission proposed, in its 1998 Communication on the statutory audit in the European Union: the way forward [8], the creation of a Committee on Auditing which could develop further action in close cooperation with the accounting profession and Member States.

(4) On the basis of the work of that Committee, on 15 November 2000 the Commission issued a Recommendation on quality assurance for the

statutory audit in the European Union: minimum requirements [9] and on 16 May 2002 a Recommendation on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles [10].

(5) This Directive aims at high-level — though not full — harmonisation of statutory audit requirements. A Member State requiring statutory audit may impose more stringent requirements, unless otherwise provided for by this Directive.

(6) Audit qualifications obtained by statutory auditors on the basis of this Directive should be considered equivalent. It should therefore no longer be possible for Member States to insist that a majority of the voting rights in an audit firm must be held by locally approved auditors or that a majority of the members of the administrative or management body of an audit firm must be locally approved.

(7) The statutory audit requires adequate knowledge of matters such as company law, fiscal law and social law. Such knowledge should be tested before a statutory auditor from another Member State can be approved.

(8) In order to protect third parties, all approved auditors and audit firms should be entered in a register which is accessible to the public and which contains basic information concerning statutory auditors and audit firms.

(9) Statutory auditors should adhere to the highest ethical standards. They should therefore be subject to professional ethics, covering at least their public-interest function, their integrity and objectivity and their professional competence and due care. The public-interest function of statutory auditors means that a broader community of people and institutions rely on the quality of a statutory auditor's work. Good audit quality contributes to the orderly functioning of markets by enhancing the integrity and efficiency of financial statements. The Commission may adopt implementing measures on professional ethics as minimum standards. When doing so, it might consider the principles contained in the International Federation of Accountants (IFAC) Code of Ethics.

(10) It is important that statutory auditors and audit firms respect the privacy of their clients. They should therefore be bound by strict rules on confidentiality and professional secrecy which, however, should not impede proper enforcement of this Directive. Those confidentiality rules should also apply to any statutory auditor or audit firm which has ceased to be involved in a specific audit task.

(11) Statutory auditors and audit firms should be independent when carrying out statutory audits. They may inform the audited entity of matters

arising from the audit, but should abstain from the internal decision processes of the audited entity. If they find themselves in a situation where the significance of the threats to their independence, even after application of safeguards to mitigate those threats, is too high, they should resign or abstain from the audit engagement. The conclusion that there is a relationship which compromises the auditor's independence may be different as regards the relationship between the auditor and the audited entity from that in respect of the relationship between the network and the audited entity. Where a cooperative within the meaning of Article 2(14), or a similar entity as referred to in Article 45 of Directive 86/635/EEC, is required or permitted under national provisions to be a member of a non-profit-making auditing entity, an objective, reasonable and informed party would not conclude that the membership-based relationship compromises the statutory auditor's independence, provided that when such an auditing entity is conducting a statutory audit of one of its members, the principles of independence are applied to the auditors carrying out the audit and those persons who may be in a position to exert influence on the statutory audit. Examples of threats to the independence of a statutory auditor or audit firm are a direct or indirect financial interest in the audited entity and the provision of additional non-audit services. Also, the level of fees received from one audited entity and/or the structure of the fees can threaten the independence of a statutory auditor or audit firm. Types of safeguards to be applied to mitigate or eliminate those threats include prohibitions, restrictions, other policies and procedures, and disclosure. Statutory auditors and audit firms should refuse to undertake any additional non-audit service that compromises their independence. The Commission may adopt implementing measures on independence as minimum standards. In doing so, the Commission might take into consideration the principles contained in the abovementioned Recommendation of 16 May 2002. In order to determine the independence of auditors, the concept of a "network" in which auditors operate needs to be clear. In this regard, various circumstances have to be taken into account, such as instances where a structure could be defined as a network because it is aimed at profit- or cost-sharing. The criteria for demonstrating that there is a network should be judged and weighed on the basis of all factual circumstances available, such as whether there are common usual clients.

(12) In cases of self-review or self-interest, where appropriate to safeguard the statutory auditor's or audit firm's independence, it should be for the Member State rather than the statutory auditor or the audit firm to decide whether the statutory auditor or audit firm should resign or abstain from an audit engagement with regard to its audit clients. However, this should not lead to a situation where Member States have a general duty to prevent statutory auditors or audit firms from providing non-audit services to their audit clients. For the purposes of determining whether it is

appropriate, in cases of self-interest or self-review, that a statutory auditor or audit firm should not carry out statutory audits, so as to safeguard the statutory auditor's or audit firm's independence, the factors to be taken into account should include the question whether or not the audited public-interest entity has issued transferable securities admitted to trading on a regulated market within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments [11].

(13) It is important to ensure consistently high quality in all statutory audits required by Community law. All statutory audits should therefore be carried out on the basis of international auditing standards. Measures implementing those standards in the Community should be adopted in accordance with Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission [12]. A technical committee or group on auditing should assist the Commission in the assessment of the technical soundness of all the international auditing standards, and should also involve the system of public oversight bodies of the Member States. In order to achieve a maximum degree of harmonisation, Member States should be allowed to impose additional national audit procedures or requirements only if these stem from specific national legal requirements relating to the scope of the statutory audit of annual or consolidated accounts, meaning that those requirements have not been covered by the adopted international auditing standards. Member States could maintain those additional audit procedures until the audit procedures or requirements have been covered by subsequently adopted international auditing standards. If, however, the adopted international auditing standards contain audit procedures the performance of which would create a specific legal conflict with national law stemming from specific national requirements related to the scope of the statutory audit, Member States may carve out the conflicting part of the international auditing standard as long as those conflicts exist, provided the measures referred to in Article 26(3) are applied. Any addition or carving out by Member States should add a high level of credibility to the annual accounts of companies and be conducive to the public good. The above implies that Member States may, for example, require an additional auditor's report to the supervisory board or prescribe other reporting and audit requirements based on national corporate governance rules.

(14) For the Commission to adopt an international auditing standard for application in the Community, it must be generally accepted internationally and have been developed with full participation of all interested parties following an open and transparent procedure, add to the credibility and quality of annual accounts and consolidated accounts and be conducive to the European public good. The need for the adoption of an International

Auditing Practice Statement as part of a standard should be assessed in accordance with Decision 1999/468/EC on a case-by-case basis. The Commission should ensure that before the start of the adoption process a review is conducted in order to verify whether those requirements have been met and report to members of the Committee set up under this Directive on the outcome of the review.

(15) In the case of consolidated accounts, it is important that there be a clear definition of responsibilities as between the statutory auditors who audit components of the group. For this purpose, the group auditor should bear full responsibility for the audit report.

(16) In order to increase comparability between companies applying the same accounting standards, and to enhance public confidence in the audit function, the Commission may adopt a common audit report for the audit of annual accounts or consolidated accounts prepared on the basis of approved international accounting standards, unless an appropriate standard for such a report has been adopted at Community level.

(17) Regular inspections are a good means of achieving a consistently high quality in statutory audits. Statutory auditors and audit firms should therefore be subject to a system of quality assurance that is organised in a manner which is independent from the reviewed statutory auditors and audit firms. For the application of Article 29 on quality assurance systems, Member States may decide that if individual auditors have a common quality assurance policy, only the requirements for audit firms need to be considered. Member States may organise the system of quality assurance in such a manner that each individual auditor is to be subject to a quality assurance review at least every six years. In this respect, the funding for the quality assurance system should be free from undue influence. The Commission should have the competence to adopt implementing measures in matters relevant to the organisation of quality assurance systems, and in respect of its funding, in cases where public confidence in the quality assurance system is seriously compromised. The public oversight systems of Member States should be encouraged to find a coordinated approach to the carrying-out of quality assurance reviews with a view to avoiding the imposition of unnecessary burdens on the parties concerned.

(18) Investigations and appropriate penalties help to prevent and correct inadequate execution of a statutory audit.

(19) Statutory auditors and audit firms are responsible for carrying out their work with due care and thus should be liable for the financial damage caused by a lack of the care owed. However, the auditors' and audit firms' ability to obtain professional indemnity insurance cover may be affected by

whether they are subject to unlimited financial liability. For its part, the Commission intends examining these issues, taking into account the fact that liability regimes of the Member States may vary considerably.

(20) Member States should organise an effective system of public oversight for statutory auditors and audit firms on the basis of home country control. The regulatory arrangements for public oversight should make possible effective cooperation at Community level in respect of the Member States' oversight activities. The public oversight system should be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. These non-practitioners may be specialists who have never been linked with the audit profession or former practitioners who have left the profession. Member States may, however, allow a minority of practitioners to be involved in the governance of the public oversight system. Competent authorities of Member States should cooperate with each other whenever necessary for the purpose of carrying out their oversight duties on statutory auditors or audit firms approved by them. Such cooperation can make an important contribution to ensuring consistently high quality in the statutory audit in the Community. Since it is necessary to ensure effective cooperation and coordination at European level among competent authorities designated by Member States, the designation of one entity, responsible for ensuring cooperation, should be without prejudice to the ability of each single authority to cooperate directly with the other competent authorities of the Member States.

(21) In order to ensure compliance with Article 32(3) on principles of public oversight, a non-practitioner is deemed to be knowledgeable in the areas relevant to the statutory audit either because of his or her past professional skill or, alternatively, because he or she has knowledge of at least one of the subjects listed in Article 8.

(22) The statutory auditor or audit firm should be appointed by the general meeting of shareholders or members of the audited entity. In order to protect the independence of the auditor it is important that dismissal should be possible only where there are proper grounds and if those grounds are communicated to the authority or authorities responsible for public oversight.

(23) Since public-interest entities have a higher visibility and are economically more important, stricter requirements should apply in the case of a statutory audit of their annual or consolidated accounts.

(24) Audit committees and an effective internal control system help to minimise financial, operational and compliance risks, and enhance the quality of financial reporting. Member States might have regard to the

Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board [13], which sets out how audit committees should be established and function. Member States may determine that the functions assigned to the audit committee or a body performing equivalent functions may be performed by the administrative or supervisory body as a whole. With regard to the duties of the audit committee under Article 41, the statutory auditor or audit firm should in no way be subordinated to the committee.

(25) Member States may also decide to exempt public-interest entities which are collective investment undertakings whose transferable securities are admitted to trading on a regulated market from the requirement to have an audit committee. This option takes into account the fact that where a collective investment undertaking functions merely for the purpose of pooling assets, the employment of an audit committee will not always be appropriate. The financial reporting and related risks are not comparable to those of other public-interest entities. In addition, undertakings for collective investment in transferable securities (UCITS) and their management companies operate in a strictly defined regulatory environment and are subject to specific governance mechanisms such as controls exercised by their depositary. For those collective investment undertakings which are not harmonised by Directive 85/611/EEC [14] but are subject to equivalent safeguards as provided for by that Directive, Member States should, in this particular case, be allowed to provide for equal treatment with Community-harmonised collective investment undertakings.

(26) In order to reinforce the independence of auditors of public-interest entities, the key audit partner(s) auditing such entities should rotate. To organise such rotation, Member States should require a change of key audit partner(s) dealing with an audited entity, while allowing the audit firm with which the key audit partner(s) is/are associated to continue being the statutory auditor of such entity. Where a Member State considers it appropriate in order to attain the objectives pursued, that Member State might, alternatively, require a change of audit firm, without prejudice to Article 42(2).

(27) The interrelation of capital markets underlines the need also to ensure high-quality work performed by auditors from third countries in relation to the Community capital market. The auditors concerned should therefore be registered so as to make them subject to quality assurance reviews and to the system of investigations and penalties. Derogations on the basis of reciprocity should be possible subject to an equivalence testing to be performed by the Commission in cooperation with Member States. In any case, an entity which has issued transferable securities on a regulated

market within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC should always be audited by an auditor either registered in a Member State or overseen by competent authorities of the third country from which the auditor comes from, provided that the said third country is acknowledged by the Commission or a Member State as meeting the requirements equivalent to Community requirements in the field of principles of oversight, quality assurance systems and systems of investigations and penalties, and that the basis of this arrangement is reciprocity. While one Member State may consider a third country's quality assurance system equivalent, other Member States should not be bound to accept that assessment, nor should the Commission's decision be pre-empted thereby.

(28) The complexity of international group audits requires good cooperation between the competent authorities of Member States and those of third countries. Member States should therefore ensure that competent authorities of third countries can have access to audit working papers and other documents through the national competent authorities. In order to protect the rights of the parties concerned and at the same time facilitate access to those papers and documents, Member States should be allowed to grant direct access to the competent authorities of third countries, subject to the agreement of the national competent authority. One of the relevant criteria for the granting of access is whether the competent authorities in third countries meet requirements which the Commission has declared adequate. Pending such a decision by the Commission, and without prejudice thereto, Member States may assess whether the requirements are adequate.

(29) Disclosure of information as referred to in Articles 36 and 47 should be in accordance with the rules on the transfer of personal data to third countries as laid down in Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data [15].

(30) The measures necessary for the implementation of this Directive should be adopted in accordance with Decision 1999/468/EC and with due regard to the declaration made by the Commission in the European Parliament on 5 February 2002 concerning the implementation of financial services legislation.

(31) The European Parliament should be given a period of three months from the first transmission of draft amendments and implementing measures to allow it to examine them and to give its opinion. However, in urgent and duly justified cases, it should be possible to shorten that period.

If, within that period, a resolution is adopted by the European Parliament, the Commission should re-examine the draft amendments or measures.

(32) Since the objectives of this Directive — namely requiring the application of a single set of international auditing standards, the updating of the educational requirements, the definition of professional ethics and the technical implementation of the cooperation between competent authorities of Member States and between those authorities and the authorities of third countries, in order further to enhance and harmonise the quality of statutory audit in the Community and to facilitate cooperation between Member States and with third countries so as to strengthen confidence in the statutory audit — cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and effects of this Directive, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve those objectives.

(33) With a view to rendering the relationship between the statutory auditor or audit firm and the audited entity more transparent, Directives 78/660/EEC and 83/349/EEC should be amended so as to require disclosure of the audit fee and the fee paid for non-audit services in the notes to the annual accounts and the consolidated accounts.

(34) Directive 84/253/EEC should be repealed because it lacks a comprehensive set of rules to ensure an appropriate audit infrastructure, such as public oversight, disciplinary systems and systems of quality assurance, and because it does not provide specifically for regulatory cooperation between Member States and third countries. In order to ensure legal certainty, there is a clear need to indicate that statutory auditors and audit firms that have been approved under Directive 84/253/EEC are considered as approved under this Directive,

HAVE ADOPTED THIS DIRECTIVE:

CHAPTER I SUBJECT MATTER AND DEFINITIONS

Article 1 Subject matter

This Directive establishes rules concerning the statutory audit of annual and consolidated accounts.

Article 2 Definitions

For the purpose of this Directive, the following definitions shall apply:

1. "statutory audit" means an audit of annual accounts or consolidated accounts insofar as required by Community law;
2. "statutory auditor" means a natural person who is approved in accordance with this Directive by the competent authorities of a Member State to carry out statutory audits;
3. "audit firm" means a legal person or any other entity, regardless of its legal form, that is approved in accordance with this Directive by the competent authorities of a Member State to carry out statutory audits;
4. "third-country audit entity" means an entity, regardless of its legal form, which carries out audits of the annual or consolidated accounts of a company incorporated in a third country;
5. "third-country auditor" means a natural person who carries out audits of the annual or consolidated accounts of a company incorporated in a third country;
6. "group auditor" means the statutory auditor(s) or audit firm(s) carrying out the statutory audit of consolidated accounts;
7. "network" means the larger structure:
 - which is aimed at cooperation and to which a statutory auditor or an audit firm belongs, and
 - which is clearly aimed at profit- or cost-sharing or shares common ownership, control or management, common quality-control policies and procedures, a common business strategy, the use of a common brand-name or a significant part of professional resources;
8. "affiliate of an audit firm" means any undertaking, regardless of its legal form, which is connected to an audit firm by means of common ownership, control or management;
9. "audit report" means the report referred to in Article 51a of Directive 78/660/EEC and Article 37 of Directive 83/349/EEC issued by the statutory auditor or audit firm;

10. “competent authorities” means the authorities or bodies designated by law that are in charge of the regulation and/or oversight of statutory auditors and audit firms or of specific aspects thereof; the reference to “competent authority” in a specific article means a reference to the authority or body(ies) responsible for the functions referred to in that Article;

11. “international auditing standards” means International Standards on Auditing (ISA) and related Statements and Standards, insofar as relevant to the statutory audit;

12. “international accounting standards” means International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), subsequent amendments to those standards and related interpretations, and future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB);

13. “public-interest entities” means entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC, credit institutions as defined in point 1 of Article 1 of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions [16] and insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC. Member States may also designate other entities as public-interest entities, for instance entities that are of significant public relevance because of the nature of their business, their size or the number of their employees;

14. “cooperative” means a European Cooperative Society as defined in Article 1 of Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE) [17], or any other cooperative for which a statutory audit is required under Community law, such as credit institutions as defined in point 1 of Article 1 of Directive 2000/12/EC and insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC;

15. “non-practitioner” means any natural person who, for at least three years before his or her involvement in the governance of the public oversight system, has not carried out statutory audits, has not held voting rights in an audit firm, has not been a member of the administrative or management body of an audit firm and has not been employed by, or otherwise associated with, an audit firm;

16. "key audit partner(s)" mean(s):
- (a) the statutory auditor(s) designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on behalf of the audit firm; or
 - (b) in the case of a group audit, at least the statutory auditor(s) designated by an audit firm as being primarily responsible for carrying out the statutory audit at the level of the group and the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries; or
 - (c) the statutory auditor(s) who sign(s) the audit report.

CHAPTER II APPROVAL, CONTINUING EDUCATION AND MUTUAL RECOGNITION

Article 3 Approval of statutory auditors and audit firms

1. A statutory audit shall be carried out only by statutory auditors or audit firms which are approved by the Member State requiring the statutory audit.
2. Each Member State shall designate competent authorities which shall be responsible for approving statutory auditors and audit firms. The competent authorities may be professional associations, provided that they are subject to a system of public oversight as provided for in Chapter VIII.
3. Without prejudice to Article 11, the competent authorities of the Member States may approve as statutory auditors only natural persons who satisfy at least the conditions laid down in Articles 4 and 6 to 10.
4. The competent authorities of the Member States may approve as audit firms only those entities which satisfy the following conditions:
 - (a) the natural persons who carry out statutory audits on behalf of an audit firm must satisfy at least the conditions imposed by Articles 4 and 6 to 12 and must be approved as statutory auditors in the Member State concerned;
 - (b) a majority of the voting rights in an entity must be held by audit firms which are approved in any Member State or by natural persons who satisfy at least the conditions imposed by Articles 4 and 6 to 12. Member States may provide that such natural persons must also have been approved in another Member State. For the purpose of the statutory audit of cooperatives and similar entities as referred to in Article 45 of Directive

86/635/EEC, Member States may establish other specific provisions in relation to voting rights;

(c) a majority — up to a maximum of 75 % — of the members of the administrative or management body of the entity must be audit firms which are approved in any Member State or natural persons who satisfy at least the conditions imposed by Articles 4 and 6 to 12. Member States may provide that such natural persons must also have been approved in another Member State. Where such a body has no more than two members, one of those members must satisfy at least the conditions in this point;

(d) the firm must satisfy the condition imposed by Article 4. Member States may set additional conditions only in relation to point ©. Such conditions shall be proportionate to the objectives pursued and shall not go beyond what is strictly necessary.

Article 4 Good repute

The competent authorities of a Member State may grant approval only to natural persons or firms of good repute.

Article 5 Withdrawal of approval

1. Approval of a statutory auditor or an audit firm shall be withdrawn if the good repute of that person or firm has been seriously compromised. Member States may, however, provide for a reasonable period of time for the purpose of meeting the requirements of good repute.

2. Approval of an audit firm shall be withdrawn if any of the conditions imposed in Article 3(4), points (b) and (c) is no longer fulfilled. Member States may, however, provide for a reasonable period of time for the purpose of fulfilling those conditions.

3. Where the approval of a statutory auditor or of an audit firm is withdrawn for any reason, the competent authority of the Member State where the approval is withdrawn shall communicate that fact and the reasons for the withdrawal to the relevant competent authorities of Member States where the statutory auditor or audit firm is also approved which are entered in the first-named Member State's register in accordance with Article 16(1), point (c).

Article 6
Educational qualifications

Without prejudice to Article 11, a natural person may be approved to carry out a statutory audit only after having attained university entrance or equivalent level, then completed a course of theoretical instruction, undergone practical training and passed an examination of professional competence of university final or equivalent examination level, organised or recognised by the Member State concerned.

Article 7
Examination of professional competence

The examination of professional competence referred to in Article 6 shall guarantee the necessary level of theoretical knowledge of subjects relevant to statutory audit and the ability to apply such knowledge in practice. Part at least of that examination shall be written.

Article 8
Test of theoretical knowledge

1. The test of theoretical knowledge included in the examination shall cover the following subjects in particular:

- (a) general accounting theory and principles;
- (b) legal requirements and standards relating to the preparation of annual and consolidated accounts;
- (c) international accounting standards;
- (d) financial analysis;
- (e) cost and management accounting;
- (f) risk management and internal control;
- (g) auditing and professional skills;
- (h) legal requirements and professional standards relating to statutory audit and statutory auditors;
- (i) international auditing standards;
- (j) professional ethics and independence.

2. It shall also cover at least the following subjects insofar as they are relevant to auditing:

- (a) company law and corporate governance;
- (b) the law of insolvency and similar procedures;
- (c) tax law;
- (d) civil and commercial law;
- (e) social security law and employment law;
- (f) information technology and computer systems;

- (g) business, general and financial economics;
- (h) mathematics and statistics;
- (i) basic principles of the financial management of undertakings.

3. The Commission may, in accordance with the procedure referred to in Article 48(2), adapt the list of subjects to be included in the test of theoretical knowledge referred to in paragraph 1. When adopting those implementing measures the Commission shall take into account developments in auditing and the audit profession.

Article 9 Exemptions

1. By way of derogation from Articles 7 and 8, a Member State may provide that a person who has passed a university or equivalent examination or holds a university degree or equivalent qualification in one or more of the subjects referred to in Article 8 may be exempted from the test of theoretical knowledge in the subjects covered by that examination or degree.

2. By way of derogation from Article 7, a Member State may provide that a holder of a university degree or equivalent qualification in one or more of the subjects referred to in Article 8 may be exempted from the test of the ability to apply in practice his or her theoretical knowledge of such subjects if he or she has received practical training in those subjects attested by an examination or diploma recognised by the State.

Article 10 Practical training

1. In order to ensure the ability to apply theoretical knowledge in practice, a test of which is included in the examination, a trainee shall complete a minimum of three years' practical training in, inter alia, the auditing of annual accounts, consolidated accounts or similar financial statements. At least two thirds of such practical training shall be completed with a statutory auditor or audit firm approved in any Member State.

2. Member States shall ensure that all training is carried out with persons providing adequate guarantees regarding their ability to provide practical training.

Article 11
Qualification through long-term practical experience

A Member State may approve a person who does not satisfy the conditions laid down in Article 6 as a statutory auditor, if he or she can show either:

(a) that he or she has, for 15 years, engaged in professional activities which have enabled him or her to acquire sufficient experience in the fields of finance, law and accountancy, and has passed the examination of professional competence referred to in Article 7, or

(b) that he or she has, for seven years, engaged in professional activities in those fields and has, in addition, undergone the practical training referred to in Article 10 and passed the examination of professional competence referred to in Article 7.

Article 12
Combination of practical training and theoretical instruction

1. Member States may provide that periods of theoretical instruction in the fields referred to in Article 8 shall count towards the periods of professional activity referred to in Article 11, provided that such instruction is attested by an examination recognised by the State. Such instruction shall not last less than one year, nor may it reduce the period of professional activity by more than four years.

2. The period of professional activity and practical training shall not be shorter than the course of theoretical instruction together with the practical training required in Article 10.

Article 13
Continuing education

Member States shall ensure that statutory auditors are required to take part in appropriate programmes of continuing education in order to maintain their theoretical knowledge, professional skills and values at a sufficiently high level, and that failure to respect the continuing education requirements is subject to appropriate penalties as referred to in Article 30.

Article 14
Approval of statutory auditors from other Member States

The competent authorities of the Member States shall establish procedures for the approval of statutory auditors who have been approved in other Member States. Those procedures shall not go beyond a requirement to

pass an aptitude test in accordance with Article 4 of Council Directive 89/48/EEC of 21 December 1988 on a general system for the recognition of higher-education diplomas awarded on completion of professional education and training of at least three years' duration [18]. The aptitude test, which shall be conducted in one of the languages permitted by the language rules applicable in the Member State concerned, shall cover only the statutory auditor's adequate knowledge of the laws and regulations of that Member State in so far as relevant to statutory audits.

CHAPTER III REGISTRATION

Article 15 Public register

1. Each Member State shall ensure that statutory auditors and audit firms are entered in a public register in accordance with Articles 16 and 17. In exceptional circumstances, Member States may disapply the requirements laid down in this Article and Article 16 regarding disclosure only to the extent necessary to mitigate an imminent and significant threat to the personal security of any person.
2. Member States shall ensure that each statutory auditor and audit firm is identified in the public register by an individual number. Registration information shall be stored in the register in electronic form and shall be electronically accessible to the public.
3. The public register shall also contain the name and address of the competent authorities responsible for approval as referred to in Article 3, for quality assurance as referred to in Article 29, for investigations and penalties on statutory auditors and audit firms as referred to in Article 30, and for public oversight as referred to in Article 32.
4. Member States shall ensure that the public register is fully operational by 29 June 2009.

Article 16 Registration of statutory auditors

1. As regards statutory auditors, the public register shall contain at least the following information:
 - (a) name, address and registration number;

(b) if applicable, the name, address, website address and registration number of the audit firm(s) by which the statutory auditor is employed, or with whom he or she is associated as a partner or otherwise;
(c) all other registration(s) as statutory auditor with the competent authorities of other Member States and as auditor with third countries, including the name(s) of the registration authority(ies), and, if applicable, the registration number(s).

2. Third-country auditors registered in accordance with Article 45 shall be clearly indicated in the register as such and not as statutory auditors.

Article 17 Registration of audit firms

1. As regards audit firms, the public register shall contain at least the following information:

- (a) name, address and registration number;
- (b) legal form;
- (c) contact information, the primary contact person and, where applicable, the website address;
- (d) address of each office in the Member State;
- (e) name and registration number of all statutory auditors employed by or associated as partners or otherwise with the audit firm;
- (f) names and business addresses of all owners and shareholders;
- (g) names and business addresses of all members of the administrative or management body;
- (h) if applicable, the membership of a network and a list of the names and addresses of member firms and affiliates or an indication of the place where such information is publicly available;
- (i) all other registration(s) as audit firm with the competent authorities of other Member States and as audit entity with third countries, including the name(s) of the registration authority(ies), and, if applicable, the registration number(s).

2. Third-country audit entities registered in accordance with Article 45 shall be clearly indicated in the register as such and not as audit firms.

Article 18 Updating of registration information

Member States shall ensure that statutory auditors and audit firms notify the competent authorities in charge of the public register without undue delay of any change of information contained in the public register. The register shall be updated without undue delay after notification.

Article 19
Responsibility for registration information

The information provided to the relevant competent authorities in accordance with Articles 16, 17 and 18 shall be signed by the statutory auditor or audit firm. Where the competent authority provides for the information to be made available electronically, that can, for example, be done by means of an electronic signature as defined in point 1 of Article 2 of Directive 1999/93/EC of the European Parliament and of the Council of 13 December 1999 on a Community framework for electronic signatures [19].

Article 20
Language

1. The information entered in the public register shall be drawn up in one of the languages permitted by the language rules applicable in the Member State concerned.
2. Member States may additionally allow the information to be entered in the public register in any other official language(s) of the Community. Member States may require the translation of the information to be certified.

In all cases, the Member State concerned shall ensure that the register indicates whether or not the translation is certified.

CHAPTER IV
PROFESSIONAL ETHICS, INDEPENDENCE, OBJECTIVITY,
CONFIDENTIALITY AND PROFESSIONAL SECRECY

Article 21
Professional ethics

1. Member States shall ensure that all statutory auditors and audit firms are subject to principles of professional ethics, covering at least their public-interest function, their integrity and objectivity and their professional competence and due care.
2. In order to ensure confidence in the audit function and to ensure uniform application of paragraph 1 of this Article, the Commission may, in accordance with the procedure referred to in Article 48(2), adopt principle-based implementing measures governing professional ethics.

Article 22

Independence and objectivity

1. Member States shall ensure that when carrying out a statutory audit, the statutory auditor and/or the audit firm is independent of the audited entity and is not involved in the decision-taking of the audited entity.
2. Member States shall ensure that a statutory auditor or an audit firm shall not carry out a statutory audit if there is any direct or indirect financial, business, employment or other relationship — including the provision of additional non-audit services — between the statutory auditor, audit firm or network and the audited entity from which an objective, reasonable and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised. If the statutory auditor's or audit firm's independence is affected by threats, such as self-review, self-interest, advocacy, familiarity or trust or intimidation, the statutory auditor or audit firm must apply safeguards in order to mitigate those threats. If the significance of the threats compared to the safeguards applied is such that his, her or its independence is compromised, the statutory auditor or audit firm shall not carry out the statutory audit.

Member States shall in addition ensure that, where statutory audits of public-interest entities are concerned and where appropriate to safeguard the statutory auditor's or audit firm's independence, a statutory auditor or an audit firm shall not carry out a statutory audit in cases of self-review or self-interest.

3. Member States shall ensure that a statutory auditor or audit firm documents in the audit working papers all significant threats to his, her or its independence as well as the safeguards applied to mitigate those threats.
4. In order to ensure confidence in the audit function and to ensure uniform application of paragraphs 1 and 2 of this Article, the Commission may, in accordance with the procedure referred to in Article 48(2), adopt principle-based implementing measures concerning:
 - (a) the threats and safeguards referred to in paragraph 2;
 - (b) the situations in which the significance of the threats, as referred to in paragraph 2, is such that the independence of the statutory auditor or audit firm is compromised;

(c) the cases of self-review and self-interest referred to in the second subparagraph of paragraph 2, in which statutory audits may or may not be carried out.

Article 23 **Confidentiality and professional secrecy**

1. Member States shall ensure that all information and documents to which a statutory auditor or audit firm has access when carrying out a statutory audit are protected by adequate rules on confidentiality and professional secrecy.
2. Confidentiality and professional secrecy rules relating to statutory auditors or audit firms shall not impede enforcement of the provisions of this Directive.
3. Where a statutory auditor or audit firm is replaced by another statutory auditor or audit firm, the former statutory auditor or audit firm shall provide the incoming statutory auditor or audit firm with access to all relevant information concerning the audited entity.
4. A statutory auditor or audit firm who has ceased to be engaged in a particular audit assignment and a former statutory auditor or audit firm shall remain subject to the provisions of paragraphs 1 and 2 with respect to that audit assignment.

Article 24 **Independence and objectivity of the statutory auditors carrying out the statutory audit on behalf of audit firms**

Member States shall ensure that the owners or shareholders of an audit firm as well as the members of the administrative, management and supervisory bodies of such a firm, or of an affiliated firm, do not intervene in the execution of a statutory audit in any way which jeopardises the independence and objectivity of the statutory auditor who carries out the statutory audit on behalf of the audit firm.

Article 25 **Audit fees**

Member States shall ensure that adequate rules are in place which provide that fees for statutory audits:

- (a) are not influenced or determined by the provision of additional services to the audited entity;

(b) cannot be based on any form of contingency.

CHAPTER V AUDITING STANDARDS AND AUDIT REPORTING

Article 26 Auditing standards

1. Member States shall require statutory auditors and audit firms to carry out statutory audits in compliance with international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 48(2). Member States may apply a national auditing standard as long as the Commission has not adopted an international auditing standard covering the same subject-matter. Adopted international auditing standards shall be published in full in each of the official languages of the Community in the Official Journal of the European Union.

2. The Commission may decide, in accordance with the procedure referred to in Article 48(2), on the applicability of international auditing standards within the Community. The Commission shall adopt international auditing standards for application in the Community only if they:

(a) have been developed with proper due process, public oversight and transparency, and are generally accepted internationally;

(b) contribute a high level of credibility and quality to the annual or consolidated accounts in conformity with the principles set out in Article 2(3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC; and

(c) are conducive to the European public good.

3. Member States may impose audit procedures or requirements in addition to — or, in exceptional cases, by carving out parts of — the international auditing standards only if these stem from specific national legal requirements relating to the scope of statutory audits. Member States shall ensure that these audit procedures or requirements comply with the provisions laid down in points (b) and (c) of paragraph 2 and shall communicate them to the Commission and Member States before their adoption. In the exceptional case of the carving out of parts of an international auditing standard, Member States shall communicate their specific national legal requirements, as well as the grounds for maintaining them, to the Commission and the other Member States at least six months before their national adoption or, in the case of requirements already

existing at the time of adoption of an international auditing standard, at the latest within three months of the adoption of the relevant international auditing standard.

4. Member States may impose additional requirements relating to the statutory audits of annual and consolidated accounts for a period expiring on 29 June 2010.

Article 27 **Statutory audits of consolidated accounts**

Member States shall ensure that in the case of a statutory audit of the consolidated accounts of a group of undertakings:

(a) the group auditor bears the full responsibility for the audit report in relation with the consolidated accounts;

(b) the group auditor carries out a review and maintains documentation of his or her review of the audit work performed by third-country auditor(s), statutory auditor(s), third-country audit entity(ies) or audit firm(s) for the purpose of the group audit. The documentation retained by the group auditor shall be such as enables the relevant competent authority to review the work of the group auditor properly;

(c) when a component of a group of undertakings is audited by auditor(s) or audit entity(ies) from a third country that has no working arrangement as referred to in Article 47, the group auditor is responsible for ensuring proper delivery, when requested, to the public oversight authorities of the documentation of the audit work performed by the third-country auditor(s) or audit entity(ies), including the working papers relevant to the group audit. To ensure such delivery, the group auditor shall retain a copy of such documentation, or alternatively agree with the third-country auditor(s) or audit entity(ies) his proper and unrestricted access upon request, or take any other appropriate action. If legal or other impediments prevent audit working papers from being passed from a third country to the group auditor, the documentation retained by the group auditor shall include evidence that he or she has undertaken the appropriate procedures in order to gain access to the audit documentation, and in the case of impediments other than legal ones arising from country legislation, evidence supporting such an impediment.

Article 28

Audit reporting

1. Where an audit firm carries out the statutory audit, the audit report shall be signed by at least the statutory auditor(s) carrying out the statutory audit on behalf of the audit firm. In exceptional circumstances Member States may provide that this signature need not be disclosed to the public if such disclosure could lead to an imminent and significant threat to the personal security of any person. In any case the name(s) of the person(s) involved shall be known to the relevant competent authorities.

2. Notwithstanding Article 51a(1) of Directive 78/660/EEC, if the Commission has not adopted a common standard for audit reports in accordance with Article 26(1) of this Directive, it may, in accordance with the procedure referred to in Article 48(2) of this Directive, adopt a common standard for audit reports for annual or consolidated accounts which have been prepared in accordance with approved international accounting standards, in order to enhance public confidence in the audit function.

CHAPTER VI

QUALITY ASSURANCE

Article 29

Quality assurance systems

1. Each Member State shall ensure that all statutory auditors and audit firms are subject to a system of quality assurance which meets at least the following criteria:

(a) the quality assurance system shall be organised in such a manner that it is independent of the reviewed statutory auditors and audit firms and subject to public oversight as provided for in Chapter VIII;

(b) the funding for the quality assurance system shall be secure and free from any possible undue influence by statutory auditors or audit firms;

(c) the quality assurance system shall have adequate resources;

(d) the persons who carry out quality assurance reviews shall have appropriate professional education and relevant experience in statutory audit and financial reporting combined with specific training on quality assurance reviews;

- (e) the selection of reviewers for specific quality assurance review assignments shall be effected in accordance with an objective procedure designed to ensure that there are no conflicts of interest between the reviewers and the statutory auditor or audit firm under review;
- (f) the scope of the quality assurance review, supported by adequate testing of selected audit files, shall include an assessment of compliance with applicable auditing standards and independence requirements, of the quantity and quality of resources spent, of the audit fees charged and of the internal quality control system of the audit firm;
- (g) the quality assurance review shall be the subject of a report which shall contain the main conclusions of the quality assurance review;
- (h) quality assurance reviews shall take place at least every six years;
- (i) the overall results of the quality assurance system shall be published annually;
- (j) recommendations of quality reviews shall be followed up by the statutory auditor or audit firm within a reasonable period.
If the recommendations referred to in point (j) are not followed up, the statutory auditor or audit firm shall, if applicable, be subject to the system of disciplinary actions or penalties referred to in Article 30.

2. The Commission may, in accordance with the procedure referred to in Article 48(2), adopt implementing measures in order to enhance public confidence in the audit function and to ensure uniform application of points (a), (b) and (e) to (j) of paragraph 1.

CHAPTER VII INVESTIGATIONS AND PENALTIES

Article 30 Systems of investigations and penalties

1. Member States shall ensure that there are effective systems of investigations and penalties to detect, correct and prevent inadequate execution of the statutory audit.
2. Without prejudice to Member States' civil liability regimes, Member States shall provide for effective, proportionate and dissuasive penalties in respect of statutory auditors and audit firms, where statutory audits are not

carried out in conformity with the provisions adopted in the implementation of this Directive.

3. Member States shall provide that measures taken and penalties imposed on statutory auditors and audit firms are appropriately disclosed to the public. Penalties shall include the possibility of the withdrawal of approval.

Article 31 **Auditors' liability**

Before 1 January 2007 the Commission shall present a report on the impact of the current national liability rules for the carrying out of statutory audits on European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability. The Commission shall, where appropriate, carry out a public consultation. In the light of that report, the Commission shall, if it considers it appropriate, submit recommendations to the Member States.

CHAPTER VIII **PUBLIC OVERSIGHT AND REGULATORY ARRANGEMENTS BETWEEN** **MEMBER STATES**

Article 32 **Principles of public oversight**

1. Member States shall organise an effective system of public oversight for statutory auditors and audit firms based on the principles set out in paragraphs 2 to 7.

2. All statutory auditors and audit firms shall be subject to public oversight.

3. The system of public oversight shall be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. Member States may, however, allow a minority of practitioners to be involved in the governance of the public oversight system. Persons involved in the governance of the public oversight system shall be selected in accordance with an independent and transparent nomination procedure.

4. The system of public oversight shall have the ultimate responsibility for the oversight of:

(a) the approval and registration of statutory auditors and audit firms;

(b) the adoption of standards on professional ethics, internal quality control of audit firms and auditing, and

(c) continuing education, quality assurance and investigative and disciplinary systems.

5. The system of public oversight shall have the right, where necessary, to conduct investigations in relation to statutory auditors and audit firms and the right to take appropriate action.

6. The system of public oversight shall be transparent. This shall include the publication of annual work programmes and activity reports.

7. The system of public oversight shall be adequately funded. The funding for the public oversight system shall be secure and free from any undue influence by statutory auditors or audit firms.

Article 33

Cooperation between public oversight systems at Community level

Member States shall ensure that regulatory arrangements for public oversight systems permit effective cooperation at Community level in respect of Member States' oversight activities. To that end, each Member State shall make one entity specifically responsible for ensuring that cooperation.

Article 34

Mutual recognition of regulatory arrangements between Member States

1. Regulatory arrangements of Member States shall respect the principle of home-country regulation and oversight by the Member State in which the statutory auditor or audit firm is approved and the audited entity has its registered office.

2. In the case of a statutory audit of consolidated accounts, the Member State requiring the statutory audit of the consolidated accounts may not impose additional requirements in relation to the statutory audit concerning registration, quality assurance review, auditing standards, professional ethics and independence on a statutory auditor or audit firm carrying out a statutory audit of a subsidiary established in another Member State.

3. In the case of a company whose securities are traded on a regulated market in a Member State other than that in which that company has its registered office, the Member State in which the securities are traded may not impose any additional requirements in relation to the statutory audit concerning registration, quality assurance review, auditing standards,

professional ethics and independence on a statutory auditor or audit firm carrying out the statutory audit of the annual or consolidated accounts of that company.

Article 35 **Designation of competent authorities**

1. Member States shall designate one or more competent authorities for the purposes of the tasks provided for in this Directive. Member States shall inform the Commission of their designation.
2. The competent authorities shall be organised in such a manner that conflicts of interests are avoided.

Article 36 **Professional secrecy and regulatory cooperation between Member States**

1. The competent authorities of Member States responsible for approval, registration, quality assurance, inspection and discipline shall cooperate with each other whenever necessary for the purpose of carrying out their respective responsibilities under this Directive. The competent authorities in a Member State responsible for approval, registration, quality assurance, inspection and discipline shall render assistance to competent authorities in other Member States. In particular, competent authorities shall exchange information and cooperate in investigations related to the carrying-out of statutory audits.
2. The obligation of professional secrecy shall apply to all persons who are employed or who have been employed by competent authorities. Information covered by professional secrecy may not be disclosed to any other person or authority except by virtue of the laws, regulations or administrative procedures of a Member State.
3. Paragraph 2 shall not prevent competent authorities from exchanging confidential information. Information thus exchanged shall be covered by the obligation of professional secrecy, to which persons employed or formerly employed by competent authorities are subject.
4. Competent authorities shall, on request, and without undue delay, supply any information required for the purpose referred to in paragraph 1. Where necessary, the competent authorities receiving any such request shall, without undue delay, take the necessary measures to gather the required information. Information thus supplied shall be covered by the obligation of professional secrecy to which the persons employed or formerly employed by the competent authorities that received the information are subject.

If the requested competent authority is not able to supply the required information without undue delay, it shall notify the requesting competent authority of the reasons therefor.

The competent authorities may refuse to act on a request for information where:

(a) supplying information might adversely affect the sovereignty, security or public order of the requested Member State or breach national security rules; or

(b) judicial proceedings have already been initiated in respect of the same actions and against the same statutory auditors or audit firms before the authorities of the requested Member State; or

(c) final judgment has already been passed in respect of the same actions and on the same statutory auditors or audit firms by the competent authorities of the requested Member State.

Without prejudice to the obligations to which they are subject in judicial proceedings, competent authorities which receive information pursuant to paragraph 1 may use it only for the exercise of their functions within the scope of this Directive and in the context of administrative or judicial proceedings specifically related to the exercise of those functions.

5. Where a competent authority concludes that activities contrary to the provisions of this Directive are being or have been carried out on the territory of another Member State, it shall notify the competent authority of the other Member State of that conclusion in as specific a manner as possible. The competent authority of the other Member State shall take appropriate action. It shall inform the notifying competent authority of the outcome and, to the extent possible, of significant interim developments.

6. A competent authority of one Member State may also request that an investigation be carried out by the competent authority of another Member State on the latter's territory.

It may further request that some of its own personnel be allowed to accompany the personnel of the competent authority of that other Member State in the course of the investigation.

The investigation shall be subject throughout to the overall control of the Member State on whose territory it is conducted.

The competent authorities may refuse to act on a request for an investigation to be carried out as provided for in the first subparagraph, or on a request for its personnel to be accompanied by personnel of a competent authority of another Member State as provided for in the second subparagraph, where:

(a) such an investigation might adversely affect the sovereignty, security or public order of the requested Member State; or

(b) judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the requested Member State; or

(c) final judgment has already been passed in respect of the same actions on such persons by the competent authorities of the requested Member State.

7. In accordance with the procedure referred to in Article 48(2) the Commission may adopt implementing measures in order to facilitate cooperation between competent authorities on the procedures for the exchange of information and modalities for cross-border investigations provided for in paragraphs 2 to 4 of this Article.

CHAPTER IX APPOINTMENT AND DISMISSAL

Article 37 Appointment of statutory auditors or audit firms

1. The statutory auditor or audit firm shall be appointed by the general meeting of shareholders or members of the audited entity.

2. Member States may allow alternative systems or modalities for the appointment of the statutory auditor or audit firm, provided that those systems or modalities are designed to ensure the independence of the statutory auditor or audit firm from the executive members of the administrative body or from the managerial body of the audited entity.

Article 38 Dismissal and resignation of statutory auditors or audit firms

1. Member States shall ensure that statutory auditors or audit firms may be dismissed only where there are proper grounds. Divergence of opinions on

accounting treatments or audit procedures shall not be proper grounds for dismissal.

2. Member States shall ensure that the audited entity and the statutory auditor or audit firm inform the authority or authorities responsible for public oversight concerning the dismissal or resignation of the statutory auditor or audit firm during the term of appointment and give an adequate explanation of the reasons therefor.

CHAPTER X SPECIAL PROVISIONS FOR THE STATUTORY AUDITS OF PUBLIC- INTEREST ENTITIES

Article 39 Application to non-listed public-interest entities

Member States may exempt public-interest entities which have not issued transferable securities admitted to trading on a regulated market within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and their statutory auditor(s) or audit firm(s) from one or more of the requirements in this Chapter.

Article 40 Transparency report

1. Member States shall ensure that statutory auditors and audit firms that carry out statutory audit(s) of public-interest entities publish on their websites, within three months of the end of each financial year, annual transparency reports that include at least the following:

- (a) a description of the legal structure and ownership;
- (b) where the audit firm belongs to a network, a description of the network and the legal and structural arrangements in the network;
- (c) a description of the governance structure of the audit firm;
- (d) a description of the internal quality control system of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning;
- (e) an indication of when the last quality assurance review referred to in Article 29 took place;

- (f) a list of public-interest entities for which the audit firm has carried out statutory audits during the preceding financial year;
- (g) a statement concerning the audit firm's independence practices which also confirms that an internal review of independence compliance has been conducted;
- (h) a statement on the policy followed by the audit firm concerning the continuing education of statutory auditors referred to in Article 13;
- (i) 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;
- (j) information concerning the basis for the partners' remuneration.

Member States may in exceptional circumstances disapply the requirement in point (f) to the extent necessary to mitigate an imminent and significant threat to the personal security of any person.

2. The transparency report shall be signed by the statutory auditor or audit firm, as the case may be. This can be done, for example, by means of an electronic signature as defined in Article 2(1) of Directive 1999/93/EC.

Article 41 **Audit committee**

1. Each public-interest entity shall have an audit committee. The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing.

In public-interest entities which meet the criteria of Article 2(1), point (f) of Directive 2003/71/EC [20], Member States may permit the functions assigned to the audit committee to be performed by the administrative or supervisory body as a whole, provided at least that when the chairman of such a body is an executive member, he or she is not the chairman of the audit committee.

2. Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members

who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, inter alia:

(a) monitor the financial reporting process;

(b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;

(c) monitor the statutory audit of the annual and consolidated accounts;

(d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

3. In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee.

4. The statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.

5. Member States may allow or decide that the provisions laid down in paragraphs 1 to 4 shall not apply to any public-interest entity that has a body performing equivalent functions to an audit committee, established and functioning according to provisions in place in the Member State in which the entity to be audited is registered. In such a case the entity shall disclose which body carries out these functions and how it is composed.

6. Member States may exempt from the obligation to have an audit committee:

(a) any public-interest entity which is a subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC if the entity complies with the requirements in paragraphs 1 to 4 of this Article at group level;

(b) any public-interest entity which is a collective investment undertaking as defined in Article 1(2) of Directive 85/611/EEC. Member States may also exempt public-interest entities the sole object of which is the collective investment of capital provided by the public, which operate on the principle of risk spreading and which do not seek to take legal or management control over any of the issuers of its underlying investments, provided that those collective investment undertakings are authorised and subject to supervision by competent authorities and that they have a depositary exercising functions equivalent to those under Directive 85/611/EEC;

(c) any public-interest entity the sole business of which is to act as issuer of asset-backed securities as defined in Article 2(5) of Commission Regulation (EC) No 809/2004 [21]. In such instances, the Member State shall require the entity to explain to the public the reasons for which it considers it not appropriate to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee;

(d) any credit institution within the meaning of Article 1(1) of Directive 2000/12/EC whose shares are not admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and which has, in a continuous or repeated manner, issued only debt securities, provided that the total nominal amount of all such debt securities remains below EUR 100000000 and that it has not published a prospectus under Directive 2003/71/EC.

Article 42 Independence

1. In addition to the provisions laid down in Articles 22 and 24, Member States shall ensure that statutory auditors or audit firms that carry out the statutory audit of a public-interest entity:

(a) confirm annually in writing to the audit committee their independence from the audited public-interest entity;

(b) disclose annually to the audit committee any additional services provided to the audited entity; and

(c) discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats as documented by them pursuant to Article 22(3).

2. Member States shall ensure that the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment and is/are allowed to participate in the audit of the audited entity again after a period of at least two years.

3. The statutory auditor or the key audit partner who carries out a statutory audit on behalf of an audit firm shall not be allowed to take up a key management position in the audited entity before a period of at least two years has elapsed since he or she resigned as a statutory auditor or key audit partner from the audit engagement.

Article 43
Quality assurance

The quality assurance review referred to in Article 29 shall be carried out at least every three years for statutory auditors or audit firms that carry out statutory audits of public-interest entities.

CHAPTER XI
INTERNATIONAL ASPECTS

Article 44
Approval of auditors from third countries

1. Subject to reciprocity, the competent authorities of a Member State may approve a third-country auditor as statutory auditor if that person has furnished proof that he or she complies with requirements equivalent to those laid down in Articles 4 and 6 to 13.

2. The competent authorities of a Member State shall, before granting approval to a third-country auditor who meets the requirements of paragraph 1, apply the requirements laid down in Article 14.

Article 45
Registration and oversight of third-country auditors and audit entities

1. The competent authorities of a Member State shall, in accordance with Articles 15 to 17, register every third-country auditor and audit entity that provides an audit report concerning the annual or consolidated accounts of a company incorporated outwith the Community whose transferable securities are admitted to trading on a regulated market of that Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC, except when the company is an issuer exclusively of debt securities admitted to trading on a regulated market in a Member State within the meaning of Article 2(1)(b) of Directive 2004/109/EC [22], the denomination per unit of which is at least EUR 50000 or, in case of debt securities denominated in another currency, equivalent, at the date of issue, to at least EUR 50000.

2. Articles 18 and 19 shall apply.

3. Member States shall subject registered third-country auditors and audit entities to their systems of oversight, their quality assurance systems and their systems of investigation and penalties. A Member State may exempt a registered third-country auditor or audit entity from being subject to its

quality assurance system if another Member State's or third country's system of quality assurance that has been assessed as equivalent in accordance with Article 46 has carried out a quality review of the third-country auditor or audit entity concerned during the previous three years.

4. Without prejudice to Article 46, audit reports concerning annual accounts or consolidated accounts referred to in paragraph 1 of this Article issued by third-country auditors or audit entities that are not registered in the Member State shall have no legal effect in that Member State.

5. A Member State may register a third-country audit entity only if:

(a) it meets requirements which are equivalent to those laid down in Article 3(3);

(b) the majority of the members of the administrative or management body of the third-country audit entity meet requirements which are equivalent to those laid down in Articles 4 to 10;

(c) the third-country auditor carrying out the audit on behalf of the third-country audit entity meets requirements which are equivalent to those laid down in Articles 4 to 10;

(d) the audits of the annual or consolidated accounts referred to in paragraph 1 are carried out in accordance with international auditing standards as referred to in Article 26, as well as the requirements laid down in Articles 22, 24 and 25, or with equivalent standards and requirements;

(e) it publishes on its website an annual transparency report which includes the information referred to in Article 40 or it complies with equivalent disclosure requirements.

6. In order to ensure uniform application of paragraph 5(d) the equivalence referred to therein shall be assessed by the Commission in cooperation with Member States and shall be decided upon by the Commission in accordance with the procedure referred to in Article 48(2). Pending such a decision by the Commission, Member States may assess the equivalence referred to in paragraph 5(d) as long as the Commission has not taken any decision.

Article 46 **Derogation in the case of equivalence**

1. Member States may disapply or modify the requirements in Article 45(1) and (3) on the basis of reciprocity only if the third-country auditors or audit

entities are subject to systems of public oversight, quality assurance and investigations and penalties in the third country that meet requirements equivalent to those of Articles 29, 30 and 32.

2. In order to ensure uniform application of paragraph 1 of this Article, the equivalence referred to therein shall be assessed by the Commission in cooperation with Member States and shall be decided upon by the Commission in accordance with the procedure referred to in Article 48(2). Member States may assess the equivalence referred to in paragraph 1 of this Article or rely on the assessments carried out by other Member States as long as the Commission has not taken any decision. If the Commission decides that the requirement of equivalence referred to in paragraph 1 of this Article is not complied with, it may allow the auditors and audit entities concerned to continue their audit activities in accordance with the relevant Member State's requirements during an appropriate transitional period.

3. Member States shall communicate to the Commission:

(a) their assessments of the equivalence referred to in paragraph 2; and

(b) the main elements of their cooperative arrangements with third-country systems of public oversight, quality assurance and investigations and penalties, on the basis of paragraph 1.

Article 47

Cooperation with competent authorities from third countries

1. Member States may allow the transfer to the competent authorities of a third country of audit working papers or other documents held by statutory auditors or audit firms approved by them, provided that:

(a) those audit working papers or other documents relate to audits of companies which have issued securities in that third country or which form part of a group issuing statutory consolidated accounts in that third country;

(b) the transfer takes place via the home competent authorities to the competent authorities of that third country and at their request;

(c) the competent authorities of the third country concerned meet requirements which have been declared adequate in accordance with paragraph 3;

(d) there are working arrangements on the basis of reciprocity agreed between the competent authorities concerned;

(e) the transfer of personal data to the third country is in accordance with Chapter IV of Directive 95/46/EC.

2. The working arrangements referred to in paragraph 1(d) shall ensure that:

(a) justification as to the purpose of the request for audit working papers and other documents is provided by the competent authorities;

(b) the persons employed or formerly employed by the competent authorities of the third country that receive the information are subject to obligations of professional secrecy;

(c) the competent authorities of the third country may use audit working papers and other documents only for the exercise of their functions of public oversight, quality assurance and investigations that meet requirements equivalent to those of Articles 29, 30 and 32;

(d) the request from a competent authority of a third country for audit working papers or other documents held by a statutory auditor or audit firm can be refused:

- where the provision of those working papers or documents would adversely affect the sovereignty, security or public order of the Community or of the requested Member State, or
- where judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the requested Member State.

3. The adequacy referred to in paragraph 1(c) shall be decided upon by the Commission in accordance with the procedure referred to in Article 48(2) in order to facilitate cooperation between competent authorities. The assessment of adequacy shall be carried out in cooperation with Member States and be based on the requirements of Article 36 or essentially equivalent functional results. Member States shall take the measures necessary to comply with the Commission's decision.

4. In exceptional cases and by way of derogation from paragraph 1, Member States may allow statutory auditors and audit firms approved by them to transfer audit working papers and other documents directly to the competent authorities of a third country, provided that:

(a) investigations have been initiated by the competent authorities in that third country;

(b) the transfer does not conflict with the obligations with which statutory auditors and audit firms are required to comply in relation to the transfer of audit working papers and other documents to their home competent authority;

(c) there are working arrangements with the competent authorities of that third country that allow the competent authorities in the Member State reciprocal direct access to audit working papers and other documents of that third-country's audit entities;

(d) the requesting competent authority of the third country informs in advance the home competent authority of the statutory auditor or audit firm of each direct request for information, indicating the reasons therefor;

(e) the conditions referred to in paragraph 2 are respected.

5. The Commission may, in accordance with the procedure referred to in Article 48(2), specify the exceptional cases referred to in paragraph 4 of this Article in order to facilitate cooperation between competent authorities and to ensure the uniform application of paragraph 4 of this Article.

6. Member States shall communicate to the Commission the working arrangements referred to in paragraphs 1 and 4.

CHAPTER XII TRANSITIONAL AND FINAL PROVISIONS

Article 48 Committee procedure

1. The Commission shall be assisted by a committee (hereinafter referred to as the Committee).

2. Where reference is made to this paragraph Articles 5 and 7 of Decision 1999/468/EC shall apply, having regard to the provisions of Article 8 thereof.

The period laid down in Article 5(6) of Decision 1999/468/EC shall be set at three months.

3. The Committee shall adopt its Rules of Procedure.

4. Without prejudice to the implementing measures already adopted, and except for the provisions laid down in Article 26, upon expiry of a two-year period following the adoption of this Directive and on 1 April 2008 at the

latest, the application of its provisions requiring the adoption of technical rules, amendments and decisions in accordance with paragraph 2 shall be suspended. Acting on a proposal from the Commission, the European Parliament and the Council may renew the provisions concerned in accordance with the procedure laid down in Article 251 of the Treaty and to that end they shall review them prior to the expiry of the period or date referred to above.

Article 49
Amendment of Directive 78/660/EEC and Directive 83/349/EEC

1. Directive 78/660/EEC is hereby amended as follows:

(a) in Article 43(1) the following point shall be added:

(15) "separately, the total fees for the financial year charged by the statutory auditor or audit firm for the statutory audit of annual accounts, the total fees charged for other assurance services, the total fees charged for tax advisory services and the total fees charged for other non-audit services.

Member States may provide that this requirement shall not apply where the company is included within the consolidated accounts required to be drawn up under Article 1 of Directive 83/349/EEC, provided that such information is given in the notes to the consolidated accounts.";

(b) paragraph 1 of Article 44 shall be replaced by the following:

1. "Member States may permit the companies referred to in Article 11 to draw up abridged notes on their accounts without the information required in Article 43(1)(5) to (12), (14)(a) and (15). However, the notes must disclose the information specified in Article 43(1)(6) in total for all the items concerned.";

(c) paragraph 2 of Article 45 shall be replaced by the following:

2. "Paragraph 1(b) shall also apply to the information specified in Article 43(1)(8).

The Member States may permit the companies referred to in Article 27 to omit disclosure of the information specified in Article 43(1)(8). The Member States may also permit the companies referred to in Article 27 to omit disclosure of the information specified in Article 43(1)(15), provided that such information is delivered to the public oversight system referred to in Article 32 of Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audit of annual accounts and

consolidated accounts [23] when requested by such a public oversight system.”

2. In Article 34 of Directive 83/349/EEC the following point shall be added:
(16) “Separately, the total fees for the financial year charged by the statutory auditor or audit firm for the statutory audit of the consolidated accounts, the total fees charged for other assurance services, the total fees charged for tax advisory services and the total fees charged for other non-audit services.”

Article 50 **Repeal of Directive 84/253/EEC**

Directive 84/253/EEC shall be repealed with effect from 29 June 2006. References to the repealed Directive shall be construed as references to this Directive.

Article 51 **Transitional provision**

Statutory auditors or audit firms that are approved by the competent authorities of the Member States in accordance with Directive 84/253/EEC before the entry into force of the provisions referred to in Article 53(1) shall be considered as having been approved in accordance with this Directive.

Article 52 **Minimum harmonisation**

Member States requiring statutory audit may impose more stringent requirements, unless otherwise provided for by this Directive.

Article 53 **Transposition**

1. Before 29 June 2008 Member States shall adopt and publish the provisions necessary to comply with this Directive. They shall forthwith inform the Commission thereof.

2. When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. The methods of making such reference shall be laid down by Member States.

3. Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field covered by this Directive.

Article 54 Entry into force

This Directive shall enter into force on the 20th day following its publication in the Official Journal of the European Union.

Article 55 Addressees

This Directive is addressed to the Member States.

Done at Strasbourg, 17 May 2006.

For the European Parliament

The President

J. Borrell Fontelles

For the Council

The President

H. Winkler

[1] OJ C 157, 28.6.2005, p. 115.

[2] Opinion of the European Parliament of 28 September 2005 (not yet published in the Official Journal) and Council Decision of 25 April 2006.

[3] OJ L 222, 14.8.1978, p. 11. Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council (OJ L 178, 17.7.2003, p. 16).

[4] OJ L 193, 18.7.1983, p. 1. Directive as last amended by Directive 2003/51/EC.

[5] OJ L 372, 31.12.1986, p. 1. Directive as last amended by Directive 2003/51/EC.

[6] OJ L 374, 31.12.1991, p. 7. Directive as amended by Directive 2003/51/EC.

[7] OJ L 126, 12.5.1984, p. 20.

[8] OJ C 143, 8.5.1998, p. 12.

[9] OJ L 91, 31.3.2001, p. 91.

[10] OJ L 191, 19.7.2002, p. 22.

[11] OJ L 145, 30.4.2004, p. 1.

[12] OJ L 184, 17.7.1999, p. 23.

[13] OJ L 52, 25.2.2005, p. 51.

[14] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 375, 31.12.1985, p. 3). Directive as last amended by Directive 2005/1/EC of the European Parliament and of the Council (OJ L 79, 24.3.2005, p. 9).

- [15] OJ L 281, 23.11.1995, p. 31. Directive as amended by Regulation (EC) No 1882/2003 (OJ L 284, 31.10.2003, p. 1).
- [16] OJ L 126, 26.5.2000, p. 1. Directive as last amended by Commission Directive 2006/29/EC (OJ L 70, 9.3.2006, p. 50).
- [17] OJ L 207, 18.8.2003, p. 1.
- [18] OJ L 19, 24.1.1989, p. 16. Directive as amended by Directive 2001/19/EC of the European Parliament and of the Council (OJ L 206, 31.7.2001, p. 1).
- [19] OJ L 13, 19.1.2000, p. 12.
- [20] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading (OJ L 345, 31.12.2003, p. 64).
- [21] OJ L 149, 30.4.2004, p. 1.
- [22] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (OJ L 390, 31.12.2004, p. 38).
- [23] OJ L 157, 9.6.2006, p. 87.

CODE OF PRACTICE ON CONSULTATIONS

The Consultation Code of Practice Criteria

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.cabinetoffice.gov.uk/regulation/consultation/index.asp>

Comments or complaints

If you wish to comment on the conduct of this consultation or make a complaint about the way this consultation has been conducted, please write to:

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