

**BERR**

Department for Business  
Enterprise & Regulatory Reform

**EUROPEAN COMPANY LAW AND  
CORPORATE GOVERNANCE**

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

SUMMARY OF COMMENTS ON THE DRAFT  
REGULATIONS AND THE GOVERNMENT'S  
CONCLUSIONS – DECEMBER 2007

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

## SUMMARY OF THE COMMENTS ON THE DRAFT REGULATIONS AND THE GOVERNMENT'S CONCLUSIONS

December 2007

### Introduction

The purpose of this note is to summarise the comments received in response to the BERR consultation on the draft Statutory Auditors and Third Country Auditors Regulations 2007, implementing Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts, and to set out the Government's conclusions. The Government has made Regulations for commencement on **6 April 2008**, in relation to reporting periods beginning on or after that date. The Regulations are available on the OPSI website at <http://www.opsi.gov.uk/si/si-2007-index.htm>.

2. The Government published in March 2007 a consultation document on the policy options for implementing the Audit Directive. In the light of the responses to that document, the Government published in July 2007 a draft set of regulations to implement the Directive, alongside a summary of the responses to the March consultation and the Government's policy conclusions. The deadline for comments on the draft regulations was 15 October 2007. Eight responses were received to that consultation and, with the exception of one response which was private, these are published on the website. During this period, the Government also held a series of informal meetings to discuss the draft Regulations with key stakeholders and delivery partners, including the Professional Oversight Board, the Auditing Practices Board, the Financial Services Authority and the Recognised Supervisory Bodies. The Regulations laid before Parliament take account of those discussions and our further consideration of the best approach to take to various issues.

3. This note sets out, for each section of the Directive, a brief summary of the comments received, and the main changes that the Government has made to the regulations since they were published in draft in July. There have also been a number of drafting changes made which have no impact on the effect of the regulation. In some cases, these have resulted in a change to the numbering of the regulations from the July consultation draft. In the discussion below the numbers used refer exclusively to the current draft.

## Approach to implementation

4. As explained in the consultation documents, the implementation of the Directive requires a range of provisions:
- Commencement of Parts 16 and 42 of the Companies Act 2006;
  - Regulations to be made by the Department for Business, Enterprise and Regulatory Reform (BERR) in relation to companies;
  - Regulations to be made by BERR in relation to miscellaneous partnerships, insurance undertakings and banks - the Government is currently consulting on these draft Regulations and a copy can be found at <http://www.berr.gov.uk/bbf/co-act-2006/draft/page40411.html>;
  - Regulations to be made by HM Treasury in relation to building societies and friendly societies - a separate consultation [will be published shortly];
  - Regulations to be made by the Professional Oversight Board (to which the Secretary of State for BERR delegates some of his powers);
  - Amendments to the Companies Act 2006 to provide statutory underpinning (and updating where necessary) of existing Ethical Standards (set by the Auditing Practices Board) and Recognised Supervisory Bodies' rules; and
  - Amendments to the rules of the Financial Services Authority.
5. The arrangements for regulations to be made by other bodies are discussed in the appropriate sections in this document.

### Statutory underpinning

6. Three respondents to the consultation questioned the need for statutory underpinning, given that many of the provisions of the Directive already exist under the current UK audit framework, and the reasons for taking a "copy-out" approach for some requirements. Statutory underpinning was also mentioned by one of those respondents in relation to the draft Impact Assessment.
7. Currently, many of the Directive requirements are applied through the rules of the recognised supervisory bodies or the Ethical Standards set by the Auditing Practices Board, which already have some statutory underpinning under the Companies Act 2006. EU law requires all Directives to be implemented by way of provisions in binding national legislation. This is a long-established requirement which has been confirmed by the European Court of Justice on a number of occasions. Rules and standards adopted on a voluntary basis, as they currently are, cannot be considered as binding legislation for this purpose. Therefore, for the UK to meet its EU law obligations, the Directive's requirements must be reflected in requirements in legislation, giving a 'statutory underpinning' to the voluntary rules and standards.

8. The Directive specifies requirements to a greater level of detail than UK legislation has previously, so it is necessary to now provide statutory underpinning to a greater level in some areas. However, since many of the requirements of the Directive are already reflected under the current system, the provision of statutory underpinning for existing rules and standards should not in practice increase the regulatory burden in relation to them.

#### **Education and Qualifications – Articles 3 to 14 and 44**

9. These provisions are covered in regulations 5, 6, 7, 14 (new S1253C(1)) and 29. Comments on these provisions in the consultation exercise were supportive, and no significant changes have been made.

#### **Registration – Articles 15 to 20**

10. As has been set out in previous statements, it will be for the Professional Oversight Board to make the detailed regulations on the register of UK statutory auditors and these provisions of the Directive are not implemented in these BERR regulations. The relevant provisions of the Companies Act will be commenced in April 2008, so that POB can make regulations effective from that date. The Professional Oversight Board plan to issue draft regulations in the next few weeks with a view to bringing these into effect on 6 April 2008. It remains the intention of the Government and the Professional Oversight Board to introduce the new substantive requirements for the register with effect from June 2009, to allow for the collection of the additional data and the development of the necessary IT systems. For clarity, it should be mentioned here that although Regulation 30 amends the register provisions in S1239 of the Companies Act, this is only in respect of the registration of third country auditors, and is discussed below in the relevant section.

11. There was only one specific comment on these provisions in the BERR regulations, which queried whether auditors will be required to provide home or office addresses. This is for POB to determine. Our understanding is that their present intention, subject to consultation, is that office addresses will be all that is required.

#### **Ethics – Articles 21 to 25**

12. Two respondents commented on the provision in Article 23.3 requiring the outgoing auditor to provide the incoming auditor with access to all relevant information concerning the audited entity. The Government has noted concerns about the purpose of providing this information and whether it may create additional liability for auditors.

13. It is the Government's view that this provision and the regulation implementing it into UK law (paragraph 9(3)(c) in regulation 19) will not alter the existing liability of each auditor in relation to his respective audit, which flows from the auditor's duties under sections 495 and 498 of the Companies Act 2006. The Regulations do not affect the application of those provisions in any way.

#### Additional independence requirements for Public Interest Entities

14. One respondent commented on the setting of a statutory maximum period for audit partner rotation and criminal offences related to breaches of ethical standards. It is a requirement of the Directive that a maximum period of seven years be implemented into UK law. The Government believes that the approach taken in the Regulations provides the APB with the flexibility to set a period of up to seven years.

15. Two respondents commented on the implementation of Article 42.3 of the Directive, which provides for key audit partners to be barred from taking up a key management position in an entity they have audited, for a period of two years after ceasing to be involved in the audit. The practical implementation of this provision is for the rules of the Recognised Supervisory Bodies, on the basis of the new paragraph 10C of Schedule 10 of the Companies Act 2006. However, the Government does not agree with the view expressed by one RSB that the APB's existing Ethical Standard 2 is sufficient to implement fully the requirements of the Directive. It is not sufficient as it does not bar the appointment; it seeks instead to mitigate the effect by requiring the resignation of the audit firm from the engagement.

#### **Standards and Reporting - Articles 26 to 28**

16. These articles in the Directive are implemented in regulation 20 and 26. Three responses to the consultation commented that the draft regulations had not allowed the full range of options allowed by Article 27(c) of the Directive, in that they required group auditors to retain copies of documentation relating to the audit of subsidiaries, as opposed to allowing the group auditor simply to agree that he can have access to the papers if required. The Regulations have now been amended to allow this.

#### **Public Oversight, Monitoring, Investigations, Discipline and Co-operation with other EEA authorities – Articles 29 to 36**

17. These parts of the Directive are implemented by a number of provisions in the regulations:

- Regulations 7, 14 (co-operation with other EEA authorities)
- Regulation 11 (publication of inspection results)
- Regulation 8 (restrictions on disclosure)
- Regulations 22, 23 and 28 (Monitoring of audits)

18. There were a number of comments on these provisions. Three responses raised issues around co-operation with other EEA authorities. The first issue concerned the scope of the duty on UK authorities to inform other authorities if they become aware of a breach of provisions of the Audit Directive. The drafting of regulation 14 has accordingly been adjusted to correspond more closely to that of the Directive. The second issue concerned the definition of circumstances where UK authorities may refuse to comply with requests from other EEA states for information or co-operation. The responses argued that on-going or complete disciplinary proceedings in a case against an auditor, as well as on-going or complete legal proceedings, should be grounds to refuse to provide information or co-operation concerning the case. Regulation 14 has been amended so that completed disciplinary proceedings may be grounds for dismissal. However, the Directive does not allow for this to be extended to on-going disciplinary proceedings.

19. One respondent sought confirmation from BERR that the level of detail of inspection results published by the Audit Inspection Unit would not be increased under BERR's proposals. The aim of these regulations is to ensure that the minimum requirements of the Directive are met. The detailed arrangements for publication of inspection results, insofar as they go beyond the minimum requirements, is a matter for the Audit Inspection Unit and the Professional Oversight Board, who have consulted widely on the issue.

20. None of the respondents to the consultation commented on the restrictions on disclosure of information by competent authorities in regulation 8. However, three respondents were concerned to further reduce the exceptions to these restrictions which were set out in paragraphs 60 and 61 of Schedule 11A. These allow information about an audit to be passed to the audited person and allow information about inspections of audit firms to be made available to the public, while preventing audited persons from being identified. Two respondents were concerned that the audited person should be under a similar obligation of confidentiality when receiving information about the audit. This is already achieved by the current provisions, which apply to the specified information whether it is held by competent authorities or held by third parties after it has been disclosed to them by the competent authorities. Another respondent was concerned that individual auditors should not be identified in information made available to the public. It will be for the POB to consider if it is appropriate to identify individual auditors. Our understanding is that it is not the POB's current intention to name individual auditors or their clients. We have amended regulation 8 in several other minor respects. It now applies to information held by the Independent Supervisor. Finally we have made clear that the new offence of unauthorised disclosure comes into effect on 6 April 2008 for all audits, not just those for company financial years beginning after that date.

21. Three responses suggested that the requirement for inspections to be conducted by persons holding recognised audit qualifications was unnecessarily stringent. We have now amended the new paragraph 13(4)(a) (in regulation 21) so that the requirement for “appropriate professional education” is consistent with the wording of the Statutory Audit Directive.

22. One response suggested that the frequency of inspections can be greater than every 3 years for audit firms conducting major audits, because of inspections by both the supervisory bodies and the AIU. The aim of the regulations is to set out the minimum requirements of the Directive in respect of the frequency of inspections. Decisions on the actual frequency are for the inspecting bodies. However, we have amended regulation 28 to ensure the AIU is able to continue to rely, or rely in part, on inspections by the supervisory bodies of smaller audit firms that carry out relatively few audits of public interest entities.

23. We have also made minor changes to the regulations to address concerns about the consistent use of terms such as monitoring and inspections. We have also clarified the provision in regulation 11 and in paragraph 13(9) of Schedule 10 to ensure that inspections by the Audit Inspection Unit and the Independent Supervisor are also included in the published annual report.

### **Appointment and Dismissal – Articles 37 and 38**

24. These parts of the Directive are almost all already implemented in sections 522 and 523 of Part 16 of the Companies Act 2006. On Regulation 42 which prevents the dismissal of auditors without proper grounds by deeming such a dismissal to be prejudicial to some of the company’s members, one response queried whether we were separating out minority shareholders for protection. In answer to this point, the Government is not; this amendment to Part 30 of the Act is designed to give effect to the prohibition on dismissing auditors without proper grounds in the way which fits best with the current structure of UK Company Law. One respondent, a Recognised Supervisory Body, raised practical issues around the handling of the notifications of auditor resignation under Sections 522 to 524. This is not a matter for the current regulations, and the Government will respond separately. The Government remains of the view that the provisions allow for the exercise of appropriate discretion by the expert authorities.

### **Public Interest Entities – Articles 39 to 43**

#### Scope

25. One respondent commented on the scope of application of the UK implementation of the specific requirements for public interest entities. The respondent points out that a common approach is required by all EU

Member States, to avoid a situation where entities are subject to public interest entity regimes in more than one Member State, or none at all. They expressed a preference for application to entities incorporated in the UK (incorporation approach) rather than to entities for which the UK is the home State (home State approach).

26. Having reflected further on the practical application of both the home State and incorporation approaches, it is the view of the Government and of the FSA that implementation should be on the basis of incorporation. The Commission and other Member States have indicated that the incorporation approach would be preferable, and so this should avoid the difficulties of overlapping regimes. It is the FSA's intention therefore to apply the requirements to those entities incorporated in the UK which trade on a regulated market in the UK or elsewhere in the EU.

#### Audit Committees

27. Four respondents to the consultation expressed their support for the approach that the Government had taken to the implementation of the provisions relating to audit committees (Article 41 of the Directive). There was also broad support for the same approach to be used in relation to requirements for corporate governance statements. Respondents noted the importance of the FSA and FRRP working together to make appropriate practical arrangements for monitoring companies' compliance with disclosure requirements.

28. The FSA will be publishing a consultation document shortly on the proposed amendments to their rules.

#### **Third Country Auditors – Articles 45 and 46**

29. These articles of the Directive are implemented in regulations 29 to 40.

30. The only comment received on these provisions suggested that the register of third country auditors should be managed as part of the wider register of UK auditors. This is a matter for the Professional Oversight Board which will have final responsibility for the maintenance of the third country register, but the Government does not intend to prevent the registers being managed in this way if that seems appropriate.

31. The Government has made some minor changes to the regulations on third country auditors which were published for consultation. In regulation 30 we make minor amendments to S1239 of the Companies Act to give the Professional Oversight Board greater flexibility to disapply elements of the registration requirements on third country auditors, and to allow POB to register third country auditors

which might have different corporate forms from those in the UK. These changes are also reflected in regulation 34. There have also been detailed changes to the definition of third country auditors to ensure smooth operation of the registration arrangements.

### **Cooperation with Third Country Authorities – Article 47**

32. Article 47 is implemented by regulations 15 and 24 (Transfer of papers to third countries). The Government has decided it is necessary to change its approach to the implementation of this article. These changes mainly affect regulation 15. As the Directive is clear that transfer of papers by the authorities cannot take place until the Commission has taken the comitology decisions required by Article 47.3, the Government has decided it should prohibit such transfer until the Commission has made such decisions. This provision in the regulations will therefore be amended in the future when the Commission has taken the appropriate decisions. This approach is reflected in the new draft of regulation 15. Arrangements for direct transfer of papers by auditors are largely unaffected, so regulation 24 has more minor changes.

33. We have considered the suggestion that the supervisory bodies, as well as the Professional Oversight Board should also be involved in the direct transfer of audit working papers to overseas competent authorities. The Government remains of the view that effective co-operation with third countries is better delivered by ensuring that there is a single authority handling such requests and the associated arrangements.

34. We have accepted the suggestion that we should change the requirement for working arrangements for the exchange of papers so that they are required to set up “comparable” rather than “reciprocal” rights. This is intended to facilitate the creation of practical working arrangements with jurisdictions where legal obligations may be structured differently to our own.

35. We agree with the suggestion that the POB should only be allowed a reasonable time in which to notify the profession of an audit working arrangement it has entered into. We have amended the new section 1253F of the Companies Act accordingly. We have also considered the suggestion that the POB should be required to publish the terms of the working arrangement. The Government considers, however that this should be a matter for the POB to determine, as only the POB will be bound by the terms of the agreement. The key issue for audit firms is whether a working arrangement exists with a particular country, and timely publication of that is secured by the amendment to S1253F discussed above.

## **Disclosure of Auditor Remuneration - Article 49**

36. Several responses covered these regulations. Some argued for a major review, while the more specific point was also made that the very broad definition of associates of auditors, coupled with the requirement for disclosure of all services provided by those associates, imposed a disproportionate regulatory burden.

37. The Government notes the arguments for wider reforms to the regulations. The Government does not propose to make major changes at present; the regulations have not yet been in place for two full reporting cycles. The operation of the regulations will nevertheless be kept under review in the light of experience and views across a range of stakeholders.

38. While the Government is not inclined to make fundamental changes to the regulations at this stage, it does accept that the detailed drafting has had the result that trivial transactions must be reported and therefore recorded. This can act as an obstacle to audit partners' involvement in wider activities unrelated to their audit practice. The Government proposes to make a minor change to the regulation to alleviate this and is therefore publishing for a further short consultation an amended draft of these regulations which exempts from the disclosure requirement small scale services provided by associates who are only distantly connected with the auditor.

39. The draft regulation is open for comment until 31 January 2008, and is available at <http://www.berr.gov.uk/bbf/co-act-2006/draft/page40411.html>.

## **The Statutory Auditors (Delegation of Functions etc) Order**

40. None of the respondents to the consultation commented on the draft Delegation Order included in the consultation paper. However we have amended the draft in a couple of areas.

41. The first of these relates to those new functions in Part 42 of the Companies Act that are now introduced by amendments made by the Statutory Auditors and Third Country Auditors Regulations in order to implement the Audit Directive. Primarily, these functions relate to cooperation with EEA and overseas competent authorities. We remain of the view that these functions should be delegated to the POB, but in parallel with the delegation arrangements for similar existing powers, we have concluded that in certain cases the Secretary of State should retain the power to act in parallel, or that the POB should seek the Secretary of State's agreement before acting.

42. The second series of amendments to the Delegation Order results from the planned administrative changes at the FRC which will come into effect in late 2007 and early 2008. These include a change to the limited company of which POB is an operating Board. It is therefore necessary to make separate references to the POB in respect of the arrangements that will exist before and after the changes.

43. The draft Delegation Order has now been laid before Parliament for approval by affirmative resolution and is available at <http://www.opsi.gov.uk/si/dsis2007.htm>.

## ANNEX

### **List of respondents to BERR's consultation on the Statutory Auditors and Third Country Auditors Regulations and the Statutory Auditors (Delegation of Functions etc) Order**

The full text of the responses can be seen at  
<http://www.berr.gov.uk/consultations/closedwithresponse/index.html>

Grant Thornton UK LLP

International Capital Markets Association

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

Joint Audit Committee

London Stock Exchange

Price Waterhouse Coopers

One private response was also received

### **List of respondents to BERR's website consultation on the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations**

Deloitte UK

Institute of Chartered Accountants in England and Wales

Law Society Scotland

Price Waterhouse Coopers

Vanessa Knapp – Freshfields Bruckhaus Deringer

BERR did not receive any responses to its website consultation on the Independent Supervisor Appointment Order

