

BIS and FRC consultation on audit regulation

With the EU legislation due to be enacted in relation to the audit regime you might be forgiven for thinking that things will be clearer. However, total clarity is still some way off. Two new consultation documents address some of the issues that will need to be resolved if the UK is to enact clear legislation and create a consistent regulatory framework.

Firstly, the Department for Business, Innovation & Skills ('BIS') published a discussion document on 17th December 2014 entitled 'Auditor regulation: effects of the EU and wider reforms'¹. It revisits the UK's audit regime in the light of the new EU Statutory Audit Directive² ("the new Directive") and Regulation³ ("the new Regulation") and sets out how it is proposed the UK will apply the Member State options available. It aims to consult on "how the UK can put in place the best possible [audit] regime, one that will most effectively respond to the modern fast moving, highly developed business economy." BIS further states "the regime must serve the needs of companies, those who work in them and those who do business with them. It must increase confidence and trust as the basis for business growth."

Secondly, in parallel with the BIS document (and in response to the tight EU timescales) the FRC published a consultation document entitled 'Consultation: auditing and ethical standards – implementation of the EU Audit Directive and Audit Regulation'⁴. The FRC document is more restricted in scope but generally tightens the regimes for listed companies above the statutory requirements. It also sets out how, if it is appointed the "competent authority" under the new regime, it will use a number of the powers delegated.

This briefing note highlights some the main proposals and areas under consultation. It assumes a good working knowledge of all the areas consider and

¹ <https://www.gov.uk/government/consultations/auditor-regulation-effects-of-the-eu-and-wider-reforms>

² Directive 2014/56/EU on statutory audits of annual and consolidated accounts.

³ Regulation (EU) No 537/2014 on specific requirements regarding statutory audit of public-interest entities.

⁴ <https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Consultation-Auditing-and-ethical-standards-implem.aspx>

concentrates on the impacts for companies and their shareholders – the impact on the audit profession will be equally as large.

Timetable and context

The BIS consultation closes on 19th February 2015 and is seeking views from interested groups to inform the approach to the implementation of the new Directive and to make legal provision for the application of the new Regulation that is applied directly under EU law. The Regulation will apply from 16 June 2016, by which time the new Directive must also have been transposed into national law. The FRC consultation closes on 20 March 2015.

Headline issues for companies

PIEs and the widening scope of the audit regime

BIS intends to maintain the core definition of a PIE (Public Interest Entity) as it is given in the EU Regulation and does not propose to extend the definition in the UK statute. However, the extended definition of a PIE in the new Regulation will apply regardless. BIS therefore propose to extend the application of Part 42 of the Companies Act on Statutory Auditors so that it should also apply to:

- all entities whose securities are admitted to trading on a regulated market
- electronic money institutions
- payment institutions
- MiFiD investment firms
- Undertakings for Collective Investment in Transferable Securities (UCITS)
- Alternative Investment Funds (AIFs).

Forms of non-legislative implementation (for example through professional standards for auditors, or through non-legislative schemes and procedures)

Main impacts:

1. Unlisted insurers and some unlisted banks will become PIEs under the new Regulation and will need to have an audit committee, whatever their size or ownership. They and their auditors may be subject to additional requirements from the FRC.
2. The financial services entities to the left will become subject to Part 42 of the Companies Act requiring a statutory audit to which additional standards apply.
3. Companies other than those with a premium listing could be subject to non-audit services restrictions if the FRC determine.



would extend the scope of requirements in certain areas.

BIS expect further amendments in legislation which would apply to each specific type of entity, running parallel to those proposed in the discussion document.

The FRC wants to consider extending some, or all, of the more stringent requirements for listed companies to some other types of company. The FRC is not proposing to extend the definition itself, but it is considering whether to extend the scope of the non-audit services restrictions to other entities in addition to PIEs. If this does happen entities such as AIM companies, non-listed financial services companies and certain others with a significant 'public interest' could be included.

Main impacts: various investigatory and disciplinary functions currently delegated to the Recognised Professional Bodies would need to change. Most of the impact will be felt by the profession.

Competent authorities – FRC role

BIS propose the FRC as the single competent authority for regulation of audit in the UK (currently the FRC shares regulatory responsibility with Recognised Supervisory Bodies such as the ICAEW). The FRC would have discretion to delegate certain elements to others (but not those in respect of PIE

audits, which limits the power's usefulness). In addition, responsibility for implementation of the requirements in respect of non-audit services is proposed to be delegated to the FRC, including the responsibility to take (or not to take) Member State options.

Non-audit services – need for clarity on implementation and sanctions

BIS make the point that, in practice, some significant non-audit services are already prohibited in the UK under the FRC's ethical standards for auditors; usually to a greater degree than in other EU Member States. It is likely that the FRC will continue to adopt tighter limits than the new Regulation.

Crucially, the new Regulation is directly applicable, so Articles 4 and 5 (the "blacklist" of prohibited non-audit services) will have legal effect from 17 June 2016 onwards without the need for any transposing into UK legislation. However, the existing UK legislation and the FRC's ethical and auditing standards framework will need to be made consistent with these provisions. And, to the extent that these Articles provide some discretion or choice for Member States, UK legislation and/or the standards framework will need to give effect to this.

BIS propose that the detailed rules on non-audit services are addressed by the FRC through development of the ethical and auditing standards framework.

A separate public disclosure, in the notes to the accounts of companies and other undertakings, of fees paid for audit and non-audit services (including the disclosures required by Article 14 of the new Regulation) is also under consideration by BIS.

Because of the way the new Regulation is drafted, the FRC consider a variety of options for implementing the EU non-audit services prohibitions, including the introduction of a 'white list' of permitted non-audit services which could include audit-related services only. However, there are alternatives, including the prohibited list direct from the EU Regulation, with or without the special tax and valuation services Member State option.

The FRC strongly suggests that a more 'principles-based approach', consistent around the world, could be 'appropriate' (i.e. desirable) and asks for views (presumably critical) on the new Regulation's approach of prohibiting a substantial amount of non-audit services within the EU, but having a less stringent regime outside the EU.

The FRC also want discussion of sanctions for breaching the non-audit services rules and recognition that an inadvertent or immaterial breach may not necessarily render the audit invalid. This is an important point for companies to consider when preparing their consultation responses.

The FRC also ask for consideration of whether some of the less intuitive aspects of the 70% non-audit services cap calculation should be amended. They suggest extending the cap to include all of the auditor's 'network' firms, not simply the member firm auditing the PIE. This might be more logical but in many cases will make the cap more restrictive.

Main impacts: The devil is in the detail here. Companies who use their auditors for significant non-audit related services, currently permitted under UK Ethical Standards, should look closely at the FRC's consultation. The implications for tender timing should be considered, particularly where a potential tenderer is carrying out prohibited services, though it may be difficult to conclude finally until the FRC consultation is concluded. Institutional investors should consider how the cap will work in practice for companies as the restriction of the cap to subsidiaries based in the EU could create a weakening of the current regime.



Tendering and duration of audits

BIS propose taking the Member State option in relation to mandatory firm rotation, and allowing an extension to 20 years maximum auditor tenure, subject to re-tendering at least every 10 years. BIS further propose to make it possible to retender the audit earlier than 10 years, but point out that there is a potential difficulty, because, as drafted, the new Regulation appears to require the tender to take place at the 10 year point to allow the extension to be effective. Until this is cleared up, it would be wise not to plan for a tender earlier than the 10-year point.

After the auditors' initial appointment, the annual report would disclose when the next retender would occur. PIEs should include their retendering plans in the Directors' report, setting out 'key matters for the audit committee on the appointment of auditors' and including

- date of current auditor appointment
- when the audit was last retendered
- the start of the next accounting year in relation to which the company expects that the auditor appointment will be based on a tender
- the reasons for considering that the proposed tender year is in the best interests of the company's members.

BIS proposes that if a PIE reports that the auditor's appointment in relation to the next but one accounting year following that covered by the report is 'intended' to be retendered, this would be binding on the PIE.

BIS are continuing to consider what sanctions should apply in cases where the resulting retendering and rotation framework is breached by a PIE and its auditor. The FRC believes that the new Regulation should be extended to impose on auditors a duty not to act when they are time-barred.

Main impacts:

1. All PIEs under the new definition, including unlisted banks and insurers, will be subject to the mandatory auditor tendering and rotation requirements, even if they are subsidiaries of EU listed companies or non-EU companies. This means that audit committees of PIEs cannot automatically appoint the group auditors.
2. Those planning to tender at less than 10 years should consider whether their existing auditors will be able to be reappointed under the drafting of the new Regulation.
3. Institutional investors should consider how BIS is considering applying the retendering timescales to allow rotation after a maximum of 20 years.



Audit reporting and additional reporting to the audit committee

BIS propose to implement the Regulation's and Directive's new requirements for audit reports and reporting to the audit committee through changes to the Companies Act and through changes to ISAs (UK and Ireland).

Main impacts: audit reports will change slightly.

Contact

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