

<b>Title:</b> UK implementation of the EU Directive on statutory audits of annual accounts and consolidated accounts, and of the EU Regulation on specific requirements regarding statutory audit of public interest entities 2014 <b>IA No:</b> BIS016(F)-16-BE <b>Lead department or agency:</b> Business, Innovation & Skills <b>Other departments or agencies:</b> N/A	<b>Impact Assessment (IA)</b>
	<b>Date:</b> 09/05/2016
	<b>Stage:</b> Final
	<b>Source of intervention:</b> EU
	<b>Type of measure:</b> Secondary Legislation
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<b>Summary: Intervention and Options</b>	<b>RPC Opinion: GREEN</b>

**Cost of Preferred (or more likely) Option 2**

Total Net Present Value	Business Net Present Value	Net cost to business per year (EANDCB on 2014 prices)	In scope of One-In, Three-Out?	Measure qualifies as
-£220.12 m	-£220.12 m	£0 m <sup>1</sup>	Part in scope	N/A <sup>2</sup>

**What is the problem under consideration? Why is government intervention necessary?**

The financial crash in 2008, led to calls for greater scrutiny of the audit profession. The belief was that the accounts of several financial institutions had been given unjustified 'clean' audit reports and so potentially misled investors and regulators, undermining confidence in the financial system as a whole and affecting the efficient allocation of financial capital. The crisis further underlined the 'expectation gap' between the assurance that a statutory auditor is required to provide and that which investors and the public assume. The risk is that the market will not provide a socially optimal level of rigorous and independent auditing, and hence there is a need for Government intervention. The market failures are due to misaligned incentives, conflict of interests and lack of competition. Companies infrequently tendering audit appointments or changing auditors cause there to be little opportunity for auditors to compete for contracts, leading to a lack of competition in the market for the provision of audit services. Meanwhile, the emphasis on client retention acts as a disincentive for auditor scepticism which brings into question the independence of the audit. 'Professional scepticism' of the auditor could also be compromised when audit and non-audit services are provided by the same organisation especially where non-audit service revenues from the statutory audit client become substantial; where auditors risk reviewing their previous non-audit work or where the provision of statutory audit services becomes a gateway to the provision of non-audit services.

**What are the policy objectives and the intended effects?**

The policy intends to improve confidence in the value of audit through enhanced audit quality and stricter independence requirements on statutory auditors, including on the provision of non-audit services to audit clients. It will also make the audit report more informative for shareholders and audit committees; will extend the regulatory requirements applying to audits of listed companies to unlisted banks, building societies and unlisted insurers, which would now be included in the definition of Public Interest Entities (PIEs); increase accountability to independent audit committees of PIEs; and increase competition in the audit market. This should strengthen investor confidence in audit reports and contribute to a more dynamic audit market in the EU.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

0. Do nothing. This will not address the problems identified by the EU around the quality and scrutiny of audits. In addition, this option would place the UK in breach of its Treaty obligation to demonstrate transposition of the Directive into UK law and implement the mandatory requirements introduced by both the Directive and Regulation. This would impose costs on the Government in fines for infraction, and could also have significant reputational and diplomatic consequences. (See page 12).
1. Take the minimum action required by the Directive and Regulation to address the problems identified. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes (see page 12).
2. Implement the EU baseline (Option 1) and apply the implementing measures for the Directive in legislation on Limited Liability Partnerships (LLPs), as the Directive does not apply to an LLP that is not a PIE.

**Will the policy be reviewed?** It will be reviewed. **If applicable, set review date:** June 2021

Does implementation go beyond minimum EU requirements?	Yes
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<sup>1</sup> Implementing the EU baseline (under Options 1 and 2) has an Estimated Annual Net Direct Cost to Business (EANDCB) of £24.71m, which is out of scope of OI30. The additional EANDCB of the preferred Option 2 (which extends the measures in the Directive to LLPs) over Option 1 (the EU baseline) is In Scope of OI30. This impact of this change is estimated to be negligible, and is thus recorded as "£0", based on advice from the Better Regulation Executive. Section F and the annexes to the Impact Assessment (IA) provide details on the estimates of the costs and benefits of the respective options, and Section G provides details on the EANDCB analysis / OI30 classification of the options.

<sup>2</sup> The In Scope element of Option 2's EANDCB is £0. The Out of Scope element is £24.71m.

Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	<b>Micro</b> Yes/No	<b>&lt; 20</b> Yes	<b>Small</b> Yes	<b>Medium</b> Yes	<b>Large</b> Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)			<b>Traded:</b>	<b>Non-traded:</b>	

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:

..... Neville-Rolfe ..... Date: 15 June 2016 .....

# Summary: Analysis & Evidence

# Policy Option 1

## Description:

### FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2016	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -269.50	High: -174.95	Best Estimate: -220.12

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	33.2	17.0	176.7
High	50.2	26.1	270.8
Best Estimate	41.7	21.3	221.6

#### Description and scale of key monetised costs by 'main affected groups'

The monetised costs<sup>1</sup> of the measures of the amended **EU Directive** are:

One-off transition costs	
£4.80m	One-off cost of establishing an audit committee by the 160 unlisted insurers.
£36.93m	Familiarisation and implementation costs
Ongoing Costs	
£16.15m	Annual on-going costs for 160 unlisted insurers who would now have to have an audit committee
£6.99m	Annual on-going costs incurred by 2,029 PIEs (listed entities and unlisted banks, building societies and insurers) as a result of additional meeting requirements on all audit committees
£0.51m	On-going costs of affecting 34-36 existing auditors of PIEs and 10-12 new in scope auditors of PIEs as a result of additional Audit Quality Review inspections by the FRC.

The **total costs** of the **EU Directive** are: **one-off costs** of **£41.7m** and **ongoing costs**<sup>2</sup> of **£23.6m per annum**.

#### Other key non-monetised costs by 'main affected groups'

- Changes to audit technical standards and qualifications are not expected to give rise to significant costs because auditors already take action on irregularities and quality control. Some smaller PIEs will incur costs of appointing independent quality control reviewer however these costs are expected to be low.
- Enhanced requirements relating to auditor independence where group audits are concerned are expected to result in on-going additional costs to all auditors of cross border groups that have members in jurisdictions outside the EU. Also, where other countries are involved, if the auditing standards of those countries are comparable to those implemented by the Directive, no additional costs are expected to fall on UK auditors from this requirement. It is therefore difficult to identify how many auditors would be affected and so not possible to quantify this cost (see Annex H for more details).
- Another important change required by the Directive is that all entities that are required to be subject to statutory audit should be the subject of a prohibition of restrictive agreements with third parties affecting their choice of auditor. The provision implementing this requirement makes any such agreements ineffective. This is also a recommendation of the Competition and Markets Authority (CMA) following its market investigation into the effect of prohibiting such clauses among FTSE 350 firms. The costs of this prohibition are difficult to monetise. The CMA concluded on the basis of its consultations with stakeholders that the prohibition of these clauses was not likely to have any significant cost implications for affected businesses.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	0.2	1.3
High	0	0.2	1.7

<sup>1</sup> Ongoing costs are presented here in constant prices.

<sup>2</sup> The Directive requirements commence in accounting years beginning after June 2016. The first accounting year affected would therefore be January 2017. The annual costs therefore begin in year 1 of the appraisal period rather than year 0. This reduces the annual average cost during the appraisal period to £21.3m instead of £23.6m.

<b>Best Estimate</b>	0	0.2	1.5
Description and scale of key monetised benefits by 'main affected groups'			
£0.20m	Average annual savings accruing to an estimated 430 auditors of only small companies and 2,322 firms with no audit clients.		
<p>The existing requirement that each audit firm must be subject to inspection at least once every 6 years will no longer apply for auditors of only small companies or audit firms that have no audit clients (who currently undergo desk-based inspections). The frequency of these inspections would instead be determined on a risk basis and the FRC expect that the frequency for such firms would reduce from 6 to 8 years. This would result in an ongoing annual saving that we estimate at about £145,000 accruing to an estimated 2,322 audit firms with no audit clients. It would also result in a further saving of about £125 per firm for auditors of only small companies that would also have inspections reduced from every 6 to every 8 years<sup>3</sup>. Rounded to the nearest £100,000 the total savings are estimated at £200,000. (See Annex G).</p>			
<b>Other key non-monetised benefits by 'main affected groups'</b>			
<p>The Directive requirements would now extend to unlisted banks and insurers as these are of considerable systemic importance to the economy. Increased audit quality and better information being made available should lead to increased investor trust in the financial statements of affected companies, which could lead to better investment decisions. As audit provides assurance of the veracity of financial statements, higher ethical standards and increased transparency would increase audit quality reducing the risk of misstatement and of resulting corporate crises. This should enhance investor protection and possibly reduce the cost of capital.</p> <p>All unlisted PIEs would now have an audit committee with an independent member to be the focus of the company's relationship with the auditor, allowing the relevant Directors to be held accountable for all matters relating to audit.</p> <p>Increased competition is also expected in the concentrated audit market. Mutual recognition of audit firms across Member States will result in the reduction of the administrative costs of applying for a new licence in each Member State in which the auditor wishes to operate and could open up access to audit markets across the EU, increasing competition.</p> <p>The prohibition of auditor clauses in loan agreements would also reduce barriers to entry; by reducing reputational barriers faced by non-Big 4 firms as a result of these clauses. This would incentivise mid-tier audit firms to compete more vigorously in the market and potentially assist companies to make a more independent choice of auditor.</p>			
<b>Key assumptions/sensitivities/risks</b>			<b>Discount rate (%)</b>
			3.5
<p>Our calculations are based on the current number of PIEs in scope. Based on the definitions in the regulations of the entities in scope we have used data from the Bank England, the FAME database and the UK Listing Authority Official List to estimate a total of 2,029 PIEs.</p> <p>The other key assumptions/risks in terms of costs and benefits are:</p> <ul style="list-style-type: none"> <li>(i) That the Bank of England and Prudential Regulation Authority lists provide full coverage of all credit institutions and insurers which are in scope of this Directive.</li> <li>(ii) Data on the costs and benefits are limited. Also estimates from the EU Commission's Impact Assessment, from auditors and from research documents referenced in the main text of this Impact Assessment on, e.g., the number of hours required to fulfil tasks, may give an imperfect indication of the costs to business of the proposed option.</li> <li>(iii) That transitional costs – familiarisation, tendering for non-audit services and establishing an audit committee – are incurred in 2016 (the UK legislation comes into force in June 2016).</li> <li>(iv) Ongoing costs will start to be incurred in 2017, as the UK legislation will apply to accounting years starting after the UK legislation comes into force.</li> </ul> <p>Ranges and best estimates are provided where these risks/uncertainties occur.</p>			

#### **BUSINESS ASSESSMENT (Option 1)**

<b>Direct impact on business (Equivalent Annual) £m:</b>			<b>In scope of OI30</b>	<b>Measure qualifies as</b>
<b>Costs: 24.9</b>	<b>Benefits: 0.2</b>	<b>Net: -24.7</b>	No	N/A

<sup>3</sup> The number of auditors that stand to benefit from the reduced frequency is expected to be 430. However, not all of these auditors would benefit under this option, because 430 includes eligible auditors who also have any LLP clients. Auditors with LLP clients would not stand to benefit from the reduction in frequency under option 1. Therefore we expect the benefit would be lower than £54,000 (£125 X 430 auditors).

# Summary: Analysis & Evidence

# Policy Option 2

Description:

## FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2016	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -269.5	High: -174.95	Best Estimate: -220.12

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	33.2	17.0	176.7
High	50.2	26.1	270.8
Best Estimate	41.7	21.3	221.6

### Description and scale of key monetised costs by 'main affected groups'

The monetised costs are as Option 1

### Other key non-monetised costs by 'main affected groups'

- As in Option 1.
- The additional cost of applying the implementing measures for the Directive in legislation on LLPs, where the LLP is not a PIE. (The Directive and Regulation will apply in any case where an LLP is a PIE). We estimate a negligible additional cost arising from the extension of changes to the Ethical standards relating to independence requirements when conducting group audits. See Sections F and G and Annex H for further discussion of this analysis.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	0.2	1.3
High	0	0.2	1.7
Best Estimate	0	0.2	1.5

### Description and scale of key monetised benefits by 'main affected groups'

- As Option 1, except we estimate the full £54,000 saving to be realised as all 430 auditors with only small audit clients would stand to benefit. Rounded to the nearest £100,000 however, we estimate the benefit still to be the same as Option 1 i.e. £200,000.

### Other key non-monetised benefits by 'main affected groups'

As Option 1, plus:

- Increased consistency between companies and LLPs in audit and accounting standards and the level of assurance of accounts provided. This increased audit quality for LLPs should lead to an equal level of trust in LLP audits and LLP accounts as there would be for other forms of businesses after the implementation of the Directive.
- There would also be a positive impact of extending the benefits of the prohibition of auditor clauses on loan agreements for LLPs.
- A consistent legislative framework for all UK audits.
- Avoidance of costs of having a dual set of auditing standards.

### Key assumptions/sensitivities/risks

As Option 1 above.

Discount rate (%)

3.5

## BUSINESS ASSESSMENT (Option 2)<sup>1</sup>

Direct impact on business (Equivalent Annual) £m:			In scope of OI30?	Measure qualifies as
Costs: £0	Benefits: £0	Net: £0	Partially in Scope	N/A

<sup>1</sup> The In Scope element of Option 2's EANDCB is £0 (displayed in this box). The Out of Scope element of the EANDCB is £24.7m (outlined in the Business Assessment box for Option 1 on page 4).

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## **Executive Summary**

This Final Stage<sup>2</sup> Impact Assessment (IA) relates to the implementation of the EU<sup>3</sup> Directive<sup>4</sup> and Regulation<sup>5</sup> on the audit of limited companies and other undertakings that are classified as ‘public interest entities’ (PIEs). (PIEs are defined on the next page)

Following the recent financial crises, this wide-ranging set of EU-wide audit reforms intend to improve confidence in the value of audit, through measures to enhance audit quality and stricter independence requirements on statutory auditors, including on the provision of non-audit services to audit clients. The reforms will also make audit reports more informative for shareholders and audit committees; will extend the regulatory requirements applying to audits of listed companies to unlisted banks, building societies and unlisted insurers; increase accountability to independent audit committees of PIEs; and increase competition in the audit market. Overall the measures should strengthen investor confidence in audit reports and contribute to a more dynamic audit market in the EU. A well-functioning audit market should ensure that financial statements are independently verified, and provide account users (e.g. shareholders, creditors etc.) with accurate financial information with which to base their decision-making.

### **The Rationale for Intervention**

Confidence of shareholders and other external stakeholders in the quality and independence of audits is fundamental to the functioning of the audit market and wider UK economy. If investors, trading partners and lenders do not trust the accuracy of financial statements, this can lead to reduced investment and higher cost of capital for companies. Audit is a service provided in the direct interests of the audited company, its lenders, trading partners, credit reference agencies and owners. It also is of public interest, such as for other businesses, employers and civil society, where business failures have knock-on effects to others. The audit report on a company’s financial statements is also used by regulators to ensure market stability.

The risk is that the market will not provide a socially optimal level of rigorous and independent auditing, and hence there is a need for Government intervention. The market failures are due to auditor misaligned incentives, conflict of interests and lack of competition between auditors.

The main objectives of the reforms are to:

- Reinforce the independence and professional scepticism of the statutory auditor;
- Increase auditor accountability to independent audit committees of PIEs and the accountability of the relevant directors of PIEs to their shareholders on matters relating to audit;
- Contribute to a more dynamic audit market in the EU, facilitating the cross-border provision of statutory audit services; and
- Improve the supervision of statutory auditors and the coordination of audit supervision by competent authorities in the EU.

This IA provides a description and cost-benefit analysis of all impacts on business, whether derived from the change to the Directive or from the new Regulation.

### **Businesses Affected**

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<sup>2</sup> The Consultation Stage IA received a Green opinion from the RPC – which we have sent you for information.

<sup>3</sup> EU Regulations have automatic legal effect in EU Member States once agreed at European-level. EU directives, once agreed at European-level, have to be actively transposed into the national law of EU Members States.

<sup>4</sup> Directive 2014/56/EU amending Directive 2006/43/EC

<sup>5</sup> Regulation (EU) No. 537/2014

The changes set out in the Directive and Regulation largely apply to Public Interest Entities (PIEs) and their statutory auditors. PIEs are defined as either:

- entities whose transferable securities are admitted to trading on an EU regulated market;
- credit institutions; and/or
- insurance undertakings.

The total number of PIEs in scope is estimated at 2,029, and these are expected to be audited by around 55 audit firms. As a result of minor changes to Financial Reporting Council (FRC) Auditing Standards, there would also be some additional costs to the auditors of other entities (non-PIEs).

### **Options**

We propose three options, including do nothing:

**Option 0:** This option will not address the problems identified by the EU around the scrutiny and quality of audits.

**Option 1:** Take the minimum action required by the Directive. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes.

**Option 2:** Implement the EU baseline (Option 1) and apply the implementing measures for the Directive in legislation on Limited Liability Partnerships (LLPs).

Where an LLP is a PIE the Directive would apply to it automatically. The impact of extending the Directive to LLPs is therefore only to the extent of its impact on non-PIE LLPs. For consistency and in order to prevent the emergence of a 'part-implementation' of EU audit requirements for LLPs we propose to implement the amendments in the new Directive for the audits of these entities.

Option 2 is therefore our preferred option.

### **Costs of Preferred Option**

The **total monetised costs** of the **EU Directive** are **one-off costs of £41.7m** and **ongoing costs<sup>6</sup> of £23.6m per annum**. These include:

- Familiarisation and implementation costs of the Directive estimated at £36.93m.
- One-off cost of £4.80m of establishing an audit committee by the 160 unlisted insurers.
- Annual on-going costs of £16.15m for 160 unlisted insurers who would now have to have an audit committee.
- £6.99m annual on-going costs incurred by 2,029 PIEs (listed entities and unlisted banks, building societies and insurers) as a result of additional meeting requirements on all audit committees.
- £0.51m annual on-going costs of affecting 34-36 existing auditors of PIEs and 10-12 new in scope auditors of PIEs as a result of additional Audit Quality Review inspections by the FRC.

Apart from this, enhanced requirements relating to auditor independence where group audits are concerned are expected to result in on-going additional costs to all auditors. However, it was not possible to quantify these. Other un-monetised costs are expected to be negligible.

### **Benefits of Preferred Option**

The main benefits of the measures are unquantified. Increased audit quality and better information being made available should lead to increased investor trust in the financial statements of affected

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<sup>6</sup> The Directive requirements would commence on accounting years beginning after June 2016. The first accounting year affected would therefore be January 2017. The annual costs therefore begin in year 1 rather than year 0.



companies, which could lead to better investment decisions. The Directive requirements would now extend to unlisted banks and insurers as these are of considerable systemic importance to the economy. All PIEs would be required to have an audit committee, the primary purpose of which is to provide oversight of (and be accountable for) the financial reporting process, the audit process, the system of internal controls and compliance with laws and regulations. As audit provides assurance of the veracity of financial statements, higher ethical standards and increased transparency and accountability would increase audit quality reducing the risk of misstatement and of resulting corporate crises. This should enhance investor protection and possibly reduce the cost of capital.

Increased competition is also expected in the concentrated audit market. The prohibition of auditor clauses in loan agreements would also reduce barriers to entry; by reducing reputational barriers faced by non-Big 4 firms as a result of these clauses. This would incentivise mid-tier audit firms to compete more vigorously in the market and potentially assist companies to make a more independent choice of auditor. Mutual recognition of audit firms across Member States will result in the reduction of the administrative costs of applying for a new licence in each Member State in which the auditor wishes to operate and could open up access to audit markets across the EU, increasing competition.

The measures would result in a reduction in frequency of inspections for auditors of only small companies or audit firms that have no audit clients (who currently undergo desk-based inspections). This would result in an ongoing annual saving of £200,000. This is the only quantified benefit.

### **Extending the Directive beyond the EU baseline under Option 2**

**The costs and benefits of the requirements of the EU Directive and Regulation would apply the same way under Option 2.** Additional costs arising from the extension of changes to non-PIE LLPs under this option are only expected to arise from changes to ethical standards relating to auditor independence where group audits are concerned. However, this cost is demonstrably small (estimated at most at approximately £30,000) and therefore we estimate a net additional cost of the gold-plating to be zero (based on Better Regulation Executive guidance on the reporting of low/negligible cost measures).

The main additional benefit would be increased consistency between companies and LLPs in audit and accounting standards and the level of assurance of accounts provided leading to an equal level of trust in LLP audits and LLP accounts as there would be for other forms of businesses after the implementation of the Directive. There would also be a positive impact of extending the benefits of the prohibition of auditor clauses on loan agreements for LLPs. Additional incremental savings to auditors of small companies and LLPs as a result of reduced frequency of inspections are also expected under this option, but it has not been possible to quantify these.

### **Small Business Assessment**

The main costs of the measures fall on PIEs and their auditors. The nature of the business operations of PIEs (i.e. listed companies, banks, building societies and insurers), means that PIEs are likely to have a significant impact on the UK's economy and society. Therefore it is considered desirable and necessary to apply to them the higher audit standards that are applied to large companies.

We estimate that there are 470 PIEs are small companies. 128 of these would be new in scope as PIEs. All PIEs are expected to bear one-off familiarisation and implementation costs. These are estimated to average at £10,000 per small and medium new in scope PIEs. Part of this relates to the changes brought under the Directive and part to those under the Regulation. Around 70 of these are small insurers that may also incur the costs of establishing an audit committee for the first time.

Auditors of PIEs are unlikely to include small businesses. Auditors of non-PIEs are expected to incur one-off familiarisation costs of £180.

## **A. Background**

1. This Impact Assessment relates to proposals to implement the measures contained within two associated pieces of EU legislation that reform audit of limited companies and other undertakings. These are Regulation (EU) No. 537/2014 on specific requirements regarding statutory audit of public-interest entities ('the Regulation') and Directive 2014/56/EU amending Directive 2006/43/EC on statutory audits of annual and consolidated accounts ('the Directive'). The Directive and Regulation entered into force on 17 June 2014, with the Regulation taking effect on 17 June 2016 and the Directive must be implemented by the same date. The Regulation and the implementation of the Directive will apply for accounting years beginning on or after 17 June 2016.
2. As the Regulation is directly applicable, the costs of measures under the regulations have not been included in the IA calculations. They have however been measured where possible and provided in the discussion for information.

## **B. Problem under consideration**

3. Following the audit scandals in the US (Enron<sup>7</sup>), Netherlands (Ahold<sup>8</sup>) and Italy (Parmalat<sup>9</sup>) it became clear there was a need for reform of audit regulation in Europe. European legislators revised the existing Eighth Directive (84/253/EEC) to strengthen the regulation of statutory auditors. As a result, in April 2006 the Council adopted, in its place, the Directive (2006/43/EC) on the audit of accounts.
4. Subsequently the 2008 financial crisis highlighted further significant concerns as to possible shortcomings in the statutory audit of major listed companies and financial institutions and pointed to the need to take measures to re-establish investor confidence in the audit process which helps to underpin the quality of financial information. This led to calls for further reform of audit and regulation within the EU.
5. As a result, in October 2010 the European Commission looked again at the role of auditors, the governance and independence of audit firms, the supervision of auditors and audit firms, and international co-operation for the supervision of global audit networks.

## **C. Rationale for intervention**

6. The risk that the market will not provide a socially optimal level of rigorous and independent auditing, and hence the need for Government intervention, arises from market failures around: the misaligned incentives from the combination of audit and non-audit services being provided by the same organisation and the auditors acting for the shareholders but being paid by the audit client; and the lack of competition in the market for the provision of audit services. The proposed changes will mean better quality information is provided by auditors - which should lead to more informed business decisions - potentially reduce the likelihood of problems in the financial sector with its associated systemic risk and result in a more open audit market with greater opportunities for winning business and for new entry.

### ***Auditor independence and integrity***

7. Confidence of shareholder and investors in audit is fundamental for the market. This includes confidence in the auditor's independence and objectivity.
8. Generally, if investors, trading partners and lenders do not trust the accuracy of financial statements, this can lead to reduced investment and higher cost of capital for companies. Audit is a service provided in the direct interests of the audited company, its lenders, trading partners, credit reference agencies and owners. It also is of public interest, such as for other businesses,

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<sup>7</sup> <http://news.bbc.co.uk/1/hi/business/1780075.stm>

<sup>8</sup> <http://www.economist.com/node/1610552>

<sup>9</sup> <http://www.worldfinance.com/home/special-reports-home/the-parmalat-scandal>

employers and civil society, where business failures have knock-on effects to others. The audit report on the financial statements is also used by regulators to ensure market stability.

9. Furthermore, following the financial crash, questions were asked as to how the financial institutions affected could have received clean audit reports prior to their failure<sup>10</sup>. Audit regulation requires auditors, through their audit reports to make an assessment about whether the financial statements present a true and fair view of the company's financial situation and the ability of the audited entity to continue to operate as a going concern. It does not have to provide an opinion of the future sustainability of the audited entity. This can create confusion amongst stakeholders about the scope of the audit and explain the expectation gap that can occur.
10. There are a number of specific areas that present a threat to the independence of the auditor, in particular; the provision of non-audit services to audit clients, the fact that the audited entity selects and pays the auditor, and familiarity resulting for example from a company retaining the same auditors for a very long period (e.g. between 2002 and 2010, the average annual switching rate for the FTSE 250 was 4%)<sup>11</sup>.

### ***The provision of non-audit services***

11. Providing non-audit services while auditing a company's financial statements presents a potential source of conflict of interest. This threat is increased where non-audit service revenues from the statutory audit client become substantial or where the provision of statutory audit services becomes a gateway to the provision of non-audit services. There is a risk that 'professional scepticism' could be compromised, with the auditor feeling unable to question assumptions when providing statutory audit services to the audited entity, because it could be reluctant to scrutinise the findings of non-audit services it also provides, and the potential conflict of interest. The Treasury Select Committee in May 2009<sup>12</sup> called for the appropriateness of the provision of non-audit services by auditors to the entities that they audit to be revisited, believing investor confidence and trust would be enhanced if auditors were prohibited from provided some, or most, of the non-audit services to those companies that are audit clients.

### ***The audit client pays and management selects the auditor***

12. The auditor's responsibility is to the shareholders and other stakeholders of the audited company but the auditor is selected and paid by the management of the company. In practice, shareholders have little or no say in the selection of the auditor. This undermines at least the appearance of the independence of the auditor and including feedback on the performance of the company's management.

### ***Threat of familiarity***

13. The regular re-appointment of audit firms over decades can result in a threat of familiarity. Whilst there are existing requirements to change periodically the audit partners within the same audit firm, the new partners may feel bound by previous decisions and feel unable to question or reopen them<sup>13</sup>. Indeed the FRC found that audit firms place considerable importance on client retention and relationship management, which may act as a disincentive for auditor scepticism.

### ***Lack of competition***

14. Evidence presented to the European Commission<sup>14</sup> showed that the effective choice in the market for audits of large listed companies and large financial institutions has gradually been limited to

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<sup>10</sup> An examiner of the Lehman Brothers bankruptcy stated that "the investing public is entitled to believe that a 'clean' report from an independent auditor stands for something." Anton R. Valukas, Examiner, Lehman Brothers Bankruptcy, Statement before the Committee on Banking, Housing & Urban Affairs, Subcommittee on Securities, Insurance and Investment, United States Senate, regarding The Role of the Accounting Profession in Preventing Another Financial Crisis, 6 April 2011.

<sup>11</sup>[http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207\\_issues\\_statement\\_final.pdf](http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf)

<sup>12</sup> <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf>

<sup>13</sup> James R. Doty, PCAOB Chairman, Rethinking the Relevance, Credibility and Transparency of Audits, speech delivered at the SEC and Financial Reporting Institute 30<sup>th</sup> Annual Conference, Pasadena (California, US), 2 June 2011.

<sup>14</sup> See [http://ec.europa.eu/internal\\_market/auditing/docs/reform/impact\\_assesment\\_en.pdf](http://ec.europa.eu/internal_market/auditing/docs/reform/impact_assesment_en.pdf)

the Big Four. This is a consequence of a number of barriers preventing new audit firms from entering the audit market for large public interest entities (PIEs):

- 1) There is asymmetric information about the quality of auditors in the market meaning the reputation of the Big Four is an important factor in auditor choice;
  - 2) Well-developed international networks of the Big Four covering the large majority of countries in which multi-national groups have a presence;
  - 3) Contract clauses that effectively require Big Four audits;
  - 4) Companies infrequently changing their auditor meaning little opportunity for new entrants to compete for contracts, leading to market stagnation; and
  - 5) Restrictive ownership rules<sup>15</sup> have led to distortions in the market by creating a competitive advantage for audit firms even in non-audit service on one hand, and by creating de facto barriers to the growth of smaller audit firms on the other, therefore protecting large audit firms from competition from medium-sized firms.
- 15.** These barriers contribute to the high concentration in audit markets. In the UK, the Big Four audit 99% of the FTSE 100, 95% of the FTSE 350 and earn 99% of audit fees in the FTSE 350. In some other important sectors in the UK economy, only three of the Big Four provide audit services. This high concentration is leading to the perception that the audit firms are 'too big to fail' and that the failure of a large firm would create a disturbance in the market<sup>16</sup>.
- 16.** The Competition and Markets Authority (CMA)<sup>17</sup> found a number of features in the market that give rise to an adverse effect on competition. They found that mid-tier audit firms face barriers to entry, expansion and selection in the FTSE 350 statutory audit market. They face experience and reputational obstacles which, combined with infrequency and unpredictability of opportunities to tender, affects their incentives to make the necessary investment to overcome such obstacles. These combined with other factors such as barriers to switching, outlined below, have the effect of reinforcing current market positions, and hindering emergence of new or strengthened rivals and so damages potential competition. It also reduces the potential competitive constraints audit firms can exercise on rivals, and weakens audit clients' bargaining power since they may have a smaller range of options available to them.
- 17.** The CMA identified a number of barriers to entry:
- 1) company management face significant opportunity costs in the management time involved in the selection and education of a new auditor;
  - 2) companies and audit firms invest heavily in a relationship of mutual trust and confidence, which neither will walk away from lightly. This is because there would be a loss of efficiency and increased risk in the technical quality in the early years of the engagement of the incoming firm, and
  - 3) companies face difficulties in judging auditor quality in advance, meaning companies cannot assess accurately the benefits that tender processes and switching would bring.
- 18.** These barriers, along with other factors can lead to an adverse effect on competition by weakening a company's bargaining power outside the tender process. The CMA believes that these features are pervasive throughout the FTSE 350 statutory audit market but their effect will be uneven across companies. How a feature or combination of features impacts on an individual company's strength of bargaining power will vary over time and depend on its particular circumstances.
- 19.** As a result of the adverse effects on competition the CMA concluded that in respect of their audits, companies are offered high prices, lower quality (including less sceptical audits) less innovation and less differentiation of offering than would be the case in a well-functioning market.

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<sup>15</sup> A majority of the voting rights in an audit firm must be held by those permitted to undertake statutory audits.

<sup>16</sup> [http://ec.europa.eu/internal\\_market/auditing/docs/reform/impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/auditing/docs/reform/impact_assessment_en.pdf)

<sup>17</sup> CMA, 2013 Statutory Audit Services for Large Companies Market Investigation - Summary of Report

## D. Policy objectives

20. The legislation will improve confidence in the quality of statutory audit by stricter independence requirements on statutory auditors, including on the provision of non-audit services to audit clients, by making the audit report more informative and by strengthening the regulatory requirements applying particularly to audits of public-interest entities (the definition of 'PIEs' for the purposes of the UK audit regulatory framework will include listed companies, banks, building societies and insurers). For listed companies transparency for shareholders has been a key aspect of a well-functioning equity market. For PIEs in the financial sector, the financial crisis demonstrated the domino effect that the lack of confidence in one financial institution can have on the whole financial system, with investors, regulatory bodies and lenders questioning the veracity of audit reports, particularly when failing financial institutions had received clean audit reports in spite of serious intrinsic financial weaknesses.
21. More specifically, the EU and UK's main objectives of the reform are to:
- (1) Further clarify the role of the statutory auditor;
  - (2) Reinforce the independence and the professional scepticism of the statutory auditor;
  - (3) Increase accountability to independent audit committees of PIEs;
  - (4) Facilitate the cross-border provision of statutory audit services in the EU;
  - (5) Contribute to a more dynamic audit market in the EU; and
  - (6) Improve the supervision of statutory auditors and the coordination of audit supervision by competent authorities in the EU.

## Scope and Application of the Directive and Regulation

22. The revised Directive will apply to all entities which are required by EU law to have a statutory audit. This includes types of entities which were not covered by the 2006 Directive but, through more recent EU instruments, are now required to have a statutory audit. The types of entity that are now newly covered, even in cases where they are not companies, LLPs and QPs are: issuers of transferable securities admitted to trading on a regulated market; 'markets in financial instruments Directive' investment firms (MiFIDs), undertakings for collective investment in transferable securities (UCITS), alternative investment funds (AIFs) and payment institutions.
23. Based on information provided by the Financial Conduct Authority (FCA), and from FAME<sup>18</sup>, we estimate that there are only 25 of these latter types of entities (all 25 of which are MiFIDs) which are not companies, LLPs or QPs, and therefore were not covered by the 2006 Directive but will now be required to comply with the requirements of the 2006 Directive as part of the implementation of the new framework.
24. Having examined the Government's 2007 Impact Assessment<sup>19</sup> for the implementation of the 2006 Directive and the number of entities affected, we have concluded that the application of the implementation to these entities is unlikely to create additional costs or benefits. This is best explained by reference to the costs arising from the 2006 Directive.
25. The 2007 Impact Assessment identified the largest headline cost applying to all UK statutory audits as that arising from requirements on dismissal and resignation of auditors, which was estimated at £215,000 per annum. (We have since reassessed the impact of this framework under Article 38 of the Directive in practice and consider it to be nearer to £594,000 per annum<sup>20</sup>). Though there were other significant costs in relation to audits of **PIEs** in the 2007 Assessment, the entities to which this older Directive will now be applied will be UK **non-PIEs**. There are also a number of other smaller and less costly requirements. The estimate of £594,000 relates to notices served of auditors leaving office in 2012, a year in which 103,611 companies had their accounts

<sup>18</sup> FAME database, Bureau van Dijk

<sup>19</sup> See PDF at <http://www.legislation.gov.uk/ukxi/2007/3495/memorandum/contents> page 6 to 26

<sup>20</sup> Impact Assessment on Notices of Auditors Leaving Office that has not yet been validated by the Regulatory Policy Committee at [www.parliament.uk/documents/impact-assessments/IA14-021.pdf](http://www.parliament.uk/documents/impact-assessments/IA14-021.pdf). Page 15 states that 13,681 notices were served in 2012. Page 17 identified a best estimate for the cost of serving these as £42.60 each. 13,681 x £42.60 = £583,000 which when updated from 2012 to 2013 as the price base year = £594,000. Page 4 of the Impact Assessment explains that in 2012 103,611 companies were audited.

audited. This means that the cost per audited company was £5.73<sup>21</sup>. For 25 additional entities covered by the Directive the total cost would therefore be £143. These costs are considered insignificant in the context of this Impact Assessment.

### **Businesses that will be affected by the proposed changes to UK audit framework**

- 26.** The changes set out in the Directive and Regulation largely apply to Public Interest Entities (PIEs) and their statutory auditors. PIEs are defined as entities whose transferable securities are admitted to trading on an EU regulated market, credit institutions and/or insurance undertakings. In our consultation stage Impact Assessment we assumed that the Bank of England's lists of Banks Building Societies and Insurers provided the full coverage of all credit institutions and insurers in scope of this Audit Directive. The Prudential Regulation Authority (PRA) has since taken the view that only UK insurance and reinsurance undertakings within the scope of the Solvency II (SII) Directive will be PIEs within the meaning of Article 2(13)(c) of the revised Audit Directive. It follows that those UK (re)insurance undertakings that are on the Bank of England list but fall outside of the scope of the SII Directive will not be PIEs under the Directive. The PRA has provided a list of 338 insurers which we have now assumed are in scope of the definition of PIEs for the purposes of the new EU requirements under both the Regulation and the Directive. Together with the Bank of England lists of Banks and Building Societies this provides the full coverage of the credit institutions and insurance undertakings in scope.
- 27.** In addition to this data we have used the FAME database and the UK Listing Authority Official List<sup>22</sup> to identify those companies which are listed on a UK regulated market (including the LSE Main Market, the Specialist Fund Market (SFM) or on another EU regulated market). Our estimate of the total number of PIEs in scope of the changes to the UK audit framework covered in this IA has also been revised to include companies with listed debt securities on the Official List.
- 28.** We derived a list of entities designated as PIEs from:
- The FAME database of companies: This provided us with UK incorporated companies with equity listed on an EU regulated market. There were 767 on the LSE main market (excluding AIM) and 9 listed on other EU markets<sup>23</sup>.
  - The UK Listing Authority Official List: This was used to identify those companies which have securities other than shares listed on a UK regulated market. There were 616 that issued only debt or derivatives and therefore would not have been included in the data obtained from the FAME database.
  - Lists<sup>24</sup> of UK authorised banks, building societies, compiled by the Bank of England and used by the Prudential Regulation Authority (PRA): These provided us with total numbers of credit institutions in scope. There are 152 banks, 44 building societies.
  - The list of Solvency II Insurers: This was compiled by the Prudential Regulation Authority and provides the names of 338 insurers that would be in scope as PIEs.
  - The Bank of England's list of Lloyds of London syndicates, in which there are 102 syndicates.
- 29.** The total number of PIEs in scope is now estimated at 2,029. The official lists were matched with companies on the FAME database to provide a size break down of the PIEs and enable impact calculations to be made with respect to entity size, and therefore allow us to conduct a small and micro business assessment of the Options' impact. Matches were found for 1,495 companies. The size distribution of those with sufficient data was extrapolated to the other and the 534 unmatched companies

<sup>21</sup> Adjusted for 2014 as price base year.

<sup>22</sup> <http://www.fsa.gov.uk/ukla/officialList.do>

<sup>23</sup> As the number of share issuers on the UKLA list is also 770, we assume that the same companies were identified.

<sup>24</sup> The lists of authorised banks and building societies are available at: <http://www.bankofengland.co.uk/pr/Pages/authorisations/banksbuildingsocietieslist.aspx>, while the lists of UK incorporated authorised Insurers and of Lloyds syndicates are available at <http://www.bankofengland.co.uk/pr/Pages/authorisations/fscs/insurance.aspx>

## **E. Options considered**

30. We propose three options, including do nothing. Option 0 would not address the problems identified above and is not considered feasible. The Directive introduces changes which are not compatible with the UK's existing framework. The Directive includes mandatory requirements that must be implemented **by 17 June 2016** for accounting years beginning on or after that date. That implementation must also provide for the application of the mandatory requirements of the Regulation on the same basis.
31. The Government's objective is to ensure that undertakings obtain the maximum benefit from the changes, whilst maintaining the integrity of the UK's audit and company law framework. In order to achieve this, additional measures are proposed alongside implementation, in order to ensure undertakings obtain the maximum benefit and least cost from the proposals. These measures are reflected in Option 2.
32. As Option 0 is not considered desirable, the focus of the analysis is limited to Options 1 and 2.

### **Option 0: Do nothing.**

33. This option will not address the problems identified by the EU around the scrutiny and quality of audits. In addition, this option would place the UK in breach of its Treaty obligation to demonstrate transposition of the Directive into UK law and implement the mandatory elements introduced by it. This would impose costs on the Government in fines for infraction, and could also have significant reputational and diplomatic consequences.

### **Option 1: Take the minimum action required by the Directive. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes.**

34. Key elements within this option include:

- Increase in scope of the 2006 Directive to cover the following entities, where they were not already included as a result of being a company, LLP or QP: issuers of securities admitted to trading on a regulated market; 'markets in financial instrument Directive' investment firms (MiFIDs); undertakings for collective investment in transferable securities (UCITS); alternative investment funds (AIFs); and payment institutions.
- Increase in scope of the requirements of Chapter X of the 2006 Directive on audits of PIEs now that most of these requirements have moved to the new Regulation.
- Changes to ethical standards relating to auditor independence and the provision of non-audit services.
- Changes to technical standards relating to reporting of irregularities and quality control.
- Changes to reporting requirements to PIEs, FCA and FRC, including requiring additional content and an additional report to the audit committee for PIEs.
- Changes to regulations regarding appointment and duration of engagement of auditors, requiring the re-tender of audit contracts at least every 10 years, and a change of auditor at least every 20 years.
- Changes related to the dismissal and resignation of auditors.
- Changes to enable cross-border provision of audit services.
- Changes to regulations regarding competent authorities and the framework for the operation of the FRC.
- The frequency of inspections of auditors to be determined on a risk basis, with the reduction of previous minimum frequencies of inspections for some auditors who audit only small firms. However this is combined with the effect of preventing the Financial Reporting Council (FRC) from delegating any inspections of auditors of PIEs and increasing in the minimum frequency of inspections of the auditors of unlisted large PIEs.

## **Option 2: Implement the EU baseline – accompanied by an extension of the Directive to LLPs**

### ***Developments in Option 2 since the Consultation IA***

35. In the Consultation Stage Impact Assessment we highlighted a small number of areas where we were still considering whether the inclusion of additional proposals, including changes to UK company law of domestic origin, would improve the UK's audit regulatory framework.
36. These were:
- to provide that retendering of the audit engagement by a PIE before the expiry of the 10 year maximum duration should still enable it to extend the maximum duration by 10 years.
  - Amending audit and non-audit fee disclosure requirements to reflect the breakdown of fees in the Regulation.
  - Changes to the framework for oversight by the FRC of the functions of the Recognised Supervisory Bodies (RSBs), including allowing the reclamation of functions by the FRC, if an RSB wishes or if problems arise.
  - Applying the implementing measures for the Directive in legislation on LLPs, where the LLP is not a PIE. The Directive and Regulation will anyway apply in any case where an LLP is a PIE.
37. Since then, BIS has confirmed that retendering of the audit engagement by a PIE before the expiry of the 10 year maximum duration should still enable it to extend the maximum duration by 10 years from that point. We now consider this to be consistent with a minimal implementation of the Directive and no additional measures needed to be implemented to ensure this.
38. After consideration with the FRC and RSBs to determine the most appropriate framework for the delegation of regulatory tasks, BIS has decided not to include additional measures in the legislative implementation that go beyond those required by the Directive on oversight by the FRC.
39. After further consideration, BIS is also not proposing to amend the framework on disclosure of auditor remuneration as part of the initial implementation of the Directive and Regulation.
40. Therefore the only other additional measure over and above option1 included option 2 is the application of the implementation of the Directive to LLPs, which we analyse below.

### ***Extending the Directive to LLPs***

41. We have considered whether the scope of application of the implementation of the Directive should be set by reference to EU law only (i.e. only to 'audits required by Union law') or whether it should also apply to audits of LLPs. At a domestic level we applied the implementation of the 2006 Directive to auditors of LLPs. For consistency and in order to prevent the emergence of a 'part-implementation' of EU audit requirements for LLPs we propose to implement the amendments in the new Directive for the audits of these entities.
42. Where an LLP is a PIE the Directive would apply to it automatically, so the decision to extend the application of the Directive actually only represents an extension to non-PIE LLPs. This is for consistency with the law for all other company audits where implementation is required as a matter of EU law. In addition some LLPs are required by EU law to be included in the implementation of the Directive because their activities (e.g. as Alternative Investment Funds) put them within the extended scope of the Directive. LLPs would only be subject to the new EU Regulation if they either issued securities on a regulated market or provided banking or insurance services. In these cases EU law would require implementation of both the Directive and the Regulation.
43. The impact of extending the Directive to LLPs is therefore only to the extent of its impact on non-PIE LLPs. However, data shows that currently all LLPs are non-PIEs. PRA-authorized insurers



cannot be LLPs<sup>25</sup> and there are currently no LLP Banks or UK LLPs with securities listed on an EU regulated exchange<sup>26</sup>.

*Rationale for applying Directive to LLPs:*

44. LLPs are one form of corporate entity which is currently subject to the same statutory audit requirements as other corporate entities, such as companies. The only reason they do not automatically fall under EU law is that they are a legal form particular to the UK (among EU countries) and were only introduced in 2001. There is no policy rationale for LLPs to be exempt from any higher audit standards brought in by the Directive. Applying the Directive requirements to audits of LLPs has the same rationale as that of applying the amended Directive's reforms to the audits of other legal forms i.e. to increase audit quality, independence and information.
45. Furthermore, as the UK has one set of Audit Standards set by the FRC that apply to all statutory audits (including those of LLPs), trying to exclude LLPs from the new requirements would suggest that the FRC maintains a separate set of standards for them (whilst amending the standards for other legal entities to implement the Directive requirements). This would add to the complexity of the UK's statutory audit requirements and therefore be expected to give rise to additional costs – both in terms of auditors being aware of two sets of standards and the FRC's monitoring of auditor compliance with them.
46. BIS has considered the alternative implementation option (of having a separate set of standards for LLPs) and concluded that the costs of this would outweigh the benefits because:
- The alternative would be expected to give rise to additional costs to auditors (These are difficult to quantify). Responses to our consultation confirm this view. We asked in the consultation whether they expected cost savings from implementing the changes required by the Directive on LLPs along with entities (such as companies) that are subject to EU Law. Seven out of eight respondents to this question suggested that costs would definitely be avoided from not having a dual regime of standards and therefore approved of Option 2 as the preferred option. Reasons for this included that a separate set of standards would increase costs and cause confusion amongst: auditors; those charged with the governance of audited entities; as well as for the users of their financial statements.
  - The alternative would have additional un-monetised costs in terms of the forgone benefits of keeping LLP audits to lower standards. This could also result in reduced trust in LLP accounts and audits as they would not be to the same standards as those of other companies.
  - The benefits of the alternative, i.e. the spared costs to auditors of LLPs (from keeping LLPs out of scope of the new standards), are expected to be negligible in our assessment (see below). Furthermore they are expected to be offset to some extent by the reduction in saving to auditors with any LLP clients who would otherwise have had the benefit of the reduction in frequency of inspections allowed by the Directive.
  - Finally if the Directive was not applied to non-PIE LLPs, it would not be possible to apply the prohibition of auditor clauses in loan agreements and other contracts, where those contracts were with non-PIE LLPs. The Directive prohibits clauses that have the effect of limiting an entity's choice of auditor. This was supported by the CMA following its review of the market for audits of UK companies in the FTSE 350. The CMA recommended that the prohibition be introduced via the implementation of the prohibition in the Audit Directive.

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<sup>25</sup> S.55B of FSMA, read with Schedule 6, Part 1D, set out the threshold conditions for insurers and at para 4B it is provided that the legal status of the person seeking permission to carry out and effect contracts of insurance must be (inter alia) "a body corporate (other than a limited liability partnership)" [...].

<sup>26</sup> However, it is theoretically possible for a bank to take this structure, and some investment banks might actually be doing so or be interested in such a set-up. This would be scrutinised very closely by the PRA. LLPs may also be PIEs by having debt securities listed on an EU regulated exchange.

47. Option 2 is therefore our preferred option.

## F. Discussion of Monetised and Non-Monetised Costs and Benefits of Proposed Options

48. Data on the costs and benefits of the proposed changes are limited and thus there is considerable uncertainty around the best estimate and we have provided ranges where relevant. Estimates are based on: the EU Commission's assessment of hours taken per activity by staff of different types/levels of seniority; the FAME database for the number, type and size of PIEs and for the audit fees; ONS data on wages; Eurostat data<sup>27</sup> on non-wage labour costs; published research and consultations and discussions with stakeholders. The main body of the text sets out the risks and assumptions for each proposed requirement.
49. In this section firstly we summarise the costs and benefits of Option 1 and 2. We then go on to describe our final analysis, and how it has been informed by consultation, in more detail. Where appropriate we have annexed more lengthy calculations and discussions of our assumptions.

### **Option 1: Take the minimum action required by the Directive. Implement only those mandatory changes to the current system which are required by the Directive and Regulation and no other changes.**

50. This section of the Impact Assessment focuses on the elements of the Directive or Regulation which are considered to have a significant impact on business. Those elements which are technical or minor changes, or which will not have a material impact on the status quo, have not been included. A summary of all measures are set out in Annex A.

51. Table 1 describes the main costs of the measures, and Table 2 the main benefits.

**Table 1: Costs of principle measures impacting on auditors and audit clients under the new Audit Directive and Regulation**

Matter	Brief description of change	Impact - Costs
<b>Scope and Application of the Directive and Regulation</b>		
Subject Matter and Scope – Directive	Increase the scope of the 2006 Directive to cover non-company/LLP/QP Issuers, MiFiDs, UCITS, AIFs and Payment institutions - see list of changes in the Audit Directive below.	Number of new entities now covered is very low (25) due to majority already being covered as a result of being a company, LLP or QP.
Subject Matter and Scope - Regulation	Increase the scope of some existing requirements on PIEs currently in Chapter X of the Directive but (with the exception of the new Article 39 on Audit Committees) now moved to the Regulation. Chapter X Article 39 used to contain a Member State option to exempt unlisted banks and insurers from all the Chapter X requirements on PIE audits. That Member State option has been removed. The main measures affected are those on audit committees, on transparency reporting by auditors of PIEs and on inspections of auditors of PIEs.	All of these costs are covered as the requirements of the new Regulation are discussed individually in this Impact Assessment.
<b>Conditions for Carrying out Statutory Audits</b>		
Ethical Standards - Audit fees	PIEs to be subject to non-audit service fees cap and 'blacklist'.	Will apply to all PIEs. No direct on-going impacts expected, but there will be one-off costs associated with reallocation of non-audit services to an alternative provider

<sup>27</sup> Source: [http://epp.eurostat.ec.europa.eu/statistics\\_explained/index.php?title=File:Labour\\_costs\\_per\\_hour\\_in\\_EUR](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Labour_costs_per_hour_in_EUR).

		where necessary.
Ethical Standards – Professional Ethics	Enhanced framework on auditor independence for all audited entities	The impact of changes would be in relation to group audits. UK auditors would have to verify the independence of auditors that are outside the EU who provide information on subsidiaries in those jurisdictions which is then used in group audits. FRC estimates that this would result in an additional 5 hours of auditor time. We expect the measures to affect only group audits that involve group members in countries where the audit standards are not comparable with the standards set in the Directive.
Technical Standards - Reporting Irregularities and Quality Control	PIE and PIE auditor reporting requirements.	Relatively low impact – most auditors will already take action on irregularities and quality control and no significant costs expected. Some smaller PIEs will incur costs of appointing independent quality control reviewer. Responses to our discussion document <sup>28</sup> indicate that these would be few.
Audit Reporting - Additional Report to The Audit Committee	New additional audit report providing additional information specifically for the audit committee.	Moderate costs involved for all auditors of PIEs in preparing an additional report.
Appointment and Scope of Audit Committee	Two changes - first to the requirements on audit committees and second on scope as unlisted banks, building societies and insurers must comply for the first time.	Significant impact of increase in scope of requirement for audit committee to include unlisted insurers. This will involve set up costs and on-going costs. Increase in requirements on audit committees will incur costs for all PIEs principally in the form of remuneration for additional time.
Regulatory Reporting and Information - Report to Supervisors of PIEs	Reporting to Financial Conduct Authority (FCA) on certain matters relating to listed companies.	Impact for listed companies only as banks and insurers are already covered by an appropriate framework for PRA. Occurrence of relevant matters is infrequent therefore costs are expected to be low.
Regulatory Reporting and Information - Retaining and Disclosing Information	Auditors of PIEs have various obligations in respect of public reporting and reporting to FRC.	Auditors of all PIEs now affected (not just of listed PIEs). Changes between new framework in Regulation and predecessor in Directive of limited impact.
<b>Appointment of Statutory Auditors or Audit Firms</b>		
Appointment Requirements - Procedure	Appointment process for PIE auditors via competitive tender by audit committee. Prohibition of 'Big Four only' clauses of policy significance.	Impact for all PIE audit committees in the form of additional time spent reviewing and processing tender.
Appointment Requirements - Duration of Engagement	Setting maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments at least every 10 years. Half of the work of policy formation already completed with publication of draft CMA Order.	Will impact only non-FTSE 350 PIEs as FTSE 350 have requirement on them through CMA order. Impact of more frequent tendering will create significant burden.
Dismissal or Resignation of Auditor	Dismissal framework for auditors of PIEs where competent authority or 5% shareholders go to court. This will be a significant new proposal in company law terms. Resignation framework much more limited	Impact on PIEs will be low and framework is permissive and voluntary therefore is considered zero cost.
Educational Qualifications, Professional Competence and Continuing Professional Development	Framework for European Economic Area (EEA) audit firms to provide services cross border; Convergence of Member State qualifications; and adaptation period as alternative to aptitude test for individual EEA migrant auditors.	Some impact on audit firms, but not significant.

<sup>28</sup> BIS (2014), 'Auditor Regulation: Discussion document on the implications of the EU and wider reforms', December 2014, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/400231/bis-14-1285-auditor-regulation-discussion-document-on-implications-of-eu-and-wider-reforms.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/400231/bis-14-1285-auditor-regulation-discussion-document-on-implications-of-eu-and-wider-reforms.pdf)

<b>Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit</b>		
Competent Authorities - Designation and Delegation of Tasks within UK	Shift in the regulatory framework that forms the basis for the operation of the FRC (i) requiring FRC to approve audit regulations under schedule 10 set by the Regulatory Supervisory Bodies (RSBs) (ii) setting up the framework in which FRC has current RSB functions but delegates them to the RSBs (iii) moving away from framework in which independent standards, inspections and investigations and discipline are delivered by unnamed independent body towards a clear framework of FRC Statutory Powers.	These changes would not result in a significant difference in the operation of the framework in which the FRC and the RSBs work. However the structure of that framework would change and some familiarisation costs might result for the RSBs and the FRC. Given the small number of bodies involved (6) we consider these to be minimal.
Competent Authorities - Powers	New powers for FRC to obtain information from third parties.  The FRC is currently the body responsible for investigation and discipline of auditors in public interest cases though without statutory powers to obtain information from third parties. These third parties might be the audited company, its staff, companies in the same group, companies with which that company has contracted etc.	These new powers would place on a statutory footing a framework of cooperation with the FRC. As existing levels of cooperation are high we would not expect these powers to be used often. However their availability is a significant enhancement in available powers, should they be needed. Where these powers are used, we would not expect this to result in an additional burden over and above option 0 as, in most cases, effective compliance has been achieved voluntarily.
Quality Assurance of auditors	For non-PIEs, the existing requirement that each audit firm must be subject to inspection at least once every 6 years will no longer apply for auditors only of small companies. Instead the frequency of these inspections of auditors would be determined on a risk basis.  For PIEs, the minimum frequency for auditors of small and medium sized PIEs is decreased from every 3 years to every 6. However this is combined with the effect of preventing the FRC from delegating any inspections of auditors of PIEs and increasing the minimum frequency of inspections of auditors of unlisted large PIEs from every 6 years to every 3.	Additional cost to auditors of becoming subject to inspection by the FRC where at present the auditors are only inspected by their professional supervisory body.  Some costs arising from increases in the frequency of inspections of auditors of entities that would now be designated as PIEs.

## **Benefits**

**52.** For most of the measures benefits have not been quantified. The benefits associated with the Directive and Regulation primarily result from an increase in audit quality, which should in turn lead to increased investor and stakeholder trust in the financial statements of companies and other undertakings, and in particular of PIEs. The proposals also aim to increase the efficiency and level of competition in the audit market, giving greater opportunities to existing and new audit entities to compete. This should also increase choice as the Big Four and Mid-Tier audit firms will have incentives to develop and expand their capabilities in order to win engagements. In particular the measures could encourage audit firms other than the Big Four to invest in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth. This increased choice should lead to more competitive pricing, higher audit quality and more innovation. For the most part we have been unable to quantify the expected benefits due to their intangible nature.

**53.** The following table sets out in more detail the qualitative assessment of the benefits.

**Table 2: Benefits of principle measures impacting on auditors and audit clients under the new Audit Directive and Regulation**

Matter	Brief description of change	Impact - Benefits
<b>Scope and Application of the Directive and Regulation</b>		
Subject Matter and Scope – Directive	Increase in scope of the 2006 Directive to cover non-company/LLP/QP Issuers, MiFiDs, UCITS, and AIFs - see list of changes in the Audit Directive below.	These audits will now be regulated as statutory audits under Part 42 of the Companies Act 2006 in a way consistent with audit regulation more widely. Closure of potential loophole for audits of providers of financial services in the investment field where these are in a non-company/LLP/QP form. Audits will also be covered by a framework for international cooperation on their regulation should the need arise. We consider these benefits are unquantifiable.
Subject Matter and Scope - Regulation	Increase in scope of some existing requirements on PIEs currently in Chapter X of the Directive but (with the exception of the new Article 39 on Audit Committees) now moved to the Regulation. Chapter X Article 39 previously used to contain a Member State option to exempt unlisted banks and insurers from all of the Chapter X requirements on PIE audits. That Member State Option has been removed. The main measures affected are those on audit committees, on transparency reporting by auditors of PIEs and on inspections of auditors of PIEs.	Unlisted banks and insurers are of considerable systemic importance to the economy. This measure will mean that their audits are regulated on the same basis as other public interest entities. We consider these benefits are unquantifiable.
<b>Conditions for Carrying out Statutory Audits</b>		
Ethical Standards - Audit fees	PIEs to be subject to Non-Audit Service fees cap and 'blacklist'.	Will apply to all PIEs. Although no direct on-going costs are expected, there will be on-going benefits of auditor scepticism and audit quality, greater confidence of investors, a widened and a more competitive market for non-audit services, in which smaller audit firms could also have the opportunity to compete. We consider these benefits are unquantifiable.
Ethical Standards – Professional Ethics	Enhanced framework on auditor independence for all audited entities	Auditor independence is fundamental to ensuring that audit reports make an assessment about whether the financial statements present a true and fair view of the company's financial situation and the ability of the audited entity to continue to operate as a going concern. This measure would also give investors, trading partners and lenders greater trust in the accuracy of financial statements, which leads to more efficient investment.
Audit Reporting - Additional Report to The Audit Committee	New additional audit report providing additional information specifically for the audit committee.	Additional information and assurance to the audit committee ensures the audit committee is seen by shareholders as the focus of the company's relationship with the auditor so that the relevant directors are held accountable accordingly. We consider these benefits are unquantifiable.
Appointment and Scope of Audit Committee	Two changes - first to the requirements on audit committees and second on scope, as unlisted banks, building societies and insurers must comply for the first time.	Clarity for shareholders as to which directors are responsible for the company's relationship with the auditor. Increased investor confidence due to the increased independence of the audit committee. We consider these benefits are unquantifiable.
Regulatory Reporting and Information - Report to Supervisors of PIEs	Reporting to FCA on certain matters relating to listed companies.	Clarity as to the role for a (limited) direct relationship between the supervisory authority and the auditor. Outside of the banking and insurance sectors, where a clear framework is already in place in the

		UK it has been unclear when it is necessary for auditors to liaise with regulatory authorities. Much of the information the auditor is now required to pass to the supervisor would have been passed previously but not consistently or in a timely way. This should improve regulatory effectiveness. We consider these benefits are unquantifiable.
Regulatory Reporting and Information - Retaining and Disclosing Information	Auditors of PIEs have various obligations in respect of public reporting and reporting to FRC.	Increased transparency of audit firms is important given that in some cases their filed accounting and reporting information can be very limited. This will now apply in respect of auditors of all banks and insurers, including unlisted banks and insurers. This change should increase trust among stakeholders. We consider these benefits are unquantifiable.
<b>Appointment of Statutory Auditors or Audit Firms</b>		
Appointment Requirements - Procedure	Appointment process for PIE auditors via competitive tender by audit committee. Prohibition of 'Big Four only' clauses of policy significance.	On-going benefits of auditor scepticism and audit quality, confidence of investors, a widened and more competitive market for audit services in which smaller audit firms could also have the opportunity to compete. We consider these benefits are unquantifiable.
Appointment Requirements - Duration of Engagement	Setting maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments at least every 10 years. Half of the work of policy formation already completed with publication of draft CMA Order.	
Dismissal or Resignation of Auditor	Dismissal framework for auditors of PIEs where competent authority or 5% shareholders go to court. This will be a significant new proposal in company law terms. Resignation framework much more limited	Increased confidence for current and prospective minority shareholders who will be able to secure the removal of an auditor if the need arises. We consider these benefits are unquantifiable.
Educational Qualifications, Professional Competence and Continuing Professional Development	Framework for EEA audit firms to provide services cross border; Convergence of Member State qualifications; Adaptation period as alternative to aptitude test for individual EEA migrant auditors.	Reduced costs for audit firms seeking to provide services cross-border or who operate cross-border already in respect of recruitment and deployment of individual audit staff. Adaptation period has potential to increase flexibility for qualified individual auditors. We consider these benefits are unquantifiable.
<b>Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit</b>		
Competent Authorities - Designation and Delegation of Tasks within UK	Shift in the regulatory framework that forms the basis for the operation of the FRC (i) requiring FRC to approve the audit regulations under schedule 10 rather than RSBs (ii) setting up framework in which FRC has responsibility for some current RSB functions but delegates them to the RSBs (iii) moving away from a legal framework in which independent standards, inspections and investigations and discipline are delivered by unnamed independent body towards a framework that clearly designates FRC as that body.	Increased confidence in UK regulatory framework for investors. We consider these benefits are unquantifiable.
Competent Authorities - Powers	New powers for FRC to obtain information from 3rd parties in relation to audits of PIEs.  The FRC is currently the body responsible for investigation and discipline of auditors in public interest cases though without statutory powers to obtain information from third parties. These third parties might be the audited company, its staff, companies in the same group, companies with which that company has contracted etc.	
Quality Assurance of auditors	For non-PIEs, the existing requirement that each audit firm must be subject to inspection at least once every 6 years will no longer apply for auditors only of small companies. Instead the frequency of these inspections of auditors would be determined on a risk basis.	Some quantifiable benefits resulting from reductions in the frequency of inspections of auditors of small companies.  Other unquantifiable benefits result from increased confidence of investors in the



	<p>For PIEs, the minimum frequency for auditors of small and medium sized PIEs is decreased from every 3 years to every 6. However this is combined with the effect of preventing the FRC from delegating any inspections of auditors of PIEs and increasing the minimum frequency of inspections of auditors of unlisted large PIEs from every 6 years to every 3</p>	<p>UK audit regulatory framework.</p>
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54. We have not been able to quantify and monetise robustly most of the benefits arising from the changes. Monetised costs and benefits are discussed below.

## **Option 2**

55. The benefits of Option 2 would be the same as those of Option 1 plus the incremental benefits of higher standards of auditing of LLPs.

56. It would also have the benefit of maintaining one set of requirements through a consistent legislative approach to all statutory audits that would be simpler to comply with for audit firms and simpler to implement, monitor and enforce by the regulatory authorities.

57. One particular incremental benefit would be would result from the increased applicability of the provision in the Directive allowing less frequent inspections of auditors all of whose clients are small non-PIEs. This would be available for auditors of small non-PIE companies, small non-PIE LLPs and auditors of a combination of small non-PIE companies and LLPs.

58. Finally applying the Directive to non-PIE LLPs would apply the prohibition of auditor clauses in loan agreements and other contracts, where those contracts were with non-PIE LLPs. This was supported by the CMA following its review of the market for audits of UK companies in the FTSE 350. The CMA recommended that the prohibition be introduced for all audited entities via the implementation of the prohibition in the Audit Directive.

59. This rest of this section summarises the main costs of the measures under Options 1 and 2. It takes a thematic approach, discussing the impact of each measure under the options separately in turn. Details and underlying assumptions of cost calculations in this Impact Assessment are provided in the Annexes. Where relevant ASHE data on hourly wages (along with an uplift for non-wage costs) has been used to estimate hourly resource costs of staff. The sources, relevant Standard Occupational Classifications (SOC) and the methodology and assumptions applied to the use of this data are provided in the Annexes.

## **Monetised Costs and Benefits of Option 1**

### ***Familiarisation costs***

60. The EU Directive and Regulation affect a number of different types of businesses (e.g. auditors, PIEs, non-PIEs). In this section of the IA we separately assess the size of the familiarisation cost imposed on each, describing our estimation more fully in Annex B.

61. There will be familiarisation costs for auditors relating to the changes to audit standards and reporting requirements. There will also be familiarisation costs for PIEs in understanding the changes to the regulation of non-audit services, the tendering and rotation of audit engagements, and the requirement to have an audit committee. We have built a model to estimate the potential costs.

62. We tested out our initial estimates based on this model through questions in the consultation and through discussions with stakeholders during the consultation period. In view of stakeholder advice and consultation responses we have revised our estimates of time invested by staff, the number of audit and non-audit staff that would be involved, as well as our assumptions on hourly wage costs.

63. From the FRCs latest research to inform its Audit Quality Review, we are also able to make more informed estimates of the number of auditors of PIEs that would be new in scope as a result of the

extension of the definition of PIEs. Our best estimate of new in scope PIE auditors is 36 and, as before, we applied our model of estimating familiarisation costs to these new in scope auditors. However, in doing so we doubled our estimates of staff time required at these firms, as we expect the costs to be disproportionately higher for auditors that are new in scope. We consulted on this during the consultation and that has confirmed this to be a reasonable assumption.

64. We have also consulted on and revised our original model to estimate the familiarisation costs to PIEs. The responses indicated that our assumptions on the average number of individuals and the hours required for this might be too high. On the other hand the mix of staff involved was skewed away from the amount of senior time they expected, and that our hourly cost rate was too low. We have therefore adjusted the assumptions we used accordingly. Here again we have doubled our estimates of staff time required for new in scope PIEs.
65. Our estimate of the total, one-off familiarisation and implementation costs across all PIEs and their audit firms is between £93.95m – £140.93m. Our best estimate is **£117.44m**.
66. The FRC is making several changes to its Auditing Standards to implement the Directive requirements. Some of these changes affect non-PIEs as well as PIEs. However, the changes do not affect audited entities so we do not expect there would be any familiarisation costs arising to non-PIE audited entities themselves.
67. Familiarisation costs to the auditors of non-PIEs would also be small due to the marginal nature of the changes that affect them. In our consultation stage Impact Assessment we assumed that the costs would be relatively small, but did not quantify these costs. We invited comments on the reasonability of this initial analysis. All 11 respondents to this question did not disagree that these costs would be relatively small. However 3 consultation respondents suggested they'd like to see analysis of these costs, therefore we have quantified and monetised these costs in the final stage Impact Assessment. To estimate these, we assume that all auditors of non-PIEs would spend an hour of their time to familiarise themselves with the changes where things need to be done differently.
68. Our estimate of the total, one-off familiarisation cost to auditors of non-PIEs is between £0.60m - £1.71m. Our **best estimate** is **£1.18m**.
69. Our **best** estimate of total costs across all auditors and PIEs is **£118.62m**. Annex B provides the details of all our calculations of familiarisation costs.

#### ***Ethical standards – audit fees***

70. Through the Regulation, PIEs will be subject to a cap applied to the fees for non-audit services provided by their auditor, as well as a complete ban on the provision by their auditor of certain non-audit services (i.e. services on the 'blacklist'). The provisions apply to 2,029 PIEs and their auditors, and will require those companies which have non-audit service fees above the threshold, or which have non-audit services which will be prohibited, to arrange for these services to be reallocated to another provider. The aim of this is to increase 'auditor scepticism', so increasing stakeholder confidence in the services provided, increasing access to the non-audit service market and competition within it.
71. Due to the difficulty of estimating the value of non-audit services that would need to be reallocated as a result of the new requirements we provided cost estimates assuming between 20%-80% of non-audit services would need to be re-allocated with a central estimate of 50% in our consultation stage Impact Assessment. We invited comments from, and had discussion with, stakeholders during the consultation period to further inform our estimates, and have revised them in view of the discussions. Our final estimate of the one-off cost to those businesses needing to change their provider of these services (on the assumption that this will involve some form of tendering process and its associated costs) is between £13.76m and £39.42m, with a best estimate of **£26.59m**. Annex C outlines how we assess the costs of the reallocation of non-audit services, and describes how this has been informed by evidence provided by stakeholders in the consultation period.

#### ***Appointment of the Audit Committee***

72. The Directive extends the scope of the requirement for an audit committee to all PIEs, beyond the existing coverage of listed PIEs, and now includes unlisted banks, building societies and insurers. Of these, those that do not currently have an audit committee would be required to establish one.



This change aims to clarify to make clear who is responsible for the company's relationship with the auditor and to increase the audit committee's independence.

73. PRA advice is that most banks and building societies would already have an audit committee. We therefore assume that the impact of the requirement to set up an audit committee would fall mainly on unlisted insurers. Based on internal analysis, the PRA estimates that up to 30% of lower impact SII insurers may not have an audit committee. There are currently 338 such insurers.
74. The requirement to set up an audit committee would also apply to the Lloyd's market i.e. to the Society of Lloyd's and the managing agents in respect of the syndicates for which they are responsible. The society of Lloyds already has an audit committee. There are currently 104 Lloyds of London syndicates managed by 59 managing agents which do not have audit committees. We therefore expect at least 59 audit committees would need to be set up to serve these syndicates.
75. For companies not on the FTSE 350, audit committees must consist of at least 2 members who must be independent in order to comply with the Regulation. We estimate a one-off cost of establishing an audit committee (with a chair and at least one other non-executive member) for all firms that do not already have one, to be between £3.79m and £5.82m, with a best estimate of **£4.80m**. The ongoing annual costs of these audit committees are estimated to be between £11.72m and £21.13m, with a best estimate of **£16.15m**. Annex D outlines how we assess the costs of the requirement to have an audit committee.

#### ***Additional report to the Audit Committee***

76. This requirement will impact auditors of PIEs, and will involve additional costs to the auditor of preparing the additional report for the audit committee – the information contained within the report is the result of the audit work itself, so there will be no additional costs relating to obtaining and collating the relevant information. There would be additional time requirements of audit committees as they would spend time reading and discussing the report. This report will increase confidence of stakeholders in the audit committee and its accountability.
77. Based on the text in the EU Regulation all PIEs will be required to have this additional report. We have based our estimates of costs to auditors on the assumption that the time taken to prepare the report would depend on whether the PIE is listed and its size. Comments on our consultation stage Impact Assessment noted that most of the reporting would already be done suggesting less time might be required than we had assumed. However it was also suggested that this was more likely to be undertaken by more senior staff than we had assumed. We have therefore revised our estimates of time required and changed our assumption on the level of audit firm staff that would be involved to be senior officials.
78. The total annual cost of the additional report to the audit committee is estimated to be between £2.33m and £3.50m, with our best estimate at **£2.91m**. Annex D outlines how we assess the costs of the requirement to have an audit committee.

#### ***Scope of Audit Committee***

79. The Directive adds additional requirements on all audit committees, impacting all PIEs requiring additional meetings between auditors and audit committee members on an annual basis. The additional requirements include monitoring the financial reporting process, the internal quality control and risk management systems, the statutory audit and additional audit report and monitoring and reviewing the independence of the statutory auditors and the appropriateness of the provision of non-audit services to the audited entity. This is intended to increase stakeholder confidence in the effectiveness of the audit committee.
80. The UK already has a comprehensive framework on audit committees meaning that for UK companies the additional requirements would be lower. On this basis we estimate that between 1 and 2 additional meetings per year would be required.
81. Comments on our consultation stage Impact Assessment stated that companies with existing audit committees would probably be able to fit a time extension within existing meeting schedules. We have therefore revised our calculations to estimate the costs to PIEs with established audit committees separately from those with newly appointed ones.

82. This will impact all PIEs and impose an estimated annual cost of £6.73m-£7.25m. Our best estimate is **£6.99m** per annum. Annex D outlines how we assess the costs of these additional requirements on audit committees.

### ***Retaining and disclosing information***

83. Under the Regulation, all auditors of PIEs have to provide a transparency report. This requirement will now apply in respect of auditors of all PIEs, not just those that are listed. The FRC expects there to be a total of 55 auditors of PIEs (once Banks building societies and Insurers are included in the definition of PIEs). This is an increase from 19 auditors of listed companies (those that had clients listed on regulated markets)<sup>29</sup>. Our best estimate of the new in scope PIE auditors is therefore 36.

84. Our best estimate of the cost to the 36 additional auditors of providing a transparency report to be **£2.12m**.

85. In addition, the auditor must also report to the competent authority on audit and non-audit revenues in respect of each PIE: this is not a current requirement. We have estimated that these reports would require 8 additional hours of auditor time. Across 2,029 PIEs, this would cost about **£0.5m per annum**. The total cost of these two requirements is therefore estimated at **£2.60m per annum**.

86. Annex E outlines how we assess the costs of the additional reporting requirements on auditors.

### ***Appointment requirements – Duration of engagement***

87. The Regulation sets a maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments after 10 years. This is already a requirement for the FTSE 350 following the introduction of the order by the CMA in 2014 on mandatory retendering of auditor appointments.<sup>30</sup> The aim is to increase ‘auditor scepticism’ by reducing the ‘threat of familiarity’ between audit firms and their clients, which may otherwise call into question the objectivity and independence of the audit. It would also open the audit market up to greater competition.

88. There is an exemption from the need to make auditor appointments by competitive tender for small and medium firms (within a specified definition). We estimate 745 PIEs to benefit from this exemption.

89. The measure would impact 984 PIEs (all PIEs excluding those UK incorporated companies in the FTSE 350 and those that are exempted) as well as the auditors of these. We estimate the cost impact of this measure in terms of the costs to auditors and PIEs of the mandatory tendering.

90. Mandatory rotation of auditors every 20 years also has an additional costs of newly appointed auditors of having to familiarise themselves with the business of a new PIE client. Our consultation stage Impact Assessment excluded this cost. Using CMA analysis and consultation responses we estimate the familiarisation cost at an annual average of **£6.72m**.

91. Our estimate of total annual cost of mandatory rotation and tendering for auditors is between £41.66m - £48.38m, with a best estimate of **£45.02m per annum**.

92. Annex F outlines how we assess the costs of these additional costs of mandatory retendering of statutory audits every 10 years.

### ***Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit***

93. Under the amended Directive and Regulation, the FRC is required to inspect auditors of all PIEs. This will increase investor confidence in the UK’s regulatory framework but reduce flexibility as, at

<sup>29</sup> This figure is taken from Key Facts and Trends in the Accountancy Profession, FRC, June 2015 [https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-(1).pdf)

<sup>30</sup> [https://assets.digital.cabinet-office.gov.uk/media/54252eae40f0b61342000bb4/The\\_Order.pdf](https://assets.digital.cabinet-office.gov.uk/media/54252eae40f0b61342000bb4/The_Order.pdf)

present the FRC is able to delegate inspection of auditors conducting fewer than 10 such audits to the professional bodies.

94. We consider two effects of changes to the audit inspection regime on the FRC as competent authority with ultimate responsibility for audit regulation:

- The impact of significantly limiting the FRC's use of the current facility to delegate inspections of some auditors<sup>31</sup> to the professional supervisory bodies.
- The impact of the wider definition of a PIE, in particular the inclusion of all unlisted insurers within the scope of FRC inspections.

95. We expect FRC inspections to continue to be charged to companies for cost recovery. Based on FRC data, it is estimated that the incremental annual average cost of FRC inspections of 34-36 auditors whose inspections are currently delegated to the Recognised Supervisory Bodies (RSBs) will be about **£385,000** per annum. Introducing additional inspections by the FRC of an estimated 10-12 more auditors of insurance companies that are now designated as PIEs would lead to additional costs of **£121,000** per annum. Our best estimate of the total cost is therefore **£0.51m per annum**. Annex G outlines how we assess the costs of the additional FRC inspections.

### ***Reduction in Frequency of inspections***

96. For non-PIEs the existing requirement that each audit firm must be subject to inspection at least once every 6 years will no longer apply for auditors of only small companies or audit firms that have no audit clients (who currently undergo desk-based inspections). The frequency of these inspections of auditors would be determined on a risk basis and the FRC expect that the frequency of inspections for such firms would reduce from 6 to 8 years. This would result in a saving.

97. The resulting savings to auditors of the reduction in frequency of inspections are estimated between £172,000 and £226,000. Our best estimate is £199,000.

98. Of this, an estimated £125 per audit firm results from the reduced frequency of inspections of auditors who do at least conduct some audits but only of small companies. The FRC expects around 430 audit firms to benefit resulting in a saving of £54,000. However, if the Directive is not extended to LLPs (as is the case in option 1), then this reduction in frequency would not apply to the auditors of these LLPs, even where their clients are all small companies. The number of firms that would benefit would therefore be smaller under Option 1 and the estimated benefit would fall below £54,000. However, as we are unable to estimate how many firms would fall out of scope of the reduction in frequency under Option 1, we have left the difference in saving between Option 1 and 2 unquantified. Given the magnitudes involved we expect the difference in the overall saving to be lost in rounding to the nearest £100,000. Further discussion and all calculations are provided in Annex G.

### **Non-monetised cost impacts**

#### ***Ethical Standards – Independence Requirements***

99. This relates to Directive changes in requirements for assessing the independence of auditors. Costs are expected to arise in relation to group audits where UK auditors would need to verify the independence of auditors that are outside the EEA and who provide information on subsidiaries or branches in those jurisdictions which is then used in group audits. The UK auditor of the (probably consolidated) accounts will now need to assess any risk to their independence arising from any indirect influence that might have been exerted via those contributors to the audit.

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<sup>31</sup> The FRC may delegate inspections of auditors conducting fewer than 10 'major audits' (that would otherwise be within its remit) to the professional bodies. The class of major audits is required by law to include all listed companies. The FRC also has discretion to include other classes of entity that are subject to statutory audit and can include more entities again by agreement with the professional bodies. At present it includes all banks (whether listed or not) and some unlisted insurers.

**100.** The cost of these changes was assumed to be negligible in the consultation stage Impact Assessment. Based on further discussions with the FRC during the consultation period we now estimate that the change would result in about 5 additional hours of audit partner time when auditing non-EEA international groups. It would therefore result in on-going additional costs to all cross border group auditors (of PIEs as well as non-PIEs), with a subsidiary outside the EU, or more specifically, outside the scope of implementation of the Directive or outside of countries that have auditing standards comparable to those implemented by the Directive. No additional costs are expected to fall on UK auditors from this requirement where groups are within such jurisdictions<sup>32</sup>. We are unable to estimate how many could be in scope; however, for those affected, it is estimated to cost £331 per group audit (£66.24 X 5 hours).

**101.** For groups with non-EEA subsidiaries costs might be incurred by auditors. However, it is not possible to identify the number of group audits impacted and therefore quantify this cost. FAME data shows 21,532 group audits. Given the large number of entities it was not considered proportionate to analyse all of the group member companies for country of incorporation to determine those outside the EEA. Further details on assumptions and calculations are provided in Annex H.

### ***Technical Standards - Reporting Irregularities and Quality Control***

**102.** This change to the Regulation will affect auditors of PIEs and relates to (i) a requirement to report any irregularities first to the audited entity and second to the designated authority in the event that the audited entity does not investigate the matter, and (ii) a requirement that, before the submission of the audit report, an engagement quality control review must be carried out by a statutory auditor not involved in the audit to which the review relates, to assess whether the statutory auditor or the key audit partner could reasonably have come to the opinion and conclusions expressed in the draft of these reports.

**103.** Whilst not explicitly required currently, adding a specific requirement around reporting irregularities in the standards should not have much impact on the conduct or procedures of auditors as it should already be part of good practice within auditors, and therefore is not expected to have significant cost implications.

**104.** There may be costs to some audit firms associated with the quality control requirements. In most cases the requirement relating to quality control will already be met, however for very small audit firms or larger firms with relatively few 'responsible individuals' with expertise in certain industry sectors, the impact could be greater, as it may be more difficult to identify such partners who are independent of the audit internally within the firm. In these cases, costs would relate to hiring an external statutory auditor for the specific purpose of carrying out quality control reviews, however as this work would be being carried out anyway, the only additional cost will be any premium for consultancy work would represent additional costs over and above the cost of carrying it out internally.

**105.** We assume that an audit firm with 4 or more 'responsible individuals' will have sufficient capacity to ensure that there is such a partner who is independent of the audit who can undertake the quality control review. Based on data from the FRC<sup>33</sup> we found that, out of the 22 audit firms which audit listed companies, only one has fewer than 4 responsible individuals and is carrying out a total of 3 audits. There may be further firms with very few 'responsible individuals' among those firms which audit other PIEs, and in addition there may a few additional larger firms which may face additional costs due to specific technical or sector expertise, but similarly these are expected to be low. Responses to our discussion document confirm this position.

**106.** Key assumptions and risks:

- Auditors of PIEs will already be meeting this requirement to a significant extent.

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<sup>32</sup> This burden only arises for audits involving work by auditors outside of the EEA because within the EEA, domestic law will require the subsidiary's own auditor to undertake this exercise (assuming it is subject to full audit which it probably will be under EU law and if it is substantial enough to affect the group accounts).

<sup>33</sup> FRC, Key Facts and Trends in the Accountancy Profession 2013

- The number of firms which will face additional costs due to the need for specialist expertise in the quality control reviewer is low.
- The cost to those firms which do face additional costs is low.

### ***Report to Supervisors of PIEs***

**107.** This requirement of the Regulation is to impact those listed companies which are not banks, insurers or other financial institutions as these entities are already subject to equivalent requirements to report to the Prudential Regulation Authority. The supervisory authority for other companies would be the FCA as the UK Listing Authority. For these entities, we would expect the frequency of events that would need to be reported to the supervisor of the PIE to be low. Also, the eventualities that are required to be reported would currently be brought to the attention of the FRC or the Listing Authority in any case via a variety of means. The incremental costs are unquantified and expected to be negligible as much of the information the auditor is now required to pass to the FCA would have been sent to the FCA anyway. The intended effect of this requirement is that this information should be brought to the attention of the listing authority at an earlier stage, in a timely and consistent way.

### ***Educational Qualifications, Professional Competence and Continuing Professional Development - Adaptation period***

**108.** This provides a framework for EEA audit firms to provide services cross-border. Part of this includes convergence of member state qualifications, as well as the potential to allow an adaptation period within the firm as an alternative to the current aptitude test for individual EEA migrant auditors.

**109.** This should not result in direct costs for the auditor seeking to establish in a new Member States compared to the baseline scenario. It may result in costs for the competent authorities if they decide to revise their current aptitude test framework, but this is not mandatory. There are non-monetised benefits arising from the fact that this measure will open new markets to statutory auditors since it will be significantly easier for them to be approved and provide services in other Member States. This will also benefit the statutory auditors employed by audit firms (e.g. possibility of relocation within audit firms).

**110.** In terms of the impact on audit firms, there are not expected to be direct costs associated with these measures.

### ***Qualifications – mutual recognition of auditors and audit firms***

**111.** There are un-monetised savings from the avoidance of the administrative costs of applying for a full audit licence in each Member State where an audit firm wants to provide services. In addition, this measure will facilitate greater cross-border working and allow existing cross-border firms to operate more efficiently. It is not known to what extent audit firms will wish to take advantage of this.

**112.** Savings are expected to result from the avoidance of the administrative costs of applying for a full audit licence in each Member State where the auditor wants to provide services. In addition, it will create the potential for access to audit markets in 28 Member States. It is not known how many audit firms would take advantage of this. In terms of indirect benefits, audit firms could more easily consolidate with other firms at cross-border level, thus facilitating the development of stronger and larger actors. Also, for existing groups, the need to keep different legal persons in each Member State is avoided. Therefore, this could lead to some savings in the administrative structure of the audit firm and to a more efficient organisation. Also, it should be easier for audit firms to provide services in a cross-border context, which should lead to increased choice for audited entities regarding audit firms. For instance, it could be easier for an SME to keep its audit firm in case the SME creates a subsidiary abroad.

### ***The Prohibition of Auditor Clauses in Loan Agreements***

**113.** This relates to restrictive clauses in loan agreements (e.g. through template loan documentation provided by the Loan Market Association (LMA)), which restrict the borrowers choice of auditors (often to the Big-Four audit firms) for the duration of the loan agreement.

- 114.** In its market investigation of the statutory audit services for large companies, the CMA considered the effect of prohibiting such clauses among FTSE 350 companies. Their conclusion was that prohibition of these clauses was not likely to have any significant cost implications for affected businesses, and expected minimal administrative costs of changes to template documentation. They also did not, on the basis of their investigation, expect lenders willingness to lend to be affected to any material degree.
- 115.** While they acknowledged that auditor clauses reflect market practice they pointed out that lenders appeared to import them into their agreements automatically because they were in the template. They concluded therefore that there is a degree of circularity that suggests that removal of the clauses is unlikely to affect lenders' decision to lend.
- 116.** The prohibition of these clauses will potentially assist companies to make a more independent choice of auditor; reduce barriers to entry; reduce reputational barriers faced by non-Big Four firms; and incentivise mid-tier audit firms to compete more vigorously in the market.
- 117.** While the costs of this prohibition are difficult to quantify we have been able to conclude on the basis of the CMA investigation that this change is unlikely to entail significant costs to business and any costs would be outweighed by the benefits given that its direct and intended effect is to increase competition.

### ***Dismissal or Resignation of Auditors***

- 118.** As part of the implementation of the reforms an amendment would be made to the Companies Act 2006 allowing in specific narrow circumstances for the Competent Authority (FRC) or 5% of the members of the company to apply to the court for an order for removing an auditor of the company from office.
- 119.** In this situation there must be 'proper grounds' for the dismissal of the auditor. The Government will not prescribe what may constitute 'proper' or 'improper' grounds for dismissal of auditors, but in line with Article 38 of the 2006 Directive has stated that divergence of opinions on accounting treatments or audit procedures shall not be 'proper grounds'.
- 120.** It has not been possible to monetise the costs of this change. The process is voluntary and the framework is simply enabling rather than mandatory.

### **Additional Impacts under Option 2**

- 121.** Below we describe the additional impacts of Option 2. The same monetised and non-monetised costs and benefits as Option 1 would arise under this option.
- 122.** The costs of this option would be the same as those for Option 1, as far as PIEs are concerned, as any PIE LLPs would automatically be in scope. The extension of the Directive to LLPs would therefore have the impact of bringing non-PIE LLPs into scope. Any difference in the cost or benefit compared to Option 1 therefore arises from changes that affect non-PIEs. These are:
- Familiarisation with new FRC standards for LLP auditors;
  - Changes in ethical standards relating to group audits;
  - Prohibiting auditor clauses in loan agreements of LLPs; and
  - Reduction in frequency of inspections for auditors of LLPs
- 123.** The changes affecting audits of non-PIEs are only those relating to auditing standards that would be changed and implemented by the FRC. As a result there are familiarisation costs to auditors of non-PIEs but no familiarisation costs to the audited entities themselves.
- 124.** We discuss these in detail below.

## ***Familiarisation with the new FRC standards***

**125.** We expect no additional familiarisation costs to arise from BIS's extension of the scope of the Directive to include LLPs. This is because, for the cost to an LLP auditor to be additional as a result of the extension to LLPs, the auditor would need to be an auditor of LLPs that does not audit any other companies (as auditors who also audit other companies would already be in scope of the Directive changes and would incur familiarisation costs anyway). We believe that it is reasonable to assume that audit firms would not restrict themselves to auditing any particular legal form, as this would limit their business prospects. Further support for this assumption is that fact that companies are much more prevalent than LLPs (around 3.6 million in the UK compared to around 58,000 LLPs, according to the FAME database). Therefore, we expect the familiarisation costs to auditors of extending the new standards to LLPs would be negligible, if not zero.

## ***Changes in Ethical Standards relating to group audits***

**126.** As with other group audits, LLP international group audits would be affected by changes to assessing the independence of firms used in a group audit. Based on further discussions with the FRC during the consultation period we now estimate that the change would result in about 5 additional hours of audit partner time when auditing groups outside of jurisdictions that have similar independence standards.

**127.** Additional costs under Option 2 would therefore result from the additional LLP group audits that would be affected by the costs of this measure. FAME data estimates that there were 21,532 group audits in the last year. Of these, 497 were LLP group audits which are not automatically covered by Option 1.

**128.** For the assessment of additional costs imposed under Option 2, which extends the Directive requirements to LLPs, we examined subsidiary data available on FAME for these 497 LLP groups. This showed that 87 of the 497 LLP group audits (17.5%) were international groups that had subsidiaries in countries where the Directive would not apply. Using 87 audits, the expected impact is expected to be £29,000 ( $£66.24^{34} \times 87 \text{ audits} \times 5 \text{ hrs}$ ).

**129.** However, we expect that the number of audits affected by the change in requirements would be less than 87 because as noted above, groups with members in countries that have standards comparable to those of the Directive are also not expected to incur further costs. However it is not considered proportionate to precisely estimate these costs (following Better Regulation Executive advice) given they are of the order of magnitude of less than £100,000.

**130.** Further details of this analysis are provided in Annex H.

## ***Prohibiting auditor clauses in loan agreements of LLPs***

**131.** The prohibition of restrictive clauses in loan agreements which limit the borrowers' choice of auditors (often to the big four audit firms) would be extended to LLPs. This measure is not expected to have significant costs generally (as explained under option 1 above) – and the incremental cost of the extension of this prohibition to LLP loan agreements is therefore also expected to be negligible.

## ***Reduction in frequency of inspections for auditors of LLPs***

**132.** As noted above, an estimated 430 audit firms are expected to benefit from a reduction in frequency of inspections at about £125 per firm. This includes audit firms that audit small companies but also have 1 or more LLP clients. Such firms only stand to benefit when the Directive is extended to LLPs i.e. Option 2. It is difficult however to estimate how many these would be and therefore quantify the additional savings from Option 2 compared to Option 1. To

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<sup>34</sup> Assuming that most group audits would be undertaken by larger audit firms, even where the firm is not a PIE. Therefore we base our estimate of audit partner time on the 75<sup>th</sup> percentile of ASHE data on hourly wages of "Chief Executives and senior officials" (for both PIE group audits and non-PIE group audits).

provide an order of magnitude, if it is assumed that between 10-20% of those firms that stand to benefit from the reduction in frequency of personal inspections had 1 or more LLP audit clients, savings under Option 2 would be £6,000 - £11,000 per annum more than Option 1. See Annex G for calculations.

**Table 3: Summary of costs for Options 1 and 2**

Subject Matter	One-off cost £m Lower bound estimate	One-off cost £m Best estimate	One-off cost £m Higher bound estimate	Ongoing cost £m Lower bound estimate	Ongoing cost £m Best estimate	Ongoing cost £m Higher bound estimate
<b>Conditions for Carrying out Statutory</b>						
Ethical Standards - Audit fees	13.76	<b>26.59</b>	39.42			
Ethical Standards - Professional Ethics				<i>unquantified</i>	<i>unquantified</i>	<i>unquantified</i>
Audit Reporting - Additional Report to The Audit Committee				2.33	<b>2.91</b>	3.50
Appointment of Audit Committee	3.79	<b>4.80</b>	5.82	11.72	<b>16.15</b>	21.13
Scope of Audit Committee				6.73	<b>6.99</b>	7.25
Regulatory Reporting and Information - Report to Supervisors of PIEs					<i>negligible</i>	
Regulatory Reporting and Information - Retaining and Disclosing Information				2.08	<b>2.60</b>	3.12
<b>Appointment of Statutory Auditors or Audit Firms</b>						
Appointment Requirements - Duration of Engagement				41.66	<b>45.02</b>	48.38
Dismissal or Resignation of Auditor		<i>negligible</i>			<i>negligible</i>	
Educational Qualifications, Professional Competence and Continuing Professional Development		<i>negligible</i>			<i>negligible</i>	
<b>Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit</b>						
Competent Authorities - Designation and Delegation of Tasks within UK				0.41	<b>0.51</b>	0.61
Competent Authorities - Powers					<i>negligible</i>	
<b>Familiarisation and Implementation costs</b>						
Costs to auditor and audited entities	94.55	<b>118.62</b>	142.63			
<b>Total Costs of Regulation and Directive</b>	<b>112.10</b>	<b>150.02</b>	<b>187.87</b>	<b>64.92</b>	<b>74.18</b>	<b>83.99</b>
<b>Regulation</b>	<b>78.87</b>	<b>108.28</b>	<b>137.65</b>	<b>46.07</b>	<b>50.53</b>	<b>55.00</b>
<b>Directive Costs under (Option 1 and 2)</b>	<b>33.23</b>	<b>41.74</b>	<b>50.22</b>	<b>18.85</b>	<b>23.65</b>	<b>29.00</b>

**133.** Table 3 summarises the quantified costs of the various changes made by the Regulation and the Directive. Quantified costs under both options are expected to be the same.

**134.** Excluding familiarisation and implementation costs (which have been estimated as the combined impact of the requirements of the Regulation and the Directive), the changes imposed by the Regulation account for 69% of the total cost impact, while quantified costs from the Directive account for 31%.

**135.** The Regulation and the Directive together impose a series of new requirements on PIEs and their Auditors. Familiarisation and implementation costs to businesses have been estimated with all the different changes in mind regardless of whether they result from the Regulation or the Directive or a combination of the two. As a result it is difficult to allocate familiarisation and implementation costs to each measure and therefore to the Directive and Regulation. We therefore apportion the familiarisation costs to the Directive and Regulation in proportion to the estimated total cost impact of measures calculated above.

**136.** The total costs of the EU Directive are one-off costs of £41.74m and ongoing costs of £23.65m per annum. The total costs of the Regulation are one-off costs of £108.28m and ongoing costs of £50.5m per annum.

**137.** The next section (Section G) sets out the Equivalent Annual Net Direct Cost to Business (EANDCB) of these two options, and its One-In, Three-Out (OI3O) treatment.



## G. One-in, three-out

- 138. Option 1** is the EU baseline (i.e. it implements only the mandatory changes to the current system which are required by the Directive and does not include any other changes or extensions). The direct (annual equivalent) impact on business of this option is £24.7m. Following the Better Regulation Framework Manual<sup>35</sup>, this is out of scope of OI30.
- 139. Option 2** extends the scope of the Directive to include LLPs which otherwise do not come under EU Law (for reasons outlined earlier in the Impact Assessment). Following the Better Regulation Framework Manual guidance, we report two EANDCB figures for this option – referring to the element of the EANDCB that is Out of Scope of OI30 and the element that is In Scope.
- 140.** The EANDCB of this option relating to the EU derived measures, which is Out of Scope, is £24.7m (as under Option 1).
- 141.** The incremental costs of extending the Directive to include LLPs under this option are unquantified but estimated to be below £29,000 per annum. This cost will be partly offset by the incremental savings from extending the Directive to LLPs, which are also not possible to quantify. For example, additional savings are expected from reduced frequency of inspections of auditors of LLPs as well as unquantified savings from having a single set of audit standards that applies to companies and LLPs. These savings would need to be deducted to calculate a precise EANDCB of extending the Directive to LLPs, under Option 2. While it is not possible or proportionate to estimate this, we know that the net EANDCB would be smaller than £29,000. Rounded to the nearest £100,000 (following Better Regulation Executive advice), therefore the additional EANDCB of extending the Directive to LLPs, is reported as £0.

## H. Wider impacts

### Statutory Equality Duties

- 142.** 171. After screening the potential impact of this proposal on race, disability and gender equality, it has been decided that there will be no impact. It is not expected to have any impact on the Convention Rights of any person or class of persons as the measure regulates incorporated businesses rather than individuals, and applies to all businesses within the stated size threshold.

### Economic Impacts

#### **Competition Impact Test**

- 143.** This proposal is expected to increase competition in the audit service market.

#### **Small and Micro Business Assessment**

- 144.** As the options are European in origin, rather than domestic, a small and micro business assessment is not required by the Better Regulation Framework Manual. However below we provide a high-level discussion of where and how small and micro businesses will be affected by the options – and why this is desirable to meet the Government's policy objectives.
- 145.** The majority of small and micro businesses are exempt from being required to have a statutory audit, however all PIEs, regardless of size are required to be audited, therefore any small or micro PIEs will be impacted by the implementation of the options.
- 146.** The nature of the business operations of PIEs (i.e. listed companies, banks, building societies and insurers), means that PIEs are likely to have a significant impact on the UK's economy and society. Therefore it is considered desirable and necessary to apply to them the higher audit standards that are applied to large companies.

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<sup>35</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/468831/bis-13-1038-Better-regulation-framework-manual.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/468831/bis-13-1038-Better-regulation-framework-manual.pdf)

147. Based on FAME data we estimate that there are 470 small companies among the 2,029 PIEs (i.e. 23%). 128 of these would be new in scope as PIEs.<sup>36</sup>
148. All PIEs are expected to bear one-off familiarisation and implementation costs. These are estimated to average at £10,000 per small and medium new in scope PIEs (see Table B5 of Annex B). Part of this relates to the changes brought under the Directive and part to those under the Regulation.
149. We estimate that about 30% of 338 unlisted insurers are expected to bear the costs of establishing an audit committee as a result of amendments to the Directive. Around 70 of the 338 insurers are expected to be small companies (based on FAME data), and these are likely to be included among those needing to establish an audit committee for the first time. The measure is estimated to have a one-off cost per firm of £30,000 and ongoing annual costs per firm of about £101,000.
150. There is an exemption for small and medium sized PIEs from the Regulation requirement to appoint auditors through a competitive tender process. We estimate that 745 companies would be eligible for this exemption.
151. Many audit firms are small in size (using the company law definition of small). There are 6,635 audit firms registered in the UK of which 6,506 (98%) have 10 or fewer 'principals' (equivalent to partners active in the firm). Small audit firms are expected to bear the costs that accrue to auditors of non-PIEs, which include a total familiarisation cost of £1.18m across all firms.
152. The impact of the measures will be disproportionately greater for relatively smaller audit firms (carrying out a small number of PIE audits or that have clients that are currently outside the PIE definition and would come into scope for the first time). However, auditors of PIEs are unlikely to be small businesses.
153. One new requirement among the changes is that the frequency of all firm inspections must be determined on the basis of an assessment of risk. Auditors of PIEs, all of whose PIE clients are SMEs, can benefit from a reduction in the frequency of audit inspections and therefore costs. Also auditors, who have no PIE clients or all of whose clients are small, are relieved of any minimum frequency of audit inspections. The total annual savings estimated as a result of the reduced frequencies of inspections are about £199,000 and smaller audit firms are expected to benefit.

### ***SAMBA for the extending the Directive to LLPs under Option 2***

154. The additional impact of the extending the Directive to LLPs is expected to fall on LLP group auditors. Currently, according to FAME, there are 29 auditors (15 large or medium firms and 14 small firms) doing the 87 international group audits that would bear additional costs estimated to be under £29,000 under Option 2. 71 of these audits are done by large auditors who therefore bear 82% of the additional cost (about £24,000). Therefore 18% of the additional cost (about £5,000 per annum) of implementing the revised standards on LLP audits under Option 2 would fall on small audit firms.
155. Option 2 also extends the scope of the benefits of the Directive measures relating to the reduction in frequency of inspections of auditors that audit only small companies which we expect to be small audit firms themselves. An estimated 430 auditors of small companies stand to make savings from this measure as opposed to Option 1, in which auditors of small companies that may also have one or more LLP clients would be excluded. It is not, however, possible to estimate how many these would be.

### ***Environmental impacts***

156. There are no obvious direct concerns in this area.

### ***Social Impacts***

#### ***Health and Well-Being:***

<sup>36</sup> These are estimates because designation of size requires firms to fulfil two out of the three thresholds on the criteria (turnover, number of employees and total assets) on which size is determined. As data in the required fields is not available for all firms, we have to extrapolate from the population that does have data available to those that don't.

157. No obvious concerns in this area.

*Human Rights:*

158. No obvious concerns in this area.

Justice System

159. BIS is separately preparing a MOJ Justice System Impact Assessment, discussing the impact of the reforms to the audit framework on the judicial system. We do not envisage significant changes to the existing system of criminal sanctions or civil penalties for non-compliance as most of the new or increased requirements can be accommodated in the existing framework. We do not expect any increases in the scope of any current sanctions. Given the emphasis in the framework on professional disciplinary sanctions, we understand the current impact on the justice system is low.

Rural Proofing

160. No obvious concerns in this area.

## I. Summary and preferred option

161. This is a Final Stage Impact Assessment and both options were considered as part of the consultation. We propose that Option 2 is the preferred approach to implementation.

## J. Implementation plan:

<b>Title</b>	<i>DIRECTIVE 2014/56/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts</i>  <i>REGULATION (EU) No 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC</i>
<b>EU Legislation Ref.</b>	<b>Directive 2014/56/EU and Regulation (EU) No 537/2014</b>
<b>Lead Department</b>	<i>Department for Business, Innovation and Skills</i>
<b>Lead Minister</b>	<i>Baroness Neville Rolfe</i>
<b>OUTLINE PROJECT PLAN / MILESTONES</b>	
<b>16 April 2014</b>	<b>Date the EU legislation was adopted</b>
<b>27 May 2014</b>	<b>First published in the Official Journal of the European Union -</b> <i>Regulation:</i> <a href="http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537">http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537</a>  <i>Directive:</i> <a href="http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0056">http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0056</a>

<b>Dependencies and Issues</b>	Amendments to primary legislation required for transposition of the Directive and to provide for application of the Regulation will be cleared with the Office of the Parliamentary Council during the course of 2016.		
<b>Method of Transposition Implementation</b>	Existing legislation <input checked="" type="checkbox"/> New primary legislation <input type="checkbox"/> New secondary legislation <input checked="" type="checkbox"/> Other / Administrative Act <input checked="" type="checkbox"/>	<input checked="" type="checkbox"/> <input type="checkbox"/> <input checked="" type="checkbox"/> <input checked="" type="checkbox"/>	<ul style="list-style-type: none"> <li>- <i>FRC's Ethical and Technical Standards for Auditors</i></li> <li>- <i>FRC Regulations</i></li> <li>- <i>PRA Rules</i></li> <li>- <i>FCA Handbook</i></li> </ul>
<b>Week beginning 24 November 2014</b>	<b>EAC clearance to publish discussion document</b>		
<b>Week beginning 15 December 2014</b>	<b>Publication of Discussion Document</b>		
<b>Autumn 2015</b>	<b>Pre-consultation RRC clearance</b>		
<b>Autumn 2015</b>	<b>Formal Consultation (Consultation period expected to last for 7 weeks due to time constraints for delivering the implementation. However, there is expected to be substantial stakeholder engagement activity to complement the formal consultation, for instance, meetings with large accountancy firms).</b>		
<b>April 2016</b>	<b>Final RRC clearance</b>		
<b>Spring 2016</b>	<b>Lay regulations</b>		
<b>w/c 13 June 2016</b>	<b>Expected date for implementation in England, Wales, Scotland and Northern Ireland</b> (Company Law and regulation of statutory audit are reserved matters other than in Northern Ireland. Following an agreement with Northern Ireland Ministers, the Secretary of State continues to use powers under the Companies Act 2006 (a UK wide Act), as well as EU implementing powers, to implement secondary legislation in these areas, including to amend primary legislation, on a UK wide basis)		
<b>17 June 2016</b>	<b>Expected date for implementation in Gibraltar</b>		
<b>w/c 13 June 2016</b>	<b>Expected date for publication of any guidance</b>		
<b>Late June 2016</b>	<b>Planned date for notifying the Commission of implementation</b>		
<b>17 June 2016</b>	<b>UK legislation enters into force</b>		
<b>17 June 2016</b>	<b>Final transposition deadline (from the EU legislation)</b>		
<b>Summer 2021</b>	<b>Proposed date for Ministerial review (taking into account date of any EU Commission review requirement)</b>		
<b>Lead Official:</b>	Paul Smith	<b>Contact No:</b>	020 7215 4164

<b>Lead Lawyer:</b>	Peter Evans	<b>Contact No:</b>	020 7215 3409
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## Annex A – Summary of all measures included in the Directive or Regulation

Matter	Regulation Article	Directive Paragraph	Brief description of change
<b>Scope and Application of the Directive and Regulation</b>			
Subject Matter and Scope	1 +2	1 + 2	Increase in scope of Directive to cover non-company/LLP/QP Issuers, MiFiDs, UCITS, AIFs and Payment institutions - see list of changes in the Audit Directive below
<b>Conditions for Carrying out Statutory Audits</b>			
Ethical Standards - Audit fees	4 + 5		PIEs to be subject to Non-Audit Service cap and 'blacklist'
Ethical Standards -Professional Ethics		13-16	Enhanced framework on auditor independence for all audited entities
Technical Standards - Reporting Irregularities and Quality Control	7+8		PIE and PIE auditor reporting requirements
Technical Standards - Organisation of Statutory Auditors		18 + 19	Adoption of ISQC1 framework on audit quality control at EU level
Technical Standards - International Standards for Auditing	9	21	No change until ISAs adopted at EU level
Technical Standards - Scope of Statutory Audits and Consolidated Accounts		20 + 22	Limited changes to harmonise and clarify EU law
Audit Reporting - Procedure for Reporting	10	23	Number of changes to the contents of the audit report largely reflecting current position in UK auditing standards
Audit Reporting - Additional Report to The Audit Committee	6 +11		New additional audit report providing additional information specifically for the audit committee
Appointment and Scope of Audit Committee		32	Two changes - first to the requirements on audit committees - second on scope as unlisted banks, building societies and insurers must comply for the first time.
Regulatory Reporting and Information - Report to Supervisors of PIEs	12		Reporting to FCA on certain matters relating to listed companies
Regulatory Reporting and Information - Retaining and Disclosing Information	13,14 +15		Auditors of PIEs have various obligations in respect of public reporting and reporting to FRC
Regulatory Reporting and Information - Confidentiality and the Transfer of Information	18	17	Changes to provisions on handover files and on transfer to group auditors and competent authorities in third countries of audit information
<b>Appointment of Statutory Auditors or Audit Firms</b>			
Appointment Requirements - Procedure	16	30	Appointment process for PIE auditors via competitive tender by audit committee. Prohibition of 'Big Four only' clauses of policy significance.
Appointment Requirements - Duration of Engagement	17 + 41		Setting maximum period of PIE audit engagements at 20 years subject to retendering of auditor appointments at least every 10 years. Half of the work of policy formation already completed with publication of draft CMA Order.
Dismissal or Resignation of Auditor	19	31	Dismissal framework for auditors of PIEs where competent authority or 5% shareholders go to court. This will be a significant new proposal in company law terms. Resignation framework much more limited
Educational Qualifications, Professional Competence and Continuing Professional Development		4,6,10 +12	Framework for EEA audit firms to provide services cross border; Convergence of Member State qualifications; Adaptation period as alternative to aptitude test for individual EEA migrant auditors.
<b>Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit</b>			

Competent Authorities - Designation and Delegation of Tasks within UK	20,21,22 +25	3, 26 + 28	Considerable shift in the regulatory framework that forms the basis for the operation of the FRC. (i) requiring FRC to set audit regulations under schedule 10 rather than RSBs (ii) setting up framework in which FRC has all current RSB functions but delegates them (iii) moving away from framework in which independent standards, inspections and investigations and discipline are delivered by unnamed independent body towards FRC framework.
Competent Authorities - Powers	23		New powers for FRC to obtain information from 3rd parties
Competent Authorities - Sanctions		25	New framework on the imposition of sanctions by competent authorities
Cooperation Between Competent Authorities Within EU	29,30,31,32 ,33	5,27,29	Developments of framework on cooperation between EEA competent authorities
Cooperation of Competent Authorities with Third Countries	36,37+38	33, 34,35	Developments of framework on cooperation with third country competent authorities. Technical issues around exchanges of audit working papers with third countries.
Quality Assurance	26, 28,31	24	Technical changes with increased emphasis on risk based approach to frequency of inspections. Enhanced framework on cooperation on inspections.
Monitoring Market Quality and Competition	27		FRC role due to develop in this direction.

## **Annex B: Calculation of Familiarisation and Implementation Costs**

1. There will be costs for auditors in familiarising themselves with the changes to the requirements relating to audits and auditors. There will also be familiarisation costs for all PIEs in understanding the requirements on themselves, in particular relating to non-audit services provided by the auditor, and the requirement to have an audit committee.

### ***Familiarisation costs to auditors of existing PIEs***

2. We have built a model to obtain the firms' estimates of likely costs (our cost estimates are shown in Table B1). This is based on: 1) three bespoke, data-driven size categories of audit firms for the purposes of the familiarisation cost calculation, according to the numbers of audit principals at the firm; 2) the average numbers of both audit principals and non-audit principals for firms in each category; 3) the person hours they would each be expected to spend in familiarisation; 4) the sizes of audit and non-audit teams in firms in each category; and 5) the number of person hours that each team would spend. According to FRC data<sup>37</sup>, there are 19 auditors of existing PIEs. 6 of these have more than 100 audit principals, which we deem to be 'large' audit firms, 6 have between 30 and 100 principals, which we deem to be 'medium' sized audit firms and 7 have less than 30 principals, which we deem to be 'small'. FRC data also provided the average number of audit and non-audit principals for each category of size.
3. We sought estimates according to these size categories of audit firms, of the costs that are likely to be involved in updating their internal quality assurance and monitoring systems. These are intended for instance to monitor the provision by the different parts of the firm of non-audit services to audit clients. This includes the time required for systems updates and adjustments of procedures and is based on our original assumption on the sizes of teams.
4. To estimate this time cost we used median hourly wage data provided by the ONS Annual Survey of Hours and Earnings (ASHE data) uplifted by a factor of 19.8% (to reflect non-wage costs)<sup>38</sup>.
5. We tested out our initial estimates based on this model through questions in the consultation and through discussions with stakeholders during the consultation period. The main response was that the median wage rate we used would greatly underestimate this cost of staff time – especially at large audit firms. To reflect this we have revised our best estimates of the time costs of auditors of PIEs (as these would be larger auditors) using hourly wage costs of the relevant Standard Occupational Classifications (SOCs) at the 75<sup>th</sup> percentile of the ASHE data (see Annex I). In accordance with consultation responses we also revised our estimates of numbers of staff affected and time invested by them. The number of audit and non-audit team members has been reduced. Time invested by audit principals is now assumed to be 40 hours and 5 hours is now assumed for non-audit principals and their teams. Where a range of views were received (e.g. on the time spent by audit principal team members), to avoid under-estimating the potential cost of business, our final analysis deployed assumptions from the higher end of the range of stakeholder views.

### ***Familiarisation costs to auditors of unlisted banks, building societies and insurers***

6. In addition to these there would be familiarisation costs to auditors of unlisted banks, building societies and insurers that would be 'new in scope' by virtue of the extended definition of PIEs.
7. From the FRC's latest research to inform its Audit Quality Review, we are also able to make more informed estimates of the number of auditors of PIEs that would be new in scope as a result of the extension of the definition of PIEs. Our best estimate of new in scope PIE auditors is 36 and, as before, we applied our model of estimating costs to these new in scope auditors. We consulted on this during the consultation and have made the revisions to the time in view of the responses. This includes assuming that staff time required for familiarisation at these firms would be double that of existing PIE auditors as we expect the costs to be disproportionately higher for auditors that are new in scope. See Table B2.

<sup>37</sup> Key Facts and Trends in the Accountancy Profession, FRC, June 2015 [https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-(1).pdf)

<sup>38</sup> Annex I provides details of hourly wage costs estimated for different categories of personnel throughout this Impact Assessment.



Table B1: covers all auditors of UK companies with securities admitted to trading on a UK regulated market.

	No of firms	Average number of Audit principals	Assumed number of accountants in audit principal's team	Average non-audit principals	Assumed number of members in non-audit principal's team	Time spent by audit principals (hrs)	Time spent by audit principal team members (hrs)	Time spent by non-audit principals (hrs)	Time spent by non-audit principal team members (hrs)	Costs of Audit Principals and teams	Costs of non-audit principals and teams	Total across all firms
Large Audit firm (>100 audit principals)	6	139	25	420	15	40	37.5	5	5	£367,850.14	£139,158.19	£28,877,414.07
Costs per hour		£66.24	£29.37	£66.24	£15.35							

	No of firms	Average number of Audit principals	Assumed number of accountants in audit principal's team	Average non-audit principals and teams	Assumed number of members in non-audit principal's team	Time spent by audit principals (hrs)	Time spent by audit principal team members (hrs)	Time spent by non-audit principals (hrs)	Time spent by non-audit principal team members (hrs)	Costs of Audit Principals and teams	Costs of non-audit principals and teams	Total across all firms
Medium sized audit firm (>30 audit principals)	6	49	16	53	10	40	37.5	5	5	£130,271.06	£17,496.27	£6,327,618.38
Cost per hr		£66.24	£29.37	£66.24	£15.35							

	No of firms	Average number of Audit principals	Assumed number of accountants in audit principal's team	Average non-audit principals and teams	Assumed number of members in non-audit principal's team	Time spent by audit principals (hrs)	Time spent by audit principal team members (hrs)	Time spent by non-audit principals (hrs)	Time spent by non-audit principal team members (hrs)	Costs of Audit Principals and teams	Costs of non-audit principals and teams	Total across all firms
Small audit firm	7	17	8	32	5	40	37.5	5	5	£45,421.39	£10,692.95	£1,536,696.17
Cost per hr		£66.24	£29.37	£66.24	£15.35							

Total costs to Auditors with clients on regulated markets  
36,741,729

Table B2: Extrapolating this information to estimated auditors of unlisted banks and building societies and insurers

	No of firms	Average number of Audit principals	Assumed number of accountants in audit principal's team	Average non-audit principals and teams	Assumed number of members in non-audit principal's team	Time spent by audit principals (hrs)	Time spent by audit principal team members (hrs)	Time spent by non-audit principals (hrs)	Time spent by non-audit principal team members (hrs)	Costs of Audit Principals and teams	Costs of non-audit principals and teams	Total across all firms
Medium sized audit firm (>30 audit principals)	17	49	16	53	10	80	75	10	10	£260,542.12	£34,996.55	£35,045,271.05
Cost per hr		£66.24	£29.37	£66.24	£15.35							

	No of firms	Average number of Audit principals	Assumed number of accountants in audit principal's team	Average non-audit principals and teams	Assumed number of members in non-audit principal's team	Time spent by audit principals (hrs)	Time spent by audit principal team members (hrs)	Time spent by non-audit principals (hrs)	Time spent by non-audit principal team members (hrs)	Costs of Audit Principals and teams	Costs of non-audit principals and teams	Total across all firms
Small audit firm	19	17	8	32	5	80	75	10	10	£90,842.77	£21,385.90	£8,510,932.62
Cost per hr		£66.24	£29.37	£66.24	£15.35							

Table B3: Overall best estimate of cost with upper and lower estimates calculated at 20% higher and lower respectively.

	Low £m	Best £m	High £m
Total familiarisation and implementation costs to auditors	£64.24	£80.30	£96.36

## Costs to Auditors of non-PIEs

8. The FRC is making several changes to its Auditing Standards to implement the Directive requirements. Some of these changes affect non-PIEs as well as PIEs. However, the changes do not affect audited entities so we do not expect there would be any familiarisation costs arising to non-PIE audited entities themselves. Familiarisation costs to the auditors of non-PIEs would also be small due to the marginal nature of the changes. Most of the additional requirements that affect non-PIEs are expected to have minimal impact – for example the addition of documentation retention requirements, or a requirement for professional scepticism which already exist in audit regulations issued by the professional bodies, and in FRC's existing standards. We describe how we estimate these below, and present our estimates in Table B4.
9. In our consultation stage Impact Assessment we did not quantify these costs, because we assumed that these businesses would not incur a significant cost as a result of our proposals. We invited views on these potential costs in the consultation. Out of 11 respondents none disagreed that these costs would be relatively small. However 3 of these consultation respondents commented that they would like to see an analysis of the potential costs. In light of these comments we undertook a quantified analysis of the familiarisation costs to auditors of non-PIEs, to illustrate that they are small in size.
10. To provide an estimate for these for the final stage Impact Assessment we assume that all auditors of non-PIEs would spend no more than an hour of their time to familiarise themselves with the changes where things need to be done differently. This assumption of familiarisation time is based on the scale of the proposed changes relative to other proposed changes in the Impact Assessment.
11. As many of these auditors would in fact be partners in an audit firm, 'Chief Executives and Senior Officials' was chosen as the most appropriate SOC to use for estimating the wage cost of these personnel while the wage cost of 'Chartered and Certified Accountants' would be a good lower bound.
12. As noted above, given discussions with stakeholders during the consultation period which indicated the view that the median wage rate would greatly underestimate this cost – especially at large firms, we have revised our estimates of the time costs of auditors of PIEs (as these would be larger auditors) using the 75<sup>th</sup> percentile of the hourly wage for 'Chief Executives and Senior officials' as our best estimate instead of the median. While auditors of non-PIEs would include some larger auditors, they would include the vast number of smaller audit firms. We therefore use the 75<sup>th</sup> percentile wage of chief executives and senior officials as our upper bound estimate of the wages of non-PIE auditors instead of our best estimate.
13. We use ASHE data on median wages for relevant standard occupation classifications to estimate the hourly cost of time for non-PIE auditors (see Annex I). Our estimate of hourly cost is between £23.26 and £66.24, with our best estimate at £45.90.
14. The total number of registered audit firms is 6,635<sup>1</sup> and the total number of registered auditors is 25,960<sup>2</sup>, or an average of 2.5 registered auditors per firm. The total costs from the implementation of the Directive requirements to these non-PIE audit firms are calculated In Table B4 below.

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<sup>1</sup> Key Facts and Trends in the Accountancy Profession, FRC, June 2015 [https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-(1).pdf)

<sup>2</sup> There are 25,960 individuals on the Register of Statutory Auditors. This is the register (maintained by ICAS) and run by the 5 RSBs (Recognised Supervisory Bodies) in compliance with FRC requirements under the Companies Act 2006. It can be found at: <http://www.auditregister.org.uk/Forms/Default.aspx>

**Table B4: One-off Familiarisation Costs to non-PIEs**

	Lower estimate	Best estimate	Upper bound estimate
Hourly wage costs (£)	23.26	45.90	66.24
Number of non-PIE audit firms	6580	6580	6580
Average number of auditors per firm	4	4	4
Total cost across all firms (£m)	0.60	1.18	1.71

### **Costs to PIEs**

15. We did not have information on the time PIEs will take to familiarise themselves and implement changes in response to the Directive and made assumptions for the consultation stage IA and tested them during the consultation process. Below we explain how our assumptions have been altered in light of responses received.
16. We assume that costs to existing PIEs would vary by size but would also be disproportionately large for companies that are newly in scope as PIEs, as this was confirmed during the consultation process. We assume that for large companies it would require the time of 4 senior managers each with a team of 3 managers leading 10 administrative staff. For small and medium firms we assume it would require the time of 2 senior managers each with a team of 2 managers, each leading 5 administrative staff. These are revised assumptions reflecting comments from the consultation which noted that more senior staff but fewer people than originally assumed are likely to be involved.
17. For new in scope PIEs we assume the same teams as for listed PIEs, but we double the time required at each level of staff. Using ASHE data to estimate wages we estimate total costs to existing PIEs as shown in Table B5 below. Our best estimate of total familiarisation and implementation costs to PIEs is £37.14m.

### **Total Familiarisation and Implementation costs across all Businesses**

18. Our best estimate of the total familiarisation and implementation costs across all PIEs and audit firms is **£118.62m**. High and low estimates have been provided as 20% above and below our central estimate reflecting the uncertainty around our assumptions about total hours invested by businesses.
19. This overall estimate of familiarisation and implementation cost relates both to the Regulation as well as the Directive. To apportion them between the Regulation and the Directive, we calculated the total ongoing and one-off costs resulting from the actual measures under the Regulation and Directive (estimated in turn in Annexes C - H) over our 10 year period of analysis as a percentage of the overall total. 69% of the costs of the changes arise from the Regulation and 31% arise from the Directive. We then allocated the familiarisation and implementation costs to the Regulation and Directive according to these percentages. Our estimate of the total costs attributable to the Directive is £36.93m and that to the Regulation is £81.69m.

**Table B5: Familiarisation and Implementation costs to PIEs**

<b>Familiarisation and Implementation Costs to Large Listed PIEs</b>	
Number of PIEs	990
Number of Senior officials and chief executives hours	32
Hourly time cost of senior officials	66.24
Number of hours of managers and directors per team headed by senior officials	96
Hourly time costs of management	38.85
Admin staff time (hrs)	960
Hourly cost of admin staff time	15.35
Time cost across all teams	20,588
Total cost across PIEs £m	20.38
<b>Familiarisation and Implementation Costs to Small and Medium Listed PIEs</b>	
Number of PIEs	403
Number of Senior officials and chief executives hours	16
Hourly time cost of senior officials	66.24
Number of hours of managers and directors per team headed by senior officials	32
Hourly time costs of management	38.85
Admin staff time (hrs)	160
Hourly cost of admin staff time	15.35
Time cost across all teams	4,760
Total cost across PIEs £m	1.92
<b>Familiarisation and Implementation Costs to Large new in scope PIEs</b>	
Number of PIEs	290
Number of Senior officials and chief executives hours	64
Hourly time cost of senior officials	66.24
Number of hours of managers and directors per team headed by senior officials	192
Hourly time costs of management	38.85
Admin staff time (hrs)	1,920
Hourly cost of admin staff time	15.35
Time cost across all teams	41,177
Total cost across PIEs £m	11.95
<b>Familiarisation and Implementation Costs to small and medium new in scope PIEs and managers of Lloyds syndicates</b>	
Number of PIEs	304
Number of Senior officials and chief executives hours	32
Hourly time cost of senior officials	66.24
Number of hours of managers and directors per team headed by senior officials	64
Hourly time costs of management	38.85
Admin staff time (hrs)	320
Hourly cost of admin staff time	15.35
Time cost across all teams	9,519
Total cost across PIEs £m	2.89
<b>Total Familiarisation and implementation costs to PIEs (£m)</b>	<b>37.14</b>

## Annex C: Calculations of Costs due to Changes in Ethical Standards

### Restrictions on the Provision of Non-Audit Services

1. The Regulation applies both a cap on non-audit services provided to a PIE by its auditor and imposes a complete ban on the provision by the auditor of certain non-audit services (i.e. these non-audit services are 'blacklisted'). When the statutory auditor provides an audit for a period of three or more consecutive financial years the total fees from non-audit services shall be limited to no more than 70% of the average audit fees paid in the previous 3 years. In addition, specific non-audit services will be prohibited. These include, among others, certain types of tax services, consultancy services relating to management or decision making of the audited entity, bookkeeping and payroll services, and services relating to risk and risk management. These requirements are being brought in to preserve the independence of the auditor and reduce the potential for a conflict of interest arising for the audit firm.
2. These provisions will apply to 2,029 PIEs and their auditors and will require those companies which have non-audit service fees above the threshold, or which have non-audit services which are prohibited from being carried out by their statutory auditor, to reallocate some of these services to another provider.
3. We would not expect there to be any on-going direct costs on either the auditors of the PIEs, or on the PIEs themselves as a result of these requirements. It is expected that the PIEs would still require the non-audit services. While the auditor would not be able to provide as many such services to that audit client, it would be able to provide them to another non-audit client who is no longer able to obtain some of its non-audit services from its own auditor. If the market for the supply of non-audit services were as restricted as the market for the largest audits, there might be an indirect competition effect resulting in increased non-audit fees because of the further restriction on a company's choice of non-audit services provider. However we think that in fact the market for provision of non-audit services is more competitive than that for audit services, given the number of additional non-auditor participants.
4. There may be some economies of scale in obtaining non-audit services from auditors who already understand much of the company's business. In particular, following the appointment of a non-audit service provider, there may be familiarisation costs. We assume that in the case of non-audit services there are no significant familiarisation costs for new appointments.
5. We would however expect there to be transitional costs incurred by those PIEs that will need to reallocate service provision. These will not legally *require* a tender, but some companies will use a tender process to reallocate their services and, in the absence of a tender, they will still incur some administrative and financial costs of finding and appointing a new service provider. The EU Impact Assessment provided estimates of costs to PIEs, as well as auditors, of mandatory retendering for auditors by companies in different size categories<sup>3</sup>. We use these as the basis for estimating a relationship between average audit fee and cost to PIEs and their auditors of tendering for the required services. We then derived the costs to PIEs and auditors for PIEs in each of 4 categories determined by turnover size. Table C1 has the number of PIEs in each size category as well as the estimated costs of the tender process to PIEs and their auditors in these categories.

**Table C1: Shows the estimated costs of the tendering process to PIEs and Auditors as a percentage of audit fees**

Turnover Size	Number of PIEs in turnover band	Average Annual Audit Fee £	cost of tender to PIE £	cost of tendering to auditor £	Cost of tendering process to PIE as a percentage of Audit Fee	Cost of tendering to auditor as a percentage of Audit Fee
Very large turnover	14	18,535,083	365,277	5,490,331	2%	30%
Large turnover	253	2,895,942	57,186	868,965	2%	30%
Medium turnover	834	868,181	17,239	269,762	2%	31%
Small turnover	928	655,899	13,057	207,032	2%	32%
<b>Total/Average</b>	<b>2,029</b>	<b>1,146,306</b>	<b>22,718</b>	<b>351,947</b>	<b>2%</b>	<b>31%</b>

<sup>3</sup> These turnover groups were used in EU IA in their estimation of tender costs. Very large: turnover >€40bn; Large: turnover of between €2bn - €40bn; Medium: turnover of between €50m - €2bn. We have added the small category of turnover smaller than €50m.

6. We estimate that for each turnover size group, the cost to PIEs is around 2% of the audit fee and the cost to auditors is around 30% of that fee. We apply these percentages to the total value of non-audit fees that we estimate would need reallocating.
7. In the consultation stage Impact Assessment we assumed that 20% to 80% of non-audit services would need to be reallocated, with our best estimate at 50%. Discussions with stakeholders during the consultation period indicated that this would be an overestimate, firstly because a large proportion of non-audit services are not black listed. Secondly, many large listed companies would have services on the 'blacklist' already being provided by separate auditors in accordance with voluntary standards. Finally, due to existing regulations of financial institutions such as banks, building societies and insurers, they too are unlikely to have to reallocate much of their non-audit services. We have therefore taken 10% as our best estimate of the proportion of non-audit services that would need to be reallocated for banks, building societies, insurers and large PIEs and 40% for small and medium listed PIEs. To reflect the remaining uncertainty around these assumptions we provide upper and lower bounds using 5% above and below our central assumption of percentages to be reallocated by each group. Table C2 shows our calculations.

**Table C2: Calculating the total cost of the relocation of non-audit services**

	Average non-Audit fee (estimates based on FAME data) £'s	number of PIEs	% of audit fee assumed would need reallocating	Value of non-audit services to be reallocated, £'s	Cost to Auditor of re-tendering as a percentage of average audit fee (at 30%)	Cost to PIE of re-tendering as a percentage of average audit fee (at 2%)	Total cost, £
<b>Best Estimate</b>							
Banks and Building societies	441000	196	10%	8643600	2,593,080	172,872	2,765,952
PRA Insurers and syndicates	90000	440	10%	3960000	1,188,000	79,200	1,267,200
Large Listed companies	673000	990	10%	66,619,852	19,985,956	1,332,397	21,318,353
Small and medium listed companies	24,000	403	40%	3,869,820	1,160,946	77,396	1,238,342
							<b>26,589,847</b>

	Average non-Audit fee (estimates based on FAME data) £'s	number of PIEs	% of audit fee assumed would need reallocating	Value of non-audit services to be reallocated, £'s	Cost to Auditor of re-tendering as a percentage of average audit (at 30%)	Cost to PIE of re-tendering as a percentage of average audit (at 2%)	Total cost, £
<b>Low Estimate</b>							
Banks and Building societies	441000	196	5%	4321800	1,296,540	86,436	1,382,976
PRA Insurers and syndicates	90000	440	5%	1980000	594,000	39,600	633,600
Large Listed companies	673000	990	5%	33,309,926	9,992,978	666,199	10,659,176
Small and medium listed companies	24000	403	35%	3,386,092	1,015,828	67,722	1,083,549
							<b>13,759,302</b>

	Average non-Audit fee (estimates based on FAME data) £'s	number of PIEs	% of audit fee assumed would need reallocating	Value of non-audit services to be reallocated, £'s	Cost to Auditor of re-tendering as a percentage of average audit fee (at 30%)	Cost to PIE of re-tendering as a percentage of average audit fee (at 2%)	Total cost, £
<b>High Estimate</b>							
Banks and Building societies	441000	196	15%	12965400	3,889,620	259,308	4,148,928
PRA Insurers and syndicates	90000	440	15%	5940000	1,782,000	118,800	1,900,800
Large Listed companies	673000	990	15%	99,929,779	29,978,934	1,998,596	31,977,529
Small and medium listed companies	24000	403	45%	4,353,547	1,306,064	87,071	1,393,135
							<b>39,420,392</b>

**8. Key assumptions and risks:**

- The cost of reallocating non-audit services is largely proportional to the value of the services
- Reallocation of non-audit services will involve costs in line with those estimated for the re-tender of audit services.
- The audit and non-audit service fees at companies for which they are available are broadly representative of those at other companies of the same kind where the fees are not available.

## Annex D: Calculation of costs from new requirements on Audit Committees

### Additional Report to the Audit Committee

1. This requirement will impact auditors of PIEs, and will involve additional costs to the auditor of preparing the additional report for the audit committee. The information contained within the report is the result of the audit work itself, therefore there will be no additional costs relating to obtaining and collating the relevant information. Based on the text in the Regulation we assume that all PIEs will be required to prepare this additional report.
2. One of the Big 6 audit firms estimated that the time to prepare the report is about 10-15 hours and this would impact auditors of PIEs that currently do not apply the FRC's UK Corporate Governance Code.<sup>4</sup> They further suggest that for larger firms, the requirements would take single figure hours of additional auditor and audit committee time. For smaller PIEs, they estimated 5-6 hours of additional auditor time. They also suggested that audit committees would probably spend 2-4 hours of audit committee time for reading and discussing the report across all PIEs.
3. Comments on our consultation stage Impact Assessment noted that most of the reporting would already be done, suggesting less time might be required than we had assumed. Our revised assumptions are that it would take 15 hours of auditor time for large unlisted PIEs and 10 hours for small and medium unlisted PIEs. For listed PIEs, that do apply the UK Corporate Governance Code, we expect the additional time to prepare the report would be single figures (9 hours for a large company and 6 hours for small and medium companies). Our assumption on additional audit committee time is on average 3 hours across all PIEs.
4. Comments on our consultation stage Impact Assessment also suggested that the additional work was more likely to be undertaken by more senior staff than we had assumed. We have therefore changed our assumption on the level of audit firm staff that would be involved to be senior officials. Table D1 provides the calculations.

**Table D1: Additional Report to Audit Committee**

	Large unlisted PIE	Small and Medium Unlisted PIE	Large listed PIE	Small or medium listed PIE
Auditor Preparation and Presentation time (hr)	15	10	9	6
Hourly cost of senior official time (£)	66.24	66.24	66.24	66.24
Cost of Auditor time (£)	994	662	596	397
Debate and discussion time (hrs)	3	3	3	3
Number of Audit Committee members	4	4	4	4
Hourly Cost of Audit Committee time (£)	66	66	66	66
Cost of Audit committee time (£)	795	795	795	795
Number of PIEs	390	246	990	403
<b>Ongoing cost (£)</b>	<b>697,922</b>	<b>358,146</b>	<b>1,376,972</b>	<b>480,628</b>
<b>Total cost across all PIEs (£)</b>	<b>2,913,668</b>			

5. Our best estimate is **£2.91m**. High and low estimates have been provided as 20% above and below this central estimate reflecting the uncertainty around the assumptions of the time involved. These estimates may overstate the costs of producing the report, as electronic programmes and sample form reports could reduce the time take to prepare the reports. Therefore these should be viewed as conservative estimates of the impact on business.

<sup>4</sup> <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

## Appointment of an Audit Committee

6. The Regulation extends the scope of the requirement for a PIE to have an audit committee to all PIEs, beyond the existing coverage of listed PIEs. Credit institutions whose shares are not listed on a regulated market and if they issue debt securities on a regulated market of a total nominal amount below €100m, have been made exempt from this requirement. PRA advice is that most Banks and building societies would already have an audit committee. We therefore assume that the impact of the requirement to set up an audit committee would fall mainly on unlisted insurers. Based on internal analysis, the PRA estimates that up to 30% of lower impact insurers under what is now the EU “Solvency II” framework may not have an audit committee. There are currently 338 such insurers.
7. The requirement to set up an audit committee would also apply to the Lloyd’s market i.e. to the Society of Lloyd’s and the managing agents in respect of the syndicates for which they are responsible. The society of Lloyds already has an audit committee. There are currently 104 Lloyds of London syndicates managed by 59 managing agents which do not have audit committees. We therefore expect at least 59 audit committees would need to be set up to serve these syndicates.
8. To provide a range we assume that 20% - 30% of the 338 insurers would need to set up an audit committee along with 59 Lloyds Syndicate Managers. We therefore expect 127 – 194 PIEs would need to set up and audit committee, with a best estimate of 160.
9. Audit committees must have between 2 and 6 members<sup>5</sup>. For companies not in the FTSE 350, audit committees must consist of at least 2 independent members<sup>6</sup> to comply with the Regulation. We therefore assume that, at a minimum, these 160 PIEs would need to recruit two non-executive members.

### Estimating appointment costs of audit committees

10. The 2006 Impact Assessment estimates the cost of recruiting an independent member to be £10,000, with an on-going cost to the company of £15,000 per annum. We do not have any more up to date information regarding the cost of recruiting an independent member or chair therefore revert to the 2006 estimates, uplifted for inflation between 2006 and 2014. Tables D2 and D3 present the calculations.

2006 Audit Directive Impact Assessment estimates	£
Recruitment of independent member fees £	10000
Recruitment of independent chairperson fees £	15000
<b>Uplift factor using GDP deflator (2006 - 2014)</b>	
	1.198150056

**Table D3: Calculation of one-off appointment costs**

One-off Appointment Costs	number of persons	Low	Best	High
Cost of Appointment of chairperson (£)	1	17,972	17,972	17,972
Cost of Appointment of member (£)	1	11,982	11,982	11,982
Total cost of appointment per entity (£)		29,954	29,954	29,954
Number of firms now needing to establish an audit committee		127	160	194
<b>Total one-off cost of appointment across entities (£)</b>		<b>3,792,145</b>	<b>4,804,582</b>	<b>5,817,019</b>

11. A 2013 PWC report on non-executive director fees provides information on the fees for small and medium companies (SMC), reporting that the average fee paid by SMCs to their audit committee

<sup>5</sup> Institute of Internal Auditors best practice

<sup>6</sup> Audit Committee Institute, 'A Practical Guide – Shaping the UK audit committee agenda'; Spencer Stuart, 'UK Board Index 2013'



chairman is £6,000 and to other members is £5,000<sup>7</sup>. The report also estimates the base fee for a non-executive director at £40,000. We assume that the fees paid by unlisted insurers without audit committees fall between those paid by the FTSE 250 companies and those paid by SMCs which have audit committees. We use the PWC figures for these groups as the high and low estimate, a mid-point as the best estimate. Tables D4 and D5 provide the calculations.

**Table D4: Reported figures on non-executive director fees**

PWC 2013	FTSE 100	FTSE 250	SMC	Mid-point between FTSE 250 and SMCs
AC Chairman additional fees £	20000	10000	6000	8000
AC Member Additional Fee £	15000	5000	5000	5000
Non executive director base fee £	61000	46000	40000	43000

**Table D5: Calculation of ongoing costs to PIEs of audit committee members**

Ongoing Annual Costs	number of persons	Low	Best	High
Cost of chairperson (Non-executive director base fee + Audit Committee Chairman fee) (£)	1	46,786	51,872	56,957
Ongoing annual cost of member (Non-executive director base fee + Audit Committee member fee) (£)	1	45,769	48,821	51,872
Total Ongoing annual cost per entity (£)		92,556	100,693	108,829
Number of firms now needing to establish an audit committee		127	160	194
<b>Total Ongoing annual cost across entities £s</b>		<b>11,717,572</b>	<b>16,151,100</b>	<b>21,134,674</b>

## Scope of Audit Committee

12. The Regulation also adds additional requirements on all audit committees, impacting all PIEs, requiring additional meetings between auditors and audit committee members on an annual basis. The additional requirements include monitoring the financial reporting process, the internal quality control and risk management systems, the statutory audit and additional audit report and monitoring and reviewing the independence of the statutory auditors and the appropriateness of the provision of non-audit services to the audited entity. In addition the audit committee will be responsible for the procedure for the selection of statutory auditor(s). This will be dealt with below as part of the cost estimates for the requirement on re-tendering of audit services.
13. The EU Impact Assessment estimates that the additional requirements on audit committees will result in the need for 2-3 additional meetings per year. The UK already has a comprehensive framework on audit committees meaning that for UK companies the additional requirements would be lower. On this basis we estimate that between 1 and 2 additional meetings per year would be required.
14. We think it is appropriate to use charge-out rates for the cost of auditor time in the calculation of the impact of this particular measure, as the burden of these meetings of audit committees with auditors will fall to companies who will have to pay the auditor for their attendance. The FSA<sup>8</sup> estimate the charge out rate for an audit partner to be £711 per hour, and for an audit manager to be £400 per hour.
15. We therefore assume an average of 4 audit committee members. In practice they may not all attend the meeting, but for the purposes of this Impact Assessment we assume all four attend, along with the audit partner, audit manager and audit firm manager. Table D6 provides the hourly cost of additional meetings.

<sup>7</sup> This re-iterates more recent evidence from KPMG's Guide to Directors' Remuneration 2013, which finds that the average (median) fees paid by the FTSE 100 are £20,000 for an audit committee chairman and £15,000 for other audit committee members, whilst average fees paid by the FTSE 250 are £10,000 for an audit committee chairman and £5,000 for other committee members.

<sup>8</sup> FSA (2011) 'Market s and regulatory failures, benefits and costs' - <http://hb.betterregulation.com/external/Market%20and%20regulatory%20failures,%20benefits%20and%20costs.pdf>. We updated the figures of this document to 2014 prices for consistency with the other figures in the Impact Assessment.

**Table D6: Hourly costs of additional meetings**

<b>Data inputs</b>	<b>No of people</b>	<b>Cost per hour (£)</b>	<b>Total cost per hour (£)</b>
Audit Partner	1	711	711
Audit manager	1	400	400
Audited firm manager	1	38.85	39
Audit committee members	4	66.24	265
<b>Total cost per hour (£)</b>			<b>1,415</b>

16. Our initial estimates in the consultation stage Impact Assessment were that these meetings would be 5 hours each resulting in an additional 7.5 hours per PIE for these meetings. Comments by stakeholders on the consultation stage Impact Assessment include the suggestion that this is an overestimate of the additional time required as companies with existing audit committees would be able to fit a time extension within existing meeting schedules. We have therefore revised our calculations to estimate the costs to PIEs with established audit committees separately from those with newly appointed ones.
17. We estimated above that between 127 and 194 PIEs would need to set up an audit committee. We now assume that these would require 7.5 hours of additional meeting time while all other PIEs would require just two 2 hours.
18. Table D7 provides the calculation for the total cost of this requirement.

**Table D7: Calculation of costs from extension of scope of Audit Committee**

<b>Calculating cost of change</b>	<b>Low</b>	<b>Best estimate</b>	<b>High</b>
Number of hours	7.5	7.5	7.5
Cost per additional hour	1,415	1,415	1,415
No of PIEs affected	127	160	194
<b>Total (£)</b>	<b>1,343,361</b>	<b>1,702,014</b>	<b>2,060,668</b>

<b>Calculating cost of change</b>	<b>Low</b>	<b>Best estimate</b>	<b>High</b>
Number of hours	2	2	2
Cost per additional hour	1,415	1,415	1,415
No of PIEs affected	1902	1869	1835
<b>Total (£)</b>	<b>5,383,063</b>	<b>5,287,422</b>	<b>5,191,781</b>

<b>Total cost across all PIEs (£)</b>	<b>6,726,423</b>	<b>6,989,436</b>	<b>7,252,449</b>
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## Annex E: Regulatory Reporting and Information

### Regulatory Reporting and Information - Retaining and Disclosing Information

1. Auditor must under the new requirements also report to the competent authority on audit and non-audit revenues in respect of each PIE: this is not a current requirement. The EU Impact Assessment estimates that preparing a report on the revenues generated in respect of the audit of each PIE would take 8 hours of the auditors' time. As this would be a resource cost to the auditing firm in terms of time of a member of staff, we base our estimate on the hourly costs of an accountant using ASHE data (see Annex I). Our estimate is presented below in Table E1.

**Table E1: Costs of additional report to competent authority**

Number of PIEs reports required (1 per PIE)	2029
Time taken to prepare report (hrs)	8
Cost per hour of auditor (£)	29.37
Cost of preparing report per PIE	234.9
<b>Total cost (£)</b>	<b>476,657</b>

### Transparency Report

2. The requirements on the contents of the transparency report are largely unchanged and we do not anticipate any significant increase compared to the current cost of preparing the report. However, the requirement for a transparency report will now apply in respect of auditors of all PIEs, not just those that are listed. In the Impact Assessment on the 2006 Audit Directive we anticipated a cost to each auditor of preparing the transparency report to be £59,000. We used this as our estimate asking respondents to comment on whether this estimate was reasonable. One audit firm who commented on this agreed that it was a reasonable estimate.
3. From the FRC's latest research to inform its Audit Quality Review work we are also able to make more informed estimates of the number of PIE-auditors that would be new in scope as a result of the extension of the definition of PIEs. The FRC expects there to be a total of 55 auditors of PIEs (once banks building societies and Insurers are included in the definition of PIEs). This is an increase from 19 auditors of listed companies (those that had clients listed on regulated markets).<sup>9</sup> A prudent estimate of new in scope PIE auditors is therefore 36. The total cost is presented below in Table E2.

**Table E2: Cost of preparing a transparency report**

Cost of preparing Transparency report £	59,000
Number of new in scope auditors	36
<b>Total Cost (£)</b>	<b>2,124,000</b>

4. The total quantified cost of the regulatory reporting and information measures is therefore £2.60m per annum.

<sup>9</sup> Key Facts and Trends in the Accountancy Profession, FRC 2015. [https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Key-Facts-and-Trends-in-the-Accountancy-Profes-(1).pdf)

## Annex F: Appointment of Statutory Auditors or Audit Firms

The Regulation requires that the auditors of PIEs must be appointed via a competitive tender by the audit committee. PIEs would incur the costs of the re-tendering exercise when they invite tenders for their audits. This includes costs that would fall on the audit committee in terms of time taken in monitoring the tender for the selection of auditors as well as validation of the chosen audit firms and those other firms that tendered. There would also be costs to statutory auditors as they would have to bid for their existing appointment at 10 years if they wanted to continue as the auditor (as they might have done in the absence of the requirement). Auditors would also incur the cost of having to bid in competitive tenders for other potential PIE clients, when the maximum term of their existing appointment of 20 years is over.

### Appointment Requirements

The Regulation sets a maximum period of a PIE audit engagement at 20 years subject to retendering of the auditor appointment at 10 years. Both PIEs and their auditors would therefore have to be involved in a mandatory tendering exercise for statutory audits every 10 years.

The impact of the Regulation is the cost of this mandatory re-tendering exercise. We include the cost of this to PIEs (the cost of tendering for an auditor at year 10 and 20) and to auditors (the cost of bidding for their existing PIE at 10 years or another PIE at 20 years)<sup>10</sup>.

Based on information provided by their stakeholders, the European Commission Impact Assessment (EU IA) estimated that the cost to an auditor of tendering for the audit of a very large PIE (total turnover more than €40bn), at €5m-7m. The estimated cost to the PIE itself of the tendering process for a PIE of this size was reported in the EU IA as €400,000. For a large PIE (with a total turnover of more than €2bn) the estimates (based on stakeholder information) of costs to auditors was €1.06-1.08m and the cost to the PIE itself was €60,000-80,000. Linearly extrapolating on this information, we estimated tendering costs to auditors and PIEs for the EU IA's medium size category (i.e. with turnover between €50m-€2bn) to be €190,817 and €12,500 respectively<sup>11</sup>.

As costs of the tendering process can be expected to be directly related to the value of the audit service, we used the information provided by the EU IA to estimate this relationship. We used FAME data to calculate the average audit fee for each of these turnover size bands. We then used these size bands as three data points to estimate a linear relationship between average annual audit fee and the cost to auditors of bidding to provide the audit service<sup>12</sup>. We also estimated a linear relationship between average audit fee and the costs to PIEs of going through the tendering process for selection of auditor<sup>13</sup>. Table F1 provides the resulting retendering costs (based on our estimated relationship between tender cost and annual average audit fee) for the audit of PIEs with very large, large, medium and small turnover.

**Table F1: Annual Audit Fees and Costs of Tendering broken down for size of firm turnover**

Size of PIE turnover	Number of PIEs in turnover band	Average Annual Audit Fee £	cost of tender to PIE £	cost of tendering to auditor £
Very large turnover	14	18,535,083	365,277	5,490,331
Large turnover	253	2,895,942	57,186	868,965
Medium turnover	834	868,181	17,239	269,762
Small turnover	928	655,899	13,057	207,032
<b>Total/Average</b>	<b>2,029</b>	<b>1,146,306</b>	<b>22,718</b>	<b>351,947</b>

<sup>10</sup> In our estimate of 'auditor costs' we include the cost of just one tender per PIE every 10 years (any additional tendering by other audit firms is not considered an impact of the Regulation).

<sup>11</sup> EU IA estimates were converted from Euros to Sterling using Bank of England Annual Average Spot rate for 31 December 2011 and then inflated to 2014 prices.

<sup>12</sup> Our estimated relationship was: Cost of tendering to Auditor = 0.296 X Average Audit Fee + 13,235

<sup>13</sup> Our estimated relationship was: Cost of tendering to PIE = 0.0198 X Average Audit Fee + 135.72

## ***Number of PIEs affected***

There is an exemption from the prescribed appointment procedure (of tendering before the reappointment or rotation of auditors) under the Regulation. The exemption applies to both of the following groups of PIEs:

1. Entities falling under the definition of a “small and medium enterprise” in Article 2(1)(f) of the Prospectus Directive - Companies that are small and medium sized, in that, according to their last annual or consolidated accounts, they meet at least two of the following three criteria:
  - an average number of employees during the financial year of less than 250;
  - a total balance sheet not exceeding €43,000,000; and,
  - an annual net turnover not exceeding €50,000,000.
2. Entities with “reduced market capitalisation”, meaning a company listed on a regulated market that had an average market capitalisation of less than €100,000,000 on the basis of end-year quotes for the previous three calendar years.

We applied the thresholds on the data available on the estimated 2,029 existing PIEs. Most of those exempted were exempted because they were small and medium enterprises under the definition above. We estimate that 745 PIEs would benefit from this exemption and 1,284 would have to meet the requirements<sup>14</sup>.

Retendering at least once every 10 years is already a requirement for those UK companies in the FTSE 350 following the introduction of the order by the CMA in 2014 on mandatory retendering of auditor appointments. There would be no additional impact on these PIEs and they are excluded from the number of companies affected by the Regulation requirements. We also exclude our estimate of the number of PIEs that meet the exemption criteria (a total of 764). We therefore estimate that 984 PIEs are in scope of the requirement (i.e. 2,029 less the 281 companies in the FTSE 350 that are already subject to this requirement and the 764 that are exempted).

It should also be noted that some reappointments of auditors would occur anyway within a 10 year period. However, given the difficulty of estimating the frequency of reappointments of auditors across the different types and sizes of companies involved we have excluded this from the analysis.

Table F2 shows our estimate of number of companies affected in each category of turnover. The total number of companies affected by the requirement is estimated to be 984.

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<sup>14</sup> There are two main caveats to the analysis. Firstly, we had incomplete data on PIEs (data was not available on all criteria required to meet exemption thresholds) therefore extrapolations had to be done for companies with incomplete no data. The second caveat is that we only have data, through the FAME database, available on market capitalisation in the last year to estimate the number of companies eligible for exemption through the “reduced market capitalisation” criterion. We therefore assume that the market capitalisation of these companies has been at similar levels in the past two years before the latest year’s data.

**Table F2: Estimating number of PIEs retendering every 10 years due to the Regulation**

	Total Number of PIEs	Number of PIEs on FTSE 350	Estimated Number exempted	Total number of PIEs affected
<b>Very large turnover</b>	14	10	0	4
<b>Large turnover</b>	253	105	0	148
<b>Medium turnover</b>	834	161	91	582
<b>Small turnover</b>	928	24	654	250
<b>Total</b>	<b>2,029</b>	<b>300</b>	<b>745</b>	<b>984</b>

Based on the above assumptions and estimates of the number of companies affected, we calculate the total cost of the mandatory re-tender every 10 years for PIEs in each size band. Given that all PIEs would not be out to tender at the same time, the cost is divided by 10 to get an annual average cost across the population. Table F3 provides our estimate of the annual average cost of PIEs appointing auditors through the mandatory tendering process every 10 years under the Regulation.

**Table F3: Total costs of mandatory retendering**

	Cost of retender to PIE £	Cost of retender to audit firm £	Total number of PIEs affected	Average annual cost of mandatory tender (£)
Very Large turnover	365,277	5,490,331	4	2,342,243
Large turnover	57,186	868,965	148	13,747,725
Medium turnover	17,239	269,762	582	16,706,559
Small turnover	13,057	207,032	250	5,497,317
<b>Total cost across all firms</b>			<b>984</b>	<b>38,293,845</b>

### **Additional Familiarisation Costs**

There will be additional costs to the auditor taking up a new appointment, from needing to familiarise themselves with a new company. Analysis by the CMA found the additional staff time in the first year of a new appointment to be 24.3% higher than that of the previous auditor. One respondent to our earlier consultation suggested that the additional familiarisation costs would be in the range of 10-15% of the total cost of doing the audit in the first year. We therefore assume the additional cost in the first year to range between 10-30% of the cost of the audit.

To estimate the cost of the audit we use the CMA's estimated 'average engagement profitability' from audit engagements between 2006 and 2011. The period average for non-FTSE350 firms is estimated at 60%<sup>15</sup>. We apply this to average audit fees to estimate the cost of the audit to the auditor. Our low high and best estimates of familiarisation costs to auditors as a percentage of the cost of the audit are 10%, 30% and 20%. We use these to estimate the additional familiarisation cost of new appointments.

Given that the auditor could be reappointed at year 10 to avoid these costs, we assume that it would be an imposed cost only at year 20 (when a new auditor would have to be appointed). Spread over a 20 year period this comes to an annual average of £6.72m. Table F5 provides the results.

<sup>15</sup> Table 2, page 638 of the document at [https://assets.digital.cabinet-office.gov.uk/media/5329db3740f0b60a73000027/131016\\_final\\_report\\_appendices\\_glossary.pdf](https://assets.digital.cabinet-office.gov.uk/media/5329db3740f0b60a73000027/131016_final_report_appendices_glossary.pdf)

**Table F4: Estimating familiarisation costs to new auditors**

Size of Company turnover	Number of PIEs in turnover band	Average Annual Audit Fee £	Cost to auditor assuming profitability of 60% £	Additional familiarisation cost to a new auditor £		
				Low (10% )	best (20%)	high (30%)
Very large turnover	4	18,535,083	7,414,033	2,965,613	5,931,227	8896840
Large turnover	148	2,895,942	1,158,377	17,194,881	34,389,761	51584642
Medium turnover	673	868,181	347,273	23,366,133	46,732,266	70098399
Small turnover	904	655,899	262,360	23,709,790	47,419,581	71129371
Total/Average	1,729			67,236,417	134,472,835	201,709,252
<b>Annual average over a 20 year period</b>				<b>3,361,821</b>	<b>6,723,642</b>	<b>10,085,463</b>

Note that as the exemptions are only for the prescribed retender exercise rather than the requirement to appoint a new auditor every 20 years; all PIEs excluding those on the FTSE 350 have been included for the additional familiarisation costs estimated here. The total number of PIEs affected by the costs is therefore 1,729.

Our estimate of total annual cost of mandatory rotation and tendering for auditors is between **£41.66m - £48.38m**, with a best estimate of **£45.02m per annum**.

## Annex G: Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit

### Competent Authority - Delegation of inspections

1. No costs were anticipated for this in the European Commission's Impact Assessment. However in the UK context we do not think this is reasonable. This is because of two effects of changes to the audit inspection regime of the FRC as competent authority with ultimate responsibility for audit regulation:
2. In future auditors of all PIEs will be required to be inspected by the FRC under the Regulation. This will significantly limit the FRC's use of its current ability to delegate inspections of some auditors to the professional supervisory bodies.
3. Inspections will also be required for auditors of all PIEs. Currently audits of all listed entities and banks and of some unlisted insurers are subject to FRC inspection. In future audits of all unlisted insurers will be brought within scope.
4. The FRC currently delegates inspections of 34 - 36 audit firms conducting 'major audits' of banks, insurers or listed companies to the professional bodies. Inspection of these is required once every 3 years and FRC estimates each of their inspections to cost between £30,000 and £40,000 (best estimate £35,000). There will be some reduction in the costs of RSB inspections as a result, although this would be small as they would still need to carry out monitoring on non-PIE work.
5. Table G1 below reports FRC estimates of different types of inspection costs per firm.

**Table G1: FRC estimates of inspection costs**

	£
<b>Estimated cost of FRC Inspections</b>	30,000
<b>Savings to RSBs of not having to inspect PIE audits</b>	2,000
<b>Estimated cost of inspection visits to auditors of small non-PIEs by RSBs</b>	3,000
<b>Estimated cost of desk inspections</b>	1,500

6. Table G2 shows our calculation of the cost of having these inspections done by the FRC.

**Table G2: Costs of Inspections of Major audits currently delegated**

	low	best	high
Number of investigations currently delegated	34	35	36
Cost of inspections less Savings to professional bodies £	28,000	33,000	38,000
Cost of FRC inspections £	952,000	1,155,000	1,368,000
Inspection done every 3 years - so average annual cost £	317,333	385,000	456,000

7. This cost will be mitigated to some extent by a new provision in the Regulation allowing auditors of PIEs to only be inspected once every 6 years where all of the PIEs audited are SMEs (discussed below). However this is on the basis that the frequency of inspections should be set in proportion to the risks arising from that auditor's audits.
8. Currently audits of all listed entities and banks and of some unlisted insurers are subject to FRC inspection. In future audits of all unlisted insurers will also be brought within scope. FRC estimate that a further 10 to 12 audit firms that would be brought into scope of FRC inspections as a result.
9. The calculations of the costs to these are shown in Table G3.



**Table G3: Additional Inspections of Auditors brought into scope**

	low	best	high
Number of auditors new in scope	10	11	12
Cost of inspection £	28,000	33,000	38,000
Total cost £	280,000	363,000	456,000
<b>Inspection done every 3 years - so average annual cost £</b>	<b>93,333</b>	<b>121,000</b>	<b>152,000</b>

10. This cost is also likely to be mitigated to a significant extent by the new provision in the Regulation allowing auditors of PIEs to only be inspected once every 6 years where all of the PIEs audited are SMEs (discussed below).

### ***Reduction in Frequency of Inspections for non-PIE Audit Firms***

11. For non-PIEs, the existing requirement that each audit firm must be subject to inspection at least once every 6 years will no longer apply for auditors only of small companies. Instead the frequency of these inspections of auditors would be determined on a risk basis. The FRC expect that the frequency of inspections for such firms would reduce from 6 to 8 years, which would result in a saving.
12. To estimate the size of this saving we took advice from the FRC. Currently 65% of all firms have personal inspection visits that cost £30,000-40,000 every 6 years (see Table G1 above). The FRC anticipate that about 5-15% of these would be moved to having inspection visits every 8 years instead. There are 6,635 audit firms in the UK. 4,313 (65%) of these currently have personal inspection visits every 6 years. We expect between 216 and 647 (with a best estimate of 431) to be moved to inspections every 8 years. Our best estimate of total savings across all firms is about £54,000 (based on a saving per firm of £125). See Table G4 below for the calculations.
13. It should be noted that the calculations include LLP audits and the estimated saving would be smaller if LLP audits were excluded from the new surveillance regime. As the Directive does not automatically apply to LLPs, reductions in the frequency of inspections would not apply automatically to auditors of small companies that also audit any LLPs. The estimated saving per firm is £125, but is not possible to estimate how many audit firms audit only small companies including LLPs and therefore it has not been possible to estimate the difference there would be to savings under option 1 (where the savings do not apply to auditors of LLPs) and Option 2 (where all 431 auditors are expected to benefit).
14. 35% of audit firms currently have desk-based inspections. These too are expected to be reduced from every 6 years to every 8 years. “Desktop visits” are made to firms with no audit clients and are less costly than personal inspection visits to the firm. The FRC’s estimate of the cost of desktop monitoring is £1,500 per firm (see Table G1 above). The total number of firms estimated to benefit from the reduction in frequency of desk inspections is 35% of 6,635 (i.e. 2,322).
15. The estimated savings to auditors of the reduction in frequency of each type of inspection are calculated and shown in Table G4.

**Table G4: Savings to Auditors of small PIEs**

<b>Personal Visit Inspections</b>	<b>Low</b>	<b>Medium</b>	<b>High</b>
<b>Total cost of inspection (£)</b>	3,000	3,000	3,000
<b>Annual average cost to firm of once every 6 years</b>	500	500	500
<b>Annual average cost to firm of once every 8 years</b>	375	375	375
<b>Saving from reduction in frequency per firm (£)</b>	125	125	125
<b>Total firms having visits (65% of total)</b>	4,313	4,313	4,313
<b>Of these, estimated percentage moving to 8 years</b>	5%	10%	15%
<b>Number of firms to benefit</b>	216	431	647
<b>Total Value of benefit across all firms</b>	<b>26,955</b>	<b>53,909</b>	<b>80,864</b>

<b>Desktop Inspections</b>	<b>Low</b>	<b>Medium</b>	<b>High</b>
<b>Total cost of inspection (£)</b>	1,500	1,500	1,500
<b>Annual average cost to firm of once every 6 years</b>	250	250	250
<b>Annual average cost to firm of once every 8 years</b>	188	188	188
<b>Saving from reduction in frequency per firm (£)</b>	63	63	63
<b>Total firms having desk based inspections</b>	2,322	2,322	2,322
<b>Total Value of benefit across all firms</b>	<b>145,141</b>	<b>145,141</b>	<b>145,141</b>

<b>Total Savings</b>	<b>172,095</b>	<b>199,050</b>	<b>226,005</b>
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16. Our best estimate of the saving from this change is **£199,000**. As noted above, the total saving is likely to be less than this when LLP audits are excluded from the application of the Directive, but it is not possible to quantify this.

### ***Competent authority – Delegation framework***

17. Other changes brought in as part of the implementation of this framework would not be expected to represent a significant cost. They represent a modest shift in the regulatory framework that forms the basis for the operation of the FRC:

- setting up framework in which FRC has some current RSB functions but delegates them to those RSBs where permitted; and,
- moving away from the framework in which independent standards, inspections and investigations and discipline are delivered by an unnamed independent body towards a clear FRC framework.

18. These changes would not result in a significant difference in the operation of the FRC and the professional bodies under the framework within which they work. However the structure of that framework would change. There is a possibility that some specific familiarisation costs might result for auditors but for the purposes of this Impact Assessment we have included those in the general familiarisation costs evaluated above.

### ***New powers for FRC to obtain information from 3rd parties***

19. The FRC is currently the body responsible for investigation and discipline of auditors in public interest cases, though without statutory powers to obtain information from third parties. These third parties might be the audited company, its staff or former staff, companies in the same group, companies with which that company contracts or has contracted etc.

**20.** These new powers would provide a framework of cooperation with the FRC (relation to audits of PIEs) with a statutory footing. As existing levels of cooperation are high we would not expect these powers to be used often. However their availability is a significant enhancement in available powers, should they be needed. Where these powers are used, we would not expect this to result in significant additional burdens as in most cases compliance would previously have followed voluntarily.

## Annex H: Ethical Standards – Auditor Independence In Relation to Group Audits

1. This relates to changes in requirements on UK auditors to verify the independence of auditors that are outside the EU who provide information on subsidiaries or branches in those jurisdictions which is then used in group audits.
2. The cost of these changes was assumed to be negligible in the consultation stage Impact Assessment. Based on further discussions with the FRC during the consultation period we now estimate that the change would result in 5 additional hours of audit partner time when auditing non-EU international groups or companies or groups with non-EU branches. It would therefore result in on-going, additional costs to all cross-border group auditors (including non-PIEs), with a subsidiary outside the EU, or more specifically, outside the scope of implementation of the Directive<sup>16</sup>. Even where other countries are involved, if the auditing standards of those countries are comparable to those implemented by the Directive, no additional costs are expected to fall on UK auditors from this requirement.
3. Because of the varying international coverage of this type of requirement in national auditing standards, it is not possible to quantify this cost. To estimate the cost of the change we would need to estimate how many group audits a year would be in scope i.e. how many group audits in a year are cross-border groups that include companies in countries that are not subject to the Directive (i.e. EU member States and others in the EEA that sign up to the Directive, or other non-EU countries where UK Standards are applied) and whose auditing standards are not comparable to those imposed by the Directive.
4. FAME data estimates that there were 1.2m audits in the last year and that 21,035 (or 2%) of these were group audits (excluding LLPs).
5. Given the large number of entities it was not considered proportionate to analyse all of the group member companies for country of incorporation. Thus we are unable to estimate how many could be in scope; however, for those affected, it is estimated to cost £331 per group audit (£66.24 X 5 hours).

### Option 2

6. For the assessment of additional costs imposed by this measure under Option 2, which extends the Directive requirements to LLPs, we further examined the data available on FAME for the 497 LLP group audits where components of the group are not subject to EU law or UK standards. This showed that 87 (17.5%) are international groups that have subsidiaries in countries where the Directive would not apply.
7. On this basis of this information the additional cost of this requirement when including LLP audits is estimated to be around £28,814 per annum (£66.24 X 87 audits X 5hrs). As noted above, groups with members in countries that have standards comparable to those of the Directive are also not expected to incur further costs, but it has not been possible to estimate how many of these there would be, in order to exclude them from the calculation. Thus, as an order of magnitude, we expect the additional costs under Option 2 to be around £29,000.
8. As this cost equates to zero when rounded to the nearest £100,000, following Better Regulation Executive advice, we have not deemed it reasonable to quantify further and have assumed it to be negligible.

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<sup>16</sup> The burden only arises for firms auditing subsidiaries of the group outside of the EU because within the EU, domestic law will undertake the subsidiary's own auditor to undertake this exercise (assuming it is subject to full audit which it probably will be under EU law and if it is substantial enough to affect the group accounts).

## Annex I: Hourly wage cost data used in the Impact Assessment

- Throughout the Impact Assessment, staff time costs are estimated based on hourly pay, excluding overtime, provided by the Annual Survey of Hours and Earnings (ASHE) 2014 provisional results Table 14.6a.<sup>17</sup> The survey takes a sample of employee jobs drawn from HMRC records of gross pay before tax, National Insurance or other deductions. These data were then uplifted by 19.8% to reflect non-wage costs (i.e. National Insurance, pension contributions, other payroll taxes and other non-statutory employee services such as transport and canteen provision) using Eurostat data on non-wage costs for the UK in 2014.<sup>18</sup> Table I1 below outlines the hourly wage rates deployed in the Impact Assessment before and after being uplifted for non-wage labour costs.

**Table I1: Wage costs based on median hourly wage data**

Standard Occupational Classification	Hourly Wage £	Uplift for non wage costs	Total cost per hour £
Accountant	19.42	1.198	23.26
Chief Executives and Senior officials	38.33	1.198	45.90
Administrative and Secretarial	10.12	1.198	12.12
Corporate Managers and Directors	20.74	1.198	24.84

- Table I1 provides the median hourly wages (rather than the mean) because this is the preferred measure of earnings as it is less affected by a relatively small number of very high earners and the skewed distribution of earnings. It therefore gives a better indication of typical pay than the mean.
- However, the main response on our consultation Impact Assessment from stakeholders was that the median wage rate we used would greatly underestimate cost of staff time in the case of PIEs and their auditors. To reflect this we have revised our best estimates of the time costs of auditors of PIEs (as these would be larger auditors) using hourly wage costs of the relevant Standard Occupational Classifications (SOCs) in the 75<sup>th</sup> percentile of the ASHE data. This is provided in Table I2.

**Table I2: Wage costs based on 75th percentile of hourly wage data**

Standard Occupational Classification	Hourly Wage £	Uplift for non wage costs	Total cost per hour £
Accountant	24.52	1.198	29.37
Chief Executives and Senior officials	55.31	1.198	66.24
Administrative and Secretarial	12.82	1.198	15.35
Corporate Managers and Directors	32.44	1.198	38.85

- Throughout the Impact Assessment we use the 75<sup>th</sup> percentile wage data for our central estimates of the staff time costs for PIEs and their Auditors. For hourly costs of auditors of non-PIEs we use median wages as our central estimate of hourly staff costs and the 75<sup>th</sup> percentile of the same SOC as the upper bound estimate of time costs. This is to reflect the fact that a large proportion of

<sup>17</sup> <http://www.ons.gov.uk/ons/re/ashe/annual-survey-of-hours-and-earnings/2014-provisional-results/2014-provisional-table-14.zip>

<sup>18</sup> [http://epp.eurostat.ec.europa.eu/statistics\\_explained/index.php?title=File:Labour\\_costs\\_per\\_hour\\_in\\_EUR](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Labour_costs_per_hour_in_EUR).

these would be smaller auditors and have smaller wage costs than the larger auditors expected to audit PIEs.