

Explanatory Text

Draft Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011

1. Part 16 of the Companies Act 2006 contains provisions for the Secretary of State to make regulations requiring companies to disclose services (both audit and non-audit services) provided by their auditor, and the fees paid for those services, in notes to the company's annual published accounts. The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489) ("the 2008 regulations") were made as part of the implementation of Part 16 of the Companies Act 2006 and of the Audit Directive¹.

2. The Department for Business, Innovation and Skills is now proposing to replace Schedule 2 to the 2008 regulations. The current Schedule provides a classification of non-audit services under 10 headings, which must be used by large companies for the disclosure of the fees they have paid to their auditor for non-audit services of different types. The replacement Schedule provides a new classification, under 9 headings, intended to make for clearer disclosure of non-audit services, improving insight into the potential questions around the auditor's independence and linking more clearly to the classification of non-audit services under Article 49 of the Audit Directive. These aims are discussed below:

Clearer disclosure improving insight

3. The 2008 regulations work in parallel with the Auditing Practices Board's (APB's) Ethical Standards for Auditors which set out the principles to be followed by auditors in order to maintain their independence. The APB completed a review of the Ethical Standards on 17 December 2010², which has led to this proposal by the Government to change the classification in the regulations. The review followed a recommendation from the House of Commons Treasury Select Committee in its report "The Banking Crisis: Reforming Corporate Governance and Pay in the City"³ which raised concerns about the fees paid to auditors by companies that they audit for non-audit services provided in the run-up to the financial crisis.

4. The Ethical Standards require auditors to undertake an analysis of threats to their independence (including from the provision of non-audit services) and to put in place any necessary safeguards in order to reduce the threats to an acceptable level. In some cases, it may be necessary for the auditor to refuse to provide certain non-audit services or alternatively to decline the audit appointment, to comply with the Ethical Standards. Under Ethical Standard

¹ 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, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC

² <http://www.frc.org.uk/apb/press/pub2470.html>

³ <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf> (para 237)

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5, which deals specifically with the provision of non-audit services, an analysis of threats, and identification of example safeguards, is set out under different headings of non-audit service that the auditor might provide. It also highlights those circumstances where it is unlikely that the threats can be reduced to an acceptable level. It therefore makes sense if the classification of non-audit services under Ethical Standard 5 links to the classification of non-audit services for the purposes of disclosure in large companies' accounts. In addition to the classification of non-audit services in Ethical Standard 5 which has 13 different headings, there is also an illustrative template in APB's Ethical Standard 1 for communicating information to an audit committee on audit and non-audit services provided to listed companies. This includes 23 headings in order to provide additional insight into questions around the auditor's independence. The proposed replacement for Schedule 2 combines some of these headings where the analysis of threats and identification of safeguards are broadly similar or where experience indicates that the quantity of services commonly provided by the auditor is limited. Respondents to the APB's consultation on amendments to its Ethical Standards supported the use of this template to meet the demand for a reduction in the perceived threats to objectivity and independence arising out of the provision of non-audit services. Amending Schedule 2 in this way is intended to result in the disclosure of a summarised version of the illustrative template, which is recommended for auditors to use when reporting to listed companies. As a result, there should be minimal additional analysis required for such companies, where the auditor already uses the template. Auditors of large unlisted companies will not need to go into the detail required by the template. Large unlisted companies need only disclose the non-audit services they receive in line with the replacement Schedule.

Clearer linkage to classification of non-audit services under the Audit Directive

5. The headings currently used in Schedule 2 for the classification of non-audit services are those originally used in the Companies (Disclosure of Auditor Remuneration) Regulations 2005 (SI 2005/2417). This predates the Audit Directive. When the Directive was implemented as part of the implementation of the Companies Act 2006, it was felt that the classification of non-audit services in the Directive (under 3 headings: other assurance services; tax advisory services and other non-audit services) matched sufficiently well with groupings of the headings in the original schedule, so that no change was needed to it. However, with the amendments to the Ethical Standards, the Government is now proposing to take the opportunity to provide a classification which can more clearly be grouped under the headings in the Directive. This is done via the wording of the final item of each group within the classification. For instance, the group of headings which between them constitute "other assurance services", for the purposes of the Directive, ends with paragraph 3 "all other assurance services not identified in paragraphs 1 or 2". Paragraphs 1 and 2 describe particular types of "other assurance service", which, together with the services under paragraph 3, form the "other assurance services" group required to be disclosed by the Directive.

Matters arising from the inspectors' report on the affairs of Phoenix Venture Holdings Ltd and MG Rover Group Ltd

6. The Government has considered whether further amendments should be made to the 2008 regulations in response to the findings of the Inspectors appointed by the Secretary of State under the Companies Act 1985 to investigate the affairs of Phoenix Venture Holdings

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Ltd, MG Rover Group Ltd and 33 other companies. The report⁴, published in September 2009, identified that, under predecessor regulations to the 2008 regulations, Phoenix Venture Holdings Ltd had disclosed non-audit fees which were considerably lower than those that the Inspectors found had been paid⁵. When the report was published the then Secretary of State asked the Financial Reporting Council (FRC) to look into certain matters relating to the inspectors' findings. Having identified the associated issues, the FRC recommended that the Government review the 2008 regulations after the APB review of the Ethical Standards was completed.

7. The reason the inspectors found higher total payments, than had been declared, in fees for non-audit services, was that the auditor was also earning fees for services to companies "connected" to Phoenix Venture Holdings Ltd, which were separate corporate vehicles owned and controlled by the directors, but not part of the Phoenix group. Fees for non-audit services provided to those corporate vehicles would not be required to be disclosed under the 2008 regulations.

8. The Government has considered whether the 2008 regulations should be amended to require disclosure of fees for non-audit services to "connected parties" of this kind. It does not intend to make proposals for such amendments. The APB's Ethical Standards have already been amended to make provision for disclosure of significant services of this kind to the audit committee, in response to the inspectors' findings. To go further than this, so as to require disclosure in the notes to the accounts would require additional (and probably separate) disclosure, based on a complicated definition of what is a "connected party". This would impose a disproportionate burden as it would need to apply to all large private companies to affect companies like Phoenix Venture Holdings Ltd.

Comments on the draft regulations

9. If you have any comments on the draft Statutory Instrument or any of the explanation above, please send them by Thursday 30 June 2011, preferably by e-mail to: auditdirective@bis.gsi.gov.uk. If you wish to comment by letter, please write to Paul Smith, Audit and Accounting Policy, Department for Business, Innovation and Skills, Spur 2, 3rd Floor, 1 Victoria Street, London SW1H 0ET. If you have any questions about the regulations, please contact Paul Smith on 020 7215 4164.

Confidentiality

10. Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want information, including personal data that you provide to be treated as

⁴ The inspectors' report is in two volumes. Pages 675 to 686 (in volume 2) cover the auditors' independence and objectivity - <http://www.bis.gov.uk/files/file52782.pdf> (volume 1) and <http://www.bis.gov.uk/files/file52783.pdf> (volume 2)

⁵ See the Progress report published by the Financial Reporting Council in November 2009 for further details: <http://www.frc.org.uk/images/uploaded/documents/ROVER%20PROGRESS%20REPORT%20-%20PUBLISHED.pdf>

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confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

11. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

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