

## **EXPLANATORY TEXT**

**(following the informal consultation of March to May 2010)**

### **THE COMPANIES ACT 2006 (TRANSFER OF AUDIT WORKING PAPERS TO THIRD COUNTRIES) REGULATIONS 2010 (SI 2010/2537)**

#### **Introduction**

1. The Companies Act 2006 (Transfer of Audit Working Papers to Third Countries) Regulations 2010 have been made by the Secretary of State and come into force on 15 November 2010. This instrument amends Part 42 of, and Schedule 10 to, the Companies Act 2006 ("the 2006 Act") to implement:
  - Commission Decision 2010/64/EU of 5 February 2010 on the adequacy of the competent authorities of certain third countries pursuant to Directive 2006/43/EC of the European Parliament and the Council ("the first Decision"); and
  - Commission Decision 2010/485/EU of 1 September 2010 on the adequacy of the competent authorities of Australia and the United States pursuant to Directive 2006/43/EC of the European Parliament and of the Council ("the second Decision").

Both Decisions have been issued under Article 47 of Directive 2006/43/EC of the European Parliament and of the Council ("the Audit Directive") and permit the transfer of audit working papers from the European Economic Area to the audit authorities of certain other ("third") countries.

#### **Background to Commission Decisions 2010/64/EU and 2010/485/EU**

2. Sections 1253D and 1253E of the Companies Act 2006 ("the 2006 Act") currently implement the requirement in Article 47 of the Audit Directive for Member States to prohibit the transfer of auditors' working papers to non-EEA audit regulators in non-investigation cases until the Commission has issued Decisions to allow transfers to specific regulators by approving them as having "adequate" requirements as regards the confidentiality of the information transferred.

3. The first Decision allows transfers of audit working papers to the Canadian Public Accountability Board, the Financial Services Agency of Japan, the Certified Public Accountants and Auditing Oversight Board of Japan and the Federal Audit Oversight Authority of Switzerland. With the implementation of that Decision, and with the agreement of working arrangements between those regulators and the Professional Oversight Board of the Financial Reporting Council (POB), it will be possible for audit working papers to be transferred to Canada, Japan and Switzerland. The first Decision is available at:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:240:0006:0009:EN:PDF>.

4. The second Decision, issued on 1 September 2010 allows transfers of audit working papers to The Australian Securities and Investments Commission, The Public Company Accounting Oversight Board of the United States of America and the Securities and Exchange Commission of the United States of America. Again, with the implementation of that Decision, and with the agreement of working arrangements between those regulators and the POB, it will be possible for audit working papers to be transferred to Australia and the United States of America. However, in respect of the USA, the adequacy Decision is time limited and will expire on 31 July 2013. The second Decision is available at:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:035:0015:0017:EN:PDF>.

### **Draft Statutory Instrument**

5. A draft of Regulations to implement the first Decision was published on the BIS website at the end of March 2010 seeking comments by 28 May 2010. A version of the Regulations, as amended in the light of comments on that draft, and also to implement the second Decision, was circulated to stakeholders for comment in October 2010, though no further changes were made. This explanatory text summarises the comments received on the draft that was published for comment in March 2010, and gives the Government response to those comments. It also explains certain other amendments that were made to the draft Regulations to implement the second Decision.

### **Government response to comments on the published draft Regulations**

6. BIS received 3 written responses commenting on the draft Regulations published on the BIS website. These were received from:

- the Institute of Chartered Accountants in England and Wales (ICAEW);
  - KPMG; and,
  - Price Waterhouse Coopers.
7. One respondent commented on the commencement arrangements for these Regulations. In particular, they thought clarification was needed of whether the amended provisions of the 2006 Act, and the amended rules applied to statutory auditors by the recognised supervisory bodies, would commence:
- for all audits on the specified date; or
  - for audits of accounts for financial years beginning on or after the specified date.

BIS has considered this issue. The final Regulations adopt the same approach as the published draft, in that the new framework applies for all audits as from the commencement date, irrespective of when the financial year of the audited accounts began. It also applies for all audit working papers transferred as of that date, irrespective of the financial year of the audited accounts to which the papers relate. In our view this only requires further clarification in relation to transfers of audit working papers by statutory auditors under the rules of the recognised supervisory bodies. In general, the requirements in Schedule 10 to the 2006 Act on the rules apply only to audits for financial years beginning on or after 6 April 2008. To ensure the new rules as to transfer of audit working papers apply to all audits and audit working papers for financial years beginning before then, we have included a new provision in regulation 8 of the final Regulations. This effectively disapplies the transitional provision at paragraph 38 of Schedule 4 to the 5<sup>th</sup> commencement order for the 2006 Act in so far as it applies to the new requirements in the Regulations as to the transfer of audit working papers by statutory auditors.

8. One respondent questioned the drafting and intended effect of the new section 1253DC to be inserted by the draft Regulations (1253DD in the final Regulations). The difficulty identified by the respondent arises from Article 2.3 of each of the Decisions, which are identical in each case. In the UK context, the provision applies where audit working papers are “exclusively held” by the auditor of a subsidiary of a UK company incorporated in another EEA state, where those papers are requested by an approved third country competent authority from the auditor of the UK parent company or from the POB. The effect of the Article is that the papers may only be transferred by the auditor of the parent company, or by the POB, with the agreement of the competent authority responsible for overseeing the audit of the subsidiary. The respondent would appear to be right that, if the auditor of the subsidiary in another EEA state literally “exclusively held” the

working papers for that audit, it would be impossible for the auditor of the UK parent company, or the POB, to comply with a request to transfer the papers to a third country. Having considered the respondent's concerns, we have included an amended provision in the final Regulations making clear what we consider is the intended effect of Article 2.3. The final Regulations interpret the words "exclusively held" to mean that the working papers being sought must have been created by the auditor of the subsidiary in relation to that audit. However copies may still be held by the auditor of the parent company and may only be transferred by it or the POB with the permission of the EEA competent authority responsible for overseeing the audit of the subsidiary.

9. One respondent suggested the Regulations should not just make a series of small amendments to section 1253E of the 2006 Act but should replace the whole section with a new one to which all the amendments had been made. Regulation 3 of the final Regulations adopts this format.
10. One respondent suggested that the requirements as to the rules of the registered supervisory bodies could be simplified if all transfers of audit working papers by statutory auditors, whether under the new paragraph 16AA of Schedule 10 to the 2006 Act, or under paragraph 16AB, were subject to the approval of the Secretary of State. The Secretary of State (or in fact the POB using its delegated authority) could then be required to ensure that the conditions applied to the transfer under the Decisions and the Audit Directive had been fulfilled before the transfer could be approved. BIS has considered this proposal and has adopted it for standard transfers to approved third country competent authorities under paragraph 16AA of Schedule 10. The requirements as to the Secretary of State's approval are then included in the new section 1253DB inserted by the final Regulations. However, we do not consider that this framework is appropriate for transfers of audit working papers under the derogation in Article 47.4 of the Audit Directive for investigations cases. We have therefore adopted the same approach as previously in Schedule 10 to the 2006 Act for these transfers so that they continue to be governed by the rules of the recognised supervisory bodies. The approval of the POB is not required under this framework, though it must be informed of the transfer in advance and, as with standard transfers, it may direct that the transfer cannot be made where questions of sovereignty arise or where legal proceedings are underway.
11. One response suggested an alternative to the approach of both the draft Regulations and the 2006 Act, which each make requirements as to the rules applied to auditors by the recognised supervisory bodies. Under Schedule 10 to the 2006 Act these rules are required to prevent the transfer of audit working papers to third country competent authorities unless certain conditions are met. The alternative approach proposed by the

respondent seemed to involve a combination of requirements imposed directly on the auditor in legislation and requirements as to the working arrangements to be agreed between the POB and the third country competent authority. We have considered whether an approach along these lines could be used. However the advantage of making requirements of the bodies' rules is that sanctions can be applied, through the rules, to those auditors who are in breach of them. These sanctions appear to be appropriate where audit working papers are transferred in contravention of the conditions in the Directive and Decisions. It is not clear what sanction could otherwise be available under the working arrangements. Also, following the original consultation by the Department for Trade and Industry on the implementation of the Audit Directive it was decided that criminal sanctions should not apply in cases of non-compliance by auditors with laws on the transfer of audit working papers.

12. One response suggested that the derogation in Article 47.4 of the Audit Directive for investigations cases should only be available for transfers to *approved* third country competent authorities. This would be a departure from the policy as currently implemented in the 2006 Act and would have required an amendment to the new paragraph 16AB inserted into Schedule 10 by the draft Regulations. As we understand it, the derogation in the Directive allows transfers to any third country competent authority in investigations cases, assuming the relevant conditions are met. Having considered this issue we think it would be better to continue to take full advantage of the derogation.
13. One response suggested that a provision comparable to the new section 1253E(7)(b) inserted by the Regulations should also be inserted into the new paragraph 16A(2) in Schedule 10 to the 2006 Act. The effect of this would be that a transfer of audit working papers could be refused if legal proceedings had been brought in relation to the auditor or audit to which the working papers related. The final Regulations include a provision intended to have this effect. The new paragraph 16A(2) requires the rules of the recognised supervisory bodies effectively to provide that a transfer of audit working papers by a statutory auditor can be blocked by the POB because of legal proceedings. Paragraph 16A(2) has been revised from that in the draft Regulations so that a statutory auditor must comply with a direction issued under section 1253E(6), rather than providing a separate second provision relating to legal proceedings. Section 1253E(6) has also been amended as compared to that in the draft Regulations. The working arrangements must now provide that the POB may refuse a transfer request *or* direct a statutory auditor to refuse the request. This change allows paragraph 16A(2) to link back to the single power now provided in section 1253E(6). As the grounds on which such a direction may be given include legal proceedings, this is also a change from the effect of the current provision in paragraph 16A(5) of Schedule 10 to the 2006 Act as it allows the POB to decide whether to refuse

a request because of legal proceedings, rather than simply requiring that the request be refused. We have provided the POB with this discretion in order that a transfer of audit working papers need not be refused by an auditor for trivial reasons.

### **Amendments to the draft Regulations made subsequently to implement the second Decision**

14. The obvious change that has been made to the Regulations as part of the implementation of the second Decision is the insertion of the additional competent authorities in Australia and the United States of America into section 1253D(2), as these are now approved for the purposes of transfers of audit working papers. However the second Decision also contains certain other new provisions affecting these transfers. The implementation of these is discussed in the paragraphs below.
15. Articles 2.4 and 2.5 of the second Decision both make additional requirements as to the working arrangements to be agreed between member state competent authorities and third country competent authorities:
  - The requirements in Article 2.4 relate to the protection of sensitive and personal data by competent authorities receiving transferred audit working papers. The final Regulations implement these via section 1253E(5)(a) of 2006 Act. This provision is applied to all transfers of working papers including to competent authorities outside of Australia and the United States. For this provision, we consider the benefits of a uniform framework for all working arrangements outweigh the benefits of making different requirements as to the POB's arrangements with different competent authorities.
  - The requirements in Article 2.5 of the second Decision are also implemented in the new section 1253E of the 2006 Act, in the new subsections (8) and (9). These provisions replicate the wording in the Article 2.5 which requires the working arrangements to provide that "contacts" between the statutory auditor and an approved third country competent authority relating to the transfer of audit working papers must be "via" the member state competent authority. As this is a new requirement of the working arrangements, section 1253E(8)(b) has been included to reflect the fact that a comparable provision must be included in the working arrangements on the involvement of the approved third country competent authority in a transfer to the UK. As both these requirements only apply to transfers of audit working papers between the UK and Australia and the United States of America, subsection (8) limits the effect of these requirements to transfers to and from the approved competent authorities in those jurisdictions.

Subsection (9) makes clear this requirement does not apply to transfers made under the derogation for investigations in Article 47.4 of the Directive.

To resolve certain technical drafting problems around the insertion of the new requirements as to the working arrangements at section 1253E(6) to (9) by the final regulations, we have restructured the earlier part of the section.

16. Article 2.6 of the second Decision makes requirements relating to inspections conducted jointly between member state competent authorities and approved third country competent authorities. The requirement, that these joint inspections should only be conducted “where necessary” appears to imply that that transfers of audit working papers to an approved third country competent authority via an inspection should only be made via a joint inspection in which the member state competent authority participates alongside the approved third country competent authority. The new section 1253DE(2) states that the POB must participate in any inspection at which a transfer of audit working papers is made to an approved third country competent authority. Section 1253DE(3) then states that the POB must lead the inspection, unless the POB permits otherwise. This implements the second requirement of Article 2.6 that “as a general rule” a member state competent authority must lead a joint inspection. Section 1253DE(1) limits the effect of the whole section to joint inspections with the approved third country competent authorities from Australia and the United States of America. It also ensures this requirement does not apply to transfers made under the derogation for investigations in Article 47.4 of the Directive.
17. We consider that Article 2.7 needs no further implementation in UK law. It is intended to ensure that the “conditions for cooperation” previously described in Article 2 are taken account of in provisions in member state law as to the agreement of working arrangements. In our view the requirements of section 1253E already take account of the conditions for cooperation in the Article.

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