

**PROPOSAL FOR A EUROPEAN DIRECTIVE
ON THE STATUTORY AUDIT OF
ANNUAL ACCOUNTS AND
CONSOLIDATED ACCOUNTS
(8TH COMPANY LAW DIRECTIVE)**

**UK GOVERNMENT RESPONSE TO THE
CONSULTATION PROCESS
AND
UPDATED REGULATORY IMPACT
ASSESSMENT.**

**Department of Trade and Industry.
February 2005.**

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PROPOSAL FOR A EUROPEAN DIRECTIVE ON STATUTORY AUDIT OF ANNUAL AND CONSOLIDATED ACCOUNTS.

UK GOVERNMENT RESPONSE TO CONSULTATION PROCESS.

1. Introduction

1.1 The European Commission published its proposed directive on the statutory audit of annual and consolidated accounts on 16 March 2004. The Department of Trade and Industry (DTI) consulted on the proposal between 10 September and 30 November 2004.

1.2 A copy of the Commission's proposal can be found at:

http://www.europa.eu.int/prelex/detail_dossier_real.cfm?CL=en&DosId=189770

A copy of the DTI consultation document can be found at:

<http://www.dti.gov.uk/consultations/consultation-1370.html>

1.3 The DTI received 17 consultation responses from bodies representing the auditors, investors and companies, accounting firms and private individuals. A list of respondents is attached at Appendix A. Copies of responses are available from Ray Taylor (raymond.taylor@dti.gsi.gov.uk) Tel 0207 215 0239.

1.4 Eight respondents indicated general approval for the proposal. (Other respondents did not indicate approval or otherwise.) Their approval was based on a recognition that confidence in the statutory audit needed to be improved across Europe, following recent scandals.

2. Consultation Process

2.1 The consultation document was divided into three parts: (1) a general invitation to comment; (2) questions relating to the UK delegation's negotiating strategy; and (3) a partial regulatory impact analysis (RIA).

2.2 This response to the consultation deals with parts (1) and (2).

2.3 A list of the consultation questions is attached at Appendix B. An updated RIA is attached at Appendix C.

3. Comments from Respondents

3.1 General Comments

A number of respondents made general comments on the proposal, while others answered specific questions. For ease of reference all comments are reported 'article by article'. Where this document makes references to "the proposed text", they are

references to the consolidated text, dated 1 December 2004, on which ECOFIN Ministers gave “agreement to the general approach”. This text is available at:

<http://register.consilium.eu.int/pdf/en/04/st15/st15500-ad01.en04.pdf>

Article 1 – Subject Matter (Question 1)

The Institute of Chartered Accounts in England and Wales (ICAEW), Association of Chartered Certified Accountants (ACCA) and the Institute of Directors (IOD) raised concerns that the scope of the proposed Directive went further than the existing 8th Directive and company law. The National Association of Pension Funds (NAPF) and PricewaterhouseCoopers (PWC) indicated that they were content with the proposed Directive’s scope.

Government Response: This issue is still under consideration.

Article 2 – Definitions (Questions 2 and 3)

(a) ICAEW, ACCA, PWC and Deloitte had concerns over the proposed definition of a “network” and the possibility that it could prevent firms from carrying out audits even though their independence from the audit client was not at risk. The IOD called for a clearer definition. The NAPF indicated that it was content with the proposed text.

Government Response: Whilst the proposed text is wider than the UK delegation might have preferred, we consider it is an acceptable compromise.

(b) ICAEW also raised concern over the inclusion of ‘practice statements’ in the definition of ‘International Standards on Auditing’.

Government Response: The UK Delegation queried this issue. The Commission indicated that it did not expect to adopt practice statements, but was looking for flexibility. We agree that practice statements should not be adopted under the Directive.

(c) A number of respondents (ICAEW, ACCA, PWC, Barclays Bank, Grant Thornton (GT), the European Group of International Accounting Networks (EGIAN), IOD and the London Investment Banking Association (LIBA)) raised concerns over the definition of ‘Public Interest Entities’ and the impact of the provisions relating to public interest entities. Most respondents argued that the term should only cover listed companies, although ACCA and IOD indicated that other large businesses should also be covered. Both Barclays Bank and LIBA argued that the definition should not cover ‘special purpose vehicles’. The NAPF were content with the proposed definition.

Government Response: The UK delegation argued for small ‘financial institutions’ to be excluded from the definition. We also argued for some of the provisions

relating to public interest entities to be reduced in scope. We believe that the proposed text is an acceptable compromise.

Article 3 – Approval of auditors and audit firms (Question 4)

There were mixed views on the proposed text. ICAEW and PWC wanted the text replaced with the existing 8th Directive text. EGIAN and NAPF were content with the proposed text. ICAEW, ACCA and PWC pointed out that the text did not sit well with the current UK regime.

Government Response: The UK Delegation successfully argued for certain amendments to the text to ensure that certain important aspects were consistent with the current UK regime.

Article 4 – Good Repute

EGIAN and GT expressed concern that the proposed text could lead to audit firms being banned from conducting audits if they engaged in any activity that was ‘incompatible with the statutory function’.

Government Response: See comments on Article 23.

Article 5 – Withdrawal of approval

No comments received.

Article 6 to 13 - Educational Qualifications/Testing and Training

ICAEW supported the need for consistent educational qualifications, and the mutual recognition of these qualifications, across the EU. EGIAN suggested an additional area to be covered in the ‘test of theoretical knowledge’. ACCA and Professor Michael Bourn rejected the requirement for a university degree. They also suggested that Article 13 could be strengthened by requiring auditors to abide by the International Federation of Accountants’ (IFAC) rules on continuing professional development.

Government Response: The UK delegation successfully argued for the inclusion of the term ‘having attained university entrance, or equivalent level’. We are, otherwise, content with the proposed text.

Article 14 - Approval of statutory auditors from other Member States (Question 5)

ICAEW and PWC argued for aptitude tests to be carried out in the language used in recording business activities in the Member State in question. ACCA, IOD and

NAPF argued for the test to be in the language of the Member State in question. Barclays Bank suggested that either the local language, or language commonly used in the financial sphere should be used.

Government Response: The UK Delegation believes that the proposed text offers sufficient flexibility.

Article 15 – Public Register (Question 6)

EGIAN raised the risk of duplication of registration information across Member State registers. It suggested the development of a pan European database.

Government response: The DTI understands that the Commission is considering the creation of a pan European register.

Article 16 and 17 – Registration of Statutory Auditors/Audit Firms (Question 7)

ICAEW and ACCA argued that these Articles might impose undue burdens on auditors and audit firms.

Government response: The UK delegation supported the Commission’s proposals, which should lead to greater transparency and confidence.

Article 18 – Update of registration information

No comments received.

Article 19 – Responsibility for registration information

ICAEW pointed out a grammatical error.

Government response: The text will be “cleaned up” before adoption.

Article 20 – Language

No comments received.

Article 21 and 22¹ – Professional Ethics and Confidentiality and secrecy (Question 8)

ICAEW and PWC argued for the adoption of the IFAC code. They opposed the use of comitology in this area. They also raised concerns relating to confidentiality and secrecy. ACCA proposed alternative wording for Article 21 that, it argued, was confusing. NAPF and IOD broadly supported the proposed text.

Government response: The UK delegation believes that the text in article 21 is sufficiently flexible. It does not agree that the enforcement and exchange of information could be impeded by Article 22.

Article 23² – Independence and Objectivity (Questions 9)

This Article generated the most comments. ICAEW, ACCA, the Law Society, PWC, CBI, Barclays Bank, GT and Deloitte were all concerned that the proposed text could undermine the 2002 EC Recommendation on Auditor Independence. They were also concerned about possible rules regarding the provision of non-audit services to audit clients. They argued for changes to reflect the UK “threats and safeguards” approach. IOD also noted that the Financial Reporting Council’s Auditing Practices Board had just published ethical standards on auditors’ independence.

NAPF did not believe that the proposed text would have significant cost implications. Dr Jill Collis and Professor Robin Jarvis argued that small businesses should be able to purchase both audit and non-audit services from their auditors.

Government Response: The UK delegation argued that the original text of the Article should not be changed and it opposed all attempts to change the text. The ECOFIN text, nevertheless, still leaves sufficient room for flexibility.

Article 24 – Independence and objectivity of the auditors

No comments received.

Article 25 – Audit Fees (Question 10)

ICAEW, ACCA, NAPF, PWC, CBI, GT and IOD all argued that this Article should deal with quality rather than cost. The Law Society recommended deletion of Article 25 (a). Barclays Bank supported the Article’s objectives, but argued that it was not possible to legislate for ‘adequate fees’.

Government Response: The UK delegation successfully argued for amendments and believes the proposed text is acceptable.

¹ Article 22 has been renumbered as Article 23 in the compromise Directive text, dated 1 December.

² Article 23 has been renumbered as Article 22 in the compromise Directive text, dated 1 December.

Article 26 – Auditing Standards (Question 11 and 12)

ICAEW, EGIAN, ACCA, PWC, CBI, LIBA, Barclays Bank, Deloitte and IOD supported the adoption of International Standards on Auditing. They accepted limited “national pluses”, but opposed ‘carve outs’. The NAPF was concerned about a ‘one size fits all’ approach.

Government Response: The UK delegation opposed ‘carve outs’, but supported limited ‘national pluses’ which would ensure that UK auditing standards were not lowered. It also argued for a simple adoption process.

Article 27 – Statutory Audit of consolidated accounts (Question 13)

ICAEW supported the proposals in Article 27 (a) and (b), but took issue, along with EGIAN, ACCA, PWC, LIBA, Barclays Bank and GT with the requirement in Article 27 (c) for auditors to keep copies of audit working papers.

Government Response: The UK delegation successfully argued for a reduction in the requirement to keep copies in Article 27 (c).

Article 28 – Audit Reporting (Question 14)

ICAEW and Barclays Bank raised concerns over the need for the individual auditor(s) to sign the audit report. ACCA and NAPF supported this requirement but opposed the introduction of a “European report”. PWC argued that either the audit firm or the auditor should be able to sign the report. It also argued for an exemption from the requirement to disclose the auditor’s identity where his or her security might be threatened.

Government Response: The UK delegation believes that it is reasonable to expect either the statutory auditor, or the key audit partner to sign the audit report. It successfully argued for an exemption from the requirement to disclose the auditor’s identity where his or her personal security could be at risk.

Article 29 – Quality Assurance Systems (Question 15)

ICAEW argued that the provision was too detailed. In particular, it was concerned the 6-yearly mandatory review was too inflexible. EGIAN and ACCA argued against a direct link between quality reviews and enforcement action. PWC was concerned about the cost of Article 29 (g). Barclays Bank argued that the phrase ‘free from any possible undue influence’ was inappropriate.

Government Response: The UK delegation successfully argued for greater flexibility. It believes that the proposed text balances stakeholders’ interests.

Article 30 – Systems of investigations and sanctions

ICAEW was concerned that the Article might require undue pro-activity on the part of investigators.

Government Response: The UK delegation does not share these concerns.

Article 31 – Principles of Public Oversight

ICAEW raised concerns that the proposals might not be consistent with the UK system of Recognised Supervisory Bodies. EGIAN supported the requirement that practitioners be in the minority on the public oversight system.

Government Response: The UK delegation believes that the proposals are broadly consistent with the new UK system of public oversight. It supports the requirements relating to the membership of the Oversight Body.

Article 32 and 33 – Co-operation between public oversight systems/Recognition of regulatory arrangements (Question 16)

ICAEW raised concerns about co-ordination. EGIAN suggested that a single European body should manage co-operation. EGIAN and ACCA opposed peer reviews of public oversight systems. ICAEW and ACCA welcomed the mutual recognition proposals in Article 33. NAPF, PWC and IOD did not anticipate any difficulties with the proposed text.

Government Response: The UK delegation successfully argued against peer reviews. It strongly supports the text in Article 33.

Article 34 – Regulatory co-operation between Member States (Question 17)

ICAEW argued that competent authorities should have greater discretion to decide when to co-operate. EGIAN argued that information should be required to be supplied ‘within a reasonable time period’, rather than ‘immediately’. ACCA and IOD sought clarification on whether a competent authority could ask another competent authority to conduct an investigation.

Government Response: The UK delegation sought to reduce the scope of this provision but was not able to secure changes in the proposed text.

Articles 35 to 37 – Appointment and Dismissal of Statutory Auditor/ Communication between audited entity and auditor (Question 18)

ICAEW, ACCA, the Law Society, LIBA, CBI, Barclays Bank and IOD expressed concerns that Article 35 would reduce flexibility and increase cost. PWC argued that Article 36 should expressly indicate that auditors have a right to resign. Several

respondents opposed the need for ‘proper grounds’ for dismissal. EGIAN supported the requirement to inform the oversight body, and argued for this information to be made public.

Government Response: The UK delegation successfully argued for the deletion of Article 37 (which related to corporate governance). It also successfully argued for greater flexibility in relation to appointments. It supports the requirement to notify dismissals to the Financial Reporting Council’s Professional Oversight Board for Accountancy, which should help raise confidence.

Article 38 – Transparency Report (Questions 19 and 20)

ICAEW and ACCA expressed concerns over the amount of detail required. Concerns were also raised that the report could be a costly ‘boiler plate’ exercise. The proposed text was supported by EGIAN and NAPF

Government Response: The UK delegation believes that the proposed text is an appropriate compromise between the stakeholders’ interests. We accept that there will be cost implications, but consider that the benefits of greater transparency should outweigh those costs.

Article 39 – Audit Committees (Question 21)

This Article generated a large number of comments. ICAEW, ACCA, NAPF, British Telecom, the Law Society, PWC, LIBA, CBI, Barclays Bank, Deloitte, IOD and the London Stock Exchange all opposed mandatory audit committees. They all supported the existing UK ‘comply or explain’ approach. EGIAN support the inclusion of audit committees within the Directive, but not necessarily the current proposals.

Government Response: The UK delegation argued for this Article to be deleted. We also sought an exemption for special purpose vehicles. We subsequently, successfully, sought to amend the Article to reduce its cost implications and make it more consistent with existing practice.

Article 40 – Independence (Question 22)

ICAEW, CBI and IOD argued that this Article should be deleted. ACCA argued that the proposal was unclear. ICAEW, EGIAN, PWC, CBI, GT and Deloitte argued against the audit firm rotation option. The proposed text was supported by NAPF.

Government Response: The UK delegation successfully argued for the proposal to be made clearer. It successfully opposed changes to make audit firm rotation mandatory.

Article 41 – Quality Assurance (Question 23)

ICAEW re-iterated its comments in relation to Article 29. ACCA and NAPF supported the proposed text.

Government Response: See comments for Article 29.

Article 42 – Public Oversight

ICAEW was concerned that a ‘US style’ oversight body might be established. EGIAN argued that the proposal might, in practice, prevent a minority of practitioners on oversight body.

Government Response: This Article has now been deleted.

Article 43 – Appointment of the statutory auditor or audit firm

CBI sought deletion of the Article.

Government Response: This Article has now been deleted.

Articles 44 to 47 – ‘International Provisions’ (Questions 24 and 25)

ICAEW, NAPF, the Law Society, PWC, LIBA, Barclays Bank and IOD considered these Articles unworkable and/or costly. ACCA and PWC raised data protection concerns. Professor Michael Bourn commented that there was a disparity between the educational requirements in Article 44 (b) and those in Article 6.

Government Response: The UK delegation argued that Articles 45 to 47 should be deleted. It subsequently, successfully sought reductions to their scope and greater flexibility in their application. It believes that the proposed text contains adequate safeguards regarding the transfer of information/ documents. The UK delegation successfully argued for Article 44 to be reworded in a similar way to the existing provision in the current 8th Directive.

Article 48 and 49 – Implementing Measures/Committee (Question 26)

ICAEW and Deloitte questioned the use of comitology. ICAEW wanted there to be full consultation on any proposals resulting from comitology considerations. ACCA supported the creation of the Audit Regulatory Committee. PWC argued for the profession to be represented on the committee.

Government Response: Article 48 has been deleted from the ECOFIN text. The UK Delegation supports the creation of the Audit Regulatory Committee.

Articles 50 – Amendments to Directives

The Law Society sought an exemption for medium sized companies.

Government Response: The UK delegation argued for an exemption for medium sized companies. This would, however, have placed this Directive at odds with other Directives.

Articles 51 to 55 – Implementation of Directive (Question 27)

ICAEW, PWC and IOD were concerned that the proposed implementation date would not give Member States sufficient time. NAPF opposed any delay in implementation. LIBA wanted a longer transitional period for Article 39.

Government Response: Member States will now have 24 months to implement the Directive from the date it comes into force.

3.2 Questions relating to costs and benefits.

Article 23 (Question 28)

ICAEW argued that the separation of audit and non-audit services would significantly increase costs for business. PWC suggested that this separation might make audit firms less attractive places to work and that this would have a detrimental effect on quality of audit.

Article 25 (Question 29)

ICAEW and PWC did not believe that this Article would have an impact on audit fees.

Article 26 (Question 30)

ICAEW and PWC indicated that there would be short-term costs, but could not estimate what these would be.

Article 27 (Question 31)

ICAEW and PWC indicated that there would be costs associated with the translation, copying, transportation and/ or storage of documentation.

Article 32 (Question 32)

ICAEW suggested that co-operation improves standards and benefits stakeholders.

Article 34 (Question 33)

No additional comments.

Article 35 (Question 34)

ICAEW and PWC agreed with DTI estimates.

Article 38 (Question 35)

PWC believed that the benefits of transparency reports would outweigh the costs.

Article 39 (Question 36)

ICAEW, IOD and PWC will consider the cost implications when the definition of ‘public interest entities’ has been finalised.

Article 40 (Question 37).

ICAEW agreed that there might be benefits arising from stronger independence regimes across the EU. IOD did not agree.

Articles 45 and 46 (Question 38)

ICAEW and PWC believed that these proposals would have significant cost implications.

Articles 48 and 49 (Question 39)

Both ICAEW and PWC asked to be consulted on the cost of “comitology” measures.

Government Response: An updated regulatory impact assessment has been published.

3.3 Auditors’ Liability

Auditors’ liability did not feature in the original Commission proposal or the DTI consultation. A number of responses, nonetheless, commented on this area.

ICAEW, EGIAN, PWC and GT all argued that the Directive should introduce requirements relating to auditors’ liability. EGIAN supported the introduction of a proportionate liability regime. PWC and GT supported a single European regime. The Investors’ Association argued that the matter should be considered by the Competition Commission. Deloitte argued for an over-riding principle that auditors’ liability should be limited.

Government Response: The Government considered this issue in 2004 and will shortly issue a White Paper setting out proposed reforms.

4. Current position on the Proposed Directive

- 4.1 Following the publication of the proposed Directive, there were a number of Council Working Group and attachés meetings, involving Member State delegations.
- 4.2 A number of changes were subsequently made to the proposal, many at the request of the UK Delegation.
- 4.3 On 7 December 2004, ECOFIN Finance Ministers gave ‘agreement to the general approach’ set out in the compromise text, dated 1 December 2004.
- 4.4 The European Parliament is currently considering the proposal. It is due to complete its deliberations by June 2005.

**Department of Trade and Industry
February 2005**

LIST OF RESPONDENTS

1. ASSOCIATION OF CHARTERED CERTIFIED ACCOUNTANTS (ACCA)
2. BARCLAYS BANK
3. BRITISH TELECOM
4. CONFEDERATION OF BRITISH INDUSTRY (CBI)
5. DELOITTE AND TOUCHE
6. DOCTOR JILL COLLIS AND PROFESSOR ROBIN JARVIS
7. EUROPEAN GROUP OF INTERNATIONAL ACCOUNTING NETWORK (EGIAN)
8. GRANT THORNTON
9. INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES (ICAEW)
10. INSTITUTE OF DIRECTORS
11. INVESTORS ASSOCIATION
12. LAW SOCIETY
13. LONDON INVESTMENT BANKING ASSOCIATION (LIBA)
14. LONDON STOCK EXCHANGE
15. NATIONAL ASSOCIATION OF PENSION FUNDS (NAPF)
16. PROFESSOR MICHAEL BOURN
17. PRICEWATERHOUSECOOPERS

APPENDIX B

Questions relating to the drafting of the Directive

Q.1 Do you have comments on the scope of the Directive as set out in Article 1?

Q.2 Do you agree with the definition of “network” (in Article 2)?

Q.3 Is the term “public interest entity” (in Article 2) defined appropriately?

Q.4 Do you have any general comments, or specific suggestions, in relation to Articles 3 (3) (b) and 3 (3) (c)?

Q.5 In what language(s) should aptitude tests be able to be conducted (Article 5)?

Q.6 Will the Recognized Supervisory Bodies (RSBs) have difficulties implementing Article 15?

Q.7 Will Articles 16 and 17 impose burdens on statutory auditors and audit firms and, if so, how?

Q.8 Do you have any general comments on Articles 21 and 22?

Q.9 Will Article 23 have adverse cost impacts on audit firms and/ or audited entities; and will these costs be outweighed by “public good” benefits?

Q.10 Do you have comments, or specific suggestions on the drafting of Article 25?

Q.11 Do you have any general comments, or specific suggestions on the “maximum harmonisation” approach proposed in Article 26?

Q.12 To what extent should Member States be allowed to set additional auditing standards following the implementation of the Directive, either on a transitional, or on a permanent basis?

Q.13 What will be the costs and benefits of Article 27 (c), and is the provision important for monitoring and enforcement purposes?

Q.14 Should an audit report be required to be signed by an individual statutory auditor?

Q.15 Are any of the requirements prescribed by Article 29 likely to pose problems?

Q.16 Do you anticipate any difficulties, or unintended consequences arising from Articles 32 and 33?

Q.17 Do you have any concerns regarding the scope, or practicality of the

proposed cooperation between Member States set out in Article 34?

Q.18 Will it cause difficulties if not all our current systems for the appointment of auditors are accommodated within Article 35; and do you have any other comments on Articles 35 to 37?

Q.19 Do you have any comments on the scope or content of the proposed annual transparency report (Article 38)?

Q.20 Does the proposed annual transparency report raise any issues for smaller audit firms, and can you quantify the cost impact on them (Article 38)?

Q.21 Do you agree with our views on Article 39, and can you quantify its cost impact?

Q.22 Do you have any comments, or specific suggestions on the drafting of Article 40?

Q.23 Do you have any comments on the benefits of, or general comments on, the proposed quality review described in Article 41?

Q.24 Do you agree with our views on Articles 44, 45 and 46?

(a) Do you believe that they could have adverse/beneficial cost impacts?

(b) Are you able to quantify these impacts?

(c) Do you have any general comments, or specific suggestions in relation to the Articles?

Q.25 Do you have any comments on the proposals for cooperation with competent authorities from third countries (Article 47)?

Q.26 Do you have any comments on Article 48, or on the proposal in Article 49 to create an audit regulatory committee?

Q.27 Do you have any comments on questions of timing and implementation (Articles 51 to 55)?

Questions relating to costs and benefits

Q.28 Will Article 23 effectively prevent statutory auditors and audit firms from providing non-audit services; and can you describe or quantify what the costs and benefits would be for your firm and/ or the wider economy?

Q.29 Will Article 25 achieve the desired benefits? Would fees change and by how much?

Q.30 Can you quantify short and longer term efficiencies and savings from the adoption of IASS (Article 26)? Can you describe the benefits, ideally using real examples?

Q.31 What would be the costs of the requirement in article 27 (c)? Can you describe the benefits, ideally using real examples?

Q.32 Can you give examples of problems caused by an absence of cooperation and/or benefits that cooperation would create (Article 32)?

Q.33 Do you have views on whether the benefits arising from regulatory cooperation set out in Article 34 would outweigh the costs?

Q.34 Do you agree with our estimation of the additional costs for the appointment of statutory auditors set out in Article 35? Can you describe the benefits of the inclusion of the principle in paragraph (1)?

Q.35 Can you quantify the likely costs on your firm and/or the wider profession of producing transparency reports as set out in Article 38? Will the benefits outweigh these costs?

Q.36 Can you quantify the costs for UK companies of the need for PIEs to have audit committees (Article 39)? Do you believe that these costs would be outweighed by the benefits?

Q.37 Can you describe the benefits, if any, of the independence arrangements set out in Article 40?

Q.38 Can you quantify the possible costs of the requirements set out in Articles 45 and 46? Would they achieve the desired benefits? (If so, please set out your arguments.)

Q.39 What would be the greatest areas of cost, and the greatest areas of benefit, arising from the application of comitology (Articles 48 and 49)?

APPENDIX C

**UPDATED REGULATORY IMPACT ASSESSMENT
ON
THE PROPOSED EUROPEAN DIRECTIVE ON THE
STATUTORY AUDIT OF ANNUAL AND
CONSOLIDATED ACCOUNTS.**

1. Proposal.

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, and amending Council Directives 78/660/EEC and 83/349/EEC. A copy of the proposal can be found at:

http://www.europa.eu.int/prelex/detail_dossier_real.cfm?CL=en&DosId=189770

1.2 The proposed Directive will replace the existing EC 8th Company Law Directive of 1984 and make a number of changes of substance to the regulation of statutory audits.

1.3 It will be made in accordance with the procedure laid down by Article 251 of the Treaty establishing the European Community (co-decision).

1.4 In the absence of a risk assessment from the European Commission, the Department of Trade and Industry (DTI) produced a partial risk assessment that it attached to its Consultation document of 10 September 2004.

1.5 On 7 December 2004, ECOFIN Ministers reached 'agreement to the general approach' set out in the Council text dated 1 December 2004

1.6 This updated risk assessment is based on the 1 December 2004 text, which can be found at:

<http://register.consilium.eu.int/pdf/en/04/st15/st15500-ad01.en04.pdf>

1.7 The DTI is not seeking comments on this impact assessment at this time. We will be consulting on the implementation of the Directive once it has come into force.

2. Purpose and Intended effect.

Objective

2.1 The proposed Directive clarifies the duties of statutory auditors: sets requirements relating to their independence, ethical standards, external quality assurance and public oversight and provides for cooperation between oversight bodies.

2.2 It also provides a basis for international co-operation between regulators in the EU Member States and regulators in third countries, such as the US Public Company Accounting Oversight Board (PCAOB). The Commission believes that such co-operation is important because of the increasingly global nature of capital markets.

- 2.3 The proposed Directive largely follows a ‘minimum harmonisation’ approach. Member States are, therefore, able to go beyond the principles set out in the Directive when implementing it.

Background

EU Developments

- 2.4 The 8th EC Company Law Directive on the approval of persons responsible for carrying out the statutory audits of accounting documents (84/253/EEC) was adopted in 1984. The Directive essentially fell into two parts:
- (a) It laid down minimum educational requirements for persons wishing to train as auditors;
 - (b) It required statutory audits to be carried out with professional integrity and appropriate safeguards to protect auditors’ independence.
- 2.5 In 1996, the Commission published a Green Paper on ‘the Role, Position and Liability of the Statutory Auditor in the EU’. Respondents to this paper recommended additional reforms at EU level. In 1998, the Commission published a Communication ‘The Statutory Audit in the European Union – a way forward’.
- 2.6 The Communication proposed the creation of a EU Committee on Auditing to develop close cooperation between the accounting profession and Member States. On the basis of the Committee’s work, the Commission published two Recommendations: ‘Quality Assurance for the Statutory Auditor in the EU’ (November 2000) and ‘Statutory Auditors’ Independence in the EU’ (May 2002). Preparatory work on the adoption of International Standards on Auditing (ISA) was also carried out. The Commission subsequently issued another communication ‘Reinforcing the statutory audit in the EU’ (May 2003) which laid the ground for the current proposed Directive.
- 2.7 The rationale for the current proposed Directive is set out in its accompanying Explanatory Memorandum:

“The recent spate of scandals in the US and the EU have emphasised that statutory audit is an important element in ensuring the credibility and reliability of companies’ financial statements. Significant economic damage to the capital markets and the economy has resulted.

Recent scandals also confirm the urgency and the need for the envisaged EU initiatives on statutory audit outlined in the May 2003 Commission Communication ‘Reinforcing the statutory audit in the EU’. This proposal is one of the most important initiatives of this Communication. It considerably broadens the scope of the former 8th EC Company Law Directive by clarifying the duties of statutory auditors, their independence and ethics, by introducing a requirement for external quality assurance, by ensuring robust public oversight over the audit profession and by improving co-operation between oversight bodies in the EU.

The proposal also provides a basis for effective and balanced international regulatory cooperation with oversight bodies of third countries such as the US Public Company Accounting Oversight Board (PCAOB). This is crucial because capital markets today are globally interconnected.”

UK Developments

- 2.8 In parallel with the EU developments, the UK Government was carrying out its own ‘post Enron’ review of audit and accountancy.
- 2.9 It set up the Co-ordinating Group on Audit and Accounting Issues (CGAA), which consisted of representatives from the Government (H. M. Treasury and the DTI), the Accountancy Profession, the Financial Services Authority and the Financial Reporting Council. The CGAA reviewed UK audit and accounting regulation and made recommendations on 29 January 2003.
- 2.10 Their recommendations covered auditors’ independence, the role of audit committees, the production of transparency reports, the monitoring of audit firms, the adoption of international auditing standards (ISAs) and closer working between the UK’s Auditing Practices Board (APB) and the International Auditing and Assurance Standards Board (IAASB)
- 2.11 The Government agreed that, while the UK audit system was fundamentally sound, it could be strengthened in a number of ways. It, therefore, took action to:
 - (a) Expand the Financial Review Reporting Panel’s (FRRP) scope and to give the panel legal powers to obtain documents and information;
 - (b) Expand the UK Corporate Governance Code to cover the role of audit committees;
 - (c) Transfer responsibility to the Financial Reporting Council for setting auditors’ ethical standards and for the monitoring, disciplining and overseeing of the audit profession;
 - (d) Require lead audit partners to be rotated every five years;
 - (e) Require major audit firms to publish annual reports covering their internal procedures; and.
 - (f) Require companies to disclose, in their annual reports, all the services that had been purchased from their auditors.

Impact of the Proposed Directive.

- 2.12 In assessing the impact of the proposed Directive, the Department has considered the extent to which it extends, or differs from the measures that are already being 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 EC Number 1606/2002);
 - (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.

3. Risk Assessment.

3.1 It is anticipated that the Government will have 24 months, from the date the proposed Directive comes into force, to implement its provisions.

3.2 The risks associated with not implementing the provisions of this Directive 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.

Options

3.3 We have identified three possible options going forward:

- (a) Do nothing.
- (b) Implement the Directive and disregard aspects of the new UK regulatory regime that the Directive does not make mandatory; and
- (c) Implement the Directive and retain aspects of the new UK regulatory regime, which the Directive permits, but does not make mandatory.

Option One.

3.4 It is not feasible to 'do nothing' because the UK Government is under a legal obligation to implement this Directive.

3.5 The risks associated with this option are set out in paragraph 3.2. The benefits associated with this option are set out in paragraph 4.1.

Option Two.

3.6 Following the CGAA recommendations, the Government made a number of changes to audit and accounting regulation.

- 3.7 A number of these changes were implemented by the Companies (Audit, Investigations and Communities Enterprise) (CAICE) Act, which will come into force during 2005. Most of them are required by the proposed Directive.
- 3.8 There would, however, be a cost in unravelling those changes that are not so required. This course of action might also adversely affect confidence in the UK regulatory regime.

Option Three.

- 3.9 This option is very similar to Option Two, except that the UK regulatory regime for statutory audit would only be changed to the extent necessary to comply with the proposed Directive. Recent reforms that go beyond the requirements of the proposed Directive would not be repealed.
- 3.10 All of the recent changes to the UK regulatory regime have already been subjected to an impact analysis and the Government is confident that their benefits outweigh their costs. (A copy of the final impact analysis on the CAICE Act can be found at: http://www.dti.gov.uk/cld/companies_audit_etc_act/ria.pdf)
- 3.11 Option Three is, therefore, the Government's preferred option.

4. Benefits.

Option One.

- 4.1 The UK Government has already taken steps to ensure continued confidence in the statutory audit. Not implementing the Directive would mean continuity of this new regime.

Option Two.

- 4.2 The proposed Directive should raise the standard of, and public confidence in, audits across the European Internal market.
- 4.3 Better quality audits and greater confidence in the audit process should bring benefits to companies, shareholders and other users of company reports and audit firms themselves. They should also provide wider economic benefits – domestic, European and global – by helping to restore faith in the corporate reporting systems which underpin capital markets. Greater confidence should reduce investor costs and have a favourable impact on the cost of capital.
- 4.4 The implementation of the proposed reforms across the EU is also significant. While the UK regime is fundamentally sound, not all Member States are as far down the road as the UK. As recent scandals have shown, confidence is a European, not just a UK, concern. A harmonised approach is, therefore, appropriate.
- 4.5 The recent reforms to the UK audit regulatory regime meets the requirements of the proposed Directive in a number of respects. Under Option Two, the 'additional' reforms, the UK has implemented, would be repealed. This would have benefits in terms of lower compliance costs. However, these benefits would

be outweighed by the costs associated with reduced confidence and disruption (see paragraph 6.3).

Option Three

4.6 The benefits associated with Option Three are similar to those identified for Option Two. The only difference is the additional benefits that flow from recent UK reforms that are not mandated by the proposed Directive.

5. Business Sectors Affected.

5.1 This Directive will affect all companies that have a statutory audit. There are additional requirements on companies classified as public interest entities¹ and for public interest entities' audit firms. This Directive will also affect statutory auditors, audit firms and their professional bodies.

6. Costs.

6.1 The proposed Directive will have cost implications for the Government and the Financial Reporting Council that is partly funded by Government. These costs have not been included in this impact analysis.

Option One.

6.1 There would not be implementation costs (to either companies or Auditors') with the 'do nothing' option. There would, however, be significant costs associated with loss of confidence in the UK audit regime.

Option Two.

6.2 Option Two would give rise to the costs of implementing the Directive identified in paragraph 6.5 below.

1. '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 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).

6.3 There would also be costs associated with the repeal of UK ‘additional’ reforms. These include:

- (a) Aspects of the APBs Independent Ethical Standards for auditors, which go beyond the requirements of the Commission’s 2002 Recommendation on Independence. The APB standards came into force in December 2004 and were accompanied by a detailed cost/benefit analysis. The Government believes that it would be undesirable for the APB to withdraw them;
- (b) Increased disclosure of non audit services purchased from a company’s statutory auditor. The Government is currently consulting on this proposal and resulting regulations will be accompanied by a cost/benefit analysis.
- (c) The requirement for companies to comply with the combined code provisions in relation to audit committees, or to explain their non compliance. These provisions are more prescriptive in some areas than the proposed Directive (for example at least three members of the committee should be independent of the company’s management). The Government does not believe that these provisions should be withdrawn because they represent best practice, not legal requirements. Compliance is a decision for the board of a company.

Option Three.

6.4 Option Three would give rise to the costs of implementing the Directive identified in paragraph 6.5 below. The costs of complying with the UK’s ‘additional’ provisions would also continue to be incurred. As noted in paragraph 6.3 above, however, the benefits of these provisions outweigh the additional costs.

6.5 We estimate the cost of implementing the proposed Directive as follows: (These figures incorporate responses to the Consultation process and should be treated as best estimates).

Articles	Subject Matter	Cost	Comment
3,4 and 5	Auditor Approval	No additional cost	The current UK system meets the Directive’s requirements.
6, 7, 8, 9, 10, 11, 12 and 13	Auditor Education	No additional cost	The current UK system meets the Directive’s requirements.
14	Other Member State Approval of Auditors	No additional cost	The current UK system meets the Directive’s requirements.
15, 16, 17, 18, 19 and 20	Public Register	Up to £10 million as one off cost.	There will be a costs associated with obtaining and storing information which is not currently held on the public register. These costs will, however, be offset against savings relating to stakeholders’ search costs (see note 1).

21 to 24	Ethics, Independence and Confidentiality	Up to £30 million as one off cost.	The current UK system meets the Directive's requirements. The costing figure of up to £30 million represents the potential cost of greater restrictions on provision on non audit services to audit clients (see note 2).
25	Auditor Fees	No additional costs	The current UK system meets the Directive's requirements.
26	Standards	No additional costs	The UK has already adopted International Standards on Auditing.
27	Consolidated Accounts	No additional costs	The current UK system meets the Directive's requirements (see note 3).
28	Audit Signature	Up to £10,000 per annum	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).
29 and 41	Quality Assurance	No additional costs	The current UK system meets the Directive's requirements (see note 5).
30	Investigations	No additional costs	The current UK system meets the Directive's requirements.
31	Public Oversight	No additional costs	The Financial Reporting Council (FRC), Professional Oversight Board for Auditors (POBA) will take on oversight of statutory auditors from April 2005.
32, 33, 33A and 34	Co-operation between oversight systems	No additional costs	The POBA meets the Directive's requirements (see note 6).
35	Auditor Appointment	No Additional costs	The current UK system meets the Directive's requirements.
36	Dismissal	Up to £215,000 per annum	Instances of auditor dismissal will be notified to the POBA. The figure of £215,000 per annum covers the preparation and transmission of dismissal letters (see note 7).
38	Transparency Report	Up to £10 million as one off cost	The requirement for published annual transparency reports will involve a 'one off' cost of updating audit firms' web sites (see note 8). Part of this cost will, however, be offset against savings related to stakeholders' search costs.

39 and 40(1)	Audit Committees	Up to £12 million per annum	The figure of £12 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).
40(2) and (3)	Auditor Rotation/Auditor 'cooling off'	No additional costs	The current UK system meets the Directive's requirements.
44, 45 and 46	International Provisions	£650 per request	<p>The current system for the registration of EU auditors meets the Directive's requirements.</p> <p>Responsibility for the approval of third country auditors will most probably fall to the POBA. The assessment of the equivalence of third countries' systems of oversight, quality assurance, investigations and sanctions will fall to the POBA and the Commission (see note 10). None of these costs are included here.</p> <p>Rather, the cost figure of £650 relates to the work that will be required of third country auditors.</p>
47	Co-operation between third countries	Up to £10 million in first year and then up to £800 per request.	The figures relate to cost of transferring information between competent authorities. Professional bodies and audit firms will need to set up and maintain information systems. The 'on going' costs will depend on the number of requests, the amount of documentation and whether this is electronic or paper copies (see note 11).
50	Disclosure	No additional costs	The current UK system meets the Directive's requirements.

Notes:

1. Up to 9000 audit firms and their recognised supervisory bodies (ICAEW, ICAS, ICAI, ACCA and AIA) will be affected by this requirement. The cost of updating and implementing the register are estimated as follows:

Top 12 Audit Firms plus 5 supervisory bodies (at £150,000 each) = £2.55 million
8986 Firms at average of £800 (4 hours of IT development time
x £200 per hour) = £7.20 million

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

2. The current Directive text allows audit firms to provide non audit services to audit clients in accordance with the existing UK ‘threats and safeguards approach’. The current text should, therefore, have no cost impact.

The current text also, however, provides for ‘comitology’ rules to be passed. A more restrictive approach, or a complete prohibition on the provision on non audit services, to audit clients, would have cost implications. For example, audit fees might increase to offset the loss of those non audit services.

Our figure of up to £30 million 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.

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

3. There will be costs to the Public Oversight Board (in the UK, POBA) associated with reviewing the work of overseas subsidiaries. These 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 current Directive text provides exceptions 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.

5. The costs to the POBA of considering quality assurance issues have not been included.

6. The POBA are likely to be responsible for co-ordinating requests (under Article 34) from other Member States authorities. Its costs have not been included.

7. The Directive will require companies to notify the POBA when they dismiss their auditors. (This is not required under the current UK regime). 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 notification costs some £100 the per annum cost of the new requirement will be £213800.

8. The figure has been calculated in the manner set out in note (1). The POBA will have responsibility for ensuring that auditors and audit firms comply with the new requirement. Its costs have not been included.

9. All of the FTSE 100 companies currently have an audit committee. We estimate, however, that around 80% of all UK listed companies currently either do not have an audit committee or have an audit committee that does not meet the proposed 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. Although requests will be made to and received by national auditor oversight bodies (whose costs have not been included here) third country auditors will need to collate and produce documentation relating to these requests. We have assumed that this work will take some eight hours and we have used an hourly rate of £80. We have not been able, at this present time, to estimate the number of requests that will be made.

11. We have calculated the costs of setting up the relevant IT system on the basis set out in note (1). The cost of dealing with requests has been calculated as follows: each request will take some ten hours costing some £80 per hour. We have not been able, at the present time, to estimate the number of requests that will be made.

7. Impact on Small Business.

7.1 This Directive does not affect small companies² that do not have a statutory audit.

7.2 The Government estimates that up to 350,000 small companies, which are not required by law to have their accounts audited, will, nonetheless, 'elect' to do so. How many of these companies would continue to so 'elect', if costs increased, is not known. The DTI will be carrying out research in this area in due course.

7.3 The Small Business Service has been consulted in the preparation of this impact analysis.

8. Competition Assessment

8.1 The proposals have the potential to affect all accountancy companies, that carry out statutory audits, and all medium sized and public interest entity companies. It is not anticipated that the proposal will: affect some of these businesses more than others; affect market structure; change the number or size of those

² Small companies are defined as: up to 50 employees; and/or a balance sheet total of up to £2.8 million; and/or an annual turnover of up to £5.6 million

businesses; lead to higher start-up costs for those businesses; or lead to higher on-going costs than at present.

9. Consultation.

- 9.1 The Department of Trade and Industry published a consultation document on the proposed Directive on 10 September 2004 (with a deadline for comments of 30 November 2004). It is available on the DTI's web site and copies were sent to interested stakeholders.
- 9.2 The Department also held regular meetings with stakeholder representatives (during Council Expert Working Group negotiations).
- 9.3 Some 17 consultation responses were received. They varied from comments on one or two Articles to a full response (including answers to the questions identified in the consultation document).
- 9.4 Respondents' assessments of the costs and benefits of the proposed Directive have been included in this updated regulatory impact assessment.

10. Current Position of the Proposed Directive.

- 9.1 On 7 December 2004, ECOFIN ministers reached 'agreement to the general approach' set out in a consolidated text of the Commission proposal.
- 9.2 The European Parliament is currently considering the proposal and we expect its deliberations to be concluded by June 2005.
- 9.3 Following the proposal's adoption, the DTI will consult on implementation.

**Department of Trade and Industry.
February 2005.**
