

PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Second Delegated Legislation Committee

DRAFT STATUTORY AUDITORS AND THIRD
COUNTRY AUDITORS REGULATIONS 2016

Monday 13 June 2016

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The Committee consisted of the following Members:

Chair: MR ANDREW TURNER

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| † Afriyie, Adam (<i>Windsor</i>) (Con) | † Sandbach, Antoinette (<i>Eddisbury</i>) (Con) |
| † Barclay, Stephen (<i>North East Cambridgeshire</i>) (Con) | Smith, Angela (<i>Penistone and Stocksbridge</i>) (Lab) |
| † Brennan, Kevin (<i>Cardiff West</i>) (Lab) | † Soubry, Anna (<i>Minister for Small Business, Industry and Enterprise</i>) |
| † Caulfield, Maria (<i>Lewes</i>) (Con) | † Stevenson, John (<i>Carlisle</i>) (Con) |
| † Dowd, Peter (<i>Bootle</i>) (Lab) | † Trevelyan, Mrs Anne-Marie (<i>Berwick-upon-Tweed</i>) (Con) |
| † Evans, Chris (<i>Ishwyn</i>) (Lab/Co-op) | † Warman, Matt (<i>Boston and Skegness</i>) (Con) |
| † Foster, Kevin (<i>Torbay</i>) (Con) | Jonathan Whiffing, <i>Committee Clerk</i> |
| † Kerevan, George (<i>East Lothian</i>) (SNP) | |
| † Kinnock, Stephen (<i>Aberavon</i>) (Lab) | |
| † Morden, Jessica (<i>Newport East</i>) (Lab) | |
| † Morris, Anne Marie (<i>Newton Abbot</i>) (Con) | † attended the Committee |

Second Delegated Legislation Committee

Monday 13 June 2016

[MR ANDREW TURNER *in the Chair*]

Draft Statutory Auditors and Third Country Auditors Regulations 2016

4.30 pm

The Minister for Small Business, Industry and Enterprise (Anna Soubry): I beg to move,

That the Committee has considered the draft Statutory Auditors and Third Country Auditors Regulations 2016.

It is a pleasure to serve under your chairmanship, Mr Turner. I have quite a lengthy explanation of what the regulations do. They are important because they effectively mark the conclusion of a substantive body of work over a number of years, emanating from the European Union, which has seen all the countries coming together—as I hope they will continue to do—in everybody's best interests to look at, in this case, auditing.

Effective financial reporting underpins the success of every business. It helps to inform decision making, improves performance and promotes confidence in the company's future. For many businesses, audit is essential to provide assurance that financial reporting to shareholders is honest and accurate. Government activity in this area should improve trust and transparency, without placing excessive or undue burden on business.

The proposed regulations implement the 2014 EU audit directive, which amends a directive adopted in 2006, and the EU audit regulation. They apply to a wide range of businesses that require audit services. The most significant changes will apply to public interest entities, which I will refer to as PIEs. Those are basically banks, building societies, insurers and other companies listed on a regulated market. The audit directive and regulation came about through recognition that action was needed to improve confidence in audit quality and assure auditor independence. That particularly came out of the financial crisis in and around 2007-08. The final legislation, which was passed with UK agreement, represents a workable and positive outcome for UK negotiation over more than two years. With our partners—including Germany, France and UK MEPs—the United Kingdom ensured that the EU took time to get these proposals right. Negotiation was heavily scrutinised by the European scrutiny Committees of both Houses of Parliament.

The directive and regulation are an extensive package of reforms, but they are not a knee-jerk reaction to the financial crisis. They take further steps that harmonise audit regulation across the European Union and allow member states flexibility to regulate audit services in ways that reflect their national systems, which have been built up over time. This is a good example of a consolidation and a coming together of all countries—including, of course, all Parliaments—and it shows how the European Union can work in everybody's best interests, in this case to ensure that our businesses are

on a sounder footing. Indeed, it shows how EU directives encompass the broad democracy of this House and the House of Lords.

The key priorities for the United Kingdom, in both the renegotiation of this legislation and its implementation, have been to help secure high-quality audits and independence in auditor judgments across the European Union, and to help avoid excessive concentration of large firms in the audit market. The regulations will amend the Companies Act 2006 and legislation on the current audit framework. I am aware that the regulations may appear complex; indeed, they are an extensive, lengthy document. However, they should be understood with the help of guidance, and that will not be difficult for our auditors.

We have tried to keep additional costs as low as we can. Our impact assessment is publicly available. I acknowledge that the majority of the costs will affect PIEs, but those are the most important businesses and effective financial reporting in this area is crucial. The regulations will implement the requirement to identify a single competent authority for the regulation of statutory audits. The Financial Reporting Council will fulfil that role. That is consistent with the written statement in the House last July. The FRC will delegate tasks to the existing recognised supervisory bodies—for example, the Association of Chartered Certified Accountants and the Institute of Chartered Accountants in England and Wales. Those delegations will include: approval of individuals and firms as eligible for appointment as auditors; inspections; investigations, and enforcement. The FRC will retain the task of inspections and investigations of PIE audits.

The regulations will introduce provisions to secure auditor independence. Most significantly, they include a framework for mandatory rotation and retendering of audit engagements with PIEs. That means that PIEs have to put their audit out to tender at least every 10 years, and change their auditor at least every 20 years, to ensure that a cosy relationship, which may not be healthy, does not arise. The framework will apply in respect of financial years beginning on or after 17 June this year.

There is currently no maximum duration for an audit engagement, and annual reappointments of the same auditor can continue indefinitely, leading to the problems that I have identified and, indeed, that we have experienced. The retendering and rotation requirement will be introduced on a phased basis. Some engagements will be given a further four to seven financial years after the regulations come into force, depending on how long the engagement has already been in place. That engagement must then be brought to an end.

The changes are expected to increase competition in the sector, as they will broaden the requirement for regular tendering of auditor appointments. The wider requirement is intended to be as consistent as possible with that introduced by the Competition and Markets Authority. As a result, and to ensure that the initial implementation of the framework is simple to follow, we have not taken up the member state option to incentivise joint audit. The practice of appointing more than one audit firm is not followed in the UK, and the CMA did not consider that it would improve competition in the audit market. We will, of course, keep that decision under review.

Another change made by the regulations will benefit the full range of businesses that use statutory audit services. Companies will no longer be permitted to sign loan agreements that restrict the choice of auditor. That represents another step towards enhancing competition. As well as implementing the directive, the change also implements an important recommendation of the CMA. The regulations also contain changes that are likely to have a deregulatory effect.

Kevin Brennan (Cardiff West) (Lab): On the Minister's point about joint audit, I do not know whether she has seen the representation that Mazars sent to Committee members—she may not have—but it said that

“the SI as drafted fails to give UK-based businesses the option of joint audits... This means that many businesses—including Mazars and other smaller auditors will be... at a competitive disadvantage compared to their EU competitors”.

Has she given any thought to that observation? I think she just said that she intends to keep the matter under review, but does she have anything to say that might give comfort to smaller businesses, such as Mazars, that are concerned about that aspect of the regulations?

Anna Soubry: My officials helpfully warned me about this issue, so I am very grateful to them. Mazars has written to several MPs about a member state option on a practice called joint audit. It is relevant to France, but not to the UK. The CMA considered whether joint audit would improve competition in the audit market and, as I described, chose not to incentivise it. We have taken the same approach and have not taken up that option. I know that Mazars has concerns because it has its origins in France and feels that joint audit has helped it secure its larger share of the market there, but that is about all I can say at this stage. We are aware of those concerns but, on balance, we think that what we have done is right, which is why I am so keen that we should all agree that these regulations are the right way forward. Nevertheless, we will, as always, keep a firm eye on all these matters. If there is ever a need to make changes, I hope we will do so.

Peter Dowd (Bootle) (Lab): On that subject, notwithstanding the fact that it might have some self-interest, Mazars suggested that smaller auditors might be at a competitive disadvantage, but also that challenger businesses would be less likely, thereby reducing consumer choice, and that the regulations would be less likely to encourage competition in the market. Will the Minister comment on that?

Anna Soubry: As I said, we are aware of Mazars's concerns and have looked at them. The important thing about the directive and the fact that the regulations will, hopefully, now come into force is that there really has been extensive consultation, which is highly commendable. We have listened to all parties. All the stakeholders that are involved in this part of the financial sector have been consulted and had their say. On that basis we are content with the regulations as they are. Nevertheless, we will keep a firm eye on them. We will always keep them under consideration.

The regulations contain changes that are likely to have a deregulatory effect, including some to make cross-border provision of audit services more straightforward.

That is encouraging, and it is a very good example of how the EU is increasingly moving in the direction of wanting to deregulate and becoming much more aware that it must not be a burden on our businesses. As well as having the potential to increase competition in the UK, the requirement must be reflected in similar provisions in other member states and should open up opportunities to UK firms.

The Government believe that a non-statutory approach to the implementation of EU legislation should be adopted wherever possible. The implementation of ethical and technical requirements in the directive for auditors will be covered by revised FRC standards. The approach reflects that taken to implementing the 2006 audit directive, as the requirements in that directive were implemented in the UK as requirements on the content of FRC standards.

Many requirements of the EU regulation will apply as part of the standards, including a blacklist of services that auditors will not be able to provide alongside the audit to avoid overfamiliarity between the management and auditors of PIEs. It also includes additional requirements on the content of the audit report of PIEs that supplement further harmonisation in the directive. That is not expected significantly to increase the length of audit reports but is likely to increase their value to users.

The Financial Conduct Authority has amended its rules to reflect changes to the framework in the directive on audit committees. The directive requires rules on audit committees to be applied to unlisted banks, building societies and unlisted insurers for the first time. The EU regulation and FRC standards then put in place further measures for corporate governance of PIEs in the form of an additional report by the auditor to the audit committee.

Finally, the regulations will strengthen standards for the audit of PIEs and make audit reporting more informative. They should also improve confidence in the independence of auditors and avoid excessive concentration in the audit market. They open up opportunities for smaller audit firms. On that basis, I commend the regulations to the Committee.

4.42 pm

Kevin Brennan: It is a great pleasure to serve under your chairmanship for the first time, Mr Turner.

As the Minister said, the regulations are quite complex in many ways, although they have a simple purpose, which is to try to ensure that the standard and quality of auditing improve right across the EU, not just in the UK, for the benefit of all concerned—investors, consumers and, ultimately, people working for businesses and organisations. Having a high quality, independent standard of business auditing is important.

As the Government's impact assessment indicates, there is clear evidence of market failure in the area due to the misalignment of incentives that can happen in business. There can be conflicts of interest between the purpose of audit, which is to give a clear and honest account of the financial situation of a business, and the need for auditing companies to obtain and maintain their clients. The regulations are a good example.

The Minister said that the measures will have a deregulatory effect, which is interesting because normally each time the Government introduce a new regulation,

[Kevin Brennan]

they say that they have a rule that they must get rid of two other regulations. They never tell us what those two other regulations are but, at this very moment, two regulations are expiring somewhere; they are on their last legs, out of breath and about to die. We do not know what they are because the Government never tell us, but the Minister says that these regulations are actually deregulatory. Whether they are or not is irrelevant. If the measures constitute good regulation, we should have them and if they are bad, we should not. That is the sensible position.

Our position is that, broadly speaking, the measures are an example of good regulation. We broadly welcome what the Government are doing. The Minister is a passionate advocate for our membership of the EU but I suspect that at least half of those Conservative Back Benchers behind her are in favour of leaving the EU. They should think again, because this is a good example of an EU-initiated reform that is of benefit to the United Kingdom and, ultimately, to businesses, consumers and workers in the United Kingdom. The regulations will bring greater consistency and better practice to the auditing of businesses, which is a very positive initiative for the European Union to take.

Adam Afriye (Windsor) (Con): Will the hon. Gentleman give way?

Kevin Brennan: I will in a moment. The regulations will be counted, no doubt, by some Government Members as yet another law made in Brussels. However, I assume that those Members—including, I suspect, the hon. Member for Windsor—are going to vote for yet another law made in Brussels in a few months.

Adam Afriye: I am enjoying the hon. Gentleman's Eurosceptic baiting. Does he know whether the audit regulations also apply to the auditing of the European Union budget?

Kevin Brennan: That is not their intention, as the hon. Gentleman knows. They are a positive contribution from the European Union that I am sure he will welcome if he makes remarks later in our deliberations.

Having got that off my chest, I will move on to ask a few questions of the Minister. Even though we broadly welcome the regulations, the job of Opposition Members here today is to probe the Government a little and to understand whether they are getting this right and whether the implementation is correct. My hon. Friend the Member for Bootle and I have raised concerns about the regulations not allowing for a joint auditing approach that could help smaller auditors. Some of these companies are quite large, even though they are small in the auditing world. Nevertheless, the Government should seriously consider anything that could enhance genuine competition in this area. I hope the Minister will review that, because there is real concern that that is a missed opportunity, as was expounded by Mazars when it got in touch with Committee members.

I want to ask the Minister a few questions about the FRC's future accountability and governance. I understand that the Government told the Lords Secondary Legislation

Scrutiny Committee that the FRC is likely to review the current accountability framework. Will the Minister include wider interests—those of consumers, investors and employee representatives—in the review of the current accountability framework and the FRC's governance structure? I would be grateful if she clarified whether the Government intend to make it a broader consultation.

As we survey the wreckage of the BHS scandal and other corporate failings, we are left wondering what auditors were actually doing in some of those cases. It is essential, in fulfilling its larger role, that the FRC works with not only audit firms—important as that is—but those with wider interests who depend on there being a high standard and class of auditing for the future of their jobs, their investments or, as consumers, for any products they purchase. Will the Government consider that as governance issues are further discussed, in addition to systems of reporting to the Department and to Parliament?

In the consultation, a number of organisations raised different issues. I want to check the Government's response to those concerns and find out whether Ministers feel they have adequately responded to them. For example, the Association of Investment Companies said that it understands the Government consider that the disclosure of non-audit services may need to be amended, so that services required by the European Union or national legislation are disclosed under a separate heading from other non-audit services. That is not urgent, as it is not due until accounting periods begin on or after 17 June 2019, but the AIC's submission recommended that the Government release a further consultation paper in due course to discuss any proposed amendment to the disclosures. Clarity about whether the Government agree with that recommendation would be helpful to the Committee.

In its response, the Chartered Institute of Management Accountants said:

“We would continue to urge that maintaining the approach whereby the audit exemption threshold tracks the small company accounting regime is taken. We believe that consistency with IFRS standards wherever possible supports international business by decreasing the regulatory burden”,

which the Minister says is the intention in the regulations. Again, will consistency with the IFRS standards be adversely affected by the proposed changes?

The Quoted Companies Alliance raised a general concern in the consultation that the impact assessment, which has been published and which I have read,

“does not provide enough detail on what the costs would be for smaller companies in connection to the new rules or what the costs would be for the non-PIEs”—

that is, non-public interest entities—

“to familiarise themselves with the audit committee. We believe that further analysis should be conducted by BIS in this regard.”

Does the Minister feel that enough research has been commissioned on the costs for small companies of familiarising themselves with the proposed changes? If necessary, will she commission further analysis, as proposed by the QCA?

Returning to a point I made earlier, PricewaterhouseCoopers recommends that a separate consultation be considered to build consensus on the appropriate future governance and oversight model for the Financial Reporting Council. As part of that, it wants BIS to consider arrangements

for how Parliament and the Department itself might exercise more active oversight of the FRC. Are the Government considering that proposal for a separate consultation?

PricewaterhouseCoopers also warns about a lack of clarity and too much ambiguity in the regulations, saying that the appropriate application of the provisions would not necessarily be clear in all cases. PwC suggests that to achieve the FRC's objective of enhancing confidence in audit quality, non-binding guidance should be developed by BIS, the FRC and the wider profession to assist audit firms and audit committees in interpreting the provisions. I believe the Minister mentioned guidance. The kind of guidance that PwC referred to would assist shareholders and the FRC, which will have responsibility for monitoring compliance. In the absence of any guidance, there is a risk that inconsistent practices could emerge. The provision of guidance would not undermine the FRC's clear focus on principles, but might prevent inconsistencies from developing. Does the Minister believe that such guidance should be issued, and are there plans to help or encourage its development between BIS, the FRC and the wider profession?

I have a couple of other questions for the Minister. The ICAEW has concerns relating primarily to the implementation of the new audit regulatory framework and a desire to ensure that the FRC can focus on the systemic risks on which a single competent authority should concentrate, while the recognised supervisory bodies should have sufficient certainty to fulfil their role effectively and efficiently. It is also concerned about the procedures for recognition of statutory auditors from other member states of the European Union. Will the Minister comment on the concerns about those procedures and on the implementation of the new audit regulatory framework?

To conclude, I confirm that it is not our intention to divide the Committee. However, if any of the leavers on the Government Benches are so offended by the fact that this is a European Union initiative that they decide not to support the Minister, we will ride to the rescue.

4.54 pm

Anna Soubry: I will respond to the various questions and comments from the hon. Member for Cardiff West. There is quite a lengthy timeline that shows that this whole process began in about 2006. Obviously, it is not a criticism of the EU that it has taken so long to do this. It has taken so long because this has been very carefully considered and of course things have changed quite substantially, especially as some of the real concerns coming out of the financial crisis became clear. In October 2013, the CMA reported on its investigation into the market for the largest auditors. The CMA report, the various to-ing and fro-ing, the careful negotiation, the fine-tuning and the making sure that any people with an interest, whatever it may be, were involved in the final set of regulations are a testament to the concern there was about getting this right.

Although I cannot say we will definitely do any of the things that have been urged, we are more than willing to—indeed, we will—keep an eye on all these matters, many of which have been raised by the hon. Gentleman, to ensure that the arrangements are working well. The regulations will have to bed down, as such things often do, but we have certainly not closed our ears or eyes to the possibility of change being needed. I should say that I am told Mazars is not a small business; it is a medium-sized business, which is quite interesting.

Kevin Brennan: I sought to make that point and to give the Minister a chance for in-flight refuelling. Often in this area there are businesses that are quite large by some standards. Nevertheless, very large businesses are involved in this practice. To give an opportunity to all, joint auditing arrangements might be something to consider for the future.

Anna Soubry: That is very helpful. My officials have also said that on rotation and retendering, there will be non-binding guidance on the implementation of the regulations. Some of that has already been published by the FRC and the CMA, and it will be updated and republished shortly. Everybody is on top of these things. As ever, if I do not respond now to any of the points the hon. Gentleman raised, I will write to him.

I hope everyone on the Committee will agree that the quality and reliability of financial reporting in our country is well regarded, and rightly so. It will always be a priority of mine to maintain the rigour and integrity of our audit regime. We know the huge importance to our economy of financial services—some 80% of our economy relies on that industry. This is a good example of the need for cross-EU regulation, so that we can do business much better. I am pleased that it is thought the regulation will be of real benefit to our own audit companies, which have a good reputation, so that they can do business in other member states even better.

The cost to business is not small by any means, but we think the benefits may well outweigh that cost. The one-off cost is estimated to be £41.7 million, with continuing costs of an additional £23.7 million a year, but we are confident that the overall benefits may well financially outweigh those costs. Compulsory retendering of audits should increase competition and choice in the marketplace, which is good for everybody.

Although the application of the requirements to auditors of LLPs goes beyond the minimum requirements of the audit directive and regulation, it will implement the recommendation of the CMA and meet the understandable desire of users and preparers of accounts for consistency in financial frameworks. On the basis that the regulations will make a good system even better and be good for a particularly important part of our financial sector, I hope that they will be passed without any difficulty.

Question put and agreed to.

4.59 pm

Committee rose.

