EXPLANATORY MEMORANDUM TO

THE STATUTORY AUDITORS AND THIRD COUNTRY AUDITORS REGULATIONS 2016

2016 No. XXXX

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Business, Innovation and Skills and is laid before Parliament by Command of Her Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 To implement Directive 2014/56/EU ("the Audit Directive") and Regulation 537/2014 ("the Audit Regulation") on the audit of limited companies and other undertakings which are classified as public interest entities ("PIEs"), that is, entities whose securities are traded on a regulated market, credit institutions and insurance undertakings.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 This SI replaces the original Regulations which were laid on 11 May 2016. The amendments have been made to take account of comments received from Counsel to the Committee, to include an additional application provision and to address another implementation issue.

3.2 Regulation 1(2)(a) and (6) now make it clear that amendments to Part 16 of the Companies Act 2006 made by Part 3 of Schedule 3, and amendments to the Building Societies Act 1986 made by Schedule 4, apply for financial years beginning on or after 17th June 2016. Meanwhile regulation 1(12) makes clear that the amendments made to Part 16 of the Companies Act 2006 do not apply to Limited Liability Partnerships (LLPs).

3.3 Regulation 23 amends the Companies (Bodies Concerned with Auditing Standards etc.) (Exemption from Liability) Regulations 2016 (SI 2016/571) to ensure that the Financial Reporting Council (FRC)'s exemption from liability in connection with setting and monitoring the issue of, and compliance with, auditing standards for companies covers its new responsibilities as the UK's competent authority for the regulation of statutory audits, except where these responsibilities have been delegated to the Recognised Supervisory Bodies.

Other matters of interest to the House of Commons

3.4 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland and includes Northern Ireland.

4. Legislative Context

4.1 The Regulations implement the Audit Directive on statutory audits of annual and consolidated accounts and make the necessary legislative provisions to apply the

Audit Regulation on specific requirements on the statutory audit of PIEs. The Regulations set out responsibilities for the Competent Authority, including monitoring and inspections, to implement the Audit Regulation, including sanctioning powers and registration of auditors. The Regulations also place restrictions on the choice of auditors and standards for the conduct of auditors (including integrity, objectivity and professional competence).

4.2 The Regulations amend the following:

(i) The Companies Act 2006

(ii) The Building Societies Act 1986

(iii) The Companies (Audit, Investigations and Community Enterprise) Act 2004

(iv) The Local Audit and Accountability Act 2014

(v) The Statutory Auditors and Third Country Auditors Regulations 2013

(vi) The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012

(vii) Companies Act 2006 (Transfer of Audit Working Papers to Third Countries) Regulations 2010

(viii) The Partnerships (Accounts) Regulations 2008

(ix) The Statutory Auditors and Third Country Auditors Regulations 2007

(x) The Companies (Bodies Concerned with Auditing Standards etc.) (Exemption from Liability) Regulations 2016

4.3 The proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (1697/11) and the proposal for a Regulation of the Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities (16972/11) was submitted to the Commons and Lords Scrutiny Committees on 19 December 2011. The proposal was cleared by the Commons Scrutiny Committee as politically important on 4 November 2013. The Lords Scrutiny Committee cleared the proposal on 24 July 2012.

4.4 A transposition note is attached at annex A.

5. Extent and Territorial Application

5.1 The extent of this instrument is the United Kingdom.

5.2 The territorial application of this instrument is the United Kingdom.

6. European Convention on Human Rights

6.1 The Parliamentary Under Secretary of State and Minister for Intellectual Property has made the following statement regarding Human Rights:

"In my view the provisions of The Statutory Auditors and Third Country Auditors Regulations 2016 are compatible with the Convention rights."

7. Policy background

What is being done and why

7.1 The Government believes that effective financial reporting is essential to the functioning of capital markets. Audit is an essential safeguard to provide independent assurance that the financial reporting of businesses properly reflects their circumstances and helps to maintain the integrity of the UK business environment.

7.2 The Regulations implement requirements of the Audit Directive that are not already contained in UK law and make further changes to UK law to give effect to the Audit Regulation.

7.3 The Audit Directive sets out a regime for audit regulation where the Government must be, or designate, a single competent authority with ultimate responsibility for all the regulatory tasks provided for in the Directive. The Directive enables the Government to allow the competent authority to delegate other bodies authorised or designated by law to carry out tasks, subject to oversight by the competent authority.

7.4 The Audit Regulation introduces directly applicable provisions into EU law specifically for audits of public interest entities. These include a framework for mandatory rotation and re-tendering of audit engagements to require all PIEs to put their audit out to tender at least every 10 years and change their auditor at least every 20 years. The definition of a PIE is restricted to entities with securities admitted to trading on a regulated market, banks, building societies, and insurers.

7.5 The Regulations are consistent with the findings of the Competition and Markets Authority on the market for statutory audit services to the largest businesses in the UK. In particular they implement the prohibition of clauses in loan agreements with businesses that restrict their choice of auditor.

7.6 The Regulations make changes to audit reporting requirements, including the reporting of irregularities; auditors of PIEs will be required to submit an additional report to the audit committee of the audited entity to help the audit committee understand the findings and judgments made by the auditors.

7.7 The Regulations will also introduce some changes that are likely to have a deregulatory effect. These include changes to enable cross-border provision of audit services. The frequency of inspections will be determined on a risk basis, with the reduction of previous minimum frequencies of inspections for some auditors of SMEs.

7.8 The Regulations will implement the requirement of the Audit Directive for Member States to identify a single competent authority for the regulation of statutory audits. The Government announced on 20 July 2015 that this would be the FRC. The FRC will continue to be the standard setting body for auditors, and will have to conduct inspections, investigations and disciplinary cases in relation to the audits of public interest entities.

7.9 The FRC will be required, through a direction by the Secretary of State, to delegate tasks as much as possible to the Recognised Supervisory Bodies (RSBs). The RSBs are: the Association of Authorised Public Accountants; the Association of Chartered Certified Accountants; the Chartered Accountants Ireland; the Institute of Chartered

Accountants in England and Wales; and the Institute of Chartered Accountants of Scotland

7.10 Alongside this instrument, the provisions of the Audit Directive and Regulation will also result in rules issued by the Financial Conduct Authority and Prudential Regulation Authority on audit committees to implement those requirements of the Directive. The FRC will also amend its auditing standards to make clear that certain provisions of the Audit Regulation are applicable as part of those standards.

7.11 The Regulations go beyond minimum implementation of EU law by applying the relevant provisions of the Audit Directive and Regulation to auditors of LLPs. This is to ensure consistency and avoid unnecessary complexity for preparers and users of audits by continuing the current approach of making auditors of LLPs subject to the same audit regulatory framework that applies to companies and other business entities.

7.12 The final Impact Assessment considers the costs and benefits of applying the amended Audit Directive framework to audits of LLPs and concludes that there would be no significant additional costs resulting from applying the updated framework to LLPs.

Consolidation

7.13 At present BIS does not intend to consolidate this legislation.

8. Consultation outcome

8.1 In December 2014, the Department published a discussion document seeking stakeholder views on the approach to implementation and to inform the technical consultation. The 43 responses received showed general support for the Government's approach of not making additional unwarranted changes. The consultation responses of those who did not request their response to remain confidential have been published at:

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

8.2 The Department also consulted between October and December 2015, seeking views on the technical implementation of the Audit Directive and Regulation. Twenty five responses were received. There was overall support for the Department's approach, which aims to ensure maximum flexibility for auditors, their clients and the relevant regulatory bodies. The consultation responses have been published at:

https://www.gov.uk/government/consultations/eu-audit-directive-and-regulation-implementing-the-requirements

9. Guidance

9.1 The implementation of the Regulations will be supported by the Financial Reporting Council's auditing standards, changes to its corporate governance code on audit committees and other guidance. Guidance on audit requirements is also available from Companies House.

10. Impact

10.1 The impact on business, charities or voluntary bodies is estimated to be £24.71 million a year.

10.2 The Impact Assessment does not cover impacts on the public sector. The changes may increase the resource needs of the FRC in respect of audit inspections, investigations and enforcement. FRC and BIS are continuing to consult with the audit professional bodies on this.

10.3 An Impact Assessment is submitted with this memorandum and is published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The Regulations apply to activities that are undertaken by small businesses.

11.2 No specific action is proposed to minimise regulatory burdens on small businesses.

11.3 The basis for the final decision on what action to take to assist small businesses was determined by the nature of the business operations of PIEs. These entities may not be exempted from audit under the EU Accounting Directive (2013/34/EU) as, by their nature, they have a significant impact on the economy and society of Member States. The Audit Directive and Regulation require Member States to apply the higher standards of audit regulation to audits of PIEs.

12. Monitoring & review

12.1 A review provision in included in these Regulations.

12.2 The Secretary of State must publish a report setting out the conclusions of the first review of these Regulations within five years of Regulations coming into force.

12.3 In carrying out the review the Secretary of State must, as far as is reasonable, consider how the Audit Directive is implemented in other Member States.

13. Contact

13.1 Paul Smith at the Department for Business, Innovation and Skills Tel: 0207 215 4164 or email: pauld.smith@bis.gsi.gov.uk can answer any queries regarding the instrument.