

EXPLANATORY MEMORANDUM TO
THE STATUTORY AUDITORS AND THIRD COUNTRY AUDITORS
(AMENDMENT) (EU EXIT) REGULATIONS 2020

2020 No. 108

1. Introduction

- 1.1 This Explanatory Memorandum has been prepared by the Department for Business, Energy and the Industrial Strategy and is laid before Parliament by Command of Her Majesty.
- 1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

- 2.1 This instrument continues the process of addressing failures of retained EU law to operate effectively and other deficiencies arising from the withdrawal of the United Kingdom (UK) from the European Union (EU). This is intended to ensure that the frameworks for regulatory oversight and professional recognition of statutory auditors and third country auditors in the UK work effectively following the UK's withdrawal from the EU. These parts of the instrument, with the other changes to the relevant frameworks, will come into force at the end of the implementation period. This is consistent with the withdrawal agreement between the UK and the European Union. The instrument also implements developments in EU law and makes sure that the UK's domestic implementation of EU law works effectively.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 This instrument uses powers under section 2(2) of the European Communities Act 1972 for the following purposes:
- to implement Commission Implementing Decision (EU) 2019/1874 of 6 November 2019 on the adequacy of the competent authorities of the People's Republic of China pursuant to Directive 2006/43/EC of the European Parliament and of the Council ("the Commission Implementing Decision on China" (OJ No. L 289, 8.11.2019, p. 55) – the relevant amendments are in regulation 15(2)(c));
 - to give effect to the ending of the adequacy of the competent authorities of Indonesia and South Africa in Article 3 of the Commission Implementing Decision (EU) 2016/1010 of 21 June 2016 on the adequacy of the competent authorities of certain third countries and territories pursuant to Directive 2006/43/EC of the European Parliament and of the Council ("the previous Commission Implementing Decision on adequacy" (OJ No. L 165, 23.6.2016, p. 17) - the relevant amendments are in regulation 15(2)(a) and (b));
 - to amend the implementation of: Articles 2(16), 22(1) and (6) and 27(1) and (3) of Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts

("the Audit Directive" (OJ No. L 157, 9.6.2006, p. 87) as amended by Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (OJ No. L 158, 27.5.2014, p. 196) - see regulations 15(3) and 17); and,

- to amend the implementation of Article 18(1)(b) of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings ("the Accounting Directive" (OJ No. L 182, 29.6.2013, p. 19) - see regulation 16).

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

- 3.2 The territorial application of this instrument includes Scotland and Northern Ireland.
- 3.3 The powers under which this instrument is made cover the entire United Kingdom (see section 1299 of the Companies Act 2006; and section 19 of the Limited Liability Partnerships Act 2000). The territorial application of this instrument is not limited either by these Acts or by this instrument.

4. Extent and Territorial Application

- 4.1 The territorial extent of this instrument is the United Kingdom.
- 4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

- 5.1 The Minister for Small Business, Consumers and Corporate Responsibility at the Department for Business, Energy and Industrial Strategy, Kelly Tolhurst, has made the following statement regarding Human Rights:

"In my view the provisions of The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020 are compatible with the Convention rights."

6. Legislative Context

- 6.1 The Audit Directive sets out requirements on the statutory audit of certain businesses that are required to be audited under EU law. It also sets out the responsibilities of the competent authorities of member States for regulation of statutory audit, including audit inspections, investigations and enforcement, and requirements as to the registration of auditors. In the UK the competent authority is the Financial Reporting Council (FRC), which has ultimate responsibility for monitoring and inspections, investigations and sanctioning of auditors. Article 14 of the Audit Directive provides for the automatic recognition of the qualification and approval of an auditor from another EEA State subject, where necessary, to passing an aptitude test or successfully completing an adaptation period.
- 6.2 Article 45 of the Audit Directive provides for the regulation of auditors of companies from outside the EEA, where those companies issue securities that are admitted to trading on the regulated market of an EEA State ("third country auditors"). It requires that these auditors are registered and regulated in the EEA state in which the regulated market is based and the securities traded. The Statutory Auditors and Third Country

Auditors (Amendment) (EU Exit) Regulations 2019 (SI 2019/177) as amended by the Statutory Auditors, Third Country Auditors and International Accounting Standards (Amendment) (EU Exit) Regulations 2019 (SI 2019/1392) (“the first audit regulations” and “the second audit regulations” respectively, and collectively “the EU exit audit regulations”) made amendments to the framework for registration and regulation of third country auditors in the UK. They will apply in combination with an amendment by the Financial Conduct Authority to its Disclosure and Transparency Rules. One of the main effects of the changes will be to include EEA auditors in the requirement for registration and regulation of third country auditors when they audit EEA or third country issuers whose securities are traded on UK regulated markets.

- 6.3 Article 46 of the Audit Directive allows the requirements on the registration and regulation of third country auditors to be disapplied, in whole or in part, subject to certain conditions, where a registered third country auditor is subject to a system of regulation which is determined to be "equivalent" to that required by the Directive. The EU exit audit regulations provided new powers for the Secretary of State to grant equivalence of third countries' audit regulatory regimes for this purpose via a new power, inserted as section 1240A of the Companies Act 2006. Section 1240A also enables the Secretary of State to make provision for the grant of equivalence to a third country. Such provision may include: specifying the procedure for assessing the audit regulatory regime of the third country and granting approval; setting out considerations which must or may be taken into account; setting out a list of third countries that have been granted approval; and making provision for the amendment, suspension or withdrawal of approval. It was intended that considerations to be taken into account would reflect those set out in Article 46 of the Audit Directive.
- 6.4 Article 47 of the Audit Directive allows member States to transfer, or permit the transfer, of audit working papers and investigation reports to a third country competent authority for audit, only where a number of conditions have been met. These usually include that the Commission has determined that the relevant third country competent authority has "adequate" requirements as regards the confidentiality of information transferred. A third country competent authority's adequacy status is granted by the Commission once it has made an assessment of the legal framework applied in the relevant third country, and of undertakings given by the third country competent authority on the handling and use of information transferred. The list of third country competent authorities granted adequacy status is in section 1253D of the Companies Act 2006 and includes some authorities whose status is time limited in EU law. When an authority's status changes, it is added to the list, or removed, by amendment under section 2(2) of the European Communities Act 1972. Meanwhile Article 36 of the Audit Directive applies to the handling of audit regulatory information by EEA competent authorities and the transfer of that information between them. It provides for the confidentiality of that information with exceptions to allow the transfers provided for. The basis for an assessment of adequacy of a third country competent authority under Article 47 of the Audit Directive is that it is subject to arrangements that achieve comparable outcomes to those required under Article 36 of the Audit Directive in the EEA States.
- 6.5 The first audit regulations amended the framework that had implemented both Articles 36 and 47 of the Audit Directive in order to treat EEA States and third countries in the same way. Transfers of audit working papers and investigation reports will continue to be on the basis of working arrangements following a determination of the adequacy of the relevant third country competent authority, including of an EEA

competent authority. However, this determination would be made by the Secretary of State in regulations under new section 1240B of the Companies Act 2006. As with section 1240A, section 1240B enables the Secretary of State also to make provision for the grant of adequacy status. Such provision may include: specifying the procedure for assessing the competent authority and granting approval; setting out considerations which must or may be taken into account; setting out a list of competent authorities that have been granted approval; and making provision for the amendment, suspension or withdrawal of approval. It was intended that considerations to be taken into account would reflect the requirement in Article 47 of the Directive that an adequate competent authority must be subject to arrangements achieving comparable outcomes to those under the implementation of Article 36 of the Audit Directive. The list of adequate third country competent authorities was moved by the first audit regulations from section 1253D of the Companies Act 2006 to Table 3 in Schedule 2 to those regulations so that it can easily be amended by the Secretary of State in future. That Table will also include the competent authorities of EU member States on a time-limited basis.

- 6.6 The EU exit audit regulations also made the following changes to the frameworks in Part 42 of the Companies Act 2006 on the equivalence of third countries and the adequacy of their competent authorities:
- The first audit regulations included provision on the FRC's power to disapply registration and regulatory requirements which would otherwise apply to a third country auditor on the basis of the equivalent or transitional status of the country in which their client business is incorporated. For equivalent third countries or those granted a transitional period under the equivalence framework, including the EEA States and Gibraltar, the intention was that the FRC would continue with the approach in its existing direction issued under section 1239(7) and 1242(4) of the Companies Act 2006. The FRC's direction disapplies certain registration and regulatory requirements to auditors of companies incorporated in those countries that issue securities admitted to trading on the UK's regulated markets. During the transitional period provided for the EEA States and Gibraltar, this would also apply to them.
 - The first audit regulations also brought the effects of the existing Decisions and Implementing Acts of the European Commission on the equivalence of third countries, and the adequacy of their competent authorities, into UK law. Equivalence status is granted to any third countries that were granted equivalence in relation to the EU by the European Commission before exit day. In the same way adequacy status is granted to any third country competent authorities that were granted adequacy by the European Commission. Schedules 1 and 2 provide a single standard implementation of all determinations of equivalence and adequacy in UK law. This replaces previous different approaches for implementing equivalence and adequacy determinations by the European Commission in UK law, which will apply up to the end of the implementation period.
- 6.7 The Government has always planned that legislation would follow in due course to provide a framework for the determination of the equivalence of third countries and the adequacy of their competent of authorities using the powers provided in sections 1240A and 1240B of the Companies Act 2006. The second audit regulations commenced the powers at sections 1240A and 1240B into the Companies Act 2006 so that those powers could be used to set out the framework for determination of the

equivalence of third countries and the adequacy of their competent authorities in full in later regulations.

- 6.8 Article 37 of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings (“the EU Accounting Directive”) (OJ No. L 182, 29.6.2013, p. 19) provides a member State option to exempt subsidiaries from preparing and publishing accounts and having them audited. Sections 479A to 479C of the Companies Act 2006 implement part of this option by providing an exemption from audit for companies that are subsidiaries of UK and EEA parent undertakings. These sections are applied to Limited Liability Partnerships (LLPs) by regulation 34A of the Limited Liability Partnerships (Application of the Companies Act 2006) (Accounts and Audit) Regulations 2008 (SI 2008/1911). The exemption is not made available to subsidiaries of third country parent undertakings.
- 6.9 The second audit regulations made amendments to the subsidiaries audit exemption so that it will only be available to subsidiaries of UK parent undertakings. However, the effect of the amendment made by the second audit regulations was this change to the audit exemption will apply in respect of all accounts published and filed at Companies House after commencement of the amendments, irrespective of the financial year to which the accounts relate. This instrument clarifies that this change will only apply to financial years beginning on or after commencement.
- 6.10 The Explanatory Memorandum relating to the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019 can be found here:
<http://www.legislation.gov.uk/ukxi/2019/177/memorandum/contents>
The Explanatory Memorandum relating to the Statutory Auditors, Third Country Auditors and International Accounting Standards Regulations (Amendment) (EU Exit) Regulations 2019 can be found here:
<http://www.legislation.gov.uk/ukxi/2019/1392/memorandum/contents>
- 6.11 The effect of Schedule 5 to the European Union Withdrawal Agreement Act 2020 is that the above instruments, like the related parts of this one, will now come into force at the end of the implementation period (“IP completion day”). That period is now in place under the UK’s withdrawal agreement with the European Union. Work is continuing during that period to make sure the UK will have a functioning statute book after its conclusion.

7. Policy background

What is being done and why?

- 7.1 Regulation 3 of this instrument makes the following changes to the effect of Schedule 2 to the first audit regulations based on assessments of the adequacy of third country competent authorities by the CEAOB on behalf of the European Union. These assessments of the authorities’ arrangements for the handling of audit working papers and investigation reports have been completed during the period from the original planned exit day of 29 March until now:
- This instrument grants the competent authorities of the People’s Republic of China provisional adequacy status from the end of the implementation period until 31 November 2024. This is the subject of a Commission Implementing Decision on China, which was published this year by the European

Commission after it was voted in favour of by EU Member State representatives. For the period up to the end of the implementation period this is implemented by regulation 15(2), which inserts references to the two audit competent authorities in the Peoples' Republic of China into section 1253D to the Companies Act 2006. The amendment to section 1253D comes into force 21 days after this instrument is made.

- This instrument provides the South African competent authority with a period of provisional adequacy from the end of the implementation period to 31 July 2022. We understand the European Commission has accepted the CEAOB's recommendation to implement a similar period of provisional adequacy. This is expected to be subjected to a vote of Member State representatives over the coming months. If the extended period is approved, an implementing decision will follow. As the previous adequacy period in EU law has already expired, it makes sense for the UK to put in place a renewed period as from the end of the implementation period, though there will be an intervening period, from 21 days after this instrument is made until the end of the implementation period, in which the South African competent authority will not be adequate in the UK. Regulation 15(2) removes the reference to the South African competent authority from the list in section 1253D to the Companies Act 2006 because its period of adequacy under the previous Commission Implementing Decision on adequacy came to an end on 31 July 2019.
- This instrument removes Indonesia's competent authority from the list of authorities having provisional adequacy status. We understand the European Commission has accepted the CEAOB's recommendation that the Indonesian competent authority's period of provisional adequacy, which has already expired in EU law and under the first audit regulations, should not be renewed. Again, regulation 15(2) removes the reference to the Indonesian competent authority from the list in section 1253D to the Companies Act 2006 because its period of adequacy under the previous Commission Implementing Decision on adequacy also came to an end on 31 July 2019. This applies from 21 days after this instrument is made.

- 7.2 Regulation 4 of this instrument inserts an additional transitional provision into Schedule 4 to the first audit regulations, applying to the amendments those Regulations make to the subsidiaries audit exemption. The exemption is currently available to subsidiaries of UK and EEA parent undertakings as provided for in EU law. The intended effect of the transitional provision is that it will continue to be available to those subsidiaries where their financial years have already begun before commencement of the amendment. The removal of the exemption for subsidiaries of EEA parent undertakings will then only apply for financial years beginning on or after the day after the end of the implementation period. The transitional provision is needed to enable subsidiaries of EEA parent undertakings to file unaudited accounts with Companies House on or after it comes into force for financial years that began before the end of the implementation period.
- 7.3 Part 3 of this instrument (regulations 5 to 14) introduces an assessment framework for the equivalence of third countries' audit regulatory frameworks and the adequacy of third country competent authorities' arrangements for the handling of audit working papers and investigation reports. It enables determinations of equivalence and adequacy by the Secretary of State on a basis similar to that under Articles 46 and 47 of the Audit Directive and setting out comparable criteria. While the final

determinations of equivalence and adequacy will be made by the Secretary of State, these may be informed by assessments by the Financial Reporting Council (FRC), or by, or on behalf of, other countries' competent authorities whose own audit regulatory frameworks are equivalent. Assessment of the equivalence of third countries' audit regulatory frameworks is considered in chapter 1 of Part 3 (regulations 5 to 9).

Assessment of the adequacy of third country competent authorities' arrangements for the handling of audit working papers and investigation reports is considered in chapter 2 of Part 3 (regulations 10 to 14). This framework commences 21 days after this instrument is made as it only applies for the purpose of determining how the Secretary of State will usually reach a determination of equivalence or adequacy, which will then require further regulations to put into place.

7.4 Regulations 15 to 17 make a series of minor amendments to the current implementation of the Audit Directive and Accounting Directive:

- Regulations 15(3) and 17(2) amend the definitions of “key audit partner” in Schedule 10 to the Companies Act 2006 and Schedule 1 to the Statutory Auditors and Third Country Auditors Regulations 2016 (SI 2016/649) respectively. Since those regulations were made, these definitions have reflected the definition in the Audit Directive. However, the definitions use terms that are defined in UK legislation in ways that differ from in the Directive. The definitions now use the appropriate defined terms in UK law. This amendment takes effect 21 days after this instrument is made.
- Regulation 16 replaces the previous breakdown of categories of non-audit services, that must be used for disclosures of auditor remuneration by managing agents of Lloyd's syndicates, in notes to the syndicates' accounts. The breakdown is set out in the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008 (SI 2008/1950) and must also be used by the Society of Lloyds in the syndicates' aggregate accounts. The previous breakdown dated back to when the regulations were made and is part of the implementation of Article 18(1)(b) of the Accounting Directive. The same breakdown was replaced for companies in 2011 and, in the same way, for LLPs, building societies and other insurers in 2017. This amendment will apply for syndicate financial years beginning on or after 6 April 2020.
- Regulation 17(3) to (5) makes minor amendments to three provisions in Schedule 1 to the Statutory Auditors and Third Country Auditors Regulations 2016 where the language is inconsistent with that elsewhere in the audit regulatory framework. These amendments have no change in the substantive effect of the provisions and commence 21 days after this instrument is made.

7.5 This instrument applies to Company Law which is a transferred matter for Northern Ireland under section 4 of the Northern Ireland Act 1998. The Companies Act 2006 provides for a single company law regime applying to the whole of the UK, so that companies are UK companies rather than GB companies or Northern Ireland companies. EU Exit legislation which amends the Companies Act or legislation made under it therefore applies to the whole of the UK. This does not affect the legislative competence of Northern Ireland: company law remains a transferred matter, and the Companies Act could be amended separately or repealed in Northern Ireland if that were so desired.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not trigger the statement requirements under the European Union (Withdrawal) Act 2018.

9. Consolidation

9.1 This is not a consolidation.

10. Consultation outcome

10.1 We have not been able to publicly consult in order to minimise sensitivities in advance of negotiations with the EU. This instrument was developed in the Department for Business, Energy and Industrial Strategy on the basis of informal consultation with representatives of various groups with an interest in the regulation of statutory auditors. Consultees included representatives of the audit profession, of the larger audit firms, of investors in companies who must make investment decisions on the basis of the audited accounts and reports of businesses, and with the FRC. BEIS officials met regularly with a group of representatives to discuss legislative options and potential impacts on auditing.

11. Guidance

11.1 Guidance is not required.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 An Impact Assessment has not been prepared for this instrument because of the low level of impact on business (less than £5 million). However, De Minimis assessments have been carried out and have concluded that only a limited sector is affected. Comparatively few auditors audit companies that issue securities that are admitted to trading on UK or EEA regulated markets or that are subsidiaries of EEA parent undertakings.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses.

13.2 To minimise the impact of the requirements on small businesses (employing up to 50 people), as these would mostly be audit firms and their small business clients including small PIEs, the approach taken in the EU exit audit regulations was to only make very necessary changes outside of those that are required in the context of sophisticated transactions between companies and financial markets. This instrument is consistent with that approach.

14. Monitoring & review

14.1 The instrument does not include a statutory review clause and, in accordance with sections 28(2)(b) and 31(2)(b) of the Small Business, Enterprise and Employment Act 2015 (c. 26), the Minister for Small Business, Consumers and Corporate

Responsibility at the Department for Business, Energy and Industrial Strategy, Kelly Tolhurst, has made the following statement:

- 14.2 “I consider that it is not appropriate to make provision for review of the amendments made to section 1253D of the Companies Act 2006 and Schedule 10 to that Act by the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020, as the Regulations are amending regulatory provision that is contained in primary legislation, which is outside the scope of the policy objectives as set out in the statutory guidance. It is also not appropriate to make provision for review of the amendments made to the Insurance Accounts Directive (Lloyd’s Syndicate and Aggregate Accounts) Regulations 2008 and the Statutory Auditors and Third Country Auditors Regulations 2016 using powers under the European Communities Act 1972, as those Regulations are themselves already subject to review, and the amendments will be considered as part of that review.
- 14.3 “A review provision is not included in respect of the provisions of Part 3 of the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020 or the amendments made by those regulations to the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019 because these provisions and amendments have no, or no significant, impact on business, charities or voluntary bodies”.

15. Contact

- 15.1 Paul Smith at the Department for Business, Energy and Industrial Strategy Telephone: 0207 215 4164 or email: pauld.smith@beis.gov.uk can be contacted with any queries regarding the instrument.
- 15.2 Andrew Death, Deputy Director, at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.
- 15.3 Kelly Tolhurst, Minister for Small Business, Consumers and Corporate Responsibility at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.