

Explanatory Text

(following publication of draft regulations on the BIS website from 7 April to 30 June 2011)

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

Introduction

1. The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011¹ have been made by the Secretary of State and will commence on 1 October 2011. They amend the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489) ("the 2008 regulations") which were made as part of the implementation of Part 16 of the Companies Act 2006 and of the Audit Directive².

2. 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) (Amendment) Regulations 2011 replace Schedule 2 to the 2008 regulations with a new Schedule 2A and amend regulation 5 so as to provide a new classification, which must be used by large companies for the disclosure of the fees they have paid to their auditor for services of different types beyond the basic fee for the statutory audit of the company in question. The replacement Schedule is intended to make for clearer disclosure of fees for audit and non-audit services, improving insight into the potential questions around the auditor's independence and linking more clearly to the classification of services in the 4th and 7th Company Law Directive requirements.

3. The new Schedule is intended to work in parallel with the Ethical Standards for Auditors³ produced by the Auditing Practices Board (APB). The 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. Under Ethical Standard 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. The standards

¹ SI 2011/2198

² 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. Article 49 of the Audit Directive amended the 4th Company Law Directive (78/660/EEC) and the 7th Company Law Directive (83/349/EEC) to introduce requirements into EU law on disclosure by companies of fees they have paid to their auditors for audit and non-audit services.

³ See www.frc.org.uk/apb/publications/ethical.cfm.

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then link to the Guidance on Audit Committees⁴ produced by the Financial Reporting Council. The Guidance was reviewed at the same time as the ethical standards so that the two documents now provide a framework for discussion between the auditor and the audit committee on the analysis the auditor has undertaken, the threats they have identified, and the safeguards they have put in place.

4. It therefore makes sense if the classification of non-audit services under the ethical standards links to the classification of non-audit services for disclosure in large companies' accounts. Following a review by the APB of the ethical standards⁵, completed with revisions to the standards in December 2010, these classifications are currently out of line. This imposes an additional administrative burden on companies, who must be able to reconcile the auditor's analysis with the fees they must disclose. However, as the company's shareholders and users of the accounts do not have such a reconciliation they do not have the insight, which the company's audit committee and directors have, into how the auditor has complied with the ethical standards.

Draft regulations

5. The Department for Business Innovation and Skills (BIS) published draft regulations⁶ on its website for comment from 7 April to 30 June 2011 intended to bring large companies' disclosure under the 2008 regulations more closely into line with the ethical standards and Directive requirements. Nine organisations responded with comments on the draft. They were:

- BDO LLP
- Confederation of British Industry (CBI)
- Deloitte LLP
- Ernst & Young LLP
- Grant Thornton UK LLP
- Institute of Chartered Accountants in England and Wales (ICAEW)
- KPMG LLP
- Price Waterhouse Coopers LLP (PWC)
- Unilever PLC

6. This explanatory text summarises the comments received on the draft regulations and gives the Government's response to those comments.

Government response to the comments on the draft regulations - Commencement provisions

7. Seven responses, one of which was endorsed by a further response, raised concerns about the commencement provision in regulation 1(2) of the draft regulations. The draft

⁴ See www.frc.org.uk/corporate/auditcommittees.cfm - documentation on the review of the standards is also available on this page.

⁵ For documentation on the review of the standards see www.frc.org.uk/apb/publications/pub2123.html and www.frc.org.uk/apb/publications/pub2324.html.

⁶ See www.bis.gov.uk/policies/business-law/accounting-auditing-reporting/audit

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amending regulations included a provision commencing the amendments on 1 October 2011, meaning that all accounts produced on or after that date would have to include notes complying with the amended 2008 regulations. All responses received suggested that the amendments should apply to all accounts of large companies for financial years beginning on or after that date. However six of these responses, including one that had been endorsed by a further response, also suggested that accounts for financial years beginning before that date should be able to include notes complying with the amended 2008 regulations, instead of notes complying with the current 2008 regulations, if the company preferred. The Government has considered this proposal and has included commencement provisions intended to have the suggested effect. This will mean that those large companies, whose accounts for financial years begin before the commencement date, and which complete their accounts after that date, will be able to choose whether to include notes complying with the current 2008 regulations or the amended regulations.

Government response to the comments on the draft regulations – Schedule 2 to the draft regulations

General concerns

8. Several respondents made comments about the general approach, both in the current Schedule 2, and in the draft new Schedule, of requiring disclosure of services under considerably more headings than is required by the 4th and 7th Company Law Directives. One response, which was endorsed by a further response, noted that this was effectively a form of “gold-plating” of the Directive, although it preceded the Directive’s introduction. While another respondent believed this additional detail was helpful, the first response argued it could only be justified on the basis of usefulness to the users of the company’s accounts. It went on to question how consistently the draft achieved its stated aim of linking the disclosure under the amended framework more clearly to that required by the Directive. It then expressed a general concern about the drafting of the paragraphs of the new Schedule and the indications given in those paragraphs as to the Directive headings under which those amounts were required to be disclosed. Several other responses seemed to be making a similar point in relation to individual paragraphs discussed below. We have responded to the general point which the response made on this issue, in relation to the individual concerns that have also been raised about particular paragraphs, where the general concern seems to have arisen. The revised Schedule in the final amending regulations is intended to address this general concern, as the Government is sympathetic with the overall aim of the respondent’s comments.

9. Another response recognised that the mapping from the Directive to the draft Schedule, and from that Schedule to the 23 categories of non-audit service identified in the ethical standards, would change with the amendments. The response suggested two ways in which guidance could be provided on the mapping that would apply. The Government and the APB have considered this concern and noted that, as a result of the amendments, the current reconciliation template⁷ contained in the ethical standards will need to be revised. The APB has agreed to consider revising this template to reflect the changes, and will provide further

⁷ The current template is available as an annex to Ethical Standard 1 at www.frc.org.uk/apb/publications/ethical.cfm

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detail in due course. In the meantime, the Government has assembled a table setting out how it considers the new categories of services in the amended 2008 regulations translate to the categories in the original 2008 regulations and to the categories in the Directive requirements. This table was originally produced as part of the Impact Assessment on the regulations. As the version of this table in the Impact Assessment relates to the draft regulations that were published for comment, an updated version is attached as an annex to this explanatory text.

10. The text below contains more detailed discussion of the individual concerns of respondents about particular paragraphs in the new Schedule and explains how the Government has responded to these.

Categories of services listed – Audit services to “associates” of the company

11. This category prompted several comments, some of which related to, what were viewed as, deficiencies in the 2008 regulations that were not being addressed by the amendments. The final amendments do not amend the basic approach of the Schedule to the 2008 regulations in that the final Schedule includes all the services fees for which are required to be disclosed under regulation 5(1)(b). These are all the services provided to the company and its associates by the auditor and its associates, other than the auditor’s statutory audit of the company. Fees for all these services must be disclosed under one of the headings in the Schedule. Five respondents, one of which was endorsed by a further response, took issue with this approach considering it to be contradictory. They took the view that:

- the company should only be required to disclose a single figure covering the total audit fee for the company and all its associates including where audit services are provided by associates of the auditor. They suggested the requirements for medium sized and small companies should be amended in line with this.
- the Schedule to the regulations, setting out the categories of other services required to be disclosed, should not include audit fees, so as to be a categorisation of non-audit services only.

12. However four responses (including two of those discussed above, one of which was endorsed by a further response) appeared to recognise that the Directive requirement for disclosure of the audit fee relates to the fee for the auditor’s statutory audit of the individual company. They suggested the individual company audit fee should be disclosed as a subtotal of the total of all group audit fees, which they thought should still be required to be disclosed as a single figure. The Government has considered this suggestion. There is no statement in the 2008 regulations suggesting that the Schedule consists only of categories of non-audit services. Though there has been some misunderstanding, this does not appear to be a consequence of any inherent confusion or contradiction in the approach of the regulations, which require disclosure of all fees for services other than the company’s own individual audit fee, under the Schedule. In this sense the fees disclosed under the Schedule are for “non-audit services”, in that the services are any services other than the company’s own individual audit. Furthermore, including all fees, other than the audit fee paid by the company, in the Schedule ensures that as many disclosures as possible are covered by the group disclosures exemption under regulation 6(2) and (3) (also see paragraph 24 on this exemption).

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13. One response welcomed the fact that the draft Schedule did address one particular deficiency relating to fees for the audits of associates of large UK companies that are not "required by legislation". Up to now this wording in the 2008 regulations has caused difficulties as not all audits of associates are required by legislation. This can be because an audit is not required by legislation at-all in the jurisdiction in which an associate is incorporated, or possibly because they are audit exempt, whether in the UK or elsewhere. The draft amendments had addressed this issue by allowing the fees for the audit of any associate to be included in the first category in the draft Schedule irrespective of whether the audit was required by legislation. This is implemented in the final amendments.

14. The Government has made a further change to address an issue that has arisen with this approach. Four responses, one of which was endorsed by a further response, considered it was unclear where under the regulations a large company would disclose any fees payable for the audit of the company to an associate of the auditor. These fees would most likely be for work done by an overseas member of the auditor's network contributing to the statutory audit of the company by doing audit work at an overseas establishment of the company (ie not a separate company which is part of the same group but an overseas office which is part of the company itself). We have now made clear that any fees payable by the company to an associate of the auditor, as part of the audit, should be included under regulation 5(1)(a) of the amended regulations. This is the simplest approach as it minimises the number of separate disclosures that need to be made.

15. Two respondents, one of which was supported by a further response, commented on the continued use of the term "associate" in the 2008 regulations following the draft amendments. The provision on interpretation of references to an associate of a company at regulation 3(2)(c) of the 2008 regulations does not conform interpretation of the term "associate" elsewhere in the Companies Act 2006, or in accounting standards. Though we accept that the use of the same term could be confusing, the reasons for the specific differences in the 2008 regulations are still justified and were not questioned. The term is also used in the main body of the regulations, outside of the new Schedule and, in this sense is established in its use in the regulations as a whole. However, the draft amendments to the regulations were only considering a relatively narrow proposal to amend the categorisation of services required to be used by large companies under the 2008 regulations. Given the limited remit of this review, the Government has not addressed this wider issue relating to the approach of the 2008 regulations.

Categories of services – Audit related assurance services

16. One respondent suggested that the second category of services required to be listed in the Schedule, that of "audit related assurance services", should be made clearer by describing the services that are intended to be included in this category. In fact those services are described as a category of "audit related services" in the ethical standards⁸ and in the revised Guidance to Audit Committees published by the Financial Reporting Council⁹. The

⁸ See paragraph 56 in Ethical Standard 5 at www.frc.org.uk/apb/publications/ethical.cfm.

⁹ See the footnote to paragraph 4.31 of the December 2010 Guidance at www.frc.org.uk/corporate/auditcommittees.cfm

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Government has taken the view that all of the services included in that category can be described as “assurance services” under the Directive requirements and that the ethical standards provide sufficient guidance on what is intended by this category to mean it is unnecessary to expand on the description of the category further.

Categories of services - Taxation advisory services.

17. Three respondents, one of which was endorsed by a further response, welcomed the separation of taxation advisory services into two categories, as taxation compliance services and other taxation advisory services. Taxation services are required to be disclosed as a single category under the 2008 regulations and under the Directive requirements. The separation of these services into two categories in the ethical standards was intended to reflect the differences in risk to the auditor’s independence of providing taxation compliance services, as compared to taxation advisory services more generally. The final regulations continue this policy. It has come to the Government’s attention that some taxation advisory services, especially taxation compliance services could also be described as “assurance services”. As taxation advisory services are a separate category of service under the Directive requirements, the final Schedule requires disclosure of “other assurance services” so as to exclude any taxation advisory services, to make sure that these services are disclosed as such.

Categories of services - Internal audit services

18. Four responses, one of which was endorsed by a further response, questioned the continued inclusion of internal audit services as a separate category of non-audit service in the Schedule. However one other response explicitly stated its support for the separate disclosure of these services. The continued inclusion of this category reflects the categorisation of non-audit services in the Ethical Standards for Auditors. Because of the particular issues that arise around the auditor’s independence from these services, the Government has concluded that the amended regulations should continue to require separate disclosure of fees for internal audit services.

19. One response questioned whether all internal audit services would be required to be disclosed as “other non-audit services” under the Directive or whether some would be required to be disclosed as “assurance services”, and therefore whether those services should be disclosed as assurance services under the new Schedule. The Government does not consider the Directive requirements intend that any internal audit services should be disclosed as “assurance services”. As a result, the final Schedule requires disclosure of “other assurance services” excluding internal audit services to make sure that internal audit services are disclosed as such. The new Schedule no longer uses the language of services being “identified in” certain paragraphs. Instead it uses the language of services “falling within” those paragraphs so as to oblige companies to disclose fees for services under the appropriate paragraph where they fall within it. As a result, where services fall within the category of internal audit services, they must be disclosed under that paragraph.

Categories of services - Services related to corporate finance transactions

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20. Six responses, one of which was endorsed by a further response, questioned whether the two categories of services relating to corporate finance transactions in the draft amendments could not be combined into a single category. The responses all considered that the separation of these services into two categories would have been difficult at times. One other respondent stated they saw little difficulty, though they also questioned the Government's justification for requiring disclosure under two separate categories. The Government had made this proposal because of the reduced risks to the auditor's independence resulting from services relating to the assembly of a circular, prospectus or listing particulars, as compared to other services relating to corporate finance transactions.

21. One of the responses pointed out that some services relating to circulars, prospectuses and listing particulars are assurance services. Under the Directive, these would almost certainly have to be disclosed as such. Some may also be tax advisory services. The Government also recognises that the paragraph requiring separate disclosure of these services, as it was drafted, would have required the inclusion of other services that did not relate to the assembly of the circular, prospectus or listing particulars, but did relate to the same transaction. These services could have been provided in relation to any corporate finance transaction, irrespective of whether a circular, prospectus or listing particulars were required and would have imposed the same risks to the auditor's independence irrespective.

22. Following its consideration of the comments received, the Government has concluded that this category should be combined with that relating to corporate finance transactions more generally. However the paragraph is different from that in the 2008 regulations because it explicitly requires the separate disclosure of assurance and tax advisory services as such, in compliance with the Directive requirements.

Categories of services - Other non-audit services

23. Six responses one of which was endorsed by a further response, questioned the drafting of the final category. This category is now drafted to reflect the fact that all the categories of service below paragraph 1 are in fact non-audit services.

Government response to the comments on the draft regulations - other points raised

Group disclosure exemption

24. Four responses, one of which was endorsed by a further response, commented on the Group disclosure exemption in regulations 6(2) and (3). They questioned whether individual companies taking advantage of the exemption should continue to be required to state that they were doing so on the basis that a disclosure was made in the consolidated accounts. Although this statement will take the form of "boilerplate" standard text, the Government continues to think this provides helpful signposting.

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

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25. Three responses, one of which was endorsed by a further response, stated their support for the Government's decision not to take forward any proposals to amend the 2008 regulations to address the issues that arose from the inspectors' report into Phoenix Venture Holdings Ltd and MG Rover Group Ltd. This issue is considered further in the Impact Assessment on the regulations.

26. The Government had 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 Ltd, MG Rover Group Ltd and 33 other companies. The report¹⁰, 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 the Inspectors found had been paid¹¹. 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 completion of the APB's review of the Ethical Standards for Auditors. The Impact Assessment on the regulations explains the consideration which the Government gave to whether the 2008 regulations should be amended to require disclosure of fees for non-audit services to "connected parties" of this kind. As stated in the explanatory text on the draft regulations, the Government does not now intend to make proposals for such amendments.

¹⁰ 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)

¹¹ See the Progress report published by the Financial Reporting Council in November 2009 for further details: www.frc.org.uk/images/uploaded/documents/ROVER%20PROGRESS%20REPORT%20-%20PUBLISHED.pdf

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Annex – Comparison of classification of non-audit services under the 2008 regulations with that in the draft 2011 amendments

This table is intended to show how the three classifications relate to one another.

2008 regulations	2011 amendments	Article 43.1(15) of the 4th Company Law Directive and Article 34.16 of the 7th Company Law Directive
1. The auditing of accounts of associates of the company pursuant to legislation (including that of countries and territories outside the United Kingdom).	1. The auditing of accounts of any associate of the company.	1. Other assurance services
2. Other services supplied pursuant to such legislation.	2. Audit related assurance services. 6. All assurance services not falling within paragraphs 1 to 5.	
3. Other services relating to taxation.	3. Taxation compliance services. 4. All other taxation advisory services not falling within paragraph 3.	2. Taxation advisory services
4. Services relating to information technology.	See Note 1 below.	See Note 2 below.
5. Internal audit services.	5. Internal audit services.	3. Other non-audit services
6. Valuation and actuarial services.	See Note 1 below.	See Note 2 below.
7. Services relating to litigation.		
8. Services relating to recruitment and remuneration.		
9. Services relating to corporate finance transactions entered into or proposed to be entered into on behalf of the company or any of its associates.	7. Services relating to corporate finance transactions entered into, or proposed to be entered into, by or on behalf of the company or any of its associates not falling within paragraphs 1 to 6 (See also Note 3 below).	
10. All other services.	8. All other non-audit services not falling within paragraphs 2 to 7 (See also Note 1 below).	

Note 1 - Fees for these classes of non-audit service under the 2008 regulations should be disclosed under paragraph 8 in the new Schedule under the 2011 amendments, unless they take the form of assurance services (in which case the fees would be disclosed under paragraph 6) or tax advisory services (in which case the fees would be disclosed under paragraphs 3 or 4 as appropriate).

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Note 2 - Fees for these classes of non-audit service under the 2008 regulations would be disclosed as other non-audit services under the Directive requirements, unless they take the form of assurance services or tax advisory services, in which case the fees would be disclosed as such.

Note 3 - Fees for these classes of non-audit service under the 2008 regulations should be disclosed under paragraph 7 in the new Schedule under the 2011 amendments, unless they take the form of assurance services (in which case the fees would be disclosed under paragraph 6) or tax advisory services (in which case the fees would be disclosed under paragraphs 3 or 4 as appropriate).

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