



**PROFESSIONAL OVERSIGHT BOARD**

**REGULATION OF THIRD COUNTRY AUDITORS –  
GIVING EFFECT IN THE UK TO THE REQUIREMENTS OF  
THE STATUTORY AUDIT DIRECTIVE**

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## One – Background

1.1 The Eighth Company Law Directive on Statutory Audit (“SAD”) was adopted by the European Union in May 2006. Member States must transpose its provisions into national law by 29 June 2008. Whilst the SAD is largely concerned with the regulation of audit firms within the European Union, it includes specific provisions on the regulation of the auditors of certain non-EU<sup>1</sup> companies who have issued securities admitted to trading on EU regulated markets (“third country auditors”).

1.2 The statutory requirements for the regulation of third country auditors are set out in some detail in the SAD itself and in the detailed implementation of those requirements in UK. The European Commission has now also proposed a separate measure in the form of a draft Decision on the implementation of these requirements, in particular providing for transitional arrangements.

1.3 The Professional Oversight Board (“the Oversight Board”) has powers, delegated by Government, to set the detailed regulatory requirements to give effect to these statutory requirements, and to apply them in practice.

1.4 The purpose of this document is to explain the requirements and to seek comments on the detailed approach the Oversight Board proposes to take to their implementation in the UK.

**The questions on which we would welcome comments are set out in Chapter 3.**

**Chapter 5 sets out how to respond.**

### **Third Country Auditor Provisions in the Statutory Audit Directive**

1.5 **Article 45** of the SAD (see **Annex 1**) sets out new requirements for the regulation of the auditors of companies incorporated outside the EU with securities admitted to trading on EU regulated markets<sup>2</sup>, including the London Stock Exchange’s main market. There is an exception where the company has issued only debt securities with a denomination per unit of at least €50,000 or equivalent at the date of issue.

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<sup>1</sup> For this purpose, the EU includes the members of the European Free Trade Area, that is, Norway, Iceland and Lichtenstein.

<sup>2</sup> Regulated markets in the UK include the main market of the London Stock Exchange plc, the regulated market segment of the SWX Europe market operated by SWX Europe Ltd, and the Plus-listed market operated by Plus Markets plc

1.6 The underlying principle is that all auditors of companies traded on EU regulated markets should be subject to a level of regulation equivalent to the minimum required for auditors under the SAD, regardless of where that issuer is incorporated.

1.7 That regulation comprises the following principal elements:

- registration of audit firms;
- external monitoring of the quality of audit work;
- continuing oversight of the audit firms;
- arrangements for investigation and sanctions.

1.8 **Article 46** allows Member States to derogate from these requirements where those auditors are subject in their home country to an equivalent system of regulation; and it allows for the European Commission to make transitional arrangements.

1.9 The requirements have a similar purpose to those in the US, through the Public Company Accounting Oversight Board, in Canada, through the requirements of the Canadian Public Accounting Board, and in Japan, where new requirements for the registration of non-Japanese audit firms are being introduced by the Financial Services Agency.

1.10 Our estimate is that, as of October 2007, there were roughly 570 companies from third countries with securities admitted to trading on UK regulated markets. These come from roughly 50 countries and have around 150 different auditors<sup>3</sup>.

1.11 Information on third country issuers with securities admitted to trading on other EU regulated markets and their auditors is imperfect. However, we understand that there are substantial numbers of third country issuers on regulated markets in Luxembourg, Ireland and Germany, with significant numbers in France and the Netherlands and small numbers in some other Member States. Many non-EU issuers will have securities listed in more than one Member State and many of their third country auditors will therefore be subject to regulation in more than one Member State.

1.12 The SAD provides that the required level of regulation can be achieved by applying registration and regulatory requirements to the third country auditor

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<sup>3</sup> This figure excludes auditors established in the European Union (and therefore subject to the 8<sup>th</sup> Directive requirements) of third country issuers. In addition there are a number of issuers for which we do not at present have information on the names of the auditors.

similar to the Member State's own domestic regulation. However, the SAD recognises that this could prove disproportionately burdensome and a Member State can disapply or modify these requirements where the third country has "equivalent" systems of public oversight, quality assurance, and investigation and penalties and does not itself impose more onerous requirements on that Member State's audit firms.

1.13 The determination of equivalence is principally a matter for the European Commission, working with EU audit regulators and Member State Governments. However, a Member State may itself determine equivalence, if the Commission has not yet taken a decision. Whilst the Commission has carried out preliminary work on the equivalence of certain third countries' audit regulatory systems, it has concluded that more detailed work is needed through 2008 before it puts forward specific proposals on equivalence. We do not consider further in this paper the question of equivalence.

1.14 More recently the Commission has proposed measures which would permit Member States for a transitional period to treat the regulatory arrangements in specified countries largely as if they were equivalent, without an assessment of equivalence having been made. This is considered further in the next section.

### **Commission's Proposals for Transitional Measures**

1.15 The European Commission put forward a draft Decision to Member States for transitional measures at the end of January. The Commission published a revised draft of the Decision on 27 May (**Annex 2**) and we understand that this will be put to the Audit Regulatory Committee<sup>4</sup> for formal approval in June. If approved by Member States, and provided that there are no objections from the European Parliament, a final Decision is expected to be published in July.

1.16 The draft Decision should provide substantial relief from the regulatory requirements of Article 45 for the majority of auditors of third country issuers, subject to those auditors providing specific information. (We refer to such auditors in this document as "**transitional third country auditors**".)

1.17 In particular:

- The majority of countries whose audit firms audit issuers on EU markets fall within the transitional arrangements and are listed as part of the draft

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<sup>4</sup> This is the Committee of representatives of Member States' Governments, established under the Statutory Audit Directive

Decision. **Annex 3** analyses the available UK data on third country issuers and their auditors, according to whether they fall within the transitional arrangements or not. (NB Issuers should note that inclusion of a country within the draft Decision is not a guarantee of inclusion in the final Decision.)

- The proposed transitional period applies in respect of audits of annual accounts for financial years starting between 29 June 2008 and 1 July 2010.
- The draft Decision does not permit Member States to apply the regulatory requirements of Article 45 to transitional third country auditors, although, the firms must provide specific information - on their legal structure, their system of internal quality control, any network to which they belong, the auditing standards and independence requirements to be applied to the relevant audits, and the date of the last external quality assurance review and necessary information about the outcome;

1.18 In addition, the relevant oversight body must make clear to the public that the relevant audit firm is subject to regulation in a country not as yet recognised as equivalent in accordance with Article 46 of the Directive;

1.19 Finally, the draft Decision does not prohibit Member States from applying their system of investigation and penalties to such auditors; it also allows for arrangements with third countries for cooperation on inspections.

## **Implementation of the Third Country Auditor Provisions in the UK**

1.20 The Financial Services Authority is responsible for imposing the requirement that a company incorporated outside the EU whose transferable securities are admitted to trading on a UK regulated market must use auditors that meet particular criteria. The FSA Consultation Paper 07/24 proposes that the auditors must either be a UK or other EU statutory auditor, or must be on the UK register of third country auditors that the Oversight Board will maintain. These requirements are expected to apply in respect of audits of accounts for financial periods starting on or after 29 June 2008.

1.21 A third country audit firm must meet the requirements for registration set out in sections 1239 to 1247 of, and Schedule 12 to the Companies Act 2006 (as amended by Regulations 34 to 40 of the *Statutory Auditors and Third Country Auditors Regulations 2007*<sup>5</sup> )

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<sup>5</sup> The *Statutory Auditors and Third Country Auditors Regulations 2007* are themselves amended by SI 2008/499.

1.22 Setting the detailed requirements, maintaining the register of third country auditors, and regulating third country audit firms in practice, are the responsibility of the Oversight Board. The relevant functions of the Secretary of State are delegated to the Oversight Board under the *Statutory Auditors (Delegation of Functions etc) Order 2008*.

1.23 The effect of the law is that an audit firm from outside the EU, to act as a third country auditor for UK purposes, must be registered by the Oversight Board, in order to sign audit reports of the relevant third country issuers that are valid for EU purposes. However, the law leaves significant flexibility to the Oversight Board to determine the precise regulatory requirements, provided that these do not go beyond what is permitted by the Directive or any Commission Decision made under it. In particular, subject to this and to general principles of law governing the exercise of the Oversight Board's functions, the Oversight Board can apply different requirements to different classes of third country auditors or particular third country auditors. It is important to note that it is the country of the audit firm that is relevant, not the country of incorporation of the third country issuer.

### **Cooperation amongst Member States**

1.24 A number of audit firms from around the world will be subject to regulation in more than one Member State. We are aware of the need for Member States to try and set requirements and make arrangements that minimise the extent of duplicative or overlapping requirements in different Member States and to maximise cooperation. This is not easy, as the Directive is not based on a system of passporting registrations from one Member State to another, and given also (i) that the European legal framework is not yet complete, and (ii) that implementation into national law in different countries is at different stages and may take differing forms.

1.25 Against this background we are working within the European Group of Auditor Oversight Bodies to develop common format application forms for registration in different Member States and to find ways of sharing information on applications and coordinating their consideration in the relevant Member States. Our expectation is that we can agree this summer common format application forms both for full registrations under Article 45 and for registration/notification under the transitional regime, and that many Member States will be able to use these forms.

## Length of Consultation Period and Next Steps

1.26 As noted above, we expect that the FSA requirements will apply in respect of audits of accounts of third country issuers for financial periods starting on or after 29 June 2008. It is unlikely therefore that third country issuers risk being in default of these new requirements until well into 2009. Nevertheless, we recognise that issuers and their auditors need to know well ahead of that date that the auditors are able to register in the relevant jurisdictions.

1.27 We are keen therefore to have full arrangements in place in the UK as soon as possible, once the European Commission has published and brought into force the Decision on transitional arrangements, which, as noted above, is expected to be in July 2008. However, following discussions with a number of our European counterparts, we think that the earliest date by which we could have available common format application forms (in line with the Commission Decision) is September or October of 2008.

1.28 Against this background:

- we would welcome views on **urgent** issues **by 27 June**, in particular on **Question 1 in Chapter 3** – that is how important it is for the Oversight Board to be able to accept and process applications for registration as soon as the Commission Decision on transitional provisions is published. This will help us to decide whether to put in place interim arrangements to receive applications both for full registration and for registration under the transitional regime, ahead of introducing common format application forms, which is unlikely to be possible before September or October of 2008.
- we would welcome **more detailed responses** to the issues raised in this document, and set out in Chapter 3 as soon as possible, but by **25 July** at the latest. This will enable us to take these into account in discussing with EU colleagues the detailed content of common application forms and arrangements for cooperation.

1.29. The details of how to respond are set out in **Chapter 5**.

## Two – Proposals for Regulating Third Country Audit Firms

2.1 For the purposes of this document, we classify third country auditors either as:

- Third country auditors in countries which come within the Commission’s transitional arrangements (“transitional third country auditors” or **TTCAs**).
- Third country auditors in countries that are outside the Commission’s transitional arrangements (“other third country auditors” or **OTCAs**).

It is important to note that, it is the country of the audit firm that is relevant, not the country of incorporation of the third country issuer.

2.2 We set out below the way in which we propose to set requirements both for TTCAs and for OTCAs, for each of the regulatory elements below:

- Registration of the relevant audit firms
- External Monitoring of the quality of audit work
- Continuing oversight of the audit firms
- Arrangements for investigating audit firms and imposing sanctions.

We also set out proposed arrangements for fees.

2.3 There are differences in the urgency with which the regulatory elements need to be addressed. The principal focus in this document is on the most urgent - the registration requirements. We set out in less detail the way in which we envisage giving effect to the other requirements.

2.4 In developing these we have taken into account:

- The requirements of the Statutory Audit Directive (**Annex 1**)
- The European Commission’s draft Decision (4<sup>th</sup> Draft), as published on 27 May (**Annex 2**)

- The UK legislative framework (*Companies Act 2006* and the *Statutory Auditors and Third Country Auditors Regulations 2007* ([SATCAR](#)), SI 2007/3494<sup>6</sup>)
- The need to cooperate with other Member States, to minimise duplicative or overlapping regulation where a third country audit firm is subject to the requirements of more than one Member State.
- The FRC's commitment to follow the Better Regulation Commission principles of good regulation, and in particular, to the extent that the statutory obligations imposed on us permit, to ensure that regulation is proportionate to the objective and does not impose unnecessary or over-burdensome regulatory requirements.

## Scope

2.5 As noted in Chapter 1, the third country auditor provisions apply to auditors of companies incorporated outside the EU with securities admitted to trading on a UK regulated market, other than where the company has issued only debt securities with a denomination per unit of at least €50,000 or equivalent at the date of issue. In the UK, under the proposed FSA rules, the new requirements will apply to the auditors of financial statements for accounting periods starting on or after 29 June 2008.

2.6 **Annex 3** analyses the available UK data on third country issuers and their auditors, according to whether they fall within the transitional arrangements or not.

## Registration of Third Country Auditors

2.7 We propose:

- Both TTCAs and OTCAs will have to register in the UK. It is important to emphasise that both TTCAs and OTCAs will be on the register of third country auditors kept for the purposes of Regulation 32 of the *Statutory Auditors and Third Country Auditors Regulations 2007* and will therefore meet the FSA requirements (see paragraph 1.20 above)
- There will be two distinct types of registration – in brief, TTCAs will have to meet only the information requirements in the Commission Decision; OTCAs

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<sup>6</sup> SATCAR is amended in a few minor but important ways by SI 2008/499.

will have to meet the full registration requirements of Article 45 of the Statutory Audit Directive, as implemented in the UK.

We will modify the detailed proposals set out below as necessary in the light of (i) the final text of the Commission's Decision, (ii) further discussions with our EU counterparts, and (iii) responses to this consultation.

### *Registration of Transitional Third Country Auditors*

2.8 The Commission's Decision will limit the information that Member States can require from TTCAs. The following is in accordance with the draft Decision. We propose that TTCAs :

- must provide the following administrative information
  - name and address
  - a description of the firm's legal structure
  - where the firm belongs to a network, a description of the network
  - a description of the firm's internal quality control systems
- must update the information it has provided in a timely manner.
- must specify the auditing standards and auditor independence rules which have been applied or will be applied to each relevant audit engagement.
- must give the date of the last external inspection to which the TTCA was subject and provide necessary information about the outcome;
- will be liable to external independent inspection of the quality of its audit work by the Oversight Board or by someone acting on behalf of the Oversight Board, if required as part of reciprocal arrangements with the TTCA's national regulatory authority, with a view to establishing mutual confidence in the inspection arrangements. The draft Decision provides for this. For the avoidance of doubt we support the principle of home country regulation where possible and would only seek to inspect where the regulatory authority of the third country auditor wished itself to inspect UK audit firms, to meet reciprocity requirements.
- must pay an annual registration fee.

2.9 A decision to register a transitional third country auditor should be straightforward in most cases. The Oversight Board will give reasons if it rejects an application for registration.

### ***Full Registration (Other Third Country Auditors or OTCAs)***

2.10 Regulations 29 to 39 of the *Statutory Auditors and Third Country Auditors Regulations (2007) (SATCAR)* ) set out requirements for full registration in detail. In accordance with these, we propose that OTCAs:

- must provide the information, in respect of firms and of individuals, set out in Regulation 34 (2) and (3) of SATCAR, for inclusion on the register of the third country. This is given at **Annex 4**;
- must update the information it has provided in a timely manner.
- must provide an Application Statement, which meets the requirements of Regulation 36 of SATCAR (see **Annex 4**), which:
  - gives the audit qualifications of each member of the firm's administrative or management body; and confirms that a majority of those members hold a qualification which is equivalent to that required by the SAD.
  - gives the audit qualifications of each individual responsible for audits of the relevant non-EU companies and confirms that each holds a qualification which is equivalent to that required by the SAD.
  - states that the firm, and specifically (i) individuals within the firm responsible for audit work and (ii) members of the management board, are fit and proper to undertake audit work;
  - specifies the auditing standards which will apply to the relevant audit engagements and confirms that the firm will conduct such audits in accordance with International Standards on Auditing or with equivalent standards.

- states the auditor independence requirements that will apply to the relevant audits and confirms that the firm will conduct such audits in accordance with standards of independence and objectivity equivalent to those required by Articles 22, 24 and 25 of the SAD.
- confirms that the firm will publish on its web-site, within three months of its year end, an annual transparency report which is equivalent to that required by Article 40 of the SAD.
- must be subject to external independent inspection of the quality of its audit work by the Oversight Board or by someone on behalf of the Oversight Board; if there are any legal restrictions on the conduct of inspections the firm should set these out.
- must cooperate with the Oversight Board in relation to regulatory oversight and investigations; where appropriate, the firm should also set out any requirements of local law that would restrict the ability of Oversight Board to conduct such an investigation.
- must provide evidence to support the accuracy of the information given in the Application Statement.
- must notify matters to the Oversight Board, where the Oversight Board has specified in writing the information to be notified; and to provide information that the Oversight Board may reasonably require in response to a written request.
- must pay an annual registration fee.

2.11 It is the responsibility of the relevant third country auditor to ensure the accuracy and reliability of the information provided. However, we may seek further verification of information provided, as we consider necessary, in particular where there is evidence that the information provided may not be accurate. We may also ask for additional information or evidence.

## **De-registration of Transitional and Other Third Country Auditors**

2.12 In exceptional circumstances where a TCA ceases to meet the requirements for registration, and, after notification under para 2.13 below, fails to take appropriate steps to rectify the position, it will be necessary to remove the TCA from the register. Examples of such circumstances include the following, where the TCA:

- has provided information that is materially inaccurate;
- has failed to provide updated information in a timely manner;
- fails to participate in monitoring or investigation arrangements;
- is no longer competent to conduct the audits of companies with securities admitted to trading on UK regulated markets;
- is no longer fit and proper to conduct the audits of companies with securities admitted to trading on UK regulated markets;
- has been barred from conducting audits of listed entities in its own country or in another EU Member State or third country;
- does not pay a periodic registration or other fee due to the Oversight Board.

2.13 Where the Oversight Board considers that there are grounds for removing a TCA from the register, the Oversight Board will notify the TCA that there are grounds and, where appropriate, setting out the steps which the firm must take to comply with its obligations as a TCA. The firm will then have three months to respond including showing the steps it has taken. The Oversight Board would then take a final decision on de-registration.

## **Independent External Inspections of Third Country Auditors**

2.14 There is less urgency to develop detailed arrangements for the monitoring of third country auditors. The first financial statements requiring an audit report to be signed by a registered third country auditor, other than in exceptional cases, will be

for the year ending 30 June 2009. The Statutory Audit Directive then requires external monitoring on a three year cycle, as is required for auditors of UK public interest entities.

2.15 We propose to take the following approach to external monitoring:

- As a general rule we shall not undertake inspections of TTCAs. As noted above, we would have the right, however, to undertake such inspections, as necessary to meet reciprocal arrangements with a third country regulatory authority.
- OTCAs will be subject to inspections by the Oversight Board in a similar way to an equivalent UK audit firm. In practice, to minimise regulatory burdens and costs, we will consider a range of inspection models, which include direct monitoring by the Audit Inspection Unit of the Oversight Board, but also inspections by another EU audit regulator or third country regulator that meets the Article 46 equivalence test. We would tailor the nature and extent of the monitoring to our assessment of the likelihood and impact of risk, as we do in relation to UK audit firms.
- We shall develop more detailed plans for monitoring over the coming year, in collaboration with colleagues in other EU Member States, with a view to putting in place effective arrangements to meet the Directive requirements but which avoid unnecessary and overlapping monitoring.

### **Continuing Oversight of Third Country Auditors.**

2.16 We expect that continuing oversight of TTCAs will be modest. We will not actively monitor the firm, and we will make clear on the register that this is the case. However, we propose that TTCAs should have to complete a simple annual return to check that we have up-to-date information. We will consider taking action where we are made aware of information that calls in question continued registration.

2.17 OTCAs will be subject to active continuing oversight. In particular we will consider the firm's continued registration in the light of each periodic external inspection. We will also require such firms to complete an annual return to ensure that we have updated information relevant to the firm's registration and the undertakings it gave on registration. As a result, we may impose additional conditions on registration, such as to a prohibition on a particular audit partner from

signing a relevant audit report for UK purposes; and we may take steps to de-register the firm.

## **Investigations and Sanctions**

2.18 TTCAs will not be subject to a formal system of investigation and sanctions, other than the proposals set out above in relation to de-registration.

2.19. As noted under “Registration”, OTCAAs will be required to be subject to arrangements for the investigation of serious concerns as to their ability or fitness to undertake the relevant audit work, and to the imposition of sanctions by the Oversight Board. Investigations would be subject to any provisions in the law of the firm’s country of establishment which restricted the ability to carry them out. In practice, we expect that a formal investigation would be exceptional and would require there to be a strong UK public interest in doing so, and balanced against the likely cost and difficulty of undertaking such an investigation. Our approach therefore in most cases will be to look first to consideration of possible de-registration for UK purposes, as proposed above.

## **Fees**

2.20. We expect to charge fees to cover the Oversight Board’s costs in setting up and maintaining a system of registration and regulation of third country auditors. This is subject to Government approval.

2.21 Our aim is to set a structure of fees which strikes a balance between the need to avoid an over-complex structure and the need to relate the fees broadly to the regulatory effort involved.

2.22 We propose the following structure of fees:

- an annual registration fee;
- a charge to cover the costs of a specific inspection undertaken by the Oversight Board, or on our behalf.

2.23 We propose to vary the level of registration fees according to the number of audit clients within scope.

2.24 We propose to differentiate the level of registration fees as between TTCAs and OTCAs. There is likely to be significantly more regulatory effort required in respect of OTCAs, and the level of fees will reflect this.

2.25 The fee for external inspection is likely to be calculated on a case by case basis.

2.26 As this is a new activity for the Oversight Board, it is extremely difficult to estimate with a high degree of confidence either the costs or the revenues that will be generated. We are likely therefore to need to change the level of fees - upwards or downwards – in the light of initial experience.

2.27 Our initial view is that we should apply the following scale of fees, based on a preliminary assessment of the costs of setting up and running systems for the first year of £200,000 (see Chapter 4 below) and an analysis of the number of audit firms likely to register.

Proposed Annual Registration Fees for Third Country Auditors		
No of relevant audit clients at date of application	Transitional	Other
0 - 9	£1000	£2000
10+	£2500	£5000

## **Three – Issues for Consultation**

We would welcome comments on urgent issues, and in particular on Question 1, by 27 June, and responses to the other issues raised by 25 July.

### **Timing of Introduction of Arrangements for Registration**

**Q1** How important is it that the Oversight Board has arrangements in place to accept and process applications (both for full registration and under transitional arrangements) from third country auditors as soon as the Commission Decision on transitional provisions is published (expected to be July)? Or should the Oversight Board allow more time to try to use common format application forms with other Member States from the outset? A realistic date for introducing this is September or October (paragraph 1.28).

### **Registration**

**Q2** Do you agree with the overall approach to registration and in particular that there should be different requirements for 'transitional' third country auditors and for 'other' third country auditors? What comments do you have on the detailed registration requirements (paragraphs 2.7 to 2.10)?

**Q3** To what extent should Oversight Board seek to verify the accuracy and reliability of the information provided to apply for registration; to what extent should it rely on the audit firm to provide accurate information; and in particular should the firm be expected to provide references in support of its statement on good repute? (paragraph 2.11).

### **De-Registration**

**Q4** What are your comments on the proposals on de-registration (paragraphs 2.12 to 2.13)?

### **External Quality Assurance Inspections**

**Q5** What are your comments on the approach to external inspections of third country auditors (paragraphs 2.14 to 2.15)?

**Q6** Do you have any suggestions that we should take into account as we develop more detailed ideas for external monitoring 'other' third country auditors?

## Oversight

**Q7** What are your comments on the proposed approach to the continuing oversight of third country auditors (paragraphs 2.16 to 2.17)?

## Investigations

**Q8** What are your comments on the proposed approach to investigations and sanctions by the Oversight Board of third country auditors (paragraphs 2.18 to 2.19)?

## Fees

**Q9** Do you have comments or suggestions on the proposed structure of fees? Do you have comments on the proposed level of fees? (paragraphs 2.20 to 2.27)

## Costs and Benefits

**Q10** Do you have comments on the assessment of costs and benefits in Chapter 4?

## Other Points

**Q11** Do you have any other comments or suggestions on how we should regulate third country auditors?

## Four – Regulatory impact assessment

### Benefits

4.1 The purpose of introducing the requirements, as set out in the Statutory Audit Directive, is to ensure that high quality work is performed by auditors from third countries thereby protecting investors and maintaining confidence in capital markets in the European Union. Quantifying the benefits of these particular regulatory changes is difficult. They are, however, likely to arise in the medium to long term, and to be most effective if the requirements prove a catalyst for the introduction of more effective audit regulation locally in third countries, which then provides a basis for the mutual reliance on one another's systems.

4.2 More generally, although the risks and costs associated with poor investor confidence in Europe and globally are also difficult to quantify, the potential costs to investors and employees following a major corporate scandal would be enormous. As noted by the then Department of Trade & Industry in 2007<sup>7</sup>, one estimate of the loss in US stock market wealth, as a result of the Enron and Worldcom scandals was some \$38 billion dollars in the first year. Thus, even modest reductions in such risks bring substantial benefits.

### Costs

4.3 Quantifying the costs is equally difficult, though they are, at most, modest in relation to the market capitalisation of many of the companies concerned. It is also important to stress that the approach – both of the UK Government and of the Oversight Board, as a part of the UK's Financial Reporting Council - , has been to argue strongly within the EU for transitional measures that are as wide as possible and which allow third countries time to develop their own equivalent systems of audit regulation on which Member States are then able to rely.

4.4 Such transitional arrangements, as reflected in the Commission's draft Decision, substantially reduce the immediate regulatory burden on third country auditors (and indirectly on the issuers), compared to what they would otherwise be. This is because, the overall costs of registration, oversight and monitoring associated with a transitional third country auditor will be substantially lower than the corresponding cost of regulating a third country auditor outside the transitional regime. An underlying consideration is that increasing the regulatory costs for a third country issuer could affect the attractiveness of London as a capital market.

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<sup>7</sup> *Implementation of Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts*, BERR March 2007

4.5 Consistent with this aim to minimise additional regulatory costs, the detailed proposals set out in Chapter 2 set the minimum requirements on third country auditors that we judge to be consistent with the requirements of the SAD and the draft Decision.

4.6 Our initial analysis (Annex 3) suggests that the number of third country audit firms that would need to register with the Oversight Board is of the order of 180 in the ratio of 4:1 TTCAs to OTCAs. In the initial phase the principal costs for the Oversight Board relate to developing the systems for registration, processing applications for registration, setting up the public register, and exercising ongoing oversight. In addition there are costs for the audit firm in preparing an application for registration and in responding to new regulatory requirements.

4.7 Our preliminary view is that the cost to the Oversight Board of setting up and running these systems over the first year is likely to be of the order of £200,000. Our aim is to recover those costs from registration fees.

4.8 In the longer term there is the potential for greater costs associated with monitoring the third country audit firms. However, there are still so many unknowns that it is premature to suggest a likely figure or range of figures. This will depend for example on the extent to which the Commission determines that regulatory arrangements in a third country are equivalent, the extent to which cooperation amongst Member States and with third countries is realised, and the type of inspection process to be used.

## Five – How to Respond

5.1 Please respond on urgent issues, and in particular on Question 1 in Chapter 3, by **27 June**, and to the other issues set out in Chapter 3 by **25 July**.

5.2 Responses should be sent by e-mail if possible to [j.grewe@frc-pob.org.uk](mailto:j.grewe@frc-pob.org.uk).

Alternatively you may send comments by post to:

John Grewe  
Professional Oversight Board  
Financial Reporting Council  
5<sup>th</sup> Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

5.3 Comments will be made publicly available on the Oversight Board section of the FRC web-site ([www.frc.org.uk/pob](http://www.frc.org.uk/pob)) unless respondents specifically request otherwise. If you send an e-mail response which includes an automatically generated notice stating that the content is to be treated as confidential you should make it clear in the body of your message whether or not you wish your comments to be treated as confidential.

## **ANNEX 1**

### **Articles 45 and 46 of Statutory Audit Directive 2006/43/EEC**

#### **Article 45**

##### *Registration and oversight of third-country auditors and audit entities*

1. The competent authorities of a Member State shall, in accordance with Articles 15 to 17, register every third-country auditor and audit entity that provides an audit report concerning the annual or consolidated accounts of a company incorporated outwith the Community whose transferable securities are admitted to trading on a regulated market of that Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC, except when the company is an issuer exclusively of debt securities admitted to trading on a regulated market in a Member State within the meaning of Article 2(1)(b) of Directive 2004/109/EC [22], the denomination per unit of which is at least EUR 50000 or, in case of debt securities denominated in another currency, equivalent, at the date of issue, to at least EUR 50000.

2. Articles 18 and 19 shall apply.

3. Member States shall subject registered third-country auditors and audit entities to their systems of oversight, their quality assurance systems and their systems of investigation and penalties. A Member State may exempt a registered third-country auditor or audit entity from being subject to its quality assurance system if another Member State's or third country's system of quality assurance that has been assessed as equivalent in accordance with Article 46 has carried out a quality review of the third-country auditor or audit entity concerned during the previous three years.

4. Without prejudice to Article 46, audit reports concerning annual accounts or consolidated accounts referred to in paragraph 1 of this Article issued by third-country auditors or audit entities that are not registered in the Member State shall have no legal effect in that Member State.

5. A Member State may register a third-country audit entity only if:

(a) it meets requirements which are equivalent to those laid down in Article 3(3);

(b) the majority of the members of the administrative or management body of the third-country audit entity meet requirements which are equivalent to those laid down in Articles 4 to 10;

(c) the third-country auditor carrying out the audit on behalf of the third-country audit entity meets requirements which are equivalent to those laid down in Articles 4 to 10;

(d) the audits of the annual or consolidated accounts referred to in paragraph 1 are carried out in accordance with international auditing standards as referred

to in Article 26, as well as the requirements laid down in Articles 22, 24 and 25, or with equivalent standards and requirements;

(e) it publishes on its website an annual transparency report which includes the information referred to in Article 40 or it complies with equivalent disclosure requirements.

6. In order to ensure uniform application of paragraph 5(d) the equivalence referred to therein shall be assessed by the Commission in cooperation with Member States and shall be decided upon by the Commission in accordance with the procedure referred to in Article 48(2). Pending such a decision by the Commission, Member States may assess the equivalence referred to in paragraph 5(d) as long as the Commission has not taken any decision.

## **Article 46**

### *Derogation in the case of equivalence*

1. Member States may disapply or modify the requirements in Article 45(1) and (3) on the basis of reciprocity only if the third-country auditors or audit entities are subject to systems of public oversight, quality assurance and investigations and penalties in the third country that meet requirements equivalent to those of Articles 29, 30 and 32.

2. In order to ensure uniform application of paragraph 1 of this Article, the equivalence referred to therein shall be assessed by the Commission in cooperation with Member States and shall be decided upon by the Commission in accordance with the procedure referred to in Article 48(2). Member States may assess the equivalence referred to in paragraph 1 of this Article or rely on the assessments carried out by other Member States as long as the Commission has not taken any decision. If the Commission decides that the requirement of equivalence referred to in paragraph 1 of this Article is not complied with, it may allow the auditors and audit entities concerned to continue their audit activities in accordance with the relevant Member State's requirements during an appropriate transitional period.

3. Member States shall communicate to the Commission:

- (a) their assessments of the equivalence referred to in paragraph 2; and
- (b) the main elements of their cooperative arrangements with third-country systems of public oversight, quality assurance and investigations and penalties, on the basis of paragraph 1.

## **ANNEX 2: Fourth draft of commission decision published 27 may 2008**

Draft

**COMMISSION DECISION (EC) No ///**

**of [...]**

**concerning a transitional period for audit activities of certain third country auditors and audit entities**

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to 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/ECC and repealing Council Directive 87/253/ECC, and in particular Article 46(2) thereof,

Whereas:

(1) Under Article 45(1) of Directive 2006/43/EC the competent authorities of the Member States are required to register third-country auditors and audit entities that conduct a statutory audit on certain companies incorporated outwith the Community whose transferable securities are admitted to trading on a market regulated within the Community. Article 45(3) of Directive 2006/43/EC requires Member States to subject such registered third-country auditors and audit entities to their systems of oversight, quality assurance systems and systems of investigations and penalties.

(2) The Commission is required under Article 46(2) of Directive 2006/43/EC to assess the equivalence of third country oversight, quality assurance and investigation and penalties systems in cooperation with Member States and make a determination. If those systems are recognised as equivalent, Member States may exempt third country auditors and audit entities from requirements of Article 45 of the Directive on the basis of reciprocity.

(3) The Commission has carried out a preliminary assessment of audit regulation in relevant third countries with the assistance of the European Group of Auditors' Oversight Bodies. However, the assessments have not allowed final equivalence decisions to be taken but have provided an initial view of the state of audit regulation in the third countries concerned. Some third countries have a system of public oversight in place, although for the time being the information about the systems is not sufficient for final equivalence decisions to be taken. Others do not have such systems of public oversight yet but have in place an audit regulatory framework offering a perspective of moving towards such system.

(4) In view of the need for further assessments for the purpose of taking final equivalence decisions regarding the audit regulation in place in third countries, it is appropriate to take a decision providing for a transitional period in respect of auditors and audit entities from the third countries concerned in order to permit such assessments to be carried out. During this period, equivalence decisions should therefore not be taken by Member States at national level.

(5) Since it is necessary to protect investors, during the transitional period auditors and audit entities from the third countries concerned should be able to continue their audit activities

without being registered under Article 45 of Directive 2006/43/EC only if they provide information about themselves, the auditing standards and independence requirements applied to when carrying out audits. Information about the outcome of individual quality assurance reviews will also be useful for this purpose.

(6) Under those conditions, auditors and audit entities from the third countries concerned should be able to continue their activities in relation to audit reports concerning annual or consolidated accounts for financial years starting during the period from 29 June 2008 to 1 July 2010. Accordingly, during that transitional period, the competent authorities referred to in Article 45 of the Directive 2006/43/EC should be able to register those auditors and audit entities. Nevertheless, this Decision should not affect Member States' rights to apply their investigations and penalties systems.

(7) The fact that third country auditors and audit entities may, under this Decision, continue their audit activities with regard to companies referred to in Article 45 of the Directive 2006/43/EC should not prevent Member States from establishing cooperative arrangements on individual quality assurance reviews between the competent authorities of a Member State and the competent authorities of a third country.

(8) The Commission should review the operation of the transitional arrangements in due time. If third countries concerned do not then have a system of public oversight in place, it should be ascertained whether the competent authorities of such countries have made a public commitment to the Commission to comply with equivalence criteria based on Articles 29, 30 and 32 of the Directive 2006/43/EC and whether an additional transitional period is necessary. At the end of the transitional period, the Commission may take decisions on the equivalence of the audit regulation of the third countries concerned. In addition, the Commission should review whether the competent authorities of Member States encountered difficulties to be recognized by such third countries. Thereafter, it is up to Member States to decide in accordance with Article 46 of the Directive 2006/43/EC on the basis of reciprocity whether to disapply or modify the requirements in Article 45(1) and (3) of the Directive to auditors and audit entities from third countries recognised as equivalent.

(9) The measures provided for in this Decision are in accordance with the opinion of the Audit Regulatory Committee,

HAS ADOPTED THIS DECISION:

#### *Article 1*

1. Member States shall not apply Article 45 of Directive 2006/43/EC in relation to audit reports concerning annual accounts or consolidated accounts, as referred to in Article 45(1) of that Directive, for financial years starting during the period from 29 June 2008 to 1 July 2010, which are issued by auditors or audit entities from the third countries referred to in the Annex to this Decision, in cases where the third-country auditor or audit entity concerned provides the competent authorities of the Member State with all of the following:

(a) the name and address of the auditor or audit entity concerned and information about its legal structure;

(b) where the auditor or the audit entity belongs to a network, a description of the network;

(c) the auditing standards and independence requirements which have been applied to the audit concerned;

(d) a description of the internal quality control system of the audit entity;

(e) an indication of whether and when the last quality assurance review of the auditor or audit entity was carried out and necessary information about the outcome of the review. Where information about the outcome of the last quality assurance review is non public and such information cannot directly be provided by the competent authorities of the concerned third country, the competent authorities of Member States shall treat such information on a confidential basis.

2. Member States shall ensure that the public is informed about the name and address of auditors and audit entities concerned from the third countries referred to in the Annex to this Decision and about the fact that those third countries are not yet recognised as equivalent for the purposes of Directive 2006/43/EC. For these purposes, the competent authorities of Member States referred to in Article 45 of the Directive may also register the auditors and audit entities from the third countries referred to in the Annex.

3. Notwithstanding paragraph 1, Member States may apply their investigations and penalties systems to the auditors and audit entities from the third countries referred to in the Annex

4. Paragraph 1 shall be without prejudice to co-operative arrangements on quality assurance reviews between the competent authorities of a Member State and the competent authorities of a third country referred to in the Annex provided that such an arrangement meets all the following criteria:

(a) it includes carrying out quality assurance reviews on the basis of equality of treatment;

(b) it has been communicated in advance to the Commission;

(c) it does not pre-empt any Commission decision under Article 47 of Directive 2006/43/EC.

#### *Article 2*

The Commission shall, at the latest within two years, review the situation of the third countries referred to in the Annex. In particular, the Commission shall verify whether the competent administrative authorities of those third countries referred to in the Annex for which no equivalence decisions have been made by the Commission yet have made a public commitment to the Commission to set up public oversight and quality assurance systems on the basis of the following principles:

(a) the systems are independent from the audit profession;

(b) they ensure adequate oversight for audits of listed companies;

(c) their operation is transparent and ensures that the outcome of quality assurance reviews is reliable;

(d) they are supported by investigations and penalties in an effective way.

*Article 3*

This Decision is addressed to the Member States.

Done at Brussels, [...]

*For the Commission*

[...]

*Member of the Commission*

**ANNEX**

**List of third countries**

Argentina

Australia

Bahamas

Bermudas

Brazil

Canada

[Cayman Islands]

Chile

China

Croatia

Guernsey, Jersey, Isle of Man

Hong Kong

India

Indonesia

Israel

Japan

Kazakhstan

Mauritius

Mexico

Morocco

New Zealand

Pakistan

Russia

Singapore

South Africa

South Korea

Switzerland

Taiwan

Thailand

Turkey

Ukraine

United Arab Emirates

United States of America

### ANNEX 3 Summary of third country uk issuers and auditors by country of incorporation of issuer

COUNTRY	TRANSITIONAL		NON TRANSITIONAL	
	Number of Issuers	Number of Auditors	Number of Issuers	Number of Auditors
Argentina	2	2		
Aruba			2	1
Australia	35	4		
Bahrain			4	2
Barbados			1	1
Bermuda	22	3		
Brazil	2	1		
British Virgin Islands			4	1
Canada	22	5		
Cayman Islands	81	4		
Chile	1	1		
China	6	6		
Croatia	2	2		
Crown Dependencies	34	14		
Egypt			9	2
Georgia			1	2
Hong Kong	3	2		
India	19	18		
Indonesia	1	1		
Israel	9	6		
Japan	76	15		
Jordan			1	1
Kazakhstan	4	2		
Kenya			1	1
Lebanon			2	2
Malawi			1	1
Malaysia			1	1
Marshall Islands			1	0
Mexico	2	2		
Morocco	1	1		
Netherland Antilles			12	3
New Zealand	2	2		
Oman			1	1
Pakistan	2	2		
Panama			1	1
Peru			1	2
Puerto Rico			1	0
Qatar			3	2
Russia	29	5		
Singapore	3	2		
South Africa	12	4		
South Korea	23	8		
Switzerland	6	3		
Taiwan	28	4		
Thailand	2	2		
Turkey	9	5		
UAE	5	3		
United States	76	5		
Zambia	1	1		
	<b>520</b>	<b>135</b>	<b>47</b>	<b>24</b>

Note: At the time of writing the Cayman Islands are included in square brackets in the Commission Decision. This table assumes that they are included in the transitional arrangements.

## ANNEX 4

### Regulations 34 to 40 of the *Statutory Auditors and Third Country Auditors Regulations 2007 (SI 2007/3494)*

#### Register of third country auditors

**34.**—(1) The designated body must keep the register of third country auditors (see section 1239 of the Companies Act 2006).

(2) The register must contain the following information in relation to each third country auditor who is an individual—

- (a) his name and address;
- (b) his registered number;
- (c) an indication that he is a third country auditor;
- (d) if he is responsible for audit work on behalf of a third country auditor which is a firm, the firm's name, address, registered number and, if it has a website, its address;
- (e) in the case of a third country auditor who has registered with an EEA competent authority—
  - (i) the name and address of that authority, and
  - (ii) the registration number which that authority has allocated to it;
- (f) the name and address of any body which has authorised the third country auditor to conduct audits in accordance with the law of a third country; and
- (g) if he has entered into arrangements with a body for the purposes of section 1242(1) of the Companies Act 2006 (duties of registered third country auditors), the name and address of that body.

(3) The register must contain the following information in relation to each third country auditor which is a firm—

- (a) its name and address;
- (b) the address of each of its offices in which it carries out third country audit work;
- (c) its registered number;
- (d) an indication that it is a third country auditor;
- (e) its contact information and, if it has a website, its address;
- (f) its legal form;
- (g) the name and address of each person who is—
  - (i) an owner or shareholder of the firm, or
  - (ii) a member of the firm's administrative or management body;
- (h) the name, address and registered number of each individual who performs third country audits on behalf of the firm;
- (i) in the case of a third country auditor which is a member of a network—
  - (i) a list of the names and addresses of the other members of that network, or
  - (ii) an indication of where that information is available to the public;

(j) in the case of a third country auditor which has registered with an EEA competent authority—

(i) the name and address of that authority, and

(ii) the registration number which that authority has allocated to it;

(k) the name and address of any body which has authorised the third country auditor to conduct audits in accordance with the law of a third country; and

(l) if it has entered into arrangements with a body for the purposes of section 1242(1) of the Companies Act 2006 (duties of registered third country auditors), the name and address of that body.

(4) The register of third country auditors must be kept in electronic form.

(5) The information on the register must be kept available for inspection by any person by electronic means, unless it is excluded in accordance with paragraph (6).

(6) Information on the register relating to an individual may be excluded from being made available for inspection if making the information so available would create or be likely to create a serious risk that the individual, or any other person, would be subject to violence or intimidation.

(7) In this regulation “network” means an association of persons cooperating in audit work by way of—

(a) profit sharing,

(b) cost sharing,

(c) common ownership, control or management,

(d) common quality control policies and procedures,

(e) common business strategy, or

(f) use of a common brand name.

(8) For the purposes of this regulation—

(a) a network is not a firm, and

(b) an association of individuals which is a firm is not a network.

### **Application for registration of third country auditor**

**35.—**(1) A third country auditor may apply to the designated body for registration in accordance with this regulation.

(2) An application for registration must be in writing.

(3) An application for registration of a third country auditor must include—

(a) the information required for his entry in the register (see regulation 34), other than

(i) his registered number, and

(ii) the name and address of any body with which he has entered into arrangements for the purposes of section 1242(1) of the Companies Act 2006 (duties of registered third country auditors);

(b) the statement required by regulation 36 (application statement); and

(c) evidence demonstrating that the matters included in the statement required by regulation 36 (application statement) are correct.

(4) For the purposes of paragraph (3)(c) a statement by the third country competent authority which oversees or regulates the third country auditor to the effect that the third

country auditor is a fit and proper person to conduct audits in that third country may be treated as evidence demonstrating that the statement required by regulation 36(c) is correct.

(5) An application for registration must—

- (a) in the case of a third country auditor who is an individual, be signed by the third country auditor;
- (b) in the case of a third country auditor which is a firm, be signed by a person authorised by the firm to sign on its behalf.

(6) An application may be delivered to the designated body by electronic means, if the designated body so agrees.

### **Application statement**

**36.—**(1) A third country auditor must make a statement for the purposes of his application under regulation 33 (application for registration of third country auditor) to the effect that—

- (a) in the case of a third country auditor who is an individual, he holds a qualification which meets requirements equivalent to those which apply to an appropriate qualification for the purposes of section 1219 of the Companies Act 2006;
- (b) in the case of a third country auditor which is a firm—
  - (i) a majority of the members of the firm's administrative or management body hold qualifications which meet requirements equivalent to those which apply to an appropriate qualification for the purposes of that section, and
  - (ii) each individual who conducts audits of UK-traded non-EEA companies (within the meaning of Part 42 of the Companies Act 2006) on behalf of that firm holds a qualification which meets requirements equivalent to those which apply to an appropriate qualification for the purposes of that section;
- (c) he is a fit and proper person to conduct audits of UK-traded non-EEA companies;
- (d) he conducts such audits in accordance with standards equivalent to those required by Articles 22, 24 and 25 of the Audit Directive (independence, objectivity and audit fees);
- (e) he conducts such audits in accordance with standards equivalent to those determined under arrangements within paragraph 22 of Schedule 10 to the Companies Act 2006 (independent determination of technical standards); and
- (f) he publishes on a website an annual transparency report equivalent to that required for auditors of public interest entities by Article 40 of the Audit Directive (transparency report).

### **Acceptance and refusal of application for registration**

**37.—**(1) The designated body may register a third country auditor if he has made an application in accordance with regulation 35 (application for registration of third country auditor).

(2) The designated body may not register a third country auditor if it considers that the statement required by regulation 36 (application statement) made by him is not correct.

(3) If the designated body refuses to register a third country auditor, it must give him written notice to that effect stating the reason for the refusal.

### **Allocation of registered number**

**38.** The designated body must allocate a number to each third country auditor which it registers, which shall be known as the third country auditor's registered number.

### **Duty to provide updated information**

**39.**—(1) A registered third country auditor must take all reasonable steps to notify the designated body without undue delay of—

(a) the name and address of any body he has entered into arrangements with for the purposes of section 1242(1) of the Companies Act 2006 (arrangements for monitoring of audits of UK-traded non-EEA companies);

(b) any information or event which may lead the designated body to consider that the statement required by regulation 36 (application statement) made by the third country auditor is not correct;

(c) any information necessary to ensure that the information in the register relating to him is correct.

### **Removal of third country auditor from the register**

**40.**—(1) If the designated body considers that the statement required by regulation 36 (application statement) made by the third country auditor is no longer correct, it must—

(a) notify the third country auditor of the steps he must take to ensure that the statement is correct, and

(b) if the third country auditor has not taken those steps on or before the date three months after the notification, remove him from the register.

(2) The designated body may remove a third country auditor from the register if it considers that the third country auditor has failed to comply with his obligations under—

(a) regulation 39 (duty to provide updated information),

(b) section 1242 of the Companies Act 2006(11) (duties of registered third country auditors),

(c) section 1243 of that Act (matters to be notified to the Secretary of State), or

(d) section 1244 of that Act (Secretary of State's power to call for information).



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