

Responses to the consultation on implementation of the Statutory Audit Directive

(Associated document: Implementation of Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts – Policy Conclusions and Draft Regulations, July 2007 - URN 07/1239)

1. Association of British Insurers
2. Association of Chartered Certified Accountants
3. Association of Investment Companies
4. Baker Tilly
5. British Bankers Association
6. Chartered Institute of Management Accountants
7. Confederation of British Industry
8. European Securitisation Forum
9. Deloitte & Touche
10. Ernst and Young
11. Financial Services Authority
12. Grant Thornton
13. Industry Governance Institute
14. International Capital Markets Association
15. Institute of Chartered Accountants England and Wales
16. Institute of Chartered Accountants Scotland
17. Institute of Chartered Secretaries and Administrators
18. Institute of Credit Management
19. Institute of Directors
20. Investment Management Association

21. KPMG
22. Law Society
23. London Investment Bankers Association
24. London Stock Exchange
25. Management Audit LLP
26. PricewaterhouseCoopers
27. Prudential
28. Quoted Companies Alliance
29. Tallaght Business School
30. Timothy Boatman (former Chairman of the audit committee of John Laing PLC)
31. BDO Stoy Hayward LLP



IMPLEMENTATION OF THE DIRECTIVE ON STATUTORY AUDITS OF ANNUAL AND CONSOLIDATED ACCOUNTS - The ABI's Response to the DTI'S European Company Law and Governance Consultative Document

Introduction

1. In March 2007 the DTI issued a consultative document dealing with implementation of the Directive on Statutory Audits of Annual and Consolidated Accounts, replacing relevant provisions of the 8th Company Law Directive.
2. This paper is the response of the Association of British Insurers to certain of the matters raised in the consultative document. ABI Members as institutional investors hold some £1.3 trillion of assets, with significant holdings in the equity and other securities of UK issuers. As users of accounts they wish to see high quality financial reporting by corporate issuers. The role of audit in providing assurance in this regard is of particular importance as is the wider governance framework within which the company's relationship with its auditors is regulated.
3. We have no specific comments to make on many of the consultation questions. Much the most significant to us are the proposals for implementing the Directive provisions relating to audit committees as per Article 41. The role and composition of the Audit Committee are of utmost importance to the overall effectiveness of the governance of UK companies. It is important that the provisions of the Directive do not cut across acknowledged best practice as per the expectations of the Combined Code and the guidance promulgated by Sir Robert Smith. We are particularly concerned to ensure that the status of the unitary board is not compromised and, indeed, the Directive provides appropriate flexibility for Member States to ensure that it is implemented in a manner that is conducive to good governance in the national context. Accordingly, we are pleased that careful thought has been given in devising four options for implementation in the UK that make use of the flexibility built into the Directive. We believe that a light touch approach to implementation of the Directive is needed but that none of the options as they currently stand are optimal. However, a better approach can be constructed out of these. Our discussions with other interested parties encourages us in this belief and we would be happy to discuss our views further with the Department if this would be helpful.
4. Our more detailed comments on each of these options are provided below. We also comment briefly on options for implementation of the requirement that company auditors are not dismissed without proper cause.

Questions for Consultation

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

Q8 Which of the three options:

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

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

We think it right that companies and their shareholders should be protected from dismissal of auditors for improper reasons. However, there is a potential conflict with the rights of the shareholders to appoint the auditor and to terminate the appointment according to their judgment of the merits of this course of action. The need is for protection of shareholders against misuse of powers of directors to dismiss auditors within the latter's term of office without the prior approval shareholders.

We do not believe that Option 1 providing for shareholders to obtain a court order on the grounds that the company's affairs are being conducted in a prejudicial manner would be of great help in practice. Since it relates to existing legislation this Option constitutes essentially the status quo. Option 3 fails to stay the process of dismissal and is of limited value. Therefore Option 2 which creates a prohibition of an improper act represents the most effective response. Within this overall option the civil unlawfulness option is to be preferred since it provides greater likelihood that improper decisions will incur sanction but avoids the unreasonable prospect of criminal sanctions impinging on honest decision-making by directors in what may be difficult circumstances. This preference for civil over criminal sanctions is also relevant in other areas covered by the consultative document.

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

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

Our analysis of the options

Each of the four options put forward are carefully constructed and potentially workable but they have important and differing implications for governance. We consider that adherence to the provisions of the Combined Code is the right starting point for establishing the benchmark for due compliance with the Directive in the UK context. We are not convinced, though, that adopting this benchmark as the focus for the regime implementing the Directive will be helpful. In particular, this would require a clear referencing of the Code under whatever means of legal enactment of the Directive is used and we consider this should be avoided if possible.

There are also likely practical difficulties in seeking to apply under company law or some other regulatory regime provisions that have been designed to operate within a "comply or explain" framework. For this reason we are inclined to exclude Options 2 and 3 from serious consideration as preferred options. Option 2 relies heavily on a legal compliance framework relating to disclosure, failure to comply with which would be an offence with the prospect of criminal sanctions. Option 3, which has no provision for disclosure to shareholders of how the substantive Directive provisions have been complied with but makes non-compliance with them an offence with criminal sanctions, strikes us as the least desirable option. It is the weakest Option as regards providing accountability and assurance to shareholders but creates the greatest risks for directors. The consultative document does not spell out what tariff of sanctions would apply under these options. The absence of this information magnifies our concerns and further reduces any inclination to agree that these options be taken forward.

The drawback of Option 1 is that it would require a considerable extension of the role of the FSA in enforcing compliance with the relevant provisions of the Combined Code. At present the FSA as UK Listing Authority is responsible for ensuring that listed companies make statements as to their compliance with the Code which in turn requires explanations by companies regarding provisions they have not complied with. The FSA does not verify whether the compliance statement is true, nor is it required to judge whether explanations for non-compliance are acceptable. We do not think the FSA should now be asked to do either of these. A definite advantage that Option 1 appears to have over Option 2 is the absence of criminal sanctions for failure to meet the requirements of the relevant regulations but we do not consider that Option 1 should be adopted on account of this when if other options would otherwise be more appropriate.

Option 4, which incorporates elements of the other options has the merit of providing a lighter touch approach and gives greater scope for companies to operate with least disruption within the existing Code framework, to account to their shareholders for any deviation from the Code benchmarks and to explain how their arrangements

fulfil the Directive requirements. Whilst it is necessary to have backstop provisions to guard against non-compliance with disclosure requirements or with the substantive Directive requirements it is, though, by no means evident to us that these need to include provision for criminal sanctions. This Option would be improved if it were reformulated to ensure a more coherent sanctions regime across the separate limbs provided under this Option by Listing Rules and legal compliance requirements and to avoid a mix of civil and criminal sanctions.

Our preferred route forward

We consider that regulations implementing the Directive requirements should themselves focus on the minimum Directive requirements under Article 41(5) rather than the Combined Code requirements as the benchmark against which substantive compliance is expected. Notwithstanding, institutional investors wish companies to comply so far as possible with the Combined Code provisions. In practice we wish regulation to be framed such that the normal route to demonstrating compliance with the minimum directive requirements will be through stating full compliance with the Combined Code provisions on audit committees or else through stating partial compliance but with modest departures from the Code benchmark that are still consistent with meeting or surpassing the Directive minimum requirements. Consideration should be given either to references within the Code, or perhaps FSA guidance, to underscore this. This would be of practical assistance to companies as well as to emphasise the status of the Combined Code and Smith guidance as the repository of best practice in the UK relevant to bodies responsible for audit committee functions and the linkage between this and the requirements of the Paragraph 41(5) of the Directive.

We see merit in the obligations to meet the Directive-minimum requirement being imposed via regulations specified by the Financial Services Authority, possibly via the link in S.1269 of the Companies Act that gives powers to the FSA to make regulations for listed companies on corporate governance. This might be the most likely route to achieving a light-touch but coherent regime that does not rely on criminal sanctions. Other approaches that do not use this FSA administrative route to specification and enforcement might be an acceptable alternative but only if clearly restricted to the use of civil sanctions.

In any event we wish to avoid the FSA, DTI or any other designated body taking a view on the accuracy of the Combined Code compliance statement of the acceptability of explanations provided. The discipline of shareholder scrutiny under the “comply or explain” framework is the right means of enforcement of Code provisions. In practice this means that the number of cases in which companies fall short will be few and it is likely that in only a small proportion even of those cases will there be a failure to comply with the minimum requirements of the Directive. Backstop sanctions for failure to make statements of compliance, for the making of inaccurate statements and for substantive non-compliance will presumably be required but all such sanctions should be proportionate as well as non-criminal.

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

We certainly do not believe that the law itself should be used to lay down relevant Code requirements. To do so will, amongst other things, unnecessarily inhibit the development of the Code which is subject to periodic review by the FRC. Neither is it desirable for the Code to be referenced by whatever body of law or regulation is used to implement this aspect of the Directive. Our preferred route forward would avoid this. Nevertheless, it will be particularly important that compliance with the Code acts as a route to meeting at least the minimum directive requirements. For this reason, it must be understood that future revisions to the Combined Code on the role and composition of audit committees will need to be made in a way that ensures that compliance with the Code, or with reasoned departures from it, also evidences compliance with at least the minimum requirements of the Directive as implemented in the UK.

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Jim Bellingham
Corporate Law and Governance Directorate
Department of Trade and Industry
1 Victoria Street
LONDON SW1H 0ET

29 May 2007

Dear Jim

IMPLEMENTATION OF DIRECTIVE 2006/43/EC ON STATUTORY AUDIT

I write on behalf of ACCA to respond to the proposals set out in the consultative document on the above. Our comments reflect the fact that ACCA is both a Recognised Qualifying Body (RQB) and a Recognised Supervisory Body (RSB) under the Companies Act 1989 and issues authorisations to conduct audit work to ACCA members based in the UK and overseas.

We welcome the DTI's general approach to implementing the requirements of the Directive, whereby it proposes to resort to new statutory rules only where necessary and, where possible, to allow appropriate rules to be set at the professional level, either by APB or the professional bodies themselves. With regard to many individual elements of the new Directive, such as professional oversight and quality assurance, the UK is recognised as having led the way, and consequently no material change to current operating practices need occur. On the whole, we consider that modest and for the most part administrative changes are necessary in order to enable the UK to comply with the requirements of the new Directive.

Our responses to those of the specific questions posed in the document on which we have comments to make are set out on the following pages.

Q1 Education and Qualifications

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The Association of Chartered Certified Accountants

The proposals in this section appear appropriate. As regards the timing of the introduction of the new requirements on the test of theoretical knowledge, we will be happy to liaise with the DTI and the Professional Oversight Board (POB) on this and other relevant matters such as the place of UK financial reporting and auditing standards in the RQBs' syllabi.

Article 10 dealing with practical training is substantially less onerous than the requirements currently in place for RQBs. We understand that the DTI's favoured approach is to retain current arrangements where they exceed the minimum standards set out in the Directive, and we would endorse this approach.

Q2 The auditor register

We do not see why the new provisions should not be brought into effect as soon as possible.

Q3 Implementation of the register requirements

We suggest that the revised requirements for the 'UK' register should go ahead as soon as is practicable and that the provisions regarding third country auditors should follow in due course. But it would appear sensible to incorporate the two sets of information in a single integrated register.

Q4 Ethics

The proposals in paras 3.15-3.19 appear reasonable to us. It makes sense to make only the minimum necessary changes to the legal requirements and leave matters of detail to FRC/APB and the RSBs. This will ensure that all applicable ethical measures are in one place and the potential for inconsistency is removed.

At para 3.17, the document addresses the requirement in article 23.3 of the Directive for outgoing auditors to provide all relevant information to the incoming auditor. We welcome the proposal to allow this matter to be dealt with in the rules of professional bodies rather than in legislation. It will be vital for there to be a clear and shared understanding of what is and what is not relevant information, one which is recognised as such by both outgoing and incoming auditors. Traditionally, professional rules have insisted that there are limits to the information which an outgoing auditor should be obliged to pass on: this is likely to remain the case. We would argue at this stage that information connected with the outgoing auditor's



actions with regard to AML/CTF issues should expressly be excluded from the range of relevant information which is liable to disclosure under article 23.2.

At para 3.19 regarding audit fees, again we believe it would be appropriate to leave this issue to be dealt with by ethical standards issued by APB.

Q5: Standards and reporting

We generally agree with the proposals in paras 3.20-3.23. In para 3.21, however, the document says that the requirement in article 27 relating to the documentation of the group auditor's review of the audit of the subsidiaries, is only partly covered by current UK auditing standards - ISA 600 will cover the outstanding requirements in due course but is not yet finalised. We are not convinced that the absence currently of a specific requirement on this matter is significant. Group audits are subject to ISA (UK and Ireland) and the general requirements for documentation in ISA (UK and Ireland) 230 should, in our view, suffice. We do not favour the introduction of changes to ISA (UK and Ireland) at this time unless absolutely necessary. With regard to article 28.2, we would not wish to see the prescription of a standard worded audit report by the EU: that would be likely to inhibit good reporting in difficult situations. We would wish instead to see the EU adopt an ISA-based solution on this matter.

Q6 Public oversight, investigations and discipline

We concur with the Government's view that the UK's existing system of quality assurance and investigations reflects the requirements of the Directive and needs only to be given minimum-level statutory underpinning.

Q10 Options regarding audit committees

We support the Government's proposal to exercise the exemption provided in this article, and would wish to see the minimum regulatory intervention to implement it.

The document says at para 3.53 that *'the Listing Rules are not in themselves sufficient to implement the Directive, because the Listing Rules leave open the option of having in place no arrangements in relation to these matters at all, under the comply or explain approach'*. This is because the provisions of the Code which relate to audit committees are presented on a comply or explain basis - companies are only required by



the Code, and by extension the Listing Rules, to say whether or not they have complied with the provisions relating to committees.

In order, therefore, to give effect to the requirements of the Directive regarding audit committees, some additional provision is necessary either in the Code itself, the Listing Rules or elsewhere.

The option of revising the text of the Code so as to accommodate the requirements of the Directive is not addressed in the document but it is, in our view, worthy of consideration as a possible solution to the problem. The revision could be effected by transforming point C.3.1 of the Code into a principle (with which companies are bound to comply) rather than a provision (in respect of which companies are only required to explain whether they have complied with it or not). This solution would have the additional virtue of retaining material on audit committees within the Combined Code, thus ensuring that it remained a comprehensive code for governance: it would be a retrograde step, in our view, for the Code to lose completely the material dealing with audit committees.

We appreciate that the DTI has no power to bring about an amendment of this kind, but note that the FRC itself has accepted that some changes to the Code might be appropriate in the light of anticipated changes to the law. Another potential issue, we recognise, is that text containing focused and detailed requirements on a particular matter might not be seen, by FRC and others, as lending itself easily to presentation as a 'principle'. There may, accordingly, be objections to the idea on the basis of consistency of drafting approach adopted within the Code.

Of the specific options put forward in the document, we would see as the most appropriate solution that set out in option 1, namely the introduction of rules by the FSA to require listed companies to establish audit committees which meet the minimum standards set out in the Directive. If this were done, we believe it would still be feasible to co-ordinate the substance of such FSA rules with a broadly-framed new 'principle' of the Code stressing the importance of audit committees to corporate governance.

Q11 The four options for implementing article 41.5

As set out above, we would favour option 1 but consider that the feasibility of amending the Code itself should be explored.



Q14 Exemption of certain classes of public interest entity from article 41.6

We note, from para 3.41, not only that the Government does not propose to go further than the minimum definition of public interest entity but that it has not sought to consult on this decision. We believe this is a public interest issue and should be explored further. We invite the DTI to consider in particular whether certain public interest bodies, such as large mutual or members' organisations as well as Government-owned companies, should have audit committees comprising external, independent members. The implementation of Article 41 in the manner that the DTI is proposing would exempt many of these entities from the audit committee requirements unless they are financial institutions granting credit etc.

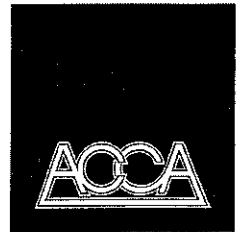
Q16 Options for implementing the new prohibition on auditors taking up management positions

Our preference would be for the proposed restriction on auditors taking up management positions to be effected by means of an offence created under the Companies Act. This would serve the interests of clarity. It would also amount to a stronger provision than a professional rule - this would in all likelihood be desirable given the potential for claims to be brought based on principles of restraint of trade and human rights. Additionally, enshrining such a provision in legislation would also be preferable for ACCA, and other RSBs which have members based outside the UK, since it would mean that we would not have to incorporate a UK-specific provision into our rules of professional conduct.

With regard to the proposals on independence and, in particular, the rotation requirement, we agree that it would be sensible to adopt the 7 years on / 2 years off rule as this will be consistent with the corresponding IFAC requirements.

Q17 Third country auditors

We concur with the DTI's proposals for implementing the provisions regarding third country auditors. We would make the point, however, that even if national quality assurance regimes might appear to be robust in principle, experience suggests that they need to be tested before they can be properly assessed. For example, to assess assurance systems thoroughly, an experienced QA reviewer would need to accompany third country QA reviewers to assess how effectively the review was carried out.



Q18/19 Co-operation with third country auditors

We note that the DTI has not addressed in the document one obvious alternative, which is to not to implement the option to allow auditors to pass documentation directly to national governments. We consider that transfers of information should take place, if absolutely necessary, through POB.

Q20 Disclosure of auditor remuneration

We concur with the Department's proposals to maintain the status quo as regards the disclosure of audit remuneration by small companies and to require medium sized companies to present the expanded range of information on request to the Professional Oversight Board.

I trust these comments will be of help.

Yours sincerely

A handwritten signature in black ink, which appears to read 'J. P. Davies', is written over the typed name.

John Davies
Head of Business Law

From: Ian Sayers [Ian.Sayers@theaic.co.uk]
Sent: 31 May 2007 10:58
To: Accounting and Audit Regulation
Cc: Guy Rainbird; John Stevens
Subject: TRIM:Audit Directive - AIC response

Background

The Association of Investment Companies (AIC) is the trade body representing some 300 investment companies, managing assets of approximately £67bn. Our Members are closed-ended investment companies whose business is to invest in a diversified portfolio of shares and securities, property and other assets. Our Members are all companies whose shares are traded on "regulated markets" as defined by the Directive, and therefore would all be public interest entities.

We have considered the consultation document and are broadly supportive of the proposals. We do, however, have a few comments in connection with the requirements in relation to the composition of the audit committee.

Audit Committee

Most investment companies subcontract their fund management, and other operational activities, to an external, FSA regulated fund manager. As a result, the directors of most investment companies are all non-executive. We have no strong views on whether one or more executives should be permitted to sit on audit committees generally, but we **strongly recommend** that there is no requirement for this, as this would be impossible for many investment companies to comply with given their current board structures.

In addition, the audit committee of an investment company will normally be formed entirely of independent non-executive directors. We therefore do not envisage any problem in meeting the independence requirement of the directive, which only requires that one member of the Committee be independent.

We are keen, however, to ensure that the industry does not take too narrow a view of what "competence in accounting" means. We note, and welcome, the fact that the Government does not intend to prescribe what is meant by "competence", and agree that these matters can only be judged in relation to the individual circumstances of the company.

That said, we are concerned to ensure that a view does not 'emerge' that the competence criterion can only be satisfied by having a person with a recognised professional accountancy qualification on the Board and/or that having a professionally qualified accountant on the Board means that this criterion is automatically satisfied. We do not consider that either view is appropriate because:

- An individual with a professional accounting qualification may have obtained such a qualification many years ago, and may have worked outside the accountancy profession since qualification, in a role which has no connection with financial accounts preparation. If such a person were to join the board of a company as a non-executive director to provide insight into the strategic direction of the company (i.e. not for accounting knowledge), then that person may well not have sufficient

competence to deal with the accounting issues facing that particular company.

- Vice versa, there are many individuals who have deep experience in the preparation and sign-off of accounts as a result of their executive roles in other companies, and who would be fully capable of demonstrating competence in the accounting issues facing the company, but who do not possess a formal professional qualification.

In this regard, it should be noted that, during the review of the Combined Code a few years ago, the question was raised as to whether there should be a specific provision requiring at least one member of the Committee to be a professionally qualified accountant. However, after consultation, it was decided that this was not appropriate and the Code provision simply requires that "at least one member of the audit committee has recent and relevant financial experience".

Therefore, whilst we support the proposal not to prescribe what "competence" means, we believe it would be helpful if the DTI could confirm that, in its view, the term does not automatically require that at least one member of the audit committee be a professionally qualified accountant, but that the matter of competence needs to be judged in a broader context by reference to the specific skills and experience that an individual possesses, and in relation to the nature and complexity of the business.

We have no strong views on the four options proposed for dealing with the mandatory nature of some of the Directive requirements in relation to the audit committee. On balance, we **recommend** leaving the "comply and explain" nature of the Listing Rules in relation to the Combined Code untouched, and simply introducing a separate listing rule in relation to the mandatory requirements of the Directive.

If you have any questions on the above response, or require any further information, please do not hesitate to contact me.

Ian Sayers

Deputy Director General
The Association of Investment Companies (AIC)

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