



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

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Corporate Law and Governance Directorate
Department of Trade and Industry
1 Victoria Street
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Sent by email only to AuditDirective@dti.gsi.gov.uk

Dear Jim

**DTI CONSULTATION DOCUMENT: IMPLEMENTATION OF THE DIRECTIVE ON STATUTORY
AUDIT OF ANNUAL AND CONSOLIDATED ACCOUNTS (REPLACING THE 8TH COMPANY LAW
DIRECTIVE)**

The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on this consultation document issued by the Department of Trade and Industry (the 'DTI') in March 2007. The Institute has an interest in the full range of issues covered by this Directive given its activity in promoting audit quality, its audit qualification and in its role as a Recognised Supervisory Body ('RSB'). We support the Government's approach to build on the existing UK framework in its implementation of these provisions but we do have a number of comments regarding the matters raised in the consultation document:

We provide comments on key issues below. We also give our detailed answers to the consultation questions in Appendix 1 to this letter and in Appendix 2 we provide comments on the DTI's draft Regulatory Impact Assessment.

1. General approach given the existing legal and regulatory framework in the UK

We welcome the issue of this consultation document and support the DTI taking a proactive role on the implementation of this Directive. We agree with the DTI's analysis that following the substantial legal and regulatory changes over the last five years, the existing UK framework already provides for a significant proportion of the areas covered by the Directive. We support the Government's approach to build on the existing UK framework in its implementation of these provisions rather than making fundamental changes to this framework. A great deal has been achieved in the UK to enhance and promote audit quality. This work continues and the FRC's *Promoting Audit Quality* initiative is an important part of this. We would refer the DTI to our response to the FRC Discussion Paper (<http://www.icaew.com/index.cfm?route=146824>) as this raises a number of key issues of relevance to the Statutory Audit Directive implementation. In particular we would highlight the need to avoid regulatory overload and complex and lengthy standards.

Given this context we do question whether all the recommendations in the consultation document to make amendments to the Companies Act 2006 (the 'Companies Act') are strictly necessary and if they are not, we consider that other simpler implementing measures would be preferable, for

example via our audit regulations. Indeed we consider that in many cases existing regulations already achieve some of the desired outcomes. We also believe that the current arrangements for such matters as the enforcement of auditing standards and the arrangements for quality assurance reviews are working well without the need to be dealt with in the Companies Act which is likely to lead to inflexibility. We do not believe that replicating the Directive into the Companies Act in this way makes for better regulation.

2. Importance of EU-wide implementation on audits in the UK

This consultation is concerned with UK implementation but we would emphasise that the way in which implementation takes place elsewhere in the EU could have a direct impact on audit firms and quality in the UK. For example, the independence provisions and the 'network' definition (see below) and the manner in which they interact is a key concern, as is the impact on quality if there is not a harmonised approach to the adoption of auditing standards. Furthermore, implementation of the education and training and recognition provisions are important from the perspective of quality and a level playing field across the EU.

In addition to working closely with each other, the UK bodies need to work with the various European bodies to achieve optimal implementation throughout the EU. It is very important to have such cooperation given the trans-national impact of certain measures and the trans-national nature of business to which the audit profession needs to respond. Whilst it needs to be recognised that this is a 'minimum harmonisation' Directive, consistency is an important objective where there could be a risk to audit quality.

3. Key definitions

We endorse the proposal by the government which would effectively restrict the definition of a public interest entity ('PIE'), for the purposes of implementing Chapter X of the Directive, to entities traded on a regulated market. While other entities may find the provisions useful, this would be likely to be on a case by case basis and for legislative purposes a narrow definition is appropriate. See also our comments regarding this in our response to the Professional Oversight Board ('POB') consultation on Article 40 on transparency reporting by firms (available at <http://www.icaew.com/index.cfm?route=143159>).

With respect to the definition of a 'network' we note that only a limited number of Member States have so far worked towards producing a definition and consistency is important in this area given the interaction with other parts of the Directive (see point 2 above). The ICAEW has produced an informal paper on the 'network' definition which we draw to the DTI's attention – see <http://www.icaew.com/index.cfm?route=147477>. We also note that IFAC has aligned its definition with that in this Directive and we would expect this to be adopted as necessary in relevant EU and UK auditor independence and other ethical standards. We also believe that it would be beneficial, in the interests of promoting audit quality, for non-EU jurisdictions to use this IFAC definition. We consider that this would be helpful in relation to the assessment of non-EU jurisdictions which the EU is currently pursuing through the international provisions in the Directive.

The definition of 'key audit partner(s)' encompasses a greater number of partners than that in the EC Recommendation on auditor independence, particularly at (b) of the definition where partners in charge of material subsidiary audits are specifically included. We believe it is group level relationships which are most likely to generate familiarity threats and it would be sensible to have a narrowly defined approach to material subsidiaries. This is because the process of becoming a partner in charge of subsidiary audits, not involved at group level, is currently often within audit firms an important stage in being given future group audit partner status. This is especially important in large groups where the group level audit engagement partner and other partners need a depth of industry knowledge. The absence of such knowledge through experience might result

in a significant threat to audit quality. Accordingly it is important that the application of this definition should be as narrow as possible.

4. Auditing standards and reporting

We await the European Commission's consultation on adoption of ISAs in the EU. As outlined in our response to the FRC *Promoting Audit Quality* Discussion Paper, we consider that the UK authorities have a crucial role to play in shaping European and international developments on standards, for example in liaising with the European Commission and other regulators, and in making the case for the importance of principles-based standards and the use of professional judgement. More work might be needed on the nature of professional judgement as this appears not to be fully appreciated by some non-UK regulators but which we believe is crucial to high quality audit work, and therefore needs to be better understood in Europe and internationally.

We also believe it essential that sufficient thinking is given to the method and timing of the implementation of clarified and revised ISAs, and we would call on the UK authorities to influence this debate. This should draw on the considerable recent experience we have gained in the UK with the implementation of ISAs (UK and Ireland), in particular the need for: a 'big bang' approach to be taken; adequate time to be given for implementation; and a moratorium on further standards for two years after the implementation of the clarified and revised ISAs.

5. Auditor independence

We agree with the government's general approach that the provisions in the Directive are substantially dealt with already and should continue to be dealt with in the APB auditor independence ethical standards or the RSB rules. The infrastructure for this is already in place and therefore little should need to be included in Schedule 10. See our answers to consultation questions 4 and 16 in Appendix 1.

With respect to the seven year rotation requirement in Article 42(2) for 'key audit partners' of public interest entities, we have highlighted in our response to the FRC's *Promoting Audit Quality* Discussion Paper the difficulties created by the existing five-year rule which currently applies in the UK. We maintain that a change to seven years (in line with the Directive) should be considered as part of the review of the APB Ethical Standards.

As outlined in our informal paper on the 'network' definition (link provided above), there needs to be assessment of the potential trans-national application of independence requirements. This is particularly relevant given the apparent intention of at least one Member State, permitted by Article 52, to introduce independence requirements over and above those required by Article 22 and the current lack of clarity regarding respect of Article 34 on mutual recognition of regulatory arrangements between Member States.

6. Education and qualifications

We broadly support the approach adopted in this area but there are a number of detailed issues which we believe are important to resolve. These are particularly important from the perspective of ensuring a 'level playing field' across the EU for statutory auditors. See our answer to consultation question 1 in Appendix 1.

7. Audit committees

We support the Government's intention on Article 41 implementation to provide maximum flexibility and adopt a 'light touch' approach. We therefore support the implementation of the Article 41 requirements for public interest entities to have an audit committee via the Financial Services Authority (FSA). See our major points and detailed answers to consultation questions 10 to 15 in Appendix 1.

8. Appointment and dismissal of auditors

We agree that any proposal for enforcement of the provisions on appointment and dismissal of auditors should be kept as simple as possible, particularly as the Companies Act 2006 has already brought in new requirements on auditors and companies in this area. Option 1 is the Government current preference and, subject to understanding how this would work in practice, we would support that. See our answer to the consultation question in Appendix 1.

9. Registration

We are concerned about the proposals and the timing of implementation. See our answer to consultation question 3 in Appendix 1.

10. Quality assurance and disciplinary systems

As with other aspects of this consultation, we are not sure that matters relating to quality assurance and disciplinary systems require any changes to the Companies Act. See our answer to consultation question 6 in Appendix 1.

The UK authorities should be active participants in Europe-wide discussions about quality assurance arrangements across Europe. The issues set out in the recent FEE position paper on this topic are relevant to these discussions. We are also aware that the European Commission is considering the possibility of reviewing and updating the 2000 EU Recommendation on quality assurance for statutory audit.

11. Third country auditors

We support the approach set out in the European Commission's recent consultation paper to be pragmatic and strategic regarding cooperation with non-EU jurisdictions and we welcome the UK authorities taking a proactive role in helping the European Commission to take this strategy forward. The Institute's response to the European Commission consultation on this subject is available at <http://www.icaew.com/index.cfm?route=147473>.

12. Auditor liability

We have responded separately to the European Commission consultation on auditor liability reform across Europe and have emphasised our view that auditor liability reform will enhance audit choice and audit quality. The lack of appropriate limitation in certain EU jurisdictions might have extra-territorial impact and we therefore believe it is important for the UK authorities to support a Recommendation to Member States on the need for appropriate limitation of liability in a manner which is consistent with the particular legal environment of each individual Member State. The Institute's response to the European Commission consultation is available at <http://www.icaew.com/index.cfm?route=147471>.

13. Voting requirements

We note that the DTI has not asked any specific consultation questions on the voting requirements for the control of approved audit firms as set out in Article 3(4). We are aware of a significant level of debate in Europe regarding how to define 'a majority' as referred to in Article 3(4) and also that important issues could arise following publication of the European Commission's study on the subject being carried out by Oxera.

14. Next steps

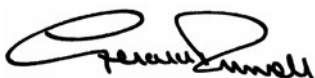
It would be helpful for the DTI and the other UK responsible bodies involved in implementation to clarify in detail the next steps envisaged on the matters raised in the consultation document. This includes the detailed timetable, Article by Article, for the implementation process and when measures are proposed to become effective. We would welcome continuing as an active participant in the DTI stakeholder group on the Directive.

We suspect that there are many issues that will arise during the implementation period, including those arising from Europe-wide discussions, so we would welcome regular liaison to address such issues.

It is also very important for the DTI and the various UK bodies to continue to be proactive in influencing developments happening both in Europe and more broadly internationally. It would be helpful to have a detailed strategy and plan for this activity and to ensure that the DTI stakeholder group continues to be involved in the discussions taking place as part of this.

Please contact me or Chris Cantwell at the ICAEW Audit and Assurance Faculty (details as below) should you wish to discuss any of the points raised in this response.

Yours sincerely



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APPENDIX 1: ANSWERS TO THE QUESTIONS IN THE CONSULTATION DOCUMENT

Questions relating to education and qualifications (Articles 3 to 14, and 44):

Q1 Do you have any comments on the Government's proposals for implementation of the requirements on education and qualifications?

We do not believe that legally we can remove the 'appropriate qualification' from a member once we have awarded it. This raises the issue of whether an ex-member of a professional body could register with another RSB and cite their appropriate qualification from the first body?

On Article 8(1) (test of theoretical knowledge) the new syllabus elements that the Directive mandates are coverage of international accounting standards, risk management and internal control, international auditing standards, and professional ethics and independence. These are all matters covered by the new ACA. We would refer the DTI to note the comments that we made in our response to the FRC discussion paper *Promoting Audit Quality* (see link above) regarding the need to tackle auditing in context and in particular to examine it in conjunction with financial reporting.

With respect to Article 10 on practical training, we are aware of a debate in Europe about whether Member States may require such training (or at least a minimum period of it) to be carried out within the Member State where the individual will be approved to undertake statutory audit. It would be helpful to obtain clarification regarding this point and the possible implications for the UK since the practical element of the UK training is considered to be essential to maintaining audit quality.

On Article 14 (approval of statutory auditors from other Member States) the relevant point is that we understand there is a debate in the EU over the scope of the statutory audit work covered by the Directive and the test for migrant auditors. The issue revolves (primarily) around whether the scope of this aptitude test should cover only statutory audit as defined in the Directive (i.e. a Community level requirement) or, in addition, also statutory audit as defined under national level which can be more extensive in scope, i.e. the Community level requirement plus the national requirement. We are aware that including national statutory audit requirements in the aptitude test can have an impact on the size of the aptitude test and therefore consequences for the freedom of movement. We also recognise that there are implementation issues arising from the structure of the profession in certain EU Member States – for example where membership of the relevant Institute confers rights to undertake statutory audit as per both Community law and national requirements. We understand that it is a matter of national competence as to whether structural arrangements can be modified. However, we consider that the aptitude test should be restricted to 'statutory audit' as required by the Directive and that there should be a 'level playing field' across the EU.

With respect to Article 44 (approval of auditors from third countries) we would be keen to know how the POB will be assessing reciprocity and in particular whether it would be sufficient for a third country to offer recognition to members of, for example, only one UK RQB in order for the necessary mutuality to exist. We understand that partial recognition might be sufficient. As highlighted in the Institute's response to the EC third country auditor consultation, it is important to ensure that there is full separation in the treatment of Article 44 from Articles 45 to 47.

We note the requirement in Article 5(3) to inform other Member States if a competent authority withdraws audit registration from an auditor who is also registered in another Member State and that the POB will be responsible for passing this information on.

We would emphasise that information on other registrations that an auditor may have is not currently held by us. We believe that it is extremely unlikely that any auditors would be registered in another Member State but it will take some time for us to confirm that this is the case by the operation of our system of annual returns. Even if we started to collect this information now we would not have received it from all firms by the implementation date of April 2008. We would therefore ask that consideration is

given to delaying this as much as possible. This information is also required for the revised audit register and in our comments on that matter we are suggesting taking the maximum transitional time allowed by the Directive. Otherwise there is a danger that one aspect of the Directive (Article 5(3)) may require a process to be put in place earlier than the provisions in respect of the register, when dealing with this matter as part of the audit register would be a more efficient process.

In one situation we do already hold this information due to the fact that the Institutes can register firms to undertake audits in the UK and the Republic of Ireland. In both jurisdictions we are each the 'competent authority' in Directive terms for the registration of auditors. Therefore your proposal would seem to require us to inform the POB when a registration is withdrawn so that it can pass this information (or even via the Irish Auditing & Accounting Supervisory Authority) to us in our capacity as a RoI competent authority. We would suggest that the law should be drafted so that there is no need to make a communication if a competent authority is also the competent authority in respect of that auditor in another jurisdiction where the auditor is registered.

Finally, a pan-EU data base is being set up to deal with the Recognised Professional Qualifications Directive, called the Internal Market Information system. We consider that using something similar to such a system would be a more efficient method of sharing the data about audit registration withdrawals directly between the bodies responsible for registration.

Questions relating to registration (Articles 15 to 20):

Q2 Do you have any comments on when the revisions to the UK auditor register should come into effect?

See the answer to Q3 below which picks up the issue of the timing of implementation.

Q3 Do you have any other comments on the Government's proposals for implementation of the register requirements?

We have a number of queries on the audit register.

Firstly, it is unclear if a new system of registration numbers needs to be created. We already give each firm a unique identifier (although it is alpha-numeric) which is different between the three Institutes. Firms are familiar with these numbers. Creating a new numbering system would seem unnecessary and inefficient. The second major point is that the register has to be electronically available to the public. It is not clear if this means accessible via the internet (as for example is the FSA's register of firms) but if this is the case then based on the evidence regarding these matters, e.g. the time taken by Companies House to change its systems, the development time is likely to be long.

This then raises consideration about the timing of implementation. As the paper points out, the new register will hold more information than is currently required. While some of that information is already held by us, not all is. We normally collect this information via annual returns, which are issued throughout the year. Thus it would take us a year to collect the original information, although once collected firms would have to inform us of any changes. This, together with the time needed to re-develop the register, would suggest to us that the maximum time allowed by the Directive, to 29 June 2009, is taken.

As regards third country auditors, we believe that this register should be in place in time for when the first such firm is registered. As this is likely to be needed before the main register is available, we suggest that an interim third country auditor register is developed. This could just be a 'Word' document held on the POB website to satisfy the public access requirement.

The consultation document does not mention the alternative formulations allowed under Article 17(h) concerning networks. In our view, it would be more efficient if this detailed information was not held on the register. Rather, the register should just contain details of where such a list can be obtained. In our

view this would be more useful to the public as that other place would almost certainly have web links to the other network firms. It is also information that auditors of public interest entities are likely to have on their websites as a result of the transparency report required by Article 40.

We would also observe that it may be helpful to consider what other Member States are doing with regard to the register so that a more common format could be developed.

Questions relating to ethics (Articles 21 to 25):

Q4 Do you have any comments on the Government's proposals for implementation of the requirements on ethics?

We agree with the government's general approach that the provisions in Articles 21, 22, and 23(1) and 23(2) are substantially dealt with already and should continue to be dealt with in the APB auditor independence ethical standards or the RSB rules. The infrastructure for this is already in place and therefore little should need to be included in Schedule 10. In particular, any wording used should not go beyond the detail included in the Directive. We would be delighted to be of assistance when the wording of the Schedule is being drafted.

The issue of access to audit files is a complex matter as they belong to the auditor rather than the client and what constitutes 'all relevant information' in Article 23(3) is also a matter of some uncertainty. Neither detailed legal provisions nor ethical standards or codes are likely to be the most appropriate places to address these. However, contrary to the view expressed in paragraph 3.17 of the consultation document, we do not regard the issue of handover information as a matter for the RSBs. It is for auditing standards to set out what should happen on individual audits and what information an auditor has to obtain for the purposes of an audit. These standards already cover some elements that would be relevant, such as ISA (UK and Ireland) 510 *Initial Engagements – Opening Balances* and ISA (UK and Ireland) 710 *Comparatives* and these also discuss the need to communicate with the previous auditor. There is also a standard about the relationship between a holding company auditor and a subsidiary auditor. These would form the basis of a standard on handover information. Compliance with such a standard is a requirement of our audit regulations.

In contrast to other areas in the consultation, we believe that there should be statutory underpinning in respect of one aspect of this requirement. Firms will be very concerned about liability issues arising from providing handover information. In our view it is key that the legislation provides clarity as to the purpose of providing handover information so as to encourage firms to be as open as possible. We suggest that a clause is added to the effect that the incoming auditor may only use information obtained through the handover process for the purpose of its audit work and no other and that protection is granted against any liability alleged to have arisen as a result of passing the information to another auditor. In situations where audit firms do provide other firms with access to their working papers, for example to investigating accountants, there is always a 'hold harmless' agreement between the firms (see our guidance regarding this in Technical Release Audit 04/03) and it is this type of arrangement that we suggest is included in law.

Article 23(4) extends confidentiality requirements to those who are no longer auditors. While we believe that our current arrangements place these requirements on members (and even ex-members for disciplinary offences committed while still a member) we do not believe that we can deal with those who intentionally commit a breach of confidentiality when no longer a member. In our view, the only way to ensure the enforceability of this article is to place the requirement in law and to extend it to those who are no longer a member of an RSB.

We agree with the consultation document that the provisions in respect of Article 25 on audit fees are best addressed in the APB auditor independence ethical standards. As the RSBs are already required by law to apply these standards to their registered auditors, it is unclear that any further detail is necessary to be included in Schedule 10 in terms of underpinning the standards.

Questions relating to standards and reporting (Articles 26 to 28):

Q5 Do you have any comments on the Government's proposals for implementation of the requirements on standards and reporting?

See our overall comments on implementation of ISAs in the main part of this letter.

With respect to paragraphs 3.21 and 3.22 of the consultation document, in our view the requirements of Article 27(a) is covered by section 495 of the Companies Act 2006 (requirement for the auditor to give a report on the entire results of the group) and Article 27(b) should be covered by auditing standards. It is then a requirement of our audit regulations that auditing standards are complied with. We do not see the need for amendments to the Companies Act on these two points if the requirements are picked up in standards.

Our audit regulations also deal with the issue of audit working papers where auditors sub-contract some of their own work (e.g. using another firm to attend a stock take at a distant location). This regulation specifically excludes group audits but could be amended appropriately to deal with Article 27(c), including the 'defences' that are allowed in the Directive if there are barriers, legal or otherwise, to prevent the papers being obtained. Again, we do not see the need for statutory underpinning.

Questions relating to public oversight, investigations and discipline (Articles 29 to 36):

Q6 Do you have any comments on the Government's proposals for implementation of the requirements on public oversight, investigations and discipline?

As with other aspects of this consultation, we are not sure that matters relating to quality assurance and disciplinary systems require any changes to the Companies Act. We have systems in place which are subject to oversight by the POB. It will no doubt consider whether our systems deal with the matters set out in Articles 29 and 30 and, if not, act accordingly.

Again, under paragraph 20, we were of the view that we already had a duty to co-operate with the POB. Section 1254 of the Act is also relevant so we see no need for further changes.

We already apply confidentiality requirements on our staff. However, there may be difficulties in enforcing these once staff have left. Therefore the approach set out in the consultation, of taking sections 348 and 349 of the Financial Services and Markets Act as a model, seems a sensible solution. As noted, we already have confidentiality arrangements but we would also draw the new requirement, once enacted, to the attention of our staff.

Questions relating to the provisions for appointment and dismissal (Articles 37 and 38):

Q7 Do you have any comments on the Government's proposed approach to defining improper grounds for 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 agree that any proposal should be kept as simple as possible, particularly as the Companies Act 2006 has already brought in new requirements on auditors and companies in this area. Option 1 is the Government current preference and we would support that. However, we would welcome further discussions with the DTI regarding how Option 1 would work in practice. For example, would auditors put in their statement that they have been dismissed under improper grounds – how will they be able to determine this if ultimately it will be down to the courts to decide after the event?

Q9 Do you have any other comments on the Government's proposals for implementation of the requirements on appointment and dismissal?

In our various responses on this during the development of the Companies Act, we indicated that the requirement for notification of when the auditor of a 'non-major audit' ceases to hold office has many practical implications that are not dealt with in the consultation document. There is nothing in the Companies Act concerning the circumstances in which we would have to notify the accounting authorities. So other than those caused by the cessation of auditor status (i.e. the auditor has died or ceased in business) we consider that we would have to refer every cessation, unless clear guidelines are provided. There is also the issue that the law (section 522) allows an RSB to determine when auditors should supply such notifications. This would allow us to collect these notifications as part of our annual review process. However, our responsibility in respect of the notifications from companies is totally unclear. Are we required to match the notifications from the company or auditor to the other and chase missing notifications? These requirements potentially have major implications for our resource requirements and those of the relevant authorities for no apparent public interest benefit.

Section 525 of the Companies Act defines a major audit where the notification has to go to the POB. However, we are not sure that all companies will know whether they are a major audit or not.

We do wonder whether any public interest is served by these new arrangements, given the current processes in the UK for the notification of changes in audit appointments. If such arrangements are needed, in the interests of better regulation, we believe that a more robust and efficient system would be for the firm and the company to notify Companies House, as is required in any event, and for Companies House to refer (to the POB or an RSB) those that meet criteria that we have agreed should require a referral. We also suggest, for absolute clarity, that the notices required under sections 522 and 523 specify that the auditor/company is specifically identified.

Questions relating to public interest entities (Articles 39 to 43):

Major points in connection with implementation of the Article 41 requirements on audit committees:

1) There is confusion around the consequences arising from the implementation options

In our view the consultation paper lacks clarity with respect to the consequences of each of the four proposed implementation options. The role of enforcement authorities and penalties for non-compliance should have been made clearer in the consultation paper to enable respondents to consider the choices in a fully informed manner. We would welcome the opportunity for further clarification on these implementation options before a final decision is made by the DTI. In this respect it might be useful for the DTI to hold an open meeting of market participants and regulators including the FSA, the FRC and the FRRP, to obtain their full and frank views.

2) Need to maintain 'maximum flexibility' and a 'light touch' regime

We support the Government's intention to provide maximum flexibility and adopt a 'light touch' approach. We would therefore support the implementation of the Article 41 requirements via the Financial Services Authority (FSA). This is consistent with our view that the FSA is the preferred authority for the implementation of the disclosure of the new corporate governance statement under Article 46A of the Fourth Directive. The use of FSA regulatory penalties for non-compliance resulting in a financial penalty or in extremis de-listing, are preferable to criminal sanctions or civil liability.

3) The inappropriateness of the Combined Code as a mandatory national provision

The provisions in respect of audit committees in the Combined Code are more extensive than the Directive requirements in terms of both composition and function. Therefore, using the Combined Code as the basis for the mandatory national provision may inadvertently place more onerous legal requirements on UK companies than would otherwise be the case if such companies were required to meet the requirements stipulated under the Directive.

4) Confusion around the requirement for monitoring substantive compliance

We understand that the role of the FSA would be extended to monitoring substantive compliance and that there are concerns that the FSA currently lacks the capacity to fulfil this responsibility. However, we are not clear why this would be radically different from the current risk-based monitoring approach. Even for some existing FSA rules we assume that any disclosure not reflecting the facts would amount to the provision of misleading information and would be a matter for substantive compliance conducted by the FSA. Furthermore, most UK companies are already fully compliant with the minimum requirements of the Directive and thus substantive monitoring of inadequate disclosure is not likely to be frequently required.

5) The FSA can delegate monitoring responsibility to the FRRP

We prefer any enforcement of Article 41 via FSA rules rather than through Companies Act legislation. However, we recognise that the FRRP may be best placed to monitor such requirements which would amount to an extension of its current role in reviewing Directors' Reports for compliance with relevant provisions of the Companies Act 1985. It may therefore be appropriate for the FSA to delegate responsibility to the FRRP and in doing so the UK would benefit from a 'light touch' regime but with adequate monitoring. Also, under Article 46A of the Fourth Directive, information around the composition and role of the audit committee will be required to be disclosed in a corporate governance statement. It would therefore be logical for the same regulator to be responsible for monitoring the disclosure of a corporate governance statement and the requirement for companies to have an audit committee in order to avoid regulatory overlap.

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

We support the Government's intention to exercise the option provided for in Article 41(5). However, in doing so, it is challenged with determining the most appropriate national provision which reflects equivalent functions to those outlined in Articles 41(1) to 41(3). Further, the monitoring and enforcement of such national provisions should be managed by a 'light touch' approach.

The national provision should not be based on the Combined Code

The Government is suggesting that the national provision may be based on either the Combined Code or specific obligations set out in rules. We do not support the use of the Combined Code as a basis for the national provision for the following reasons:

- The provisions in respect of audit committees in the Combined Code are more extensive than the Directive requirements in terms of both composition and function. For example, in relation to independence requirements, the Combined Code recommends that the entire audit committee be independent whereas, under the Directive, this is restricted to 'at least one member'. We are informed that many UK companies do not meet the Combined Code recommendation for the entire audit committee to be independent (but explanations are provided regarding the deviation) and this is particularly onerous for smaller companies.
- Stipulating the Combined Code as a mandatory national provision may inadvertently place more onerous legal requirements on UK companies than would otherwise be the case if such companies were obliged to meet the requirements stipulated under the Directive. This could potentially lead to increases in liability, higher D&O premiums and an overall reluctance of non-

executive directors to take up positions on audit committees. Combined Code recommendations should not be used as the basis for a mandatory national provision, given the option to have less onerous requirements under the Directive itself.

- UK companies would continue to be obliged to follow the recommendations of the Combined Code under the traditional 'comply or explain' approach which encourages good practice over and above minimum requirements. This approach would retain the role of shareholders in evaluating Combined Code disclosures while also meeting the obligations for the Government to ensure that mandatory Directive requirements, under FSA rules, are provided for and enforced.

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

In our view the consultation paper lacks clarity with respect to the consequences of each of the four proposed implementation options. The role of enforcement authorities and penalties for non-compliance should have been made clearer in the consultation paper to enable respondents to consider the choices in a fully informed manner. We would welcome the opportunity for further clarification on these implementation options before a final decision is made by the DTI. In this respect it might be useful for the DTI to hold an open meeting of market participants and regulators including the FSA, the FRC and the FRRP, to obtain their full and frank views.

We do recognise the Government's desire to allow for maximum flexibility to take into account the individual circumstances of each company when meeting audit committee requirements. However, there are a number of potentially adverse consequences which may arise from each of the implementation options described in the consultation. We therefore recommend an alternative approach.

Our recommendation

The Government would exercise the option provided for in Article 41(5). In doing so, the minimum national provision would be outlined in rules based on the minimum requirements in Articles 41(1) to 41(3).

1. *The national provision would be created under new FSA Listing Rules, rather than in new Companies Act regulations.* The Government may wish to create FSA rules based on the wording of the Directive with amendments as necessary. FSA regulatory penalties for failure to comply with rules leading to possible financial penalties or in extremis de-listing, are preferable to criminal sanctions or civil liability under a legislative approach. This would help to maintain a 'light touch' corporate governance regime which is in accordance with the Government's intention.
2. *The FSA would delegate the responsibility of monitoring audit committee requirements to the FRRP.* In doing so, the UK would benefit from clear FSA rules outlining the requirements while relying on the FRRP to conduct adequate monitoring. The FRRP is also the logical authority to monitor the disclosure of a corporate governance statement required under the Fourth Directive which would extend its current role in reviewing Directors' Reports for compliance with relevant provisions of the Companies Act 1985. Information around the composition and role of the audit committee will be required to be disclosed in this statement. It would therefore be appropriate for the same regulator to be responsible for monitoring the disclosure of a corporate governance statement and the requirement for companies to have an audit committee in order to avoid regulatory overlap.
3. *The Combined Code would remain a separate and voluntary instrument.* Our view regarding the inappropriateness of the Combined Code as a mandatory national provision is made explicit in our response to Q10 above.

4. *Institutional investors would continue to play an important role* in monitoring corporate governance through the 'comply or explain' system based on Combined Code disclosures. This includes disclosures made in respect of the audit committee recommendations in the Combined Code which cover all of the minimum requirements of the Directive. Shareholders would thus continue to play a monitoring role by evaluating Combined Code disclosures and, in the event that there is non-compliance, reacting accordingly.

Comment on the role of regulators

We understand that the role of the FSA would be extended to monitoring substantive compliance and that there are concerns that the FSA currently lacks the capacity to fulfil this responsibility. However, we are not clear why this would be radically different from the current risk-based monitoring approach. Even for some existing FSA rules we assume that any disclosure not reflecting the facts would amount to the provision of misleading information and would be a matter for substantive compliance conducted by the FSA. Furthermore, most UK companies are already fully compliant with the minimum requirements of the Directive and thus substantive monitoring of inadequate disclosure is not likely to be frequently required.

A potentially more complex issue may arise as a consequence of additional monitoring responsibilities. In the event that a complaint arises, regulators may lack the capacity to judge and determine appropriate outcomes to meet the particular needs of individual companies and are thus limited in their ability to respond accordingly. For example, in the event that a complaint arises around the independence of committee members, difficulties may arise in defining concepts which may lead to narrow definitions embedded in rules and the proliferation of legal interpretation. Instead the business and investment communities are more appropriate in determining what constitutes acceptable good practice around issues such as independence of audit committee members.

Remarks on Options 1 to 4

Option 1

While we support the implementation of Article 41(5) via FSA rules we do not support Option 1 for the following reasons:

- The Combined Code should not be the basis for the mandatory national provision for reasons expressed under Q10 above.
- The ability for companies to have alternative arrangements in place may inadvertently reduce UK corporate governance standards. If companies were legally obliged to meet either recommendations outlined in the Combined Code, or given a choice of having alternative arrangements, it is likely that they would opt for the latter. The minimum requirements for having alternative arrangements in place are far less onerous than the Combined Code recommendations. If recommendations in the Combined Code were to be mandatory, companies may be encouraged to choose minimum compliance below the excellent standards of corporate governance we currently enjoy.

Option 2

While we recommend that the FRRP is an appropriate authority to monitor the implementation of Article 41(5) this would be enforced through FSA Listing rules. We therefore do not support Option 2 for the following reason:

- Failure to comply with Directors' Report requirements, and in this case audit committee requirements, under the FRRP would lead to a criminal offence imposed upon an individual director. We believe this sanction is unnecessarily excessive.

Option 3

We do not support Option 3 for the following reasons:

- It is not clear how the Directive requirements will be enforced. It is assumed complainants would turn to the courts for redress but it is unclear whether this system would lead to appropriate outcomes.
- Failure to meet the obligations made under Companies Act regulations would be an offence imposed upon the company and we believe criminal sanctions are unnecessarily excessive.

Option 4

There would be no requirement for either the FSA or the FRRP to play a role in monitoring substantive compliance which would address concerns around the capacity for such authorities to effectively fulfil this role. However, we do not support Option 4 for the following reasons:

- Most UK companies already meet the minimum requirements for exemption under Article 41(5). Companies that do not will be required to follow regulations under the Companies Act. Creating regulations only for companies that do not comply with the Combined Code, and specifically excluding those that do comply, has the same effect for requiring all companies to comply either voluntarily or by a legal obligation.
- Given that most companies already do comply with minimum standards, the introduction of rules (via the FSA) is not likely to cause too much disruption to the current status quo.
- While it is assumed that the role of the FSA will remain unchanged under this option, there is no indication how requirements will be monitored or enforced.
- Failure to meet the obligations made under Companies Act regulations would be an offence on behalf of the company and we believe criminal sanctions are unnecessarily excessive.

Conclusion

We consider that the best way forward would be to implement the minimum requirements in company law, to be monitored by the FRRP, leaving the Combined Code completely untouched, such that companies will carry on, as now, operating to a higher standard than required by the minimum requirements.

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?

The answer to this question has been addressed in Q10 and Q11 above. However, we do have some general observations on the potential impact of the Directive implementation requirements in the UK.

The UK corporate governance system is emulated throughout the EU

Article 41 is primarily based on the UK model contained in a number of provisions in the Combined Code. This is testament to the leading role that the UK has in the area of corporate governance (as also exemplified by Article 46A of the Fourth Directive). This indicates that the European institutions, led by the European Commission, have confidence that the UK system is sufficiently robust and is effective in achieving high standards of corporate governance. It is therefore important that the implementation of Article 41 requirements be as simple as possible and not lead to unnecessary changes to the current status quo.

'Comply or explain' would become 'comply or comply'

The Combined Code should continue to operate on a 'comply or explain' basis. Otherwise, the juxtaposition of placing mandatory legal requirements in a voluntary Combined Code would fundamentally alter 'comply or explain' to 'comply or comply' in respect to audit committees. This would lead to a hybrid of the current Combined Code which may ultimately damage the concept of the 'comply or explain' approach and confuse interpretation around what companies are legally obliged to comply with and what are simply voluntary disclosures.

UK corporate governance is robust and proportionate

The UK system of corporate governance, underpinned by the 'comply or explain' system, takes into account the volatile and flexible nature of business while setting out clear recommendations for good practice. Most, if not all, UK companies currently comply with the Combined Code recommendations relating to audit committees (with the exception of those relating to independence where deviations are explained). This compliance has evolved, not from any legal obligation, but from voluntary disclosure under the system of 'comply or explain'.

Good practice recommended in the Combined Code exceeds the minimum requirements outlined in the Directive which we recommend should be transposed into FSA rules. Such rules will serve a valid purpose of clarifying minimum expectations but will not incur criminal sanctions. At the same time shareholders will continue to play a role in evaluating Combined Code disclosures. This, in effect, will provide a dual monitoring system for the implementation and enforcement of the Directive requirements.

Q13 Do you have any comments on the use of the specific exception for public interest entities which are also small or medium-sized companies?

We accept the Government's reasoning behind not proposing to take up the specific option in Article 41.1 given the intention to take up the wider exemption provided for in Article 41.5.

Q14 Do you have any comments on the options to exempt certain classes of public interest entity under Article 41.6?

We support the Government's position to exempt entities as permitted by the Directive.

Q15 Do you have any other comments on the Government's approach?

With respect to the obligations on auditors set out in Article 41.4, as these are to do with "key matters arising from the statutory audit", our view is that these obligations are covered by an auditing standard (ISA 260) and we therefore see no need for a change to the law.

With respect to the seven year rotation requirement in Article 42(2) for 'key audit partners' of public interest entities, see the comments in the main part of our letter. We consider that a change to seven years (in line with the Directive) should be considered as part of the review of the APB Ethical Standards. In general with respect of Articles 42(1) and 42(2), as the RSBs are already required by law to apply the APB Ethical Standards to their registered auditors, it is unclear that any further detail is necessary to be included in Schedule 10 in terms of underpinning the standards..

Q16 Which of the two options:

Option 1: New offence created under the Companies Act; or

Option 2: Provision in the rules of the Recognised Supervisory Bodies' rules

do you think would be the better approach for the enforcement of the prohibition on auditors taking up management positions? Do you have any other comments on the Government's approach to this prohibition?

In our view, the existing APB requirements on 'cooling off' in paragraph 44 of ES2 comply with the requirements of Article 42(3). They both cover key audit partners (we assume the APB will align the definition of this with the Directive), they both cover PIEs and they both require a two year cooling off period. We assume the concern is that the APB has phrased the requirement in terms of 'if the partner joins the client the auditors must resign' whereas the Article says 'the partner shall not join the client. However, the net effect is the same: if the auditor resigns then the employer is no longer an audit client therefore there is no breach of Article 42(3).

However, as the consultation document points out, RSBs would have no sanctions against members who resign their membership so as to take up management positions with audit clients during the two year quarantine period. In our view, once the questions of who is barred and from what positions, have been settled, enforcement should be by a prohibition on the company employing such people.

Questions relating to third country auditors (Articles 45 to 46):

Q17 Do you have any comments on the Government's approach to the implementation of the provisions for third country auditors?

We note the proposals in respect of third country auditors. Our comments are on paragraph 3.81, where there is reference to amending the law (in respect of quality assurance systems for public interest entities). In our view the current process, operated between ourselves and the Audit Inspection Unit, deals with Article 43 and is enabled by paragraph 23 of schedule 10 of the Companies Act 2006. Equally Article 29 is dealt with in paragraph 12 of schedule 10. Placing these detailed requirements in law could create inflexibilities.

Questions relating to co-operation with third country authorities (Article 47):

Q18 Which of the three options:

Option 1: A new offence created under the Companies Act;

Option 2: Provision in the Recognised Supervisory Bodies' rules; or

Option 3: Regulations providing for any such transfer to be unlawful

do you think is the best approach to implementing the prohibition applying to auditors?

See answer to Q19 below. We do question whether the 'prohibition' approach is the right one as Article 47 could be viewed as enabling rather than prohibiting. It would seem inappropriate to make it illegal for a UK firm to co-operate with a third country authority where the firm considers that it would be in its interests to do so.

Q19 Do you have any other comments on the Government's proposed approach to the prohibition?

We believe that there has to be absolute clarity as to the scope of Article 47. We do not consider that it is designed to prevent the transfer of audit working papers between auditors. For example, if a US company has a branch or subsidiary in the UK, and the auditor of the US company asks a UK auditor to undertake work on its behalf, we do not believe that this Article prevents the UK auditor transferring audit working papers to the US auditor.

There also needs to be clarity as to the entities referred to in Article 47. The reference to 'issued securities' could mean that the company in question has shares listed on a stock exchange in the third country. The reference to a group issuing statutory consolidated accounts presumably means there is a requirement for the group to publish or file with the relevant authorities. This does not seem to require that the holding company of the group has issued shares. Thus the scope of this Article seems to be any subsidiary of a company that is required to file group accounts in a third country and any company that has issued securities in a third country.

Nor is it clear what 'other documents' in Article 47(1)a refers to. These could be papers held by a Recognised Supervisory Body or the Audit Inspection Unit as a result of the review of that particular audit, or the firm's own internal quality control review. It is not clear if these papers would also have to be transferred. Our view is that they should not. The papers should only be those in the control of the auditor which were used to arrive at the auditor's opinion.

Assuming that the above can be clarified, our view is that the requirements should be put in place via the rules of the RSBs. This gives the greatest flexibility and would only need to state that a firm must deliver up the papers in respect of a transfer request that had been made by an overseas competent authority that has been approved by the POB in accordance with Article 47(1)d. We are of the view that greater certainty is achieved if all requests from third countries are routed via RSBs and use is not made of the exceptional case route allowed in Article 47(4).

Questions relating to the disclosure of auditor remuneration (Article 49):

Q20 Do you agree with the Government's proposed approach to implementing Article 49?

We do not agree with the Government's proposed approach to implementing Article 49. We believe that any public policy objectives in the Regulations can and should be achieved in the context of considerable simplification of the Regulations, and that the Regulations should be made consistent with the Directive. Our main reasons are summarised below. We would very much welcome the opportunity to discuss these issues with the DTI.

- (a) The proposed approach involves a considerable degree of 'gold-plating' of the Directive, requiring disclosure in ten categories of 'other services' rather than just four. We accept that the Government may have public policy reasons for requiring additional disclosure; but in this case, the additional disclosures should be based on further sub-divisions of the four categories in the Directive rather than on a completely different and incompatible analysis.
- (b) The Regulations are in our view needlessly complicated, requiring, for example, a distinction to be made between the fees for auditing the consolidated accounts and the fees for the statutory audits of subsidiaries. This cannot be seen as highlighting a threat to independence.
- (c) We consider that the definition of associates of the auditors in Schedule 1, paragraph 1(d) of the Regulations is flawed and could lead to highly inappropriate disclosures under 'other services'. For example, a partner in an audit firm may be a director of a company, unconnected with the audit firm, which provides services to a client of the audit firm. The services may be completely unrelated to services provided by the audit firm, and the partner may have no involvement in the relevant audit, yet the Regulations would require disclosure of the fees for these services.
- (d) Including pensions schemes within the disclosures is in our view inappropriate, since under UK pension law UK schemes are not permitted to be controlled by their sponsoring company, and are therefore completely different from subsidiaries in this regard.

APPENDIX 2: COMMENTS ON THE DTI'S DRAFT REGULATORY IMPACT ASSESSMENT

Public Register

1. We have not seen how the estimate of updating the register was arrived at. The current register is a very simple database operating on Microsoft software. This will have to be substantially modified and upgraded if it is to include more information and be accessible via a website. Until detailed costs are produced it is very difficult to assess if these suggested costs are accurate.
2. We note that the AIA will be expected to bear its share of the development costs. Our view is that the operating costs of the register should be shared between the RSBs (and the POB for third country auditors) in ratio to the number of firms registered by each RSB. However we believe that the set up costs should be shared equally since these are not a function of the number of entries on the register.
3. It is noted that there should be no ongoing costs as firms already have to complete an annual return. This misses the point that additional information is required, together with updating that information by the RSBs. Thus changes to information that does not currently need notifying will have to be notified and amended. We could easily envisage 1,000 additional data changes annually for firms registered with the Institute. We would estimate that these would cost £50 each to process, together with additional costs in the firms to supply the information.
4. It is noted that these costs would be offset by reductions in costs for persons searching the register. However, our experience is that there are not many such searches. Thus many of these costs do not have an off-setting benefit.

Dismissal and resignation of auditors

It is unclear what these administrative costs are meant to represent. Until we can see our exact responsibilities, it is difficult to determine what our costs of dealing with these notifications will be.