

EXPLANATORY MEMORANDUM TO

THE STATUTORY AUDITORS AND THIRD COUNTRY AUDITORS (AMENDMENT) (EU EXIT) (NO. 2) REGULATIONS 2020

2020 No. 1247

1. Introduction

- 1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

- 2.1 This instrument will make amendments to previously made legislation to prepare the United Kingdom's (UK's) audit regulatory regime for the end of the Transition Period. It will grant states of the European Economic Area (the EEA States) and Gibraltar approval as equivalent third countries and their audit regulatory authorities status as "approved third country competent authorities" on account of the adequacy of their arrangements for the transfer of audit working papers and investigation reports.
- 2.2 This instrument will also extend the duration of the period of provisional approval as an approved third country competent authority that has been granted to the Independent Regulatory Board of South Africa.
- 2.3 These amendments will come into effect at the end of the Transition Period. This instrument is intended to ensure that the UK's audit regulatory regime continues to allow for cross-border listing of securities on the UK's regulated markets by companies in the EEA States and Gibraltar and makes sure there are no obstacles in the UK framework for regulatory cooperation with their competent authorities.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

- 3.2 As the instrument is subject to negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

4. Extent and Territorial Application

- 4.1 The territorial extent of this instrument is the United Kingdom
- 4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

- 5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

- 6.1 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 (“The Audit Directive” - OJ L157, 9/6/2006, p. 87) sets out requirements on the statutory audit of certain businesses that are required to be audited under EU law. It also sets out the responsibilities of the competent authorities of member States for regulation of statutory audit, including audit inspections, investigations and enforcement. In the UK, the competent authority is the Financial Reporting Council (FRC), which has ultimate responsibility for monitoring and inspections, investigations and sanctioning of auditors.
- 6.2 Article 45 of the Audit Directive provides for the regulation of auditors of companies from outside the EEA, where those companies issue securities that are admitted to trading on the regulated market of an EEA State ("third country auditors"). It requires that these auditors are registered and regulated in the EEA state in which the regulated market is based, and the securities traded. The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019 (SI 2019/177) as amended by the Statutory Auditors, Third Country Auditors and International Accounting Standards (Amendment) (EU Exit) Regulations 2019 (SI 2019/1392), and the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020 (SI 2020/108) (“the first, second and third audit regulations” respectively) and the Companies and Statutory Auditors etc. (Consequential Amendments) (EU Exit) Regulations 2020 (SI 2020/523) (collectively “the EU exit audit regulations”) made amendments to the framework for registration and regulation of third country auditors in the UK. They will apply in combination with an amendment by the Financial Conduct Authority to its Disclosure Guidance and Transparency Rules. One of the main effects of the changes will be to include EEA auditors in the requirement for registration and regulation of third country auditors when they audit EEA or third country issuers whose securities are traded on UK regulated markets.
- 6.3 Article 46 of the Audit Directive allows the requirements on the registration and regulation of third country auditors to be disapplied, in whole or in part, subject to certain conditions, where a registered third country auditor is subject to a system of regulation which is determined to be "equivalent" to that required by the Directive. The first and second audit regulations provided new powers for the Secretary of State to grant equivalence of third countries' audit regulatory regimes for this purpose via a new power to make regulations, inserted as section 1240A of the Companies Act 2006. Section 1240A also enabled the Secretary of State to make provision for the grant of equivalence to a third country. The third audit regulations included provision specifying the procedure for assessing the audit regulatory regime of the third country and granting approval, and setting out considerations which must be taken into account. Following the completion of appropriate procedures, this instrument adds the EEA States and Gibraltar to the list of third countries that have been granted approval.
- 6.4 Article 47 of the Audit Directive allows member States to transfer, or permit the transfer, of audit working papers and investigation reports to a third country competent authority for audit, only where a number of conditions have been met. These usually include that the Commission has determined that the relevant third country competent authority has "adequate" requirements as regards the confidentiality of information transferred. A third country competent authority's adequacy status is granted by the Commission once it has made an assessment of the

legal framework applied in the relevant third country, and of undertakings given by the third country competent authority on the handling and use of information transferred. The third country competent authorities granted adequacy status by the Commission includes some authorities whose approved status is time limited in EU law and may need to be extended or renewed. This has happened recently in the case of the Regulatory Board of Auditors of South Africa in Commission Implementing Decision (EU) 2020/589 of 23 April 2020 on the adequacy of the competent authority of the Republic of South Africa pursuant to Directive 2006/43/EC (OJ No L 138, 30.4.2020), p. 15- “the Commission Implementing Decision”). Meanwhile Article 36 of the Audit Directive applies to the handling of audit regulatory information by EEA competent authorities and the transfer of that information between them. It provides for the confidentiality of that information with exceptions to allow the transfers provided for. The basis for an assessment of adequacy of a third country competent authority under Article 47 of the Audit Directive is that it is subject to arrangements that achieve comparable outcomes to those required under Article 36 of the Audit Directive in the EEA States.

6.5 The first audit regulations amended the framework that had implemented both Articles 36 and 47 of the Audit Directive in order to treat EEA States and third countries in the same way. Transfers of audit working papers and investigation reports will continue to be on the basis of working arrangements following a determination of the adequacy of the relevant third country competent authority, including of an EEA competent authority. However, this determination would be made by the Secretary of State in regulations under new section 1240B of the Companies Act 2006. As with section 1240A, section 1240B enables the Secretary of State also to make provision for the grant of adequacy status. The third audit regulations included provision specifying the procedure for assessing the competent authority and granting approval, and setting out considerations which must or may be taken into account. Following the completion of appropriate procedures this instrument amends the provisional approval of the competent authorities of the EEA States and Gibraltar so that it is no longer provisional and will apply on an indefinite basis.

6.6 The Explanatory Memorandum relating to the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019 can be found here:

<http://www.legislation.gov.uk/uksi/2019/177/memorandum/contents>

The Explanatory Memorandum relating to the Statutory Auditors, Third Country Auditors and International Accounting Standards (Amendment) (EU Exit) Regulations 2019 can be found here:

<https://www.legislation.gov.uk/uksi/2019/1392/memorandum/contents>

The Explanatory Memorandum relating to the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020 can be found here:

<http://www.legislation.gov.uk/uksi/2020/108/memorandum/contents>

The Explanatory Memorandum relating to the Companies and Statutory Auditors etc. (Consequential Amendments) (EU Exit) Regulations 2020 can be found here:

<https://www.legislation.gov.uk/uksi/2020/523/memorandum/contents>

7. Policy background

What is being done and why?

- 7.1 Regulation 2(2) grants the EEA States and Gibraltar approval as equivalent third countries. Following an assessment by the Department for Business, Energy and Industrial Strategy (BEIS), which took into consideration the views of the Financial Reporting Council (FRC), the provisions grant approval for an indefinite period. This determination in the regulations is based on the findings of BEIS's assessment that the regimes of these countries are equivalent to that of the UK based on the criteria set out in the third audit regulations. Previously, as part of the UK's planning for the possibility that a withdrawal agreement would not be reached with the EU, the first audit regulations granted these countries approval as transitional third countries until 31 December 2020. The previous grant of transitional equivalence status is withdrawn accordingly.
- 7.2 Regulation 2(3) grants the competent authorities of the EEA States and Gibraltar approval as approved third country competent authorities (otherwise known as granting "adequacy" status). Following an assessment by BEIS, which took into consideration the views of the Financial Reporting Council (FRC), the provisions grant this status indefinitely. This determination in the regulations is based on the findings of BEIS's assessment that the frameworks applicable to these authorities included 'adequate' provision on the transfer of audit working papers and investigation reports. Previously, as part of the UK's planning for the possibility that a withdrawal agreement would not be reached with the EU, the first audit regulations granted these countries' competent authorities provisional approval as approved third country competent authorities until 31 December 2020. The previous expiry date due to that provisional approval is withdrawn accordingly.
- 7.3 These changes will take effect from the end of the Transition Period (or 'IP completion day'), which will be from 23:00 on 31st December 2020.
- 7.4 Regulation 2(4) makes a consequential amendment on account of the changes in Regulation 2(2). It amends wording in a transitional provision in paragraph 2(a) of Schedule 4 to the first audit regulations, which now requires the EEA States to also be treated as equivalent for financial years beginning before the end of the Transition Period. This is intended to ensure consistency in the operation of the framework after the end of the Transition Period.
- 7.5 Regulation 3 extends the duration of provisional approval as an approved third country competent authority to the Independent Regulatory Board of Auditors of South Africa. Approval begins as from the end of the Transition Period. Previously, the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2020, applied this provisional approval until 31 July 2022, this amendment will extend provisional approval 30 April 2026. This reflects the Commission Implementing Decision, which will be retained EU law after the end of the Transition Period.
- 7.6 Regulation 4 removes an amendment in regulation 17(b) of the Companies and Statutory Auditors etc. (Consequential Amendments) (EU Exit) Regulations 2020 before that amendment takes effect. It would have amended paragraph 2(1) of Schedule 1 to the first audit regulations, but this is no longer needed because of the removal of paragraph 2(1) by regulation 2(2)(c) of this instrument.

7.7 This instrument applies to Company Law which is a transferred matter for Northern Ireland under section 4 of the Northern Ireland Act 1998. The Companies Act 2006 provides for a single company law regime applying to the whole of the UK, so that companies are UK companies rather than GB companies or Northern Ireland companies. EU Exit legislation which amends the Companies Act or legislation made under it therefore applies to the whole of the UK. This does not affect the legislative competence of Northern Ireland: company law remains a transferred matter, and the Companies Act could be amended separately or repealed in Northern Ireland if that were so desired.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not trigger the statement requirements under the European Union (Withdrawal) Act 2018.

8.2 This instrument is not being made under the European Union (Withdrawal) Act 2018 but relates to the withdrawal of the United Kingdom from the European Union. This is because at the end of the Transition Period the United Kingdom will no longer be subject to the Audit Directive and will be able to implement independent decisions on the equivalence of third countries and the adequacy of their competent authorities.

9. Consolidation

9.1 This is not a consolidation.

10. Consultation outcome

10.1 We have not been able to publicly consult in order to minimise sensitivities in advance of negotiations with the EU. This instrument was developed in the Department for Business, Energy and Industrial Strategy on the basis of informal consultation with representatives of various groups with an interest in the regulation of statutory auditors. Consultees included representatives of the audit profession, of the larger audit firms, of investors in companies who must make investment decisions on the basis of the audited accounts and reports of businesses, and with the FRC. BEIS officials met regularly with a group of representatives to discuss legislative options and potential impacts on auditing.

11. Guidance

11.1 Guidance is not required.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 Almost all of the provisions in this instrument will result in amendments to Schedules 1 and 2 to the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019. Analysis of impacts was carried out for that instrument and concluded that only a limited group of companies was affected by most of the substantial changes. It found that comparatively few EU companies issue securities that are admitted to trading on UK regulated markets. This instrument now provides equivalence on an indefinite basis which will have modest further benefits beyond

those provided in 2019. All of the relevant costs and benefits to auditors and their client businesses under this particular amending instrument are costs and benefits to businesses and auditors based outside the UK. As such, in line with the HMT Green Book and better regulation rules, a further detailed impact assessment has not been completed, and all the relevant impacts / analysis relating to overseas countries have been appropriately factored into this decision.

13. Regulating small business

- 13.1 The legislation applies to activities that are undertaken by small businesses.
- 13.2 To minimise the impact of the requirements on small businesses (employing up to 50 people), as these would mostly be audit firms and their small business clients including small PIEs, the approach taken in the EU exit audit regulations was to only make very necessary changes outside of those that are required in the context of sophisticated transactions between companies and financial markets.
- 13.3 This instrument is consistent with that approach, which is the basis for the final decision on what action to take to assist small businesses.

14. Monitoring & review

- 14.1 The regulation does not include a statutory review clause and, in line with the requirements of the Small Business, Enterprise and Employment Act 2015 the Parliamentary Under Secretary of State for Climate Change and Corporate Responsibility, Lord Callanan has made the following statement:
- 14.2 "A review provision is not included in respect of the provisions of the Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) (No. 2) Regulations 2020 because these provisions and amendments have no, or no significant, impact on business, charities or voluntary bodies".

15. Contact

- 15.1 Paul Smith at the Department of Business, Energy and Industrial Strategy Telephone: 0207 215 4164 or email: pauld.smith@beis.gov.uk can be contacted with any queries regarding the instrument.
- 15.2 Andrew Death, Deputy Director for Corporate Responsibility and Audit, at the Department of Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.
- 15.3 Lord Callanan, Parliamentary Under Secretary of State for Climate Change and Corporate Responsibility at the Department of Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.