

These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004

COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT 2004

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 1: Auditors, Accounts, Directors' Liabilities and Investigations Chapter 1: Auditors

Summary and Background

13. The provisions in this Chapter amend the statutory framework for the regulation of auditors, as provided for in the Companies Act 1989. Under this framework, a company auditor must be a member of a recognised supervisory body and hold a recognised professional qualification. A professional accountancy body may act as a recognised supervisory body and/or offer a recognised professional qualification where it has been so recognised by the Secretary of State. The Secretary of State also has the power to recognise appropriate overseas qualifications as equivalent to a UK recognised professional qualification.
14. Five bodies are currently recognised by the Secretary of State as recognised supervisory bodies: the Institute of Chartered Accountants in England and Wales (ICAEW); the Institute of Chartered Accountants of Scotland (ICAS); the Association of Chartered Certified Accountants (ACCA); the Institute of Chartered Accountants in Ireland (ICAI); and the Association of Authorised Public Accountants.
15. Five bodies are currently recognised by the Secretary of State as offering recognised professional qualifications: the ICAEW; ICAS; ACCA; ICAI; and the Association of International Accountants.
16. The recognised supervisory bodies have day to day responsibility for ensuring the appropriate supervision of auditors and audit firms. The detailed requirements which they must observe in carrying out this supervision role are set out in Part 2 of Schedule 11 to the Companies Act 1989.
17. The provisions in this Chapter amend that Schedule by placing new requirements on the recognised supervisory bodies. The new requirements are designed principally to ensure the independence of the regulation of major public interest audit work, and to permit delegation of the Secretary of State's powers under Part 2 of the Companies Act 1989 (principally the power to recognise accountancy bodies as recognised supervisory bodies for auditors) to a wider category of persons than before.
18. Also relevant to the structure and funding of audit regulation are provisions in Chapter 2 which replace the Secretary of State's grant-making power in section 256(3) of the Companies Act 1985 with a new power which enables the Secretary of State to make grants in respect of a wider range of activities relating to financial reporting and administration. Previously, section 256(3) has enabled the Secretary of State to make grants for the issuing or enforcement of accounting standards or for overseeing or directing such activity. This power has been used to fund in part the activities of the FRC

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(Financial Reporting Council) and its two associated Boards, the ASB (Accounting Standards Board) and the FRRP (Financial Reporting Review Panel). The extension to the power will enable grants to be made for the new activities that the FRC is taking on.

19. In accordance with the recommendations contained in the Government's report on its review of the regulatory regime of the accountancy profession, published in January 2003, the FRC has taken on the functions of the Accountancy Foundation Ltd (which was set up to provide non-statutory independent regulation of the accountancy profession in the UK). The new FRC includes five Boards formed by subsidiary companies of the FRC. These Boards have three main areas of responsibility:
 - the setting of accounting and audit standards (through the ASB and the Auditing Practices Board (APB));
 - their enforcement or monitoring (through the FRRP, the Accountancy Investigation and Discipline Board (AIDB), and the new audit inspection unit reporting to the Professional Oversight Board for Accountancy (POBA)); and
 - the oversight of the major professional accountancy bodies (through the POBA).
20. Other provisions in Chapter 2 will enable the Secretary of State to impose a levy on bodies or persons towards the costs of a designated body (which the Government envisages will be the FRC). Currently, the FRC's costs are met by voluntary contributions divided equally between listed companies (collected alongside their listing fees), the accountancy profession and the Government. The levy is expected to be applied to those who currently contribute, should it prove necessary in order to ensure security of funding for the body concerned.
21. In addition, further provisions exempt a body receiving a grant under [section 16](#) (expected to be the FRC), its subsidiary bodies (currently the ASB, FRRP, APB, AIDB, POBA) and their individual members, officers and staff from liability in damages for things done or not done for the purposes of, or in connection with, the activities listed in [section 16](#). That list essentially covers all the regulatory activities of the FRC and its subsidiaries.

Recognised supervisory bodies

Sections 1 and 2 - Additional requirements for recognition of supervisory bodies; arrangements to which additional requirements for recognition relate

22. [Section 1](#) amends Part 2 of Schedule 11 to the Companies Act 1989, which sets out the requirements that accountancy bodies must meet in order to be recognised as supervisory bodies for auditors. Specifically, the section places new requirements on the recognised supervisory bodies by making it a condition of recognition that they participate in independent arrangements for:
 - the setting of auditing standards relating to professional integrity and independence ([subsection \(2\)](#)) and the setting of technical standards ([subsection \(3\)](#));
 - the monitoring of audits of listed companies and other companies whose financial condition is of particular importance ([subsection \(4\)](#)); and
 - the investigation and taking of disciplinary action in relation to public interest cases ([subsection \(5\)](#)).
23. [Section 2](#) inserts a *new Part 3* into Schedule 11 to the Companies Act 1989. The new Part sets out the criteria which must be met by the independent standard setting, monitoring and disciplinary arrangements. The section seeks to ensure the independence of these arrangements by providing (in *new paragraph 21 of Schedule 11*) that the recognised supervisory bodies cannot be involved in the selection and appointment of those who carry out the standard setting (*new paragraphs 17 and 18*), monitoring (*new paragraph*

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19) and disciplinary functions (*new paragraph 20*), nor can they be involved in the carrying out of those functions. *New paragraph 20* also provides for transparency in the disciplinary arrangements by requiring that independent disciplinary hearings must be held in public, unless that would not be in the interests of justice.

24. The practical effect of these sections is to make the recognised supervisory bodies subject to a more independent regulatory regime in respect of the setting, monitoring and enforcement of auditing standards.

Delegation of Secretary of State's functions in relation to auditors

Sections 3 to 5 - Delegation of functions by Secretary of State to new or existing body; circumstances in which Secretary of State may delegate functions to existing body; supplementary provisions about delegation orders

25. Section 46 of the Companies Act 1989 empowers the Secretary of State to establish a body corporate to exercise her powers relating to company auditors and the recognition of bodies which supervise auditors and/or provide a professional qualification; and Schedule 13 sets out a number of supplementary provisions relating to the delegation of those functions. But section 46 does not allow the Secretary of State to delegate her functions to anyone other than a body corporate actually established by the delegation order. The policy of the Government is that the functions should be delegated to the POBA, which has been set up within the FRC structure. To achieve this policy aim, these sections enable the powers to be delegated to a body other than one created by the delegation order.
26. *Section 3* amends section 46 of the Companies Act 1989 to allow the Secretary of State to delegate her functions not only to a body created by delegation order under section 46 but also to an existing body - which can be either a body corporate or an unincorporated association - provided certain requirements are satisfied.
27. *Section 4* inserts a *new section 46A* into the Companies Act 1989. The new section sets out the circumstances in which the Secretary of State may delegate functions to an existing body. *New subsection (2)* provides that the body to whom the functions are to be delegated must be willing and able to exercise the functions and must meet certain other conditions set out in *new subsection (3)*. *New subsection (5)* deals with the case of a body that has (non-statutory) functions relating to arrangements in which recognised supervisory bodies may participate in order to meet the new criteria for recognition introduced by *sections 1* and *2*. Under this subsection, such a body may also exercise the delegated functions of the Secretary of State. The aim of this provision is to ensure that the POBA (which is expected to be the body to be designated by the first delegation order, provided it fulfils the requirements for designation) is not precluded from exercising any delegated function (for example, recognition of a supervisory body) on the basis of its involvement with the monitoring, investigation or disciplinary arrangements set out in *section 2*.
28. *Section 5* amends Schedule 13 to the Companies Act 1989 to reflect the extension of the delegation power in amended section 46. Essentially, this section specifies which provisions in Schedule 13 apply to a body created by the delegation order and which apply to an existing body. *Subsection (5)* provides that where the body is an unincorporated association (as the POBA will be), any proceedings brought in connection with the exercise of the delegated functions by the body may be brought in the name of the body corporate whose constitution provides for the establishment of the association - this would be the POBA Ltd.

Auditors' qualifications

Section 6 – Approval of overseas qualifications for auditors

29. This amendment of section 33 of the Companies Act 1989 is designed to improve the operation of the Secretary of State's power to approve overseas qualifications. It is intended that this power, together with other functions under Part 2 of the Companies Act 1989, will be delegated to an independent regulator under section 46 of that Act as amended by *section 3*.
30. Section 33 of the Companies Act 1989 allows the Secretary of State to recognise overseas qualifications as equivalent in the UK. Before its amendment by *section 6*, it was only possible to recognise either all or none of the people who held a particular overseas qualification (for example, all those who held a particular accounting diploma). However, there are circumstances where it would in fact be appropriate to recognise some but not all of those people. For example, where an overseas qualification originally fell below the criteria for approval in section 33 but was subsequently changed so that it met those criteria, the Secretary of State may wish to recognise the qualification, provided that it was gained after the date when the change was made. Similarly, where different combinations of learning modules and examinations offer alternative routes to the same qualification, the Secretary of State may wish to recognise the qualification, provided that the audit-related modules and examinations have been undertaken.
31. The unamended section 33 did not allow the Secretary of State to do either of these things and she therefore had to refuse recognition to the qualification as a whole. *Section 6* amends section 33 to remedy this, by providing that persons who hold a specified professional qualification *and meet other specific requirements* may be regarded as holding an approved overseas qualification.

Services provided by auditors

Section 7 - Disclosure of services provided by auditors and related remuneration

32. *Section 7* replaces sections 390A(3) and 390B of the Companies Act 1985 with a *new section 390B* and makes a number of related amendments to the Act. The purpose of this section is to enable the Secretary of State, by regulations, to require companies to publish more information about the types of services they and their associates have purchased from their auditors and their associates. Section 390B in its previous form gave the Secretary of State power to require companies to disclose the total value of their non-audit services (that is to say, services not related to the audit which an auditor provides to the company it is auditing). Under previous section 390A(3) companies were required to disclose the amount of remuneration paid for audit services. The effect of this section is to widen the Secretary of State's regulation-making power, so that regulations can also require disclosure differentiating between audit and non-audit services and between different types of non-audit service, with a breakdown of the costs of each. Examples of non-audit services include tax advice, valuations, actuarial work, litigation support, IT and legal advice.
33. The aim is to address concerns about possible conflicts of interest between the audit firm in its role as auditor and in its role as provider of other services to the company. More detailed disclosure requirements should allow stakeholders and others to identify particular features of the company/auditor relationship that may raise concerns over the auditor's independence.
34. *Subsection (1)* replaces existing section 390B of the Companies Act 1985.
35. *Subsection (1)* of *new section 390B* enables the Secretary of State to make regulations requiring disclosure by companies of (a) the nature of the services provided to a company by its auditors and their associates, and (b) the amount of remuneration to

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be paid for those services. The effect of *new subsection (1)* is also to replace existing section 390A(3) which, under *subsection (2)(a)* of [section 7](#), ceases to have effect.

36. *Subsection (2)* of *new section 390B* enables regulations under *new subsection (1)* to be flexible in how they classify the services provided by auditors and their associates for which disclosure is required. The effect, for example, is that the regulations could differentiate between a particular service which was considered so important that it should be disclosed separately (no matter how relatively small the amount paid for it) and other services considered less important from the perspective of ensuring auditor independence and which would thus not require separate identification at all, or not below a certain amount. The subsection also enables the audit or non-audit fees to be broken down so that, for example, it will be possible to require separate disclosure of amounts paid in respect of tax advice by each company in a group or an aggregate figure for tax advice for the group as a whole.
37. *Subsection (3)* of *new section 390B* provides further powers to require disclosure of auditors' remuneration to include "expenses", benefits in kind, and services provided to associates of the company; and to define what is meant by "associate" of an auditor or a company.
38. *Subsection (3)(d)* enables disclosure to be required in the case of services provided to "associates" of a company. This enables the broadening of the definition of an "associated undertaking" of a company contained in Regulation 2 of the [Companies Act 1985 \(Disclosure of Remuneration for Non-Audit Work\) Regulations 1991 \(SI 1991/2128\)](#). will mean that services provided, for example, to pension funds (which are not "undertakings") may be included in the regulations, as part of any disclosure.
39. *Subsection (4)* of *new section 390B* is concerned with the location of the required disclosures. Previously, the disclosure of audit services required by section 390A(3) had to be made in the notes to the company's individual or group accounts; and disclosures of non-audit services required by regulations under previous section 390B could be required to be made in the auditors' report or in the notes to the company's individual or group accounts. *Subsection (4)* is drafted flexibly to allow the regulations to require the disclosure to be made in the notes to the company's individual or group accounts; in the directors' report; or in the auditors' report.
40. Under *subsection (5)* of *new section 390B*, if directors are required by the regulations to make the disclosures in the notes to the accounts or the directors' report, the regulations may also require the auditors to supply the directors with any information necessary to enable them to make the disclosure. This re-enacts the latter part of the previous section 390B(3). In addition, *new subsections (5)(b)* and *(6)* enable the regulations to apply, as appropriate, the criminal penalties in sections 233(5) (approval of defective annual accounts) and 234(5) (preparation of defective directors' report) of the Companies Act 1985. They also enable the existing administrative arrangements under sections 245 to 245C of the Act on the voluntary revision, or compulsory revision through application to the court, of accounts and reports to be applied. Non-compliance by an auditor with the requirement to supply the directors with the information they need will be dealt with by disciplinary action by the relevant supervisory body.
41. *Subsection (7)* of *new section 390B* re-enacts previous section 390B(4). It enables the regulations to differentiate, for example, between larger and smaller companies. It is not currently intended to apply the detailed disclosure requirements for non-audit services to companies qualifying as small or medium-sized (SMEs) under the 1985 Act. SMEs will, however, have to continue to disclose the audit fee itself where relevant. In January 2004 the Government increased the qualifying conditions for SMEs for company law purposes. To qualify as an SME, a company must satisfy two or more of the following requirements: turnover of not more than £22.8 million; balance sheet total of not more than £11.4 million; and no more than 250 employees.

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42. *Subsection (2)(a) and (3) of [section 7](#) repeal the provisions in section 390A and in Schedule 4A of the Companies Act 1985 relating to disclosure of remuneration for audit services, so that all the requirements relating to disclosures about services provided by auditors are located in one place under the *new section 390B*. *Subsection (2)(b)* updates the reference to "payments in cash" in section 390A(5), by changing it to "payments of money".*