



Governance *in brief* BIS and the FRC consult on options for UK implementation of the EU Audit Directive & Regulation

Headlines

- The UK will take the option to extend the mandatory auditor rotation period to 20 years provided that there is a tender at the ten year point.
- A range of potential options for restrictions on the provision of non-audit services by auditors are set out including having a 'white list' of permitted services with everything else banned or a 'black list' of prohibited services.
- The FRC is considering whether non-audit services restrictions should apply just to public interest entities (those with securities admitted to trading on an EEA regulated market, credit institutions and insurers) or to a wider class of entities (e.g. AIM companies).
- Changes are proposed to the requirements for composition of audit committees of public interest entities including the ability for members who are not board members as long as they have been approved by shareholders.

Background

The Department for Business Innovation & Skills and the Financial Reporting Council have both issued consultation papers on audit reform. These discuss options for UK implementation of the EU Audit Directive and Audit Regulation and also build on the work of the Competition and Markets Authority (CMA). The Directive applies to all statutory audits; the Regulation applies to the audit of public interest entities.

BIS and the FRC consider that it would be most appropriate for the application of the provisions in the Directive and Regulation that clearly relate to matters currently covered by the FRC's standards to be implemented by an enabling power in the law which allows the FRC to implement via auditing, quality control and ethical standards. These standards will be given the direct force of law, rather than via the rules of the applicable professional body.

Highlights from the FRC's consultation paper

The FRC consultation document identifies and explains the range of positions the FRC is considering with respect to the Member State options in the Directive and Regulation, should it be granted the delegated power to exercise them, and seeks stakeholder views about them. Any proposed specific changes to the FRC's standards, taking into consideration responses received, will be consulted on in 2015. This consultation is likely to include other changes arising from the FRC's ongoing review of the auditors' ethical framework.

Extending the requirements for 'public interest entities' to other entities	The FRC believes that some, but not all, of the more stringent requirements applicable to PIEs as defined in EU law should be extended more broadly – probably restrictions on non-audit services and potentially the 70% cap on non-audit fees. Entities that might fall within the possible extended scope would be large private or AIM quoted companies.
Prohibited non-audit services and Member State options	<p>The EU Audit Regulation bans certain non-audit services for public interest entities, but provides a Member State option to permit some tax and valuation services that are immaterial. As a reminder these are summarised below. In addition, some services are banned by the FRC's Ethical Standards but permitted under the EU Audit Regulation and vice versa. The FRC is asking for views on:</p> <ul style="list-style-type: none"> • whether to retain the existing bans in FRC standards in areas where EU law does not require a ban; to move to a "white list" approach where only permitted services can be provided; and whether or not to take up the member state options to allow immaterial tax and valuation services; • whether the EU restrictions, which apply to provision of services to entities in the EU, should be extended outside the EU, and whether they should apply to component auditors who are not members of the group auditor's network; • what sanctions should be in place for breaches of the regime. <p>The paper explores the pros and cons of each of these.</p> <p>See below for further details on the scope of services being considered either for prohibition (the 'black list') or for the 'white list'.</p>
Cap on permitted non-audit services	<p>The 70% cap in the EU regulation compares the fees for non-audit services (other than those required by law or regulation) provided by the group auditor to the preceding three years of group audit fees. The FRC asks if the cap should be extended to include non-audit services provided by network firms.</p> <p>BIS has indicated that the restriction only applies after the auditor has been providing both non-audit services and audit services for three years from the date of implementation. The FRC asks if a modified cap should apply in earlier years.</p> <p>The FRC says that it does not believe it should exercise the option to lower the cap below 70%, but invites views.</p>
Auditing standards	The FRC proposes to retain the right to set additional standards in areas not covered by ISAs as issued by the International Auditing and Assurance Standards Board (IAASB), and to add requirements to those standards where necessary to address national legal and regulatory requirements and/or add to the credibility and quality of financial statements. This is likely to be exercised to retain the additional auditors' responsibilities in respect of corporate governance and UK legal requirements.
Proportionate application and simplified requirements for auditing standards for small entities	The FRC believes it does not need to take action on the proportionate application of ISAs. In addition, the FRC invites views on the future of simplified ethical standards for the audit of smaller entities.
Audit partner rotation	The Audit Regulation limits key audit partners to seven years' service followed by three years cessation before they can serve again. The existing FRC regime applies a five year maximum followed by a five year cessation for audit engagement partners; other partners can serve seven years with two years off. The FRC asks if they should retain their existing tougher requirements and whether these should apply more broadly than PIEs.
Retention periods for audit records	The FRC asks whether they should be setting a retention period for audit records and, if so, what that period should be.

Highlights from the BIS Discussion Paper

The BIS Discussion Paper focuses on identifying legislative and non-legislative actions necessary to:

- strengthen standards for the audit of public interest entities;
- improve confidence in the independence of auditors;
- avoid excessive concentration in the audit market; and
- make audit reporting more informative.

Key points raised in the BIS discussion paper include:

Mandatory rotation period	<p>The Government is proposing to take up the Member State option to allow audit firms to serve a public interest entity for a maximum of twenty years, rather than ten, provided that a tender is undertaken after ten years. They are not proposing to take up the option to extend to twenty four years where there are joint auditors.</p> <p>Consistent with the Competition and Markets Authority Order on auditor tendering, BIS is seeking views on steps to encourage tendering earlier than ten years.</p>
Definition of “public interest entity”	<p>BIS is asking whether the definition of “public interest entity” (PIE) in law should be extended beyond entities with securities admitted to trading on a regulated market, credit institutions (including banks and insurance companies) and insurers. The Government is not minded to extend the definition to a wider class of entities.</p>
Regulation and oversight of audit	<p>Changes to the regulation and oversight of audit are necessary. The government is proposing that, rather than the current regime whereby major audits are inspected by the FRC and others by recognised supervisory bodies (RSBs) such as the ICAEW, the FRC should be responsible for all inspections but delegate these back to RSBs for most non-public interest entities. Similar arrangements are suggested for investigation and discipline and a range of other regulatory functions.</p> <p>In the area of standard setting, the indirect force of FRC standards whereby RSBs must require their members to follow those standards will be changed so that FRC standards apply to statutory auditors directly as a matter of law.</p>
Composition of audit committees	<p>The previous legal requirement for listed companies to have an audit committee was implemented in DTR 7.1. The UK is proposing that the FCA should amend DTR 7.1 to implement the necessary changes for listed companies which will put on a statutory footing the requirement for the majority of audit committee members to be independent, to allow audit committees to include those not on the board but appointed by a general meeting of shareholders. The FCA will consult on these changes in due course.</p> <p>The UK has previously taken an option to exempt unlisted banks and insurers from the requirement to have an audit committee. As this option is no longer available, they are suggesting that the requirement be introduced via the rules of the Prudential Regulation Authority.</p>

EU Regulation – summary of prohibited non-audit services

The following is a reminder of the list of non-audit services which will be prohibited under the EU regulation. This would be the basis of the **'black list'** of prohibited non-audit services referred to above. Within the list, the only options for Member States to 'relax' the prohibition are in respect of the five tax-related services marked with an asterisk and the valuation services category. These services can be permissible providing: they have no direct, or have an immaterial effect, on the audited financial statements; the effect on the audited financial statements is documented and explained in the report to the audit committee; and the principles of independence are complied with. The FRC is asking for views on whether this Member State option should be taken.

The FRC is also considering whether there are any additional services which the UK should add to this list of prohibited non-audit services.

Tax services	<ul style="list-style-type: none"> * Preparation of tax forms. Payroll tax. Customs duties. * Identification of public subsidies and tax incentives unless support from the statutory auditor or audit firm in respect of such services is required by law. * Support regarding tax inspections by tax authorities unless support from the statutory auditor or audit firm in respect of such inspections is required by law. * Calculation of direct and indirect tax and deferred tax. * Provision of tax advice.
Legal services	<ul style="list-style-type: none"> • The provision of general counsel; • Negotiating on behalf of the audit client; or • Acting in an advocacy role in the resolution of litigation.
Human resources services	<p>Being in a management position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:</p> <ul style="list-style-type: none"> • searching for or seeking out candidates for such positions; or • undertaking reference checks of candidates for such positions. <p>Structuring the organisation design.</p> <p>Cost control.</p>
Services that involve playing any part in the management or decision-making process of the audited entity	<p>Including:</p> <ul style="list-style-type: none"> • Bookkeeping and preparing accounting records and financial statements. • Payroll services. • Services related to the audit client's internal audit function. • Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or financial information technology systems.
Valuation services	<ul style="list-style-type: none"> * Including valuations performed in connection with actuarial services or litigation support services.
Corporate Finance services	<ul style="list-style-type: none"> • Services linked to the financing, capital structure and allocation, and investment strategy of the audit client, except providing assurance services in relation to the financial statements, including the provision of comfort letters in connection with prospectuses issued by the audit client. • Promoting dealing in, or underwriting shares in the audited entity.

The “white list” approach of having a list of permissible non-audit services and banning all other services would start with, the FRC is proposing, those services deemed ‘audit-related’ per Ethical Standard No.5. These are as follows:

- reporting required by law or regulation to be provided by the auditor;
- reviews of interim financial information;
- reporting on regulatory returns;
- reporting to a regulator on client assets;
- reporting on government grants;
- reporting on internal financial controls when required by law or regulation; and
- extended audit work that is authorised by those charged with governance performed on financial information and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions.

In addition, it is proposed to add other services where it is sensible for the auditor to be used to the ‘white list’, for example:

- skilled persons’ reports under financial services law;
- reporting accountant work (both public and private reporting); and
- assurance services on other information issued by the entity e.g. assurance on the “front half” of the annual report.

Under the ‘white list’ approach all other services would be prohibited. The FRC seeks views on this approach and, if popular, would consult further in due course.

For further information

Financial Reporting Council

Consultation Document: Auditing and Ethical Standards – Implementation of the EU Audit Directive and Audit Regulation

Comments are invited by 20 March 2015.

Department for Business, Innovation & Skills

Auditor regulation: discussion document on the implications of the EU and wider reforms

Comments are invited by 19 February 2015 and will be followed by a formal consultation on draft regulations in summer 2015.

Deloitte View

- The implementation of the EU audit directive and the result of these consultations are hugely important regulatory milestones for the accountancy and auditing profession and will set the scene for many years not only for the profession but for London’s capital markets.
- Deloitte will be submitting responses to both consultations.

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