

**EXPLANATORY MEMORANDUM TO THE COMPANIES ACT 1989
(DELEGATION) ORDER 2005**

2005 No.

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of her Majesty.

2. Description

2.1 The order delegates most of the Secretary of State for Trade and Industry's functions in relation to company auditors to the Professional Oversight Board for Accountancy ("the POBA"), a subsidiary Board of the Financial Reporting Council.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 This order supersedes the draft order laid on 24th February 2005 in respect of which the Joint Committee on Statutory Instruments in its Eleventh Report of the Session 2004/5 indicated that it was not drawing the special attention of both Houses.

4. Legislative Background

4.1 Whilst the term "accountant" is not regulated in statute and there are no qualification requirements for someone to practice as an accountant, three areas of accountancy work are regulated by statute. One of these areas is audit.

4.2 Part 2 of the Companies Act 1989 ("the CA89") - which implemented the Eighth Company Law Directive 84/253/EEC - contains provisions for the regulation of company auditors. Under these provisions, the Secretary of State (amongst other things) recognises accountancy bodies which meet the statutory requirements for the supervision of auditors and also recognises professional audit qualifications which meet the statutory requirements. In order to be eligible to act as a company auditor, a person must be appropriately qualified and registered with a recognised supervisory body.

4.3 Section 46 of the CA89 originally allowed the Secretary of State to delegate her statutory functions in relation to auditors to a body established by the delegation order. Section 46 was subsequently amended by sections 3 to 5 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 to also permit delegation to a body that is already in existence. The aim of these amendments was to enable delegation to the POBA, which is an existing body. The delegation order is the first use of the section 46 power.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 The Parliamentary Under-Secretary of State, and Minister for Employment Relations and Consumer Affairs, Gerry Sutcliffe has made the following statement regarding Human Rights:

In my view, the provisions of the Companies Act 1989 (Delegation) Order 2005 are compatible with the Convention rights.

7. Policy Background

7.1 The main purpose of Part 2 of the CA89 is to ensure that only people who are properly supervised and appropriately qualified can carry out audits of companies, and that audits are carried out properly, with integrity and a proper degree of independence.

7.2 Following the major corporate scandals of Enron and WorldCom in the US in which both those responsible for preparing accounts, and those responsible for auditing them, were implicated, the Government undertook a review of the way the accountancy and audit professions were regulated.

7.3 One of the issues addressed by the review was whether there would be benefits in an independent body carrying out the recognition function instead of the Secretary of State. Of the respondents who commented, a small majority were in favour of delegation. Those in favour argued that delegation would enable the activities of the recognised bodies to be carried out by those with a practical understanding of audit issues; those against delegation argued that it would bring no clear benefits or economies and would bring another layer of authority into the regulatory structure.

7.4 The review concluded that delegation would result in more effective oversight of recognised bodies and qualifications as it would mean that oversight would be carried out by a body with audit and professional oversight responsibilities. The Secretary of State for Trade and Industry announced in January 2003 that she accepted the review's conclusions.

8. Impact

8.1 A Regulatory Impact Assessment (RIA) has not been prepared for this instrument. The policy proposal to delegate the Secretary of State's functions was included in the final RIA for the audit regulation provisions of the Companies (Audit, Investigations and Community Enterprise) Act 2004. A copy of this RIA is enclosed at **Annex A**.

9. Contact

Julie Ford at the Department of Trade and Industry, tel: 020 7215 2162 or e-mail: julie.ford@dti.gov.uk can answer any queries regarding the instrument.

Gerry Sutcliffe

(Parliamentary Under-Secretary of State
for Employment Relations and Consumers Affairs)

23rd May 2005

ANNEX A TO THE EXPLANATORY MEMORANDUM

COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT

REGULATION OF THE AUDIT PROFESSION – FINAL REGULATORY IMPACT ASSESSMENT

1. Proposal

1.1 Companies (Audit, Investigations and Community Enterprise) Act 2004: regulation of auditors.

2. Purpose and intended effect

(i) Objective

2.1 The objective of the provisions is to protect and improve the quality of accounts and audit by ensuring that the audit profession is regulated in the most effective way.

2.2 **Devolution:** The provisions affect the law in England, Wales and Scotland, except in relation to the power to impose a levy on business and the accountancy profession in respect of their contribution to the funding of the Financial Reporting Council (FRC), which also extends to Northern Ireland.

(ii) Background

2.3 The term 'accountant' is not defined in statute and there are no qualification requirements in order for someone to practise as an accountant. However, for professional and/or commercial reasons, many accountants choose to qualify under the auspices of one of the professional accountancy bodies and pay to be a member of such a body. In 2000 a non-statutory oversight system for the regulation of the accountancy profession was established by the Consultative Committee of Accountancy Bodies (CCAB)¹. The system consists of four boards established under the overall ambit of the Accountancy Foundation, an organisation wholly funded by the CCAB bodies themselves.

¹ Institute of Chartered Accountants in England & Wales (ICAEW); Institute of Chartered Accountants of Scotland (ICAS); Institute of Chartered Accountants in Ireland (ICAI); Chartered Institute of Management Accountants (CIMA); Chartered Institute of Public Finance & Accountancy (CIPFA); Association of Chartered Certified Accountants (ACCA)

2.4 By contrast, the Companies Act 1989 prescribes a statutory scheme for the regulation of auditors, under which the Secretary of State for Trade and Industry recognises certain accountancy bodies as capable of training and supervising auditors.

2.5 Following an interim recommendation of the Co-ordinating Group on Audit and Accounting Issues (set up jointly by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer to review the situation in the UK following the Enron and WorldCom scandals), the Secretary of State announced on 24 July 2002 a review of the way the accountancy profession is regulated. A consultation document seeking views on the main issues was published in October 2002.²

2.6 The Secretary of State published the final report of the review on 29 January 2003 and accepted all the report's recommendations³. The main recommendations were:

- that the FRC should take on the Accountancy Foundation's functions to create a new unified and authoritative structure with three areas of responsibility: setting accounting and audit standards; their enforcement or monitoring; and oversight of the major professional accountancy bodies; and
- that independent regulation and review of audit by the FRC should be significantly strengthened. Specifically, that responsibility for setting auditor independence standards and monitoring the audit of listed companies and other significant entities should be transferred from the professional accountancy bodies to the FRC.

2.7 In her statement to Parliament, the Secretary of State said that there was a strong case for statutory underpinning to make the new body work, that she would consider this further, and that she would report her conclusions to the House. On 11 March 2003 a consultation document was published containing the Government's proposals for legislative provisions to support the new regulatory functions of the FRC⁴. The Government's response to this consultation was published in February 2004⁵.

² "Review of the Regulatory Regime of the Accountancy Profession" [URN 02/1340]

³ "Review of the Regulatory Regime of the Accountancy Profession – Report to the Secretary of State for Trade and Industry" [URN 03/589]

⁴ "Review of the Regulatory Regime of the Accountancy Profession: Legislative Proposals" [URN 03/717]

⁵ "Review of the Regulatory Regime of the Accountancy Profession: Legislative Proposals – Report on the public consultation and the Government's conclusions" [URN 04/537]

(iii) Risk assessment

2.8 High standards of financial reporting are essential for the UK economy, companies and capital markets, and the millions of people who invest in them (either as individuals or through their pension funds). Independent auditors play an important role in enhancing the reliability of financial information. It is important that the Government ensures that the public interest in financial reporting is fully met by securing public confidence in the impartiality and effectiveness of auditors and accountants. Effective oversight of the auditing profession is therefore critical to the reliability and integrity of the financial reporting process. There is a risk that a large corporate failure in the UK would have an adverse effect on confidence in companies and a corresponding effect on the UK's capital markets.

2.9 The review of the regulatory regime of the accountancy profession found no evidence that the UK's existing regulatory system was seriously flawed. However, there were concerns about the perceived independence of key aspects of the arrangements.

2.10 For credibility and legitimacy reasons it is important that those who oversee auditors are, and are seen to be, independent of the auditing profession. One way in which the independence of the regulatory system could be compromised is if the regulatory arrangements were funded in a manner over which the accountancy profession and/or some other closely interested party were able to exercise control (e.g. in relation to its timing or amount). This could result in a perception that those subject to regulation exercise a measure of control over the activities and effectiveness of the regulator, which would reduce public confidence in the effectiveness of regulation.

2.11 While there is a public interest in the quality of all auditing, the public interest is particularly strong in relation to the audit of listed companies because these companies are economically significant to large numbers of individuals and other businesses; collectively these companies occupy a dominant role in many sectors of the economy; their value represents a large part of the savings of the population as a whole; and loss of faith in the credibility of their financial statements can undermine the capital market, restricting economic growth.

3. Options

3.1 A number of possible options were considered:

- **Option 1.** Retain the current statutory regulatory system for auditors unchanged.
- **Option 2a.** Retain the current statutory regulatory system for auditors but require supervisory bodies to participate in independent standard setting, monitoring and disciplinary processes. The Secretary of State to retain her role of recognising professional supervisory bodies. The FRC to be funded as at present, i.e. voluntary tri-partite funding by Government, business and the accountancy profession.
- **Option 2b.** Retain the current statutory regulatory system for auditors but require supervisory bodies to participate in independent standard setting, monitoring and disciplinary processes. The Secretary of State's powers relating to company auditors and the recognition of bodies which supervise them to be delegated to an independent body. The contribution to the FRC's costs by the business community and accountancy profession to be secured by if necessary a statutory levy.
- **Option 3.** Confer statutory status and powers on a body to regulate company auditing (such as the FRC).

4. Benefits

Option 1

4.1 There would be no additional benefits arising from this option.

Option 2a

4.2 This approach would build on the current framework for the regulation of audit and would improve public confidence in the effectiveness of the system of auditor oversight. The introduction of specialist monitoring arrangements focusing on the audits of listed companies would concentrate regulatory attention and resources on the area of the strongest public interest (for the reasons set out in para 2.11 above).

Option 2b

4.3 This approach would have the same benefits set out in para 4.2 above. Delegation of the Secretary of State's powers in relation to company auditors would result in more effective oversight of recognised bodies and qualifications as it would be carried out by a body with audit and professional oversight responsibilities and experience. There would also be some savings for the DTI in no longer having to carry out this function. It is estimated that these savings would be in the region of £17,500 per annum.

4.4 The introduction of a statutory levy would have the benefit of providing security of funding for the regulatory activities of the FRC and thus ensure that its independence would not be compromised. This security of independence of funding will be important in the context of assuring overseas governments that the UK's regulatory environment is robust. This, in turn, will be important in persuading these governments that they do not need to impose additional requirements on UK firms auditing companies registered in their markets. It would ensure that the regulatory system is in accordance with the International Organisation of Securities Commissions' principle that auditor oversight bodies should have adequate funding that was not under the control of the auditing profession⁶.

Option 3

4.5 This option would ensure independent regulation of the auditing profession. It would send a clear message to the profession and the public about the Government's determination to improve the quality of financial reporting in the UK.

Business sectors affected

4.6 The provisions will affect the market for audit services. As at 31 December 2003, there were 11,006 registered audit firms (including sole practitioners)⁷.

4.7 Auditing is mainly confined to medium-sized and large accountancy firms, reflecting the need for a considerable number of specially trained staff. The size of the UK market for accounting and audit services (i.e. the preparation and presentation of annual accounts) was estimated as approximately £3.3 billion in 2001, 66% of which was taken by the then Big Five (now the Big Four) accountancy firms.⁸

⁶ Principles for Auditor Oversight - Statement of the Technical Committee of IOSCO (October 2002)

⁷ annual reports on Audit Regulation to the Secretary of State for Trade and Industry for the year to 31 December 2003 - ICAEW/ICAS/ICAI, ACCA, AAPA.

⁸Key Note 2002 report on Accountancy - www.keynote.co.uk

Issues of equity and fairness

4.8 The provisions relating to independent standard setting and disciplinary arrangements will apply to all the professional bodies that have Recognised Supervisory Body (RSB) status. The provisions relating to the delegation of the Secretary of State's recognition power will apply to all RSBs and Recognised Qualifying Bodies.

4.9 The provisions in relation to participation in independent monitoring arrangements will in practice be restricted to those RSBs whose members undertake audits of listed or other large companies. The majority of such auditors are supervised by the ICAEW.

4.10 As at August 2002, there were 106 audit firms registered with the ICAEW with one or more listed client.

5. Costs

(i) Compliance costs

5.1 The operating costs of the FRC for the year ending 31 March 2003 amounted to £2.8 million. The costs were funded on a one-third basis by Government; the CCAB; and listed companies and the banking/investment communities.

5.2 The operating charges of the Accountancy Foundation and its associated bodies for the year ended 31 December 2002 amounted to £2.57 million. These costs were met by the CCAB members.

5.3 It is provisionally estimated that the operating costs of the new FRC could eventually amount to up to £12 million annually. The anticipated increase in costs relates principally to the assumption of Accountancy Foundation functions, and the increased costs of pro-active consideration of accounts by the Financial Reporting Review Panel (which we estimate as approximately £3.0 million per annum). Neither of these measures results from the proposed legislative provisions, but the funding powers in the proposed legislation will be necessary in order to assure the availability of funding for them. These costs will be funded on an equal tri-partite basis by the Government, CCAB and listed companies, reflecting the FRC's current funding model.

Option 1

5.4 There would be no additional costs for this option.

Option 2a

5.5 There would be the same costs as set out in paras 5.1 to 5.3, although these will not be directly incurred as a result of the provisions.

5.6 There will also be some additional costs to RSBs in ensuring they comply with additional recognition criteria. However, we anticipate that the RSBs will comply with new criteria in respect of standard setting and discipline by, respectively, continuing to follow auditing standards set by the existing Auditing Practices Board and participating in the Accountancy Investigation and Discipline Board Scheme. We therefore do not anticipate significant additional costs for RSBs in complying with these requirements.

5.7 There will be some additional costs to RSBs and the audit firms registered by them in respect of the requirement for independent monitoring of the audits of listed and other large companies. As stated in para 4.9, the majority of audit firms that carry out such audits are registered with the ICAEW. We anticipate that this requirement will be fulfilled by the new Audit Inspection Unit of the FRC and estimate that the costs of this unit could be in the region of £1.3 million per annum by 2007. These additional monitoring costs will to some extent be offset by the concomitant reduction in the costs of the existing monitoring regime.

Option 2b

5.8 There will be the same costs as set out for Option 2a above. There will also be additional costs for the independent body (which we anticipate to be the Professional Oversight Board for Accountancy of the FRC) in carrying out the delegated powers in relation to company auditors including that of recognition. The introduction of the power to impose a levy on business and the accountancy profession in respect of their shares of the FRC's costs would not of itself impose any additional costs as it is anticipated that the level of any levy would be set at the same rate as the relevant voluntary contribution, although the voluntary contribution will increase to reflect the overall increased costs of the FRC. It is intended that, should it be necessary to impose the levy on businesses, it will be collected on the same basis as the current (voluntary) business contributions – that is, as part of the Financial Services Authority's process for collecting the listing fee. Thus there will be no additional administrative cost.

Option 3

5.9 There would be additional costs for an independent body which became the statutory regulator of the auditing profession. It would have to take over the registration, monitoring and disciplinary arrangements for all auditors from the RSBs, and there would be additional costs for the body in developing rules on the eligibility of persons to act as auditors and the conduct of audit work, although this would to a certain extent be offset by a reduction of costs for the professional accountancy bodies that are RSBs. There would also be additional costs for auditors in re-registering with the statutory regulator.

(ii) Other costs

5.10 The Government considers that there are no other costs imposed on sectors other than business.

(iii) Costs for a typical business

5.11 The legislative proposals will not impose any additional substantive requirements on audit firms; the aim of the new requirements is to ensure that those who carry out standard setting, monitoring and disciplinary functions are independent of the RSBs. There will be no requirement for audit firms to register with a new body, nor to train e.g. staff in new requirements. There may be some additional costs to those audit firms that fall within the scope of the new independent monitoring arrangements through the increased focus on their audit work in relation to listed companies, although it is anticipated that this is unlikely to be substantial in comparison to the turnover charged by the firms.

5.12 In June 2004, the FRC announced that a listed company's contribution to the FRC for 2004/05 would increase from £400 per listed company to £4,250 for a FT-SE 350 company and £1,600 for other listed companies. However, the vast majority of this increase results from the new regulatory functions of the FRC which do not result from the legislative provisions (see paras 5.1 to 5.3 above).

6. Consultation with small business: the small firms' impact test

6.1 We consulted a number of small audit firms about the effect of any changes to the regulatory structure. Those firms which responded expressed concern about the effect of the proposals on the level of audit registration fees for all registered auditors. One respondent commented that an increase in fees could lead to smaller audit firms leaving the market and thus make it more difficult for smaller entities to obtain audit services. One respondent expressed concern that full statutory control could lead to a more bureaucratic and costly system.

6.2 We have no reason to believe that legislative provisions to increase the independence of audit regulation would significantly increase the costs to, or otherwise adversely affect small audit firms and small businesses. Nor do we have reason to believe that the changes would lead to increased costs of registration for audit services for customers, including small businesses, for the reasons set out in paras 5.6 to 5.7.

7. Competition Assessment

7.1 We have considered the impact of the proposed options in section 3 on competition between audit firms and we do not believe that any of these would have a detrimental impact on competition.

7.2 This view is based on the fact that the provision of a statutory basis for certain functions of the independent regulator would not change the functions of the regulator. The costs (and savings) of changes to the regulatory structure detailed in the options would not represent a significant proportion of the turnover of audit firms. As such, we do not believe that any of the options would be likely to affect the structure of the market, nor lead to higher costs for new or potential audit firms as compared to existing firms. We have not carried out a detailed assessment but believe the overall effect of the options on competition would be neutral.

8. Enforcement and sanctions

8.1 At present, in the event that a RSB does not comply with the statutory criteria set out in the Companies Act 1989 for the conduct of its supervisory role, the Secretary of State can seek a court order directing the body to comply with the requirements. The Secretary of State also has the power to derecognise an RSB.

8.2 The proposed additional requirements relating to independent standard setting, monitoring and disciplinary arrangements would be subject to the same enforcement mechanisms set out in para 8.1 above. If the recognition function was delegated to an independent body, then that body would also have the same enforcement powers.

8.3 Contributions towards the FRC's funding by companies and bodies which were the subject of a levy would constitute a civil debt owed to the FRC and, if not paid, would be enforceable by the FRC through the courts.

9. Monitoring and review

9.1 The Government will keep the new regulatory arrangements under review. The FRC will be required to report to the Secretary of State annually on the exercise of its regulatory functions.

10. Consultation

(i) Within government

10.1 The DTI consulted the Small Business Service, the Office of Fair Trading, HM Treasury and the devolved administrations.

(ii) Public consultation

10.2 The Government published a consultation document on 11 March 2003 seeking views on the proposed statutory provisions to support the regulatory functions of the FRC. Twenty five responses were received.

10.3 Respondents were generally supportive of the proposed changes. Of the 17 respondents who commented on the proposal to legislate to tie the professional bodies into the regulatory regime set by the FRC, but not to make the FRC a fully-fledged statutory body, 12 were in favour. The others were evenly split between those who thought that no legislation was necessary and those who thought that only a fully statutory regulator would be effective.

10.4 Fifteen respondents also commented on the draft RIA in the consultation document. A number of respondents considered that the proposals might reduce the number of firms which would be likely to engage in audit work which could impact adversely on consumers of audit and accountancy services.

10.5 A couple of respondents considered that the proposals did not go far enough as they did not extend to the whole of the accountancy profession, and that the reforms would therefore not benefit smaller companies or unincorporated businesses. A number of respondents also commented on the need to keep the cost effectiveness of the new regulatory regime under review.

11. Summary and recommendation

11.1 The table below shows a summary of the costs and benefits of the proposal.

<i>Description</i>	<i>Costs</i>	<i>Benefits</i>
1 – retain current system unchanged	No additional costs. Non-legislative changes currently being carried out will increase costs of regulation from approximately £5.5 million to approximately £12 million. Estimated increase in costs to listed companies of funding the FRC from £400 to £4,250 for FT-SE 350 companies and £1,600 for other listed companies.	No additional benefits.
2a – require RSBs to participate in independent standard setting, monitoring and disciplinary processes	Same costs as for option 1. Some additional costs for RSBs and audit firms in complying with new requirements, although these are not expected to be significant.	Improve public confidence in effectiveness of regulatory system for auditors. Focuses regulation on area of strongest public interest.
2b – as per Option 2a but also delegate Secretary of State's recognition power and provide a power to impose a levy	Same costs as for option 2a. Some additional costs to independent body in carrying out the delegated recognition function.	Same benefits as for Option 2a. Plus more effective oversight of RSBs and DTI savings of approx £17,500/yr. Security of funding for the regulator.
3 - confer statutory status and powers on a body to regulate company auditing	Extra costs to statutory body of registering, monitoring and disciplining all auditors. Extra costs to auditors in re-registering with statutory body.	Improve public confidence in the effectiveness of the regulatory system for auditors.

11.2 The recommended Option 2b has been adopted in the Act. We believe that this option will offer the greatest net benefit by providing a more effective system for the regulation of audit which will improve public confidence in the effectiveness of the regulatory system.

12. Declaration

I have read this Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Minister of State for Industry, and the Regions and Deputy Minister for Women and Equality

Jacqui Smith

Jacqui Smith MP

Date: November 2004

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