Regulatory measures arising from proposals for audit and corporate reporting reform in the UK **IA No:** BEIS037(C)-20-BF **RPC Reference No:** **Lead department or agency:** Dept for Business, Energy and Industrial Strategy **Other departments or agencies:** Financial Reporting Council, HM Treasury	Impact Assessment (IA) Date: 12/03/21 Stage: Consultation Source of intervention: Domestic Type of measure: Various Contact for enquiries: Nick.Munn@beis.gov.uk
Summary: Intervention and Options	**RPC Opinion: Not Applicable**

Cost of Preferred (or more likely) Option **(in 2016 prices)**			
Total Net Present Social Value	**Business Net Present Value**	**Net cost to business per year**	**Business Impact Target Status**
Optional	Optional	Optional	Qualifying provision

What is the problem under consideration? Why is government intervention necessary?

Following several high-profile company failures there is a widely recognised need to improve the quality of audit regulation and audit, and other corporate information provided by large UK companies. At the heart of the issue is a principal-agent problem which has been exacerbated by weaknesses in regulatory power and scope. Audit quality also has the properties of a public good for users, where perceptions of poor audit quality affect how all users interpret company information. The CMA also identified a lack of choice and resilience in the statutory audit market.

What are the policy objectives and the intended effects?

The policy proposals aim to increase the quality of corporate reporting, governance, audit and stewardship. They have implications for the work of all participants in the chain of audit reporting i.e. accountants, auditors, and company Directors. They are designed to focus incentives of participants on achieving higher levels of audit quality than is currently observed. For example, in 2019/20, only 73% of inspected FTSE 350 audits (35 out of 48) were assessed as good or requiring limited improvements.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

This IA covers around 150 recommendations from 3 reviews of audit in the UK. They cover broadly:

- The scope of statutory audit and corporate reporting
- Improved corporate governance including duties for directors and audit committees
- The establishment of a new statutory regulator, the Audit, Governance and Reporting Authority (ARGA)
- The purpose and coverage of audit
- Audit market structure

Will the policy be reviewed? *Yes. Timing of review to be set out in Final Impact Assessment.*

Does implementation go beyond minimum EU requirements?		N/A			
Is this measure likely to impact on trade and investment?		Yes			
Are any of these organisations in scope?	**Micro** **No**	**Small** **No**	**Medium** **Yes**	**Large** **Yes**	
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)		Traded: N/A		Non-traded: N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Matan Cole Date: 12/03/21

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Background

1. The UK's position as a world-leading destination for foreign investment is maintained through the strength of its workforce, innovation, and its approach to better regulation, which includes the regulation of audit and corporate reporting. Robust corporate reporting requirements and high-quality audit are critical to building shareholder and stakeholder confidence in corporate reporting information, and therefore, play a crucial role in the success of financial markets, wider economic stability, and the effective functioning of the market economy overall. However, recent large corporate failures have brought into focus a range of audit issues, including the role that audit might have played in these collapses. In the wake of this, and in response to related concerns raised by Parliament, the Government, and the public, the Government commissioned three reviews of audit. These were:

- The Independent Review of the Financial Reporting Council (FRC)[1], which investigated the role and function of the FRC, the scope of its powers, and its impact. The FRC Review reported in December 2018.
- The Competition and Markets Authority (CMA) statutory audit services market study[2] which considered issues related to choice and switching, market resilience, and the incentives between market players. The CMA market study reported in April 2019.
- The Independent Review into the Quality and Effectiveness of Audit (the Brydon Review)[3], which covers the quality and effectiveness of the audit process and product, and how it could be improved to better serve its users and the wider public interest, reported in December 2019.

<u>The Independent Review of the FRC</u>

2. The Independent Review of the FRC (FRC Review) was published in December 2018. Its main conclusion was that the FRC should be replaced by a new body which:

   i. Has a clear and precise sense of purpose and mission.

   ii. Is firmly focused on the interests of consumers of financial information, not producers.

   iii. Is respected by those who depend on its work, and where necessary feared by those whom it regulates.

   iv. Has the right powers and resources it needs to do its job; and

   v. Can attract the highest quality people.

3. The Review made 83 recommendations including:

   i. The Government should review the UK's definition of a Public Interest Entity (PIE), which are subject to strengthened audit rules (recommendation 18).

   ii. BEIS should consider a strengthened framework around internal controls in the UK, learning any lessons from the operation of the Sarbanes-Oxley regime in the US (recommendation 51).

   iii. A range of other recommendations which are focused on strengthening how the regulator carries out its duties and an expansion of its duties.

[1] The full Independent Review of the FRC can be found here: https://assets.publishing.service.gov.uk/Government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

[2] The full CMA market study can be found here: https://www.gov.uk/cma-cases/statutory-audit-market-study

[3] The full Brydon report can be found here: https://assets.publishing.service.gov.uk/Government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf

4. *The full list of measures is contained in Annex I.*

The CMA Statutory Audit Services Market Study

5. The CMA study concluded that the FTSE 350 audit market exhibited several long-standing problems, which were driven by the following deep-seated issues:

   - The selection and oversight of auditors by companies' audit committees is not sufficiently focused on audit quality and does not consistently prioritise auditor scepticism and challenge. The report also noted that it is difficult for audit committees to observe audit quality, and that the time spent monitoring the audit engagement by audit committees was variable.
   - Challenger firms face barriers to expansion and competition as a result of supply and demand-side factors which, in combination with regulatory requirements on FTSE 350 auditors, lead to limits on choice in the market, lower market resilience, and concerns around audit quality.
   - Audit firms operate a multi-disciplinary model, providing both audit and non-audit services, which weakens audit partners' incentives to prioritise quality in delivering audits.

6. The CMA made four recommendations to the Government for addressing these issues:

   - Regulatory oversight of audit committees that run the selection process for audited companies and oversee the audit, to make them more accountable and ensure they prioritise quality.
   - Mandatory joint audit, to increase the capacity of challenger firms, to increase choice and resilience in the market and thereby drive up quality; with peer review for the largest and most complex audits, and the introduction of measures to mitigate distress or failure of a Big Four firm to limit further concentration in the market.
   - An operational separation between the Big Four's audit and non-audit businesses to ensure maximum focus on audit quality.
   - A five-year review of progress by the regulator.

The Brydon Review

7. The Brydon Review reported in December 2019. It identified considerable room for improvement in the quality and effectiveness of audit which, if addressed, would lead ultimately to improvements in the cost and allocation of capital, and in the value generated to the wider economy by audit. To this end, the Review made 64 recommendations to be applied to Public Interest Entities (PIEs)[4] and PIE sub-groups. Recommendations include:

   - Establishing a new, comprehensive definition of audit and its purpose in company law, that reinforces audit as a function of public interest as opposed to merely a compliance exercise.
   - Creating a new, independent audit profession that would be guided by its own governing principles, standards and qualifications.

[4] The current PIE definition is established in EU Directive 2014/56/EU and Regulation 537/2014, which were implemented before the UK left the EU. The Directive applies to all statutory auditors/audit firms and their clients in the EU and EEA, while the Regulation applies only to audits of PIEs. A definition was introduced by the 2006 Statutory Audit Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts.

- Extending the scope of auditor assurances beyond financial statements.
- Introducing mechanisms to enable and encourage shareholder involvement in audit-related matters with a view to increasing their influence over the scope of the audit and their ability to hold audit committees and auditors to account, and
- Introducing a requirement to report on actions taken to prevent and detect fraud for both company directors and auditors.
- Introducing new directors' reporting requirement, including a corporate Audit and Assurance Policy, Resilience Statement, and Public Interest Statement.

The full list of the Review's recommendations is provided in *Annex II*.

8. This IA is published alongside a consultation. The policy and options will evolve over time because of consultation responses and further policy work. Any estimates of costs, benefits and companies covered should be considered as indicative at this stage. One major challenge in the development of this assessment has been the establishment of an appropriate baseline, which is fundamental in determining costs and benefits of any policy change, and particularly important for estimating the implications for the Business Impact Target. At this stage, with uncertainty about the final package of measures, **we use a do-nothing baseline for all measures in the IA.** This is the status quo and assumes no reforms have been introduced. We consider this an appropriate approach given the number of moving parts across the different components of the audit reform programme and the variability in the extent to which auditors and their audit clients are already acting in response to published findings. In so doing, we also ignore any potential interaction between the different measures in this IA – for example, the potential impact of changes to the PIE definition on costs related to measures that will applied to PIEs. We will revisit the baseline, and our treatment of these interactions, when there is a final package of measures.
9. **We assess costs over a 10-year appraisal period and present our estimates in terms of present value costs for the 10-year period (PVC) and equivalent annualised net direct costs to business (EANDCB)**[5].
10. We flag key uncertainties in the text of the IA and would be grateful for any views on resolving or addressing these.

Problem under consideration

11. There is a widespread perception that the quality, accuracy and reliability of corporate information is not consistently high enough and that auditors have, in some cases, not provided sufficient challenge to incentivise improvements in the quality of information provided. For example, in 2019/20, only 73% of inspected FTSE 350 audits (35 out of 48) were assessed as good or requiring limited improvements[6]. Recent corporate failures such as the collapses of BHS, Carillion and Patisserie Valerie have brought the quality of corporate information under additional scrutiny. Whilst it is not the duty of an auditor to predict when a company might fail, it is felt that auditors too often fail to spot the reporting problems sometimes associated with a potential corporate failure. Each of the three reviews identified factors that may have contributed to poor quality audits:
    i. The Independent Review of the FRC identified several constraints on the FRC's effectiveness as the audit regulator, including:

[5] All costs are given in 2016 prices. Where necessary, costs obtained for different years were adjusted to 2016 prices using the ONS GDP Deflator at Market Prices and Money GDP, March 2019.

[6] Based on audit firm specific inspection reports available at https://www.frc.org.uk/auditors/audit-quality-review/audit-firm-specific-reports?id=1204, and information from FRC.

- The FRC does not have a clear statutory basis for all its regulatory activities.
- The FRC operates under a Government Direction to delegate the approval of the auditors of public interest entities to the professional bodies.
- The FRC is partly funded through a voluntary levy on regulated firms, which may blunt the FRC's incentive and ability to properly regulate the firms.

Furthermore, the Independent Review identified several weaknesses in the FRC's operation. For example:

- The FRC's Corporate Reporting Review (CRR) is too limited in its scale and scope.
- The FRC has not been an effective champion of the need for annual reports and accounts to be comprehensible.
- The FRC has applied an inconsistent and incomplete approach to managing conflicts of interest.

ii. The CMA's statutory audit services market study found that:

- There is significant variation in the performance of audit committees within the FTSE 350, and their selection and oversight of auditors is not sufficiently focused on quality. For example, the CMA found that auditor selection often prioritises factors, such as "cultural fit", rather than factors like independence and willingness to challenge, which are important determinants of audit quality.
- Auditors in multi-disciplinary firms may have weaker incentives to prioritise audit quality. Despite current restrictions on the non-audit services audit firms can provide to their audit clients, auditor incentives are still, to some degree, influenced by the non-audit side of the business, which tends to be larger and more profitable. This results in auditors prioritising the commercial relationship with the client over delivering high quality audits.

iii. The Brydon Review identified some key issues with the audit process and product that have contributed to lower quality:

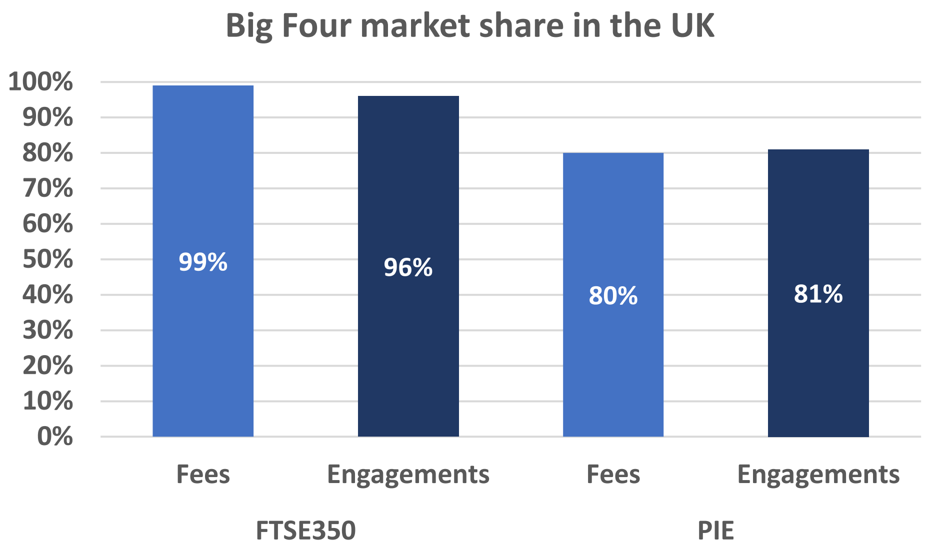
- The purpose of audit is not clearly defined or understood by auditors, preparers and users of financial information. This partially explains the audit 'expectations gap'[7]. The Review noted further that, among auditors, this lack of understanding encourages a culture of minimum compliance with laws and regulatory requirements over investigative rigour.
- There is a lack of clarity around what an auditor is, and to whom they owe a professional duty, as a result of audit being an extension of the wider accounting profession instead of an independent profession guided by its own standards, principles, and ethics.
- The full role of the auditor and the extent of the assurance they are contracted to provide is not routinely set out to shareholders by company directors. Shareholders typically have little influence over the scope of company audits, despite being the primary users of the information they are meant to assure.

[7] The audit expectation gap is the difference between what the public believes about auditors' obligations and actions they should take in delivering against them, and what auditors are actually required to do (by legislation and auditing standards) and the actions they take in compliance.

- Stakeholders lack clarity on the depth and scope of reporting on the company's survival, and on the context in which the judgements underpinning these reports are made.

12. The CMA also attributed poor audit quality to a lack of choice. The FTSE 350 audit market is dominated by the Big Four auditors: EY, Deloitte, KPMG, and PwC[8]. Together, they account for nearly all audits (96%[9]) and audit fee income (99%[10]) of the FTSE 350. The Public Interest Entity[11] (PIE) audit market is less concentrated, with the Big Four accounting for 80% of fee income and 81% of all engagements.

Figure 1 - Big Four Market Share in the UK



13. The lack of choice is exacerbated by mandatory auditor rotation, which aims to prevent cosy relationships between auditor and auditee and thereby increase audit quality, and conflicts of interest which give some companies relatively little choice of auditor. For example, the CMA found that around 25% of FTSE 350 tenders that they reviewed had at most two competing bidders[12]. Indeed, whilst the measures in this IA aim to address the deep-seated issues affecting choice in the market, some are in part designed to overcome the unintended consequences of previous regulatory interventions to boost audit quality.

14. The failure of a Big Four auditor would constrain choice yet further and could potentially lead to lower audit quality and higher fees. The CMA report noted that recent experience suggests that the Big Four firms are resilient and that they have withstood reputational harm caused by several high-profile cases of audit failure in the UK and elsewhere. This resilience comes from regulatory requirements for listed companies to appoint an external auditor, larger and complex companies' demand for Big Four auditors with large, international, networks, and the ability to contain reputational harm to individual teams and partners. But the CMA noted that concerns remain about the ability of the market to manage more catastrophic failure (such as the failure of Arthur Andersen which led to the Big Five becoming the Big Four). The risk of Big Four exit was considered low probability, but a possibility, and with a high impact.

[8] FRC (2020), Key Facts and Trends in the Accountancy Profession. Available at:https://www.frc.org.uk/getattachment/0f7be411-fb89-4afc-8e8c-281529cf76fc/Key-Facts-and-Trends-2020.pdf

[9] FRC, Developments in Audit 2019

[10] Based on 2019 FTSE 350 audit fee data from Audit Analytics.

[11] The current UK definition of PIEs includes all EEA-registered entities whose transferable securities are listed on EEA regulated markets and all credit granting or insurance undertakings, regardless of their listing status. This definition is established in EU Directive 2014/56/EU and Regulation 537/2014.

[12] CMA Report, page 81, para 3.103, p83, para 3.107.

15. Reforms introduced following the Competition Commission's market investigation have created opportunities for competition, but this has not been enough to have an impact on the deep-seated issues listed above, and the market share gap between challenger firms and the Big Four has widened in recent years. The CMA further concluded that without intervention, the market will not be self-correcting.

16. Part of the reason for this is attributed to the reluctance of audit committees to select challenger firms. This demand-side barrier is a consequence of the real or perceived lack of relevant experience and capacity among challengers, risk aversion amongst audit committee members, and concerns about the quality of tenders received from challenger firms. For example, the CMA reported that reasons given by companies for why non-Big Four auditors are eliminated at an early stage of tender processes include: lack of the required scale of operations, international presence, experience with large company audits; and lower perceived audit quality[13].

17. Lacking a client demand, challenger firms are reluctant to invest in the capabilities required for FTSE 350 audits. For example, the CMA provided evidence that challenger firms were deterred from bidding for FTSE 350 audits because of the time and cost involved relative to their chances of success[14]. Therefore, the market, left to its own devices, is unlikely to bring about the changes necessary to encourage challenger investment in building capability and address the demand-side bias.

Rationale for Intervention

18. The issues identified in the three reviews indicate four rationales for intervention, which the measures in this IA, taken as a package, aim to address.

19. There are many reasons why poor audits may occur. Not only may auditors lack understanding of complex company information, but the provision of information on corporate performance by companies is potentially characterised by high degrees of market failure. At its heart is a ***principal-agent problem***. Companies are meant to provide the best information possible to allow shareholders and creditors to make informed decisions about whether to invest or offer credit, and auditors are meant to provide independent, "reasonable assurance" that the financial statements are free from material misstatement. But auditors are appointed by the company's Audit Committee, and the interests of senior leaders in the company may diverge from the best interests of shareholders. For example, the audit committee may prioritise the ease of working with the auditor rather than audit quality; or company management may provide inaccurate or partial corporate reporting which reflects their personal incentives rather than those of shareholders.

20. This can lead to auditors taking a minimum compliance approach, and directors not routinely providing as detailed a picture as would most benefit shareholders. It also means that users of corporate financial information are unable to consistently rely on it to make investment decisions. This may contribute to an inefficient allocation and increasing cost of capital, and in the worst cases, to catastrophic economic losses.

21. The role of the regulator is to set and enforce regulation of corporate reporting to ensure that investors and other stakeholders have the information they need. But recent large-scale corporate failures have raised questions about the quality of information provided and the way audit is regulated in the UK. Measures aimed at strengthening the regulator are aimed at tackling ***regulatory failure***. The regulator, as it is currently constituted, has been criticised for not always acting in the interests of the users of company information. For example, the regulator is seen as

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[13] CMA report, p85, para 3.117.

[14] CMA report, p87, para 3.129.

being too close to those that it regulates, and it does not have a clear and consistent statutory basis, unlike similar regulators.

22. Additionally, the enforcement regime and good audit and information provision have the potential to create ***externalities*** or spill-overs. Poor enforcement reduces incentives for firms to invest in high quality audit and other information. The lack of information can lead to poorer decision making by investors and other related parties, e.g. suppliers. As a result, investors and related parties face increased risk of losses in the event of corporate failure.

23. Further, the audit market for the largest companies is highly concentrated, which limits choice:

    i. Reduced choice potentially imposes a loss of economic surplus on audit clients (companies) and audit firms, as audit clients value the services of audit firms differently, and reduced choice means more imperfect matches between audit clients and auditors.

    ii. Given existing constraints on levels of choice at the top end of the UK audit market, the exit of a Big Four auditor – resulting in a 'Big Three' - would impose significant economic costs on client companies, especially given the effect of regulations to ensure sufficient levels of audit quality[15]. For example, there is academic evidence[16] for the US which suggests that the exit of a Big Four auditor from the US market would reduce client firms' economic surplus by $1.2-$1.8 billion per year and increase audit fees by $0.3-$0.5 billion per year.

    iii. Measures to preserve or increase choice could maintain or increase economic benefits for companies and prevent circumstances where a lack of choice, perhaps caused by the exit of a Big Four auditor, reduces incentives for high quality audit.

24. Similarly, measures to prioritise quality in the delivery of audits also serve the public interest. For users of audit, audit has many of the characteristics of a ***public good***[17], including the properties of non-excludability[18] and non-rivalry[19]. Good audits provide confidence that the overall system is working as intended. Bad quality audits, however, create the potential for negative spill-overs undermining perceptions of audit quality overall, reducing the level and efficiency of investment in the UK economy and the perception of the UK as a good place to do business.

Policy Objectives

25. The policy proposals ultimately aim to increase the quality of company information, especially financial information, increasing confidence in the UK's regulatory framework and the operation of its audit markets. Ultimately, these improvements are expected to increase the quality of company financial information and confidence in the UK's regulatory framework and the operation of its markets. To this end, the proposals would:

    - Better align the regulator's operations with the interests of users of financial information: The regulator should largely act, and be seen to act, in the public interest as a proxy for the interests of users of financial information.

    - Ensure that the scale and scope of its activities are sufficient but proportionate. The regulator should carry out more scrutiny, to improve standards of corporate reporting and audit.

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15 This was the judgement in the CMA report, see p95, para 3.165.

16 J Gerakos and C Syverson (2014), Competition in the Audit Market: Policy Implications, Working Paper 13-63, Chicago Booth.

17 For example, see Jim Stewart (2006) Auditing as a Public Good and the Regulation of Auditing, Journal of Corporate Law Studies, 6:2, 329-359, DOI: 10.1080/14735970.2006.11419955

18 Audit reports can be and are used by people other than the shareholders that pay for the audit, as audit reports are published.

19 One person using an audit report does not affect the ability of others to use the same audit report.

- Ensure that the regulatory framework is consistent and without gaps – for example, there are currently limits to the regulator's ability to take enforcement action against directors who are not members of professional accountancy bodies. These limits should be removed.
- Strengthen the standards that preparers and auditors of accounts must adhere to.
- Ensure that the regulator is adequately resourced to achieve the above.
- Address issues that limit the effectiveness of companies' going concern and viability reporting, and the lack of a detailed engagement with shareholders on the scope of the assurances provided by the auditor.
- Address the lack of directors' reporting on meaningful actions to detect and prevent fraud and auditors' lack of reporting on their actions to do the same.
- Address transparency issues related to companies' dividend policies and decisions.
- Address issues with incentives by increasing the focus of audit committees and audit firms on audit quality; and
- Address restricted choice in, and increase the resilience of, the audit market by increasing the number of firms capable of delivering high quality audits to the FTSE 350 market.

Section 1: The PIE definition

Summary: Analysis & Evidence — PIE extension option 1

Description: *Extending the scope of the current PIE definition to include a combination of large non-traded entities that are already required to include a corporate governance statement in their directors' report and UK-incorporated AIM companies with market capitalisation greater than €200m.*

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2016	**Year** 2017	**Years** 10	**Low:**	**High:**	**Best Estimate: -1,717.1**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**124.7**		**185.0**	**1,717.1**

Description and scale of key monetised costs by 'main affected groups[20]'

Key monetised costs of this measure stem from additional activities that in-scope companies, their auditors and the regulator are expected to undertake. These include: one-off costs from familiarisation with the PIE audit regime, reallocation of non-audit services, audit committee appointment costs; and ongoing costs from compliance with additional regulatory reporting requirements, audit committee meetings, Mandatory retendering and rotation of auditors, and compliance with reporting requirements under the Non-Financial Reporting Directive.

Other key non-monetised costs by 'main affected groups'

No other key sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

The benefits of increasing the scope of the current PIE definition have not been quantified. Expanding the PIE definition is intended to increase auditor independence and scepticism by putting in place stringent audit requirements for entities that, by virtue of their employment and financial scale, should be considered as being of significant public relevance. Potentially, this can contribute to an increase in audit quality and transparency for companies brought into scope, which could translate into increased investor and stakeholder confidence in the financial information they provide. A wider benefit is the potential for a reduction in the cost of capital faced by these companies because of greater risk transparency.

[20] We expect that some costs faced by auditors will be passed on to their clients, but for the purposes of this assessment, we account for these costs as costs incurred by the auditors in scope.

Key assumptions/sensitivities/risks	**Discount rate (%)**	3.5

- Our calculations are based on the current number of entities in scope (companies to be brought into scope of the PIE definition and their auditors). Based on the entities defined under each option, we have used the Fame database, the London Stock Exchange AIM companies, and the FRC's Key Facts and Trends in the Accountancy Profession. We assume that these sources provide full coverage of the entities in scope.
- We assume that all auditors of companies in scope will continue to provide audits to these companies after they become PIEs. In practice, we expect there to be some dropout, but lack sufficient evidence on which to model future auditor behaviour.
- We assume that new PIEs will avoid some of the additional audit committee-related costs on the basis that they already have some audit committee arrangements in place and follow the UK Corporate Governance Code to some degree.
- A key risk to the analysis is that data/evidence on the costs and benefits is limited. We have used, where available, estimates from previous Impact Assessments, however, these may only provide an imperfect indication of the true costs and benefits of this option.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 993.9**
Costs: 198.8	**Benefits: 0**	**Net: -198.8**	

Summary: Analysis & Evidence — PIE extension option 2

Description: *Extending the scope of the current PIE definition to include a combination of large non-traded entities (by the "500-test") and UK-incorporated AIM companies with market capitalisation greater than €200m.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -1,244.7**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low				
High		1		
Best Estimate	**85.5**		**134.7**	**1,244.7**

Description and scale of key monetised costs by 'main affected groups'

The nature of key monetised costs of this measure are the same as in option 1. The difference in the scale of costs is driven solely by the number and characteristics of the companies brought into scope.

Other key non-monetised costs by 'main affected groups'

No other key sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

The benefits of this option are expected to be the same in nature, and similar in magnitude, as in Option 1. Any differences would be due solely to the number and characteristics of the companies brought into scope.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Same as in Option 1

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 722.3
Costs: 144.5	**Benefits: 0**	**Net: -144.5**	

Assessment of the PIE definition

Policy Overview

26. Several measures introduced by the EU Audit Framework apply only to PIEs and their auditors. These are aimed at improving and sustaining the quality of the audits of those entities. The definition of PIEs covers all EEA-registered entities whose transferable securities are issued for trading on EEA regulated markets[21], and all credit institutions or insurance undertakings[22]. When EU law ceases to be applicable following the end of the transition period, the definition of a PIE in UK domestic law will be limited in scope to UK registered entities.

27. PIEs are so defined because the nature of their business makes them of significant public relevance. The statutory audits of those entities are subject to more stringent regulation, for example, in relation to:

    - how they are appointed including in relation to the selection procedure used and the maximum duration of their appointment.
    - the statutory auditor's functions including additional requirements as to the content of the auditor's report, the prohibition on non-audit services, and the requirement for a report to be made to the PIE's audit committee (or equivalent body); and
    - the regulation of statutory auditors including a requirement for the regulator to take direct responsibility for inspecting, investigating and imposing sanctions in relation to audits of PIEs.

28. The Independent Review of the FRC indicated significant public interest in measures to further improve the quality of statutory audits of PIEs. Against the backdrop of recent corporate failures, the Review also highlighted concerns that the current PIE definition excludes entities whose nature of business may not indicate significant public relevance, but whose operations (size and financial scale) are large enough for them to be considered of significant public interest[23]. These concerns underpin the rationale for expanding the scope of companies included in the definition of PIEs. Responses to the Government's initial consultation supported this view, and the groups of companies proposed in the options below overlap with those suggested by consultation responses.

Options considered

29. We propose two options for consideration. The Government's consultation will seek views on these changes to the scope of the definition of PIEs.

<u>Option 1 – Extending the scope of the current PIE definition to include a combination of large companies (defined by reference to those required to include a corporate governance statement in their directors' report), and UK-incorporated AIM companies with market capitalisation greater than €200m.</u>

30. The entities in scope of this option include all large private <u>and</u> large public but unquoted companies registered in the UK. For the purpose of this assessment, large companies are defined according to the "Wates" criteria. These were developed recently to determine which large private companies should be required to report annually on their corporate governance

[21] As defined in Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments. The list of EEA regulated markets provided on the European Securities and Markets Authority (ESMA) Registers Portal.

[22] As defined in Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings.

[23] This was also reflected in responses to BEIS initial consultation in March 2019.

arrangements[24]. The criteria are having more than (a) 2,000 employees **OR** (b) a turnover of more than £200 million and a balance sheet of more than £2 billion. By this definition, we estimate that **1,961 large companies would be brought into scope[25].**

31. This group of companies was proposed for inclusion in the PIE definition since, given their size and scale of operation, corporate failures among this group could have a relatively wide impact. The lack of transparency among this group is also viewed as a contributor to the frequency and scale of recent financial problems. Further, the fact that the quality of audits (and measures to improve it) for this group is in the public interest is indicated by the requirement for these companies to, by virtue of their size and operational scale, satisfy additional reporting requirements under the Companies (Miscellaneous Reporting) Regulations 2018. Companies in this grouping also fell within the scope of the FRC's AQR inspections prior to the adoption of current PIE rules.

32. In addition to these Wates companies, this option includes UK-incorporated companies that are listed on the London Stock Exchange Alternative Investments Market (AIM) and NEX exchange with a market capitalisation greater than €200m[26]. We therefore estimate that **105 AIM companies would be brought in scope** under this option[27].

33. These entities were proposed for inclusion in the PIE definition since they are currently subject to the FRC's Audit Quality Review process and Audit Enforcement Procedure, and therefore, the quality of their audit (and measures to improve it) are already judged to be in the public interest. Further, bringing these entities into scope of the PIE definition would minimise the potential for market selection decisions (between the regulated main market and AIM) to be distorted by PIE-regime compliance costs.

34. **Therefore, we estimate that, in total, 2,066 companies would be brought in scope of the PIE definition under this proposed expansion.**

35. The consultation document asks whether the PIE definition should be extended to Lloyd's Syndicates and third sector entities. They are not included in this option, but if these were brought into scope, we expect our estimates of the cost of this option (set out below) to increase.

Option 2 – Extending the scope of the current PIE definition to include a combination of large companies (defined by reference to the "500-test"), and UK-incorporated AIM companies with market capitalisation greater than €200m.

36. This option covers all large private and large public but unquoted companies registered in the UK. For this option, large companies are defined by reference to the "500-test" – i.e. having over 500 employees and a turnover of more than £500 million – which is the same as the threshold for additional non-financial reporting requirements applied to existing PIEs[28]. This option therefore adopts a narrower scope than option 1. By this definition, we estimate that **1,058 large companies would be brought into scope[29].**

[24] The Companies (Miscellaneous Reporting) Regulations 2018 (http://www.legislation.gov.uk/ukdsi/2018/9780111170298)

[25] Based on data from the Fame database. This estimate excludes companies that match the size definition but are already defined as PIEs (e.g. banks and insurers).

[26] As determined under the MIFID II framework

[27] Using the AIM companies list as at September 2020.

[28] Section 414CA-414CB of the Companies Act 2006 implements Article 19a, Directive 2013/34/EU on disclosure of nonfinancial and diversity information by certain large undertakings and groups. It requires large undertakings which are PIEs and have more than 500 employees to disclose a range of non-financial information. This includes business specific disclosure on environmental, employee, social, anticorruption and bribery matters, and respect for human rights.

[29] Based on data from the Fame database. This estimate excludes companies that match the size definition but are already defined as PIEs (e.g. banks and insurers).

37. As in option 1, this option also adds the **105 AIM companies** with a market capitalisation greater than €200m.

38. **Therefore, we estimate that, in total, 1,163 companies would be brought in scope of the PIE definition under this proposed expansion.**

Assessment of monetised and non-monetised costs of each option

39. For each of the options, expanding the definition would reframe the scope of existing audit and corporate reporting requirements already applied to PIEs. Therefore, the key elements of the costs of expanding the PIE definition are the same, with the only differences being the number and characteristics of the set of entities affected. The costs are expected to stem from the additional activities that PIEs, their auditors, and the regulator are expected to undertake.

40. **The companies brought into scope** of PIE audit requirements will be required to, for example:
    - appoint an audit committee (or body performing equivalent functions) if they do not already have one.
    - undertake a re-tendering exercise for their audits at 10 years of the current engagement and rotate their auditor when the current engagement of 20 years is complete (under mandatory retendering and rotation requirements); and
    - for those with more than 500 employees, prepare an enhanced strategic report and anti-corruption and bribery statement in accordance with the domestic implementing measures for the requirements of the EU Non-Financial Reporting Directive[30].

41. We have also considered potential costs to entities in scope from the loss of accounting exemptions they can currently use (as non-PIEs) under Parts 15 and 16 of the Companies Act 2006. The only related source of additional costs we have identified relates to the loss of the subsidiaries audit exemption available under Part 16 of the Act. These costs are discussed in the section that follows.

42. **The auditors of companies** brought into scope will be required to:
    - Provide a transparency report, and a report on revenues from audit and non-audit services in respect of each of their new PIE clients to the regulator.
    - Provide a report to the audit committee of each of their new PIE clients that covers the audit work provided.
    - Bid for their existing audit appointment at 10 years and tender for potential PIE clients when their appointment of 20 years is complete (under mandatory retendering and rotation requirements).

43. In this assessment, we assume that bringing a company into scope of the PIE regime does not lead them to change their auditor. We also assume that all auditors of companies in scope will continue to provide audits to these companies once they become PIEs.

44. In practice, we expect that some auditors brought in to scope will choose not to register as PIE auditors and provide audits to their new-PIE clients due to the relatively high cost of complying with the PIE audit regime. Previous experience (the 2016 UK implementation of the EU Directive on statutory audits) confirms that auditor dropout is a possible response from audit firms brought into scope. The FRC's records show that the changes introduced in 2016 resulted in 23 of the 58 auditors discontinuing their audit engagements with their new-PIE clients i.e. 40% of auditors brought into scope. We still use this dropout rate to illustrate the potential impact of auditor

[30] In the Companies Act 2006, section 414CA.

dropout on costs, where applicable in our discussion below, but we currently lack sufficient relevant evidence on which to base predictions of future audit firm behaviour in response to the change assessed here, and so have assumed no auditor dropout in our analysis.

45. Additionally, we expect some additional costs faced by auditors brought into scope to be passed on to their clients. We have, however, accounted for all additional costs to auditors as being incident on the auditors, and have not treated these as passed on costs. As burdens on auditors and audited companies are both within scope of the BIT target, this assumption has no effect on the BIT score.

46. **The regulator** will be required to expand the scope of the regulatory tasks it must undertake in relation to PIE audits and auditors, including its company audit inspections (the AQR process), to cover the audits of the new companies brought into scope.

47. The Government's consultation proposes allowing a significant lead-in time before introducing the new PIE definition, which would be phased in over two or more stages. However, we do not account for this in our assessment, since the details of these aspects of the proposal are yet to be finalised. We hope to use responses to the consultation and further policy work to develop this component of the analysis.

Costs

48. Estimates of costs are tentative at this stage. More policy work and responses to the consultation will help us refine our estimates. One challenge is the extent to which the costs are likely to be additional. For example, large companies may have an audit committee even if they are currently not required to do so.

49. We expect all entities in scope to face **familiarisation costs**[31]. There will be familiarisation costs for firms relating to the changes to audit standards applicable to the auditors of 'new PIE' clients. For the new PIEs themselves, there would be familiarisation costs in understanding the changes to regulations related to their audit arrangements.

50. Our estimates of total familiarisation costs across all new PIEs and their auditors are provided for each option in *Table 1*. The basis of this estimate is outlined below.

Table 1- Total Familiarisation Costs (one-off)

	Entities in scope	PVC, 10 yr period	EANDCB
Option 1	2,066 Companies and their auditors	£72.7m	£8.4m
Option 2	1,163 Companies and their auditors	£42.7m	£5.0m

Familiarisation costs for auditors of new PIEs

51. For each option, we assume the audit principals[32] and supporting teams within each audit firm, who will undertake statutory audits for new PIEs, would need to familiarise themselves with the

[31] We do not consider familiarisation costs for the regulator as the nature of its current activity is unaffected by the options considered here.

[32] Partners of an LLP who hold an audit qualification.

requirements of the PIE audit regime as it relates to their clients. In this assessment, we consider only those auditors in scope that do not provide audits to any current PIEs[33].

52. Familiarisation costs to audit firms are expected to be one-off costs that will apply in the first year of implementation only as auditors are expected to comply with the PIE audit regime from the first year. Our estimates are based on the average number of audit principals and the assumed number of accounting staff per audit firm; the cost per hour for audit principals and accounting staff (based on ONS ASHE[34] data); and the estimated time required by audit professionals and accounting staff for familiarisation[35]. This methodology is adapted from that used in *IA No: BIS016(F)-16-BE* (the "2016 IA") on the basis that both applications are concerned with the same type of change (i.e. bringing new companies in scope of PIE audit requirements). The key change we have made to the 2016 methodology relates to the number and composition of the teams that will require familiarisation. The 2016 IA assumed that all teams (audit and non-audit) within firms will need to familiarise themselves with the PIE audit regime, but given the specific context of these changes, we expect only the teams currently auditing those companies to require familiarisation. Our estimates of the familiarisation cost to auditors are provided for each option in *Table 2* and further details are provided in *Annex III*.

Table 2 - Familiarisation Costs to Auditors of new PIEs

	Entities in scope	PVC, 10 yr period)	EANDCB
Option 1	90 audit firms	£7.1m	£0.8m
Option 2	22 audit firms	£1.7m	£0.2m

53. However, as we noted previously, the 2016 UK implementation of the EU Directive on statutory audits led to some auditors discontinuing their audit engagements with companies brought into the PIE regime. If the same happens in this case, costs will be lower than our estimates suggest. For example, if the same dropout rate observed under the previous program of changes (around 40%) applied, we could expect the number of auditors brought into the scope of PIE audit requirements under each option, and hence the associated familiarisation costs, to be around 40% lower than indicated in *Table 2*.

Familiarisation costs to new PIEs

54. For new PIEs in scope, we assume that senior officials, team managers and admin staff would need to familiarise themselves with the PIE audit regime.

55. Here too, familiarisation costs are expected to be one-off and would apply only in the first year of implementation. Our estimates are based on the estimated time taken by senior officials, team managers, and admin staff (considering the size distribution of firms in scope); ONS ASHE data on hourly earnings for senior officials, team managers, and admin staff. This methodology is adapted from that used in the 2016 IA for the reasons outlined above. Details are provided in *Annex III*.

[33] Auditors providing audits to current PIEs will not need to familiarise themselves with the PIE audit regime as a result of the changes assessed here. This estimate therefore covers the auditors in scope that are not listed as PIE auditors in the FRC's Key Facts and Trends in the Accountancy Profession 2019.

[34] In this impact assessment, we have used the 75th percentile of hourly wages for the positions indicated in ONS ASHE 2018 data, with a non-wage uplift of 20%.

[35] In all cases in this assessment (for auditors and new PIEs), our estimates of the time required for familiarisation by each staff grouping have been adopted from BIS IA No: BIS016(F)-16-BE. The underlying assumptions were developed during the consultation that preceded the Final Stage Impact Assessment.

56. Our estimates of the familiarisation cost to new PIEs are provided for each option in *Table 3*.

Table 3 - Familiarisation Costs to New PIEs

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	2,066 companies	£65.7m	£7.6m
Option 2	1,163 companies	£41.0m	£4.8m

Appointment of an audit committee

57. Where necessary, new PIEs will be required to appoint an audit committee (or body performing equivalent functions), which would be responsible for all aspects of the company's engagement with their auditor. This requirement would impose one-off audit committee appointment costs in the first year, and ongoing costs related to remuneration of the audit committee and time spent on committee meetings.

58. In developing the cost estimates for audit committee appointment and ongoing activity, we relied on the methodology used to calculate these specific costs in the 2016 IA. We have used the 2016 IA's assumptions on costs (appropriately adjusted for inflation) as we do not have any more up-to-date information on recruitment and appointment costs. These are provided in *Table 4* below[36]. We assume that all new PIEs would need to appoint an audit committee which must consist of at least two independent members (a chairperson and one member) in keeping with current regulatory requirements.

59. Given the size and scale of new PIEs, it is likely that most will have some form of audit committee in place, even if they are not fully compliant with the requirements for current PIEs, or even if they do not report on these in their annual reports[37]. We also recognise that most new PIEs already apply some aspects of the UK Corporate Governance Code[38], albeit to varying degrees. Therefore, we assume that they will avoid some of the additional costs of setting up and maintaining audit committees.

60. For in-scope AIM-listed companies, in a random sample of 20 companies, all were found to have audit committees, with the majority indicating that they satisfied audit committee requirements for medium-sized companies. Therefore, these companies will need to make only those changes necessary to ensure that they are fully compliant with PIE audit committee requirements[39]. We assume that in doing so, they would incur 25% – 50% of the cost they would face if they had no audit committee arrangements in place, with a best estimate of 37.5%. In our assessment of aggregate costs, we take this sample of companies to be representative of all AIM-listed companies in scope. We therefore assume that aggregate audit committee appointment costs will be 37.5% of the cost that would have otherwise been incurred by this group.

61. Similarly, for other large companies brought into scope, we assume that some will already have audit committees in place, but that these represent a smaller proportion than the AIM-listed group. We recognise that it is highly unlikely that these companies will bear audit committee-related costs in full. However, as these companies seldom report on their audit committee arrangements, we lack robust evidence with which to determine appropriate cost offsets for the group. Therefore, we make the relatively conservative assumption that, in aggregate, they will

[36] For cost of appointment of member and ongoing cost of member, the best estimate is based on the mid-point between available estimates for FTSE 250 companies and those in the small-medium size category.

[37] Currently, these firms are not required to have audit committees and as such are not required to include details of any audit committee arrangements in their annual reports.

[38] FRC (2014), The UK Corporate Governance Code.

[39] These changes could relate to both audit committee member appointments and the conduct of audit committees.

avoid between 25% – 50% of the additional audit committee costs. Our best estimate is that they will bear around 62.5% of the total cost they would have incurred if they had no audit committee arrangements.

Table 4 a) and b) - one-off and ongoing audit committee costs

One-off appointment costs	Cost of Appointment of chairperson (£)	18.0k
	Cost of Appointment of member (£)	12.0k
	Total cost of appointment per entity (£)	**30.0k**
Total One-off Costs (£)		**30.0k**

		Best Estimate
Ongoing audit committee costs	Cost of chairperson (£)	53.0k
	Ongoing annual cost of other members (£)	50.0k
	Total Ongoing annual cost per entity (£)	**103.0k**
Ongoing cost of audit committee meetings	Audit Partner total cost per hour	729
	Audit manager total cost per hour	417
	Audited firm manager total cost per hour	42
	Audit committee members total cost per hour	295
	Total cost per hour	1,483
	Number of hours	7.5
	Total cost of additional meetings per entity (£)	11.0k
Total Ongoing Costs (£)		**114.0k**

62. Our estimates of the total one-off (appointment) and ongoing audit committee costs are provided for each option in *Table 5*.

Table 5 - Total Audit Committee Costs (appointment and ongoing)

	Entities in scope	**PVC, 10-yr period**	**EANDCB**
Option 1	2,066 companies	£639.1m	£74.3m
Option 2	1,163 companies	£599.6m	£69.7m

Non-Financial Reporting Directive requirements

63. Companies that are brought into scope of the PIE definition will also fall within scope of requirements in section 414CA of the Companies Act 2006. Under the relevant requirements, PIEs with more than 500 employees are required to prepare and submit a report on their approach to anti-bribery and corruption matters, and an enhanced strategic report. We expect this requirement to extend to all new PIEs.

64. We expect new PIEs to face both one-off costs (from familiarisation in the first year only) and ongoing costs from annual reporting. In assessing these impacts, we have used the methodology and core assumptions made in *IA No: BISCFA001* (the "NFRD IA") [40], which was developed to assess the impact of introducing NFRD requirements in 2016. Our estimates are based on the

[40] https://assets.publishing.service.gov.uk/Government/uploads/system/uploads/attachment_data/file/575540/NFRD_impact-assessment-_final_August_2016.pdf

time taken for familiarisation in the first year, and the time taken in the first and subsequent years to prepare the required reports. In all cases we have used ONS ASHE data on hourly earnings for the directors, professionals, and administrative staff. These are provided in *Table 6* and *Table 7* below.

Table 6 - NFRD Requirements Familiarisation Costs

		Familiarisation (hr)	Total cost per hour (£)	Total cost per PIE (£)
Anti-Bribery and Corruption Statement	Director	5	71	354
	Professional	20	26	512
	Administrative	1	14	14
	Total cost			**0.9k**
Enhanced Strategic Report	Director	2	71	142
	Professional	10	26	256
	Administrative	1	14	14
	Total cost			**0.4k**
Total cost per new PIE				**£1.3k**

Table 7 - Total Ongoing Costs from NFRD

		Average Annual Time Cost (hr)				
		Low Estimate	Best Estimate	High Estimate	Total cost per hour (£)	Total cost per PIE (£)
Anti-Bribery and Corruption Statement	Director	1	2	3	71	142
	Professional	3	7	10	26	166
	Administrative	2	8	14	14	110
	Total cost					**0.4k**
Enhanced Strategic Report	Director			10	71	700
	Professional			45	26	1,150
	Administrative			23	14	310
	Total cost					**2.2k**
Total ongoing cost per new PIE						**£2.6k**

65. Our estimates of the total cost to new PIEs from NFRD requirements are provided for each option in *Table 8*.

Table 8 - Total Costs to New PIEs from NFRD requirements

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	2,066 companies	£44.8m	£5.2m
Option 2	1,163 companies	£22.2m	£2.6m

Regulatory reporting requirements

66. The auditors of all new PIEs must prepare and submit a report on their audit and non-audit revenues in respect of each of their PIE clients to the regulator. We expect any related cost to be a resource cost to the auditor, in the form of staff time. Estimates used in the 2016 IA assumed 8 hours of the auditor's time for preparing this report. We have assumed the same here and have based our estimates on ONS ASHE data on hourly earnings for accountants.

67. Auditors brought into scope will also be required to prepare and submit a transparency report to the regulator. We only account for related additional costs to auditors that do not provide audits to any current PIEs[41]. Here too, due to the lack of updated evidence, we have relied on previous estimates of the cost of preparing the transparency report per audit firm. The estimate is taken from the 2016 IA, with appropriate adjustments for inflation. We consider this estimate to be the upper bound of transparency reporting costs, as it included costs to auditors of large numbers of PIEs whose transparency reports would have, therefore, been more complicated and more costly. We do not expect that new audit firms will perform more than a small number of audits of companies brought into scope, so the true costs are likely to be smaller than our estimates indicate. Our cost assumptions are provided in *Table 9* below.

Table 9 - Auditor's Revenue and Transparency Reporting Costs

Revenue report preparation time (hr)	8
Cost per hour of auditor (£)	29.4
Cost of revenue report per PIE (£)	235.2
Cost of transparency report per PIE (£)	60.5k

68. Our estimates of the total cost from additional regulatory reporting requirements are provided for each option in *Table 10*.

Table 10 - Total Cost to Auditors of New PIEs from Regulatory Reporting Requirements

	Scope	PVC, 10-yr period	EANDCB
Option 1	2,066 reports; 90 audit firms	£41.5m	£4.8m
Option 2	1163 Reports; 22 audit firms	£11.2m	£1.3m

69. In practice, we expect costs to be lower than the estimates presented above due to the possibility of auditors not wishing to continue an engagement when a client company is brought into the PIE regime. Extending the example used for auditor familiarisation costs, with an auditor dropout rate of 40%, we could expect regulatory reporting costs to be around 37% lower than estimated here[42].

[41] Whilst audit firms with current PIE clients will face some additional cost from this requirement, we expect this to be very small, as they already report on transparency in respect of their PIE audit practice and therefore, the scope of any additional transparency reporting will be limited.

[42] A 40% reduction in the number of auditors does not translate to a 40% reduction in costs, since some regulatory reporting costs stem from reports on audit and non-audit revenues in respect of each new PIE client, which is driven by the number of new PIEs in scope, and therefore, does not vary with changes in the number of auditors.

Additional audit committee report

70. This requirement will impose additional costs on the auditors of all new PIEs from the preparation and presentation of the report. The information in the report is expected to be based on the work conducted during the audit, so we expect no additional costs from collecting and collating information. This requirement will also impose costs on the new PIEs themselves, related to the audit committee's review of the report.

71. The methodology used to estimate costs related to this requirement is based on a method previously used to determine this specific impact. This is outlined in *Annex D* of *IA BIS016(F)-16-BE*. Our estimates consider the costs of auditor preparation and presentation time, PIEs' audit committee time, and the number of PIEs in scope. These costs were calculated separately for large and small/medium PIEs (by the standard Companies Act classification). We have used the Fame[43] database to determine the size distribution of new PIEs.

72. We do not have up-to-date information on the related costs, so estimates of the time required for preparation of the report, and the review and discussion of the report by audit committees are the same as those used in the IA referenced above (appropriately adjusted for inflation), with hourly wage estimates from ONS ASHE data for the relevant positions. As in the case of audit committee appointment, we have not adjusted our estimates to account for companies already applying the UK Corporate Governance Code. Details on costs of auditor time and audit committee time per new PIE are provided in *Table 11* below.

Table 11 - Additional Report to the Audit Committee

		Large PIEs	Small and Medium PIEs
Auditors	Auditor Preparation and Presentation time (hr)	15	10
	Hourly cost of senior official time (£)	£71	£71
	Cost of Auditor time (£)	**£1.1k**	**£0.7k**
Audit Committee	Debate and discussion time (hrs)	3	3
	Number of Audit Committee members	4	4
	Hourly Cost of Audit Committee time (£)	£71	£71
	Cost of Audit committee time (£)	**£0.9k**	**£0.9k**
Ongoing cost per report (£)		**£1.9k**	**£1.6k**

73. Our estimates of the total cost from the requirement for an additional audit committee report are provided for each option in *Table 12*.

Table 12 - Total Cost from Additional Report to Audit Committee

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	2,066 companies and their auditors	£26.9m	£3.1m
Option 2	1,163 companies and their auditors	£15.5m	£1.8m

[43] Fame is a database of company records and filings developed using Companies House data. It allows us to identify companies and key company metrics using bespoke criteria-based queries.

Subsidiaries Audit Exemption

74. Some entities in scope are subsidiaries that use the subsidiaries audit exemption in Part 16 of the Companies Act 2006. These subsidiaries would no longer be able to do so once they are reclassified as PIEs (and hence, made subject to the PIE audit regime). They would therefore incur a cost equivalent in magnitude to the saving they experienced by using the exemption. We estimate that 27 subsidiaries will lose this exemption under option 1, with the corresponding number being 7, for option 2.

75. The exemption allows these subsidiaries to save on the cost of having a full audit. Some costs are, however, generated at the group level in respect of subsidiaries using this exemption, since auditors of the group's consolidated accounts are still required to test, verify and assure the subsidiary's financial information included in the consolidated accounts.

76. In assessing the saving to these subsidiaries, we have drawn on assumptions made in *IA No: BIS0301*, in which the impact of this specific exemption was originally assessed. In keeping with the methodology set out in that IA, we consider the saving from the exemption to be the difference in cost between the amount incurred at the group level from testing, verifying and assuring the subsidiary's financial information, and the estimated cost of a full audit of the subsidiary. The IA estimated a saving of between 10% and 25% of the estimated average audit fee for companies in different size bands. In this assessment, we use the same assumption, and take the mid-point of this range, 17.5%, as our best estimate.

77. Therefore, after these subsidiaries move to being defined as PIEs, they could incur a cost equivalent to 17.5% of the estimated audit fee for PIEs in their turnover size band[44]. The cost per subsidiary for each turnover band is provided in *Table 13* below.

Table 13 - Additional Audit Costs to Previously Exempt Subsidiaries

	Very High TO PIEs	High TO PIEs	Medium TO PIEs	Low TO PIEs
Average PIE Audit Fee	£19.0m	£3.0m	£0.9m	£0.7m
Additional Audit Fees per previously exempt subsidiary	£3.3m	£0.5m	£0.2m	£0.1m

78. Our estimated total costs to the 21 subsidiaries who could lose the exemption are presented in *Table 14* below.

Table 14 - Total Cost from Additional Audit Fees

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	2,066 companies and their auditors	£34.3m	£4.0m
Option 2	1,163 companies and their auditors	£10.2m	£1.2m

[44] Turnover size bands classified as: low (below £43k); medium (between £43k and £1.7m); high (between £1.72m and £34.4m); and very high (above £34.4m).

Mandatory rotation and retendering requirements

79. All new PIEs will be required to appoint their auditors via competitive tender by the audit committee. The maximum term of a PIE audit appointment is 20 years, subject to retendering at 10 years.

80. Audit committees would therefore bear the cost of monitoring the tender, assessing bids, and validating the chosen auditor. Auditors would also face some costs as they would have to bid for their existing appointment every 10 years, and for new PIE engagements at the end of their existing appointment (at 20 years).

81. Our estimate of the overall cost of retendering and rotation of auditors considers the total cost of tendering to UK PIEs and their auditors every 10 years, and additional familiarisation costs faced by auditors every 20 years (when establishing new audit appointments). Since PIEs would retender and rotate their auditors at different times, we estimate an average annual cost applied over the appraisal period[45]. We have used the same underlying cost assumptions used in the 2016 IA, which specifically assessed the impact of mandatory retendering and rotation on new PIEs and their auditors. We also consider transitional costs (in year 1) to previously audit-exempt subsidiaries brought into scope under Options 2 and 3. These subsidiaries will lose the current exemption and will be required to appoint auditors via competitive tenders.

82. We assume a linear relationship between the average annual audit fee (for PIEs sized by turnover) and the cost of the tender exercise to PIEs and to audit firms bidding to provide audit services to them. Details are provided in *Annex III*.

83. Our estimates of the total cost to the auditors of new PIEs from mandatory rotation and retendering requirements are provided for each option in *Table 15.*

Table 15 - Total Cost from Mandatory Retendering and Rotation Requirements

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	2,066 companies and their auditors	£832.9m	£96.8m
Option 2	1,163 companies and their auditors	£521.5m	£60.6m

Restrictions on the provision of non-audit services

84. PIE audit regulations apply restrictions on the non-audit services that could be provided to PIEs by their auditors. When new PIEs are brought into scope, they will be required to reallocate the non-audit services being provided by their current auditor in order to comply with the Regulations. We expect any associated cost to be one-off, and to apply in the first year of implementation only. We do not expect any ongoing costs from this requirement.

85. We estimate that new PIEs will need to reallocate non-audit services equal in value to 10% of the average non-audit fee for companies considered under each option. This is in keeping with the assumptions and methodology used in the 2016 IA, which looked specifically at this impact. New PIEs will face costs from having to tender for new providers of these non-audit services. Auditors in scope will also need to bid in these competitive tenders for new non-audit engagements and will face any associated costs. Here too, we follow the 2016 IA methodology to estimate the cost of the tender exercise – the IA assumed tender exercise costs would be some proportion of the average value of non-audit services to be reallocated. These assumptions are set out in the *Table 16* below.

[45] We assume that companies retain their auditors at the retendering stage.

Table 16 - Reallocation of Non-Audit Services Costs

	Large Unquoted Companies	Large AIM
Average non-audit fee	£375k	£121k
% of non-audit fee to be reallocated	10%	10%
Value of non-audit services to be reallocated	£38k	£12k
Cost to Auditor of tender (30% of average non-audit fee)	£11k	£3.6k
Cost to PIE of tender (2% of average non-audit fee)	£0.8k	£0.2k
Total Cost	**£12k**	**£4k**

86. Our estimates of the total from the requirement to reallocate non-audit services are provided for each option in *Table 17.*

Table 17 - Total Cost from the Reallocation of Non-Audit Services

	Entities in scope	PVC, 10 yr period	EANDCB
Option 1	2,066 companies and their auditors	£18.7m	£2.2m
Option 2	1,163 companies and their auditors	£20.5m	£2.4m

Surveillance of the auditors of new PIEs

87. Auditor inspections (via the AQR process) will be required for the auditors of new PIEs. These additional costs do not apply to AIM companies and their auditors, as they are already subject to the AQR process. These inspections are required once every 3 years and will be conducted by the regulator on a sample of 30% of the population of PIE auditors. We therefore expect additional costs to relate to the inspections of 30% of the new auditors brought into scope (~24 out of 73). In developing our estimates of this impact, we have used an estimate of the average inspection cost provided by the FRC in 2016 for the 2016 IA, with appropriate adjustments for inflation. This is provided in *Table 18* below.

Table 18 - FRC auditor inspection cost estimate

Inspection of Auditors brought into scope	
Estimated average inspection cost every 3 years (£, 2016)	£31.0k
Average annualised inspection cost (£, 2016)	£10.0k

88. Our estimates of the total cost to the regulator from the surveillance of the auditors of new PIEs are provided in *Table 19*.

Table 19 - Total Cost from Surveillance of Auditors

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	Regulator; 29 auditors	£6.1m	*NA (no cost to business)*
Option 2	Regulator; 6 auditors	£1.3m	*NA (no cost to business)*

Overall Estimates of Costs for Options Considered

89. Estimates of overall costs (Present Value Costs and Equivalent Annual Net Direct Cost to Business) for each option are provided in *Table 20* below.

Table 20 - Overall Costs of Options Considered

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	2,066 companies and their auditors; the regulator	£1,717.1m	£198.8m
Option 2	1,163 companies and their auditors; the regulator	£1,244.7m	£144.5m

Section 2: Corporate Governance

90. This section covers the following measures:

- Proposals for strengthening the law on dividends and capital maintenance in a proportionate way. They include proposals for giving the regulator powers to define realised profits and losses and new requirements for companies to report on their distributable reserves.
- Options for strengthening the UK's internal controls framework, including strengthening the responsibility and accountability of board members for the effectiveness of internal control and risk management procedures, and options for expanding the role of external auditors in providing assurance that companies' internal controls are effective.

Summary: Analysis & Evidence **Capital maintenance option 1**

Description: *Transfer responsibility for defining the realisation test to ARGA*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -0.2**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**0.2**			**0.2**

Description and scale of key monetised costs by 'main affected groups'

We assess costs to the regulator only, under this option – the regulator would be required to prepare and issue guidance to companies on what to include in their assessments of realised profits. We propose two alternative approaches under this option; however, costs are expected to be the same regardless of the alternative taken forward.

Other key non-monetised costs by 'main affected groups'

No other key sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

This option will place the definition of "realised profits" and "realised losses" on a formal legal footing, and in so doing, would strengthen directors' obligation to comply with the legal framework and the rules governing dividends and capital maintenance. It would also help to address issues associated with variations in the interpretation of the guidance provided to companies currently. Ultimately, this would assist in focusing directors on their key responsibilities and duties when preparing and paying dividends.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

We make the following key assumptions:

- Due to the regulator's current engagement with accounting standards and practice, we assume it will not incur any significant costs in assessing the generally acceptable principles of accounting that would inform the guidance produced for companies.
- The regulator would not change the definitions of realised profits and losses, despite having the power to do so. We assume any costs associated with supervision and enforcement of any additional reporting requirements are picked up in Section 9.
- The baseline guidance-setting costs provided to BEIS by the FRC includes the cost of consultation and stakeholder engagement required by this option.
- The cost of each alternative measure proposed in this option would be driven solely by guidance-setting costs, and therefore, overall costs of the option will be the same regardless of the measure selected.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: N/A**
Costs: N/A	**Benefits: N/A**	**Net: N/A**	

Summary: Analysis & Evidence — Capital maintenance option 2

Description: *Option 1 + the introduction of new requirements on companies to disclose their distributable reserves*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -13.7**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**2.2**		**1.3**	**13.7**

Description and scale of key monetised costs by 'main affected groups'

In addition to costs identified under option 1, we expect the regulator to face further costs from preparing and issuing guidance to aid companies in preparing the required disclosures. We also expect companies to incur costs in familiarising themselves with disclosure requirements and guidance provided by the regulator, and from preparing the necessary disclosures.

Other key non-monetised costs by 'main affected groups'

No other key sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

The benefits under this option build on those outlined for option 1. This option adds clear disclosure requirements with which companies must comply. The benefit of this is expected to accrue through greater clarity, primarily to investors but also to wider users of this information, on the legality and sustainability of the companies' dividends.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

In addition to the assumptions and risks outlined for option 1, we assume:

- Only individuals directly involved with compliance within companies would need to familiarise and work on developing the necessary disclosures. We do not account for wider involvement across the company but recognise that others may wish to be involved (such as from the company board).
- We assume that companies have the information for required disclosures readily available to them at negligible additional cost.
- We assume that any additional audit work in respect of these disclosures would be minimal and negligible in cost.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 7.7
Costs: 1.5	**Benefits: 0**	**Net: -1.5**	

Summary: Analysis & Evidence — Capital maintenance option 3

Description: *Option 2 + a new directors' statement about the legality of proposed dividends and the effects on the future solvency of the company*

Price Base Year 2016	**PV Base Year** 2017	**Time Period Years** 10	**Net Benefit (Present Value (PV)) (£m)**		
			Low:	**High:**	**Best Estimate: -18.6**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**3.0**		**1.8**	**18.6**

Description and scale of key monetised costs by 'main affected groups'

This option builds on option 2. It adds a requirement for directors' attestations confirming their compliance with dividend rules and other relevant duties. In addition to costs identified for option 2, we expect companies to face one-off familiarisation costs, and costs from compiling information from company accounts, resilience statements and risk reports into the required ongoing disclosures.

Other key non-monetised costs by 'main affected groups'

No other key sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

These attestations go further than disclosures under option 2 in increasing transparency around their dividend decisions. Investors and other users of this information would benefit from greater clarity around directors' compliance with their duty to consider the potential impact of dividend payments on company solvency and would therefore further enhance directors' accountability to investors and their compliance with the relevant legal frameworks.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

In addition to the assumptions and risks outlined for option 2, we assume:

- No further costs to the regulator in this option.
- The information needed to inform directors' attestations is already captured in companies' accounts, risk reports, resilience statements, and other relative elements of company reporting. We expect that no new assessments will be necessary.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 10.0**
Costs: 2.2	**Benefits: 0**	**Net: -2.2**	

Assessment of capital maintenance measures

Policy Overview

91. The Companies Act 2006 sets clear dividend and capital maintenance rules which determine the amount of a company's earnings that can be distributed in dividends, and the source of dividend payments. The Act requires that:

    - dividend payments can only be made from its accumulated "realised profits" less its accumulated "realised losses"[46] (s830);
    - public companies must apply a net asset test[47] (s831); and
    - in paying dividends, company directors have regard to their statutory duties[48] to exercise care and due diligence and promote the success of the company, and their common law duty to seek the company's best interest.

92. However, high profile examples of companies paying out significant dividends shortly before profit warnings and, in some cases, insolvency, have raised questions about the extent to which the dividend and capital maintenance rules are being respected and enforced. Moreover, this issue was raised by several respondents[49] during the Brydon Review consultation, which has compounded the questions raised about the robustness of the legal framework. There are three key issues which potentially limit the effectiveness of the current framework:

    - The rules are based on the concept of realised profits and realised losses, but these definitions are not fixed[50]. They are subject to change in line with the evolution of generally accepted accounting principles applicable at the time of reporting. Therefore, there is a lack of clarity around how profits recorded for accounting purposes should be separated into distributable and non-distributable profits. There are also questions about how the generally accepted principles should be identified – guidance currently used by companies in doing this[51] sets out the generally accepted accounting principles of the time, but lacks legal status, and companies have no obligation follow them exactly – and who should be responsible for defining the "realisation test".
    - Current legislation makes no explicit requirement under company law or accounting standards for financial statements to disclose the total amount of profits that are distributable. This transparency issue arises as companies adopt accrual accounting (using IFRS[52] or UK GAAP[53]), which does not recognise the concept of realised or unrealised profits. As such, profits recorded in their annual accounts do not necessarily equate to realised, distributable profit. In effect, beyond taking it on trust, shareholders are not able to know with any certainty whether dividends are being paid from distributable profits, or whether there is any headroom between the total dividend and the company's total distributable reserves.
    - Current accounting practice and the focus of the current framework are backward looking and concerned only with companies' historical performance. Whilst this focus allows companies to present a view of performance at a given point in time, they do not allow for the future financial requirements or performance of the company to be assessed.

[46] Section 853 takes realised profits and realised losses as those that are so defined under generally accepted accounting principles at the time the company's accounts are prepared.

[47] Companies may only make a distribution if its net assets is greater than the sum of its called-up share capital and non-distributable reserves.

[48] Under Companies Act 2006 s174 and s172(1), respectively.

[49] Brydon Report, para 19.1

[50] See definition in footnote 46 above.

[51] TECH 02/17BL, Guidance on Realised and Distributable Profits under the Companies Act 2006

[52] International Financial Reporting Standards

[53] Generally Accepted Accounting Principles

Directors are required to have regard to their statutory duties under Section 172 Companies Act 2006 – promoting the success of the company, including over the long term, and considering the company's future financial needs – when declaring a dividend, but there is no requirement for them to demonstrate how they have done so within the current legal framework.

93. Whilst the Brydon Review made no specific recommendations for addressing these issues, it suggested some measures that would assist in ensuring that companies act with due regard for the legal framework, and their statutory and common law duties, in declaring dividends:

- In proposing a dividend, directors should prepare a statement that the dividend is within known distributable reserves and would not pose any risks to the existence of the company. In so doing, they should also confirm that the statement is consistent with the information in their Resilience Statement and has been subject to the appropriate level of assurance (in accordance with their Audit and Assurance policy).
- In cases where it is likely that distributable reserves are found to be similar in size to a proposed dividend, the dividend should only be recommended by the directors if the level of the distributable reserves is known and payment of that dividend is consistent with the company's Resilience Statement and other Companies Act 2006 directors' obligations. These distributable reserves should also be subject to audit.

94. The Government supports the view that strengthened disclosure related to dividends and capital maintenance would be of value to investors and wider stakeholders. Responses to the Government's Insolvency and Corporate Governance consultation also suggested that there is a demand for this information from companies.

95. Options for strengthening the current framework of rules governing dividend payments are assessed below[54].

Entities in scope

96. The options proposed here are intended to increase transparency around the legality and sustainability of company dividends for external shareholders in those companies. Therefore, we assess these options as applying to **1,422 UK companies listing shares on the LSE main market and AIM**[55].

97. We will update our analysis to reflect any changes to the intended scope arising from consultation responses.

Options considered

98. We propose three options in this section. The Government's consultation seeks views on these options.

99. Our estimates of costs are tentative at this stage, and responses to the consultation will help us to refine these.

Option 1 – transfer responsibility for defining the realisation test to the regulator

100. Under this option, the realisation test will become a statutory responsibility for the new regulator. This is expected to present an opportunity to give the definition formal legal status, and would

[54] These options also consider responses to the 2018 Government consultation on Insolvency and Corporate Governance and recommendations made by BEIS Select Committee following the 2019 Future of Audit Inquiry.

[55] Based on the London Stock Exchange Issuers List as of 30th September 2020.

address any issues related to whether, and how, it should be applied. Giving the regulator responsibility for the definition would also allow for stronger action against non-compliance through the regulator's enforcement powers.

101. Two possible approaches are proposed:

- the regulator would have a statutory duty to identify the prevailing generally accepted principles and to prepare guidance for companies which sets out what should be treated as realised profits and losses in accordance with those principles. The authority of the regulator, in this regard, would be further strengthened by a new provision in the Companies Act 2006 which would require the court to consider its guidance in determining what generally accepted principles are at any point in time; or
- the regulator would be given powers to set the "realisation rules" that preparers would need to follow. These rules would be developed by reference to the prevailing generally accepted principles and could additionally require the consent of the Secretary of State before being brought into force.

102. Under both proposals, the regulator would be required to develop the necessary guidance, or the realisation rules, in consultation with investors, creditors and other users of this information.

<u>Option 2 – Option 1 + the introduction of new requirements on companies to disclose their distributable reserves</u>

103. This option builds on option 1 in that it also introduces new requirements on companies to disclose their distributable reserves. This option comprises two disclosure components, which are set out below.

i. Disclosure of the distributable reserves in the financial statements

- Individual companies – or in the case of groups, parent entities only – would need to disclose the total amount of their distributable reserves in their annual report. By virtue of its inclusion in the company's financial statements, these disclosures would need to be included in the scope of the company's audit, which would therefore provide further assurance about the company's compliance with guidance set by the regulator.
- In cases where it is not possible for companies to determine the exact amount of their distributable reserves[56], this disclosure component would allow them the flexibility to report a minimum, "not less than" estimate, which they would then need to use as a dividend cap.
- It is expected that the disclosures arising from this measure would assist shareholders in assessing the headroom between the company's proposed dividend and its total distributable reserves, and therefore, provide greater transparency on the sustainability and legality of the company's dividends.

ii. Disclosure of estimates of a group's dividend-paying capacity

- The second disclosure component is intended to complement the first, in that it seeks to address a weakness in the current reporting framework that arises in certain group situations. In some groups, where, for example, the subsidiaries earn significant profits that are not yet passed to the parent company at the time of its own distribution, the disclosure of the parent company's distributable profits would understate its potential overall capacity to pay future dividends.

[56] For example, where companies may have an extensive profit history that makes it difficult or disproportionate for them to calculate an exact figure.

- This component would require parent companies to estimate and disclose the amount of *potential* distributable profits across the group that could, in principle, be passed to them for them for the purpose of paying future dividends to its shareholders. The disclosures would also need to include, where appropriate, an explanation of any constraints on the subsidiaries' ability to pass a share of their distributable profits to the parent company.
- This option would allow parent companies some flexibility in deciding how these estimates and narrative disclosures would be presented, and would also allow them, where reasonable, to decide which group entities it would include in the assessment. The extent to which companies may make use of this flexibility would be set out in guidance issued by the regulator, which would also include further guidance on reporting best-practice.

<u>Option 3 – Option 2 + a new directors' statement about the legality of proposed dividends and the effects on the future solvency of the company</u>

104. This option builds on option 2 with the addition of a requirement for directors to confirm that in proposing a dividend, they have complied with all relevant legal obligations and have given due consideration to the potential impact of the dividend on the solvency of the company. This measure is intended to address issues related to the backward-looking nature of the current framework, and to encourage directors to act in a way that ensures proposed dividends will not threaten the company's future viability and solvency.

105. Under this option, company directors would be required to prepare a statement confirming:

    i. That in proposing the dividend, they have: (i) satisfied themselves that the dividend is within known distributable reserves; and (ii) given due regard to their duties under Section 172 (1) of the Companies Act 2006 and their wider common law and fiduciary duties.

    ii. That based on their knowledge of the company's position at the date the dividend is proposed, and based on company risk assessments, they are satisfied that payment of the dividend would not threaten the solvency of the company for the following two years. Where relevant, directors would also need to confirm that the dividend is consistent with the company's Resilience Statement.

106. Whilst this measure does not itself require directors to conduct further risk assessments, or assessments of the company's starting position, it does require some degree of consistency-checking against existing assessments.

Assessment of monetised and non-monetised costs of each option

107. Our cost estimates are tentative at this stage, and we will use further policy work and responses to this consultation to develop our analysis further. Cost estimates are summarised in *Table 21* below.

108. We assume that costs to the regulator will be covered by an increase in the FRC levy, which is out of scope of the Better Regulation Framework, and therefore, not included in our Business Impact Target (BIT) calculations. We consider any additional activity by the regulator from processing and reviewing additional reports to be included in the scope of their current BAU activity, and therefore, take any associated increases in cost to be negligible.

Table 21 - Summary of cost impact of options assessed

	Cost Summary	
	PVC, 10-yr period	**EANDCB**
Option 1	£0.2m	*NA (no cost to business)*
Option 2	£13.7m	£1.5m
Option 3	£18.6m	£2.2m

Option 1: Costs to the regulator

109. We consider costs to the regulator for each alternative proposal in turn.

110. **Under proposal (a) of this option**, we expect the regulator to face costs from assessing the prevailing generally accepted principles of accounting and from developing and issuing guidance to companies on what to include in their assessments of realised profits.

111. We take costs related to assessing the generally accepted principles to be negligible. Given that ARGA would be regulator for auditors, accountants and actuaries and, hence, have expertise in matters related to accounting standards, principles and practice, we expect them to have a thorough understanding of the prevailing generally accepted principles.

Cost of developing and issuing guidance

112. We use an FRC estimate that developing and issuing guidance for regulated companies will impose a one-off cost of £250k[57]. We assume that this cost will apply in the first year of implementation only. Therefore, the PVC to the regulator from proposal (a) is estimated to be £0.2m over the 10-year appraisal period.

113. **Under approach (b)**, we expect the same cost as in approach (a) above. Whilst the regulator will have the power to establish realisation rules, we assume that they would maintain the current rules and definitions, but that they will bring them into scope of their enforcement functions[58]. We assume any costs associated with supervision and enforcement of any additional reporting requirements are included in Section 9 cost estimates. Therefore, we expect that the only cost to the regulator will arise from developing and issuing guidance for companies.

Option 1: Costs to companies in scope

114. We do not account for costs to companies in scope from this option. Whilst any changes introduced by the regulator, under either proposal, may have an impact on companies' activities, the scale of that impact will depend on the specific changes introduced at that time. As such, we consider our overall estimates for this option to represent the lower bound.

[57] This estimate reflects the staff and other costs of preparing the guidance and engaging with stakeholders at all stages, as appropriate, to prepare, consult, communicate and embed the new guidance. We aim to capture more detail for future iterations of this IA.

[58] If the FRC deems it necessary to establish entirely new rules and definitions, it will incur some costs, but we do not expect these to be significant. Further engagement with the FRC is necessary to test and validate this assumption.

Option 1: Overall Costs

115. This option will **deliver an estimated PVC of £0.2m over the 10-year appraisal period**. Given that the cost of this option is the same regardless of the approach taken, we make no further distinction between the two alternative proposals in the assessments of options 2 and 3.

Option 2: Costs to the regulator

116. As this option builds on option 1, we expect costs to the regulator from this option to stem from the costs of measures under option 1 and from the additional cost of preparing and issuing guidance under components (i) and (ii) of this option.

117. Here too, we use FRC cost estimates[59]. Based on this the total PVC to the regulator from this option is estimated to be £0.4m over the 10-year appraisal period.

Option 2: Costs to companies in scope

118. We expect companies in scope to face costs from familiarisation with new requirements, and from the ongoing requirement to prepare the necessary disclosures.

Familiarisation costs

119. All companies in scope are expected to face familiarisation costs in understanding and interpreting the guidance provided by the regulator and assessing what compliance would mean for them in practice. We expect familiarisation costs to apply as one-off costs in the first year of implementation only.

120. Our estimates are based on the time spent on familiarisation by company staff levels that are most likely to be responsible for preparing the required disclosures. Therefore, our estimates are based on the hourly remuneration rate of Chief Financial Officers (CFOs)[60], senior managers, professional accounting staff, and administrative staff[61] (see *Table 22* below).

Table 22 - Familiarisation costs to companies in scope

Familiarisation Costs	
Number of companies in scope	1,422
Number of hours per CFO	4
Hourly cost of CFO time	£165
Number of admin Staff Hours	4
Hourly cost of admin staff time	£17
Number of professional hours	10
Hourly cost of professional staff time	£29
Number of senior manager hours	8
Hourly cost of senior manager time	£71
Total familiarisation cost per company	**£1.6k**

Hourly CFO cost based on the assumption that the average CFO of in-scope companies works 2,080 hours per year with an estimated annual salary of c.£340k. Hourly cost for senior managers, professional accounting staff and admin staff based on the 75th percentile of hourly wages in ONS ASHE 2018 table 14.5a, for levels 1115, 2421 and 4 respectively.

[59] We take this cost to be double that of Option 1 since this option requires an extra set of guidance material.

[60] We developed our estimate of CFO hourly remuneration using the average CFO salary given in Deloitte's 2018 Director's Remuneration Report for the FTSE 250 market cap band containing the average market cap of companies in scope of the measures assessed here.

[61] We use the 75th percentile of hourly wages in ONS ASHE table 14.5a for senior managers, professional accountants and admin staff, with a non-wage uplift of 20%.

121. We recognise that the company board may wish to familiarise themselves with these requirements, but since the measures assessed here do not require them to do so, we do not account for any associated costs in our assessment.

122. We expect familiarisation costs to be roughly the same for both components of this option, based on their complementary nature and similar levels of complexity. We therefore do not account separately for familiarisation of individual companies with component (i), and parent companies with component (ii).

123. We estimate the PVC of familiarisation costs for all companies in scope to be £1.8m over the 10-year appraisal period. The EANDCB is estimated to be £0.2m.

Cost of preparing ongoing disclosures

124. We expect companies in scope to face additional costs from the requirement to provide information on their distributable reserves in their annual financial statements. We do not expect companies to face significant costs from this requirement. We assume that companies are already preparing these calculations, as they are currently paying dividends, and therefore, to do otherwise would mean that their dividend payments are non-compliant with the current legal framework. We will revisit this assumption in light of responses to the consultation. The components of this option do not require companies to prepare new calculations, but to package or refine existing information into the required disclosures. On this basis, we estimate the PVC to companies in scope to be £11.5m over the 10-year appraisal period, with an associated EANDCB of £1.3m. Further details are provided in *Table 23*.

125. We recognise that by virtue of including the disclosures in their financial statements they will be included in the company's audit, and therefore, this requirement could lead to additional audit costs for the company. However, we assume, given the expected scale of additional work, that the extra audit work is likely to fall within the range of normal variations in the scale of work that auditors could reasonably expect during the course of a large company audit. We therefore do not account for increased audit costs in this assessment.

Table 23 - Cost of preparing ongoing disclosures (per company)

Cost of preparing required disclosures	
Number of companies in scope	1,422
Number of hours per CFO	4
Hourly cost of CFO time	£165
Number of admin Staff Hours	2
Hourly cost of admin staff time	£17
Number of professional hours	6
Hourly cost of professional staff time	£29
Number of senior manager hours	4
Hourly cost of senior manager time	£71
Ongoing reporting cost per company	**£1.2k**

<u>Option 2: Overall Costs</u>

126. We estimate the PVC of this option to be £13.7m over the 10-year appraisal period. The EANDCB is estimated to be £1.5m.

Option 3: Costs

127. Under this option, in addition to the meeting the requirements of option 2, directors in scope would need to make attestations confirming their compliance with dividend rules, their duties under Section 172(1) of the Companies Act 2006 and their wider duties and that, based on their knowledge of the company, the proposed dividend would not threaten the company's solvency.

Option 3: Costs to the regulator

128. As this option builds on option 2, we expect costs to the regulator from this option to the same as in option 2. We do not expect any further costs to the regulator from the measures under this option. Therefore, the total PVC to the regulator from this option is estimated to be £0.4m over the 10-year appraisal period.

Option 3: Costs to companies in scope

129. We expect companies in scope to face costs from familiarisation with additional requirements, and from the ongoing requirement to prepare the necessary disclosures. Whilst the measure itself does not require directors to conduct any new assessments of company performance, resilience, or risk, directors are expected to prepare the relevant statements, and therefore, to incur some costs in the process. We discuss these below.

Familiarisation costs

130. In addition to familiarisation costs under option 2, we expect all companies in scope to face some familiarisation cost under this option. As above, we expect these to be one-off costs applying in the first year of implementation only. We expect familiarisation to be carried out by company directors, and the professional accountants and administrative staff that form their support team (see *Table 24* below).

131. We calculate familiarisation costs on the same basis as applied in option 2 above. We estimate that this option will generate a PVC from familiarisation of £2.6m. The EANDCB is estimated to be £0.3m.

Table 24 - Familiarisation costs to companies in scope

Familiarisation Costs	
Number of companies in scope	1,422
Number of director hours	8
Hourly cost of director time	£41
Number of professional hours	10
Hourly cost of professional staff time	£29
Number of admin staff hours	4
Hourly cost of admin staff time	£17
Familiarisation cost per company	£686
Familiarisation cost per company from option 2	£1.6k
Total familiarisation cost per company (option 2 + option 3)	£2.3k
Hourly cost for directors, professional accounting staff, and admin staff based on the 75th percentile of hourly wages in ONS ASHE 2018 table 14.5a for levels 11, 2421 and 4 respectively.	

Cost of preparing ongoing disclosures

132. For ongoing reporting, we expect directors, and their support teams to generate additional costs in compiling information that is already captured in company accounting information, and their risk and resilience reports. We therefore estimate the PVC to companies in scope from director attestations to be £15.5m over the 10-year appraisal period, with an associated EANDCB of £1.8m. As with our estimates of familiarisation, these estimates include ongoing reporting costs calculated for option 2. Further details are provided in *Table 25*.

Table 25 - Cost of preparing ongoing disclosures (per company)

Cost of preparing required disclosures	
Number of companies in scope	1,422
Number of director hours	4
Hourly cost of director time	£41
Number of professional hours	6
Hourly cost of professional staff time	£29
Number of admin staff hours	4
Hourly cost of admin staff time	£17
Ongoing reporting cost per company	£406
Ongoing reporting cost per company from option 2	£1.2k
Total ongoing reporting cost (option 2 + option 3)	**£1.6k**

Option 3: Overall Costs

133. We estimate the PVC of this option to be £18.6m over the 10-year appraisal period. The EANDCB is estimated to be £2.2m.

Risks and uncertainties

134. Under option 1, we use FRC estimates for the cost of preparing and issuing guidance. The FRC's process for developing guidance typically involves a consultation, but the specific consultation requirements of this option may go beyond the standard FRC process. Therefore, in practice, costs may be higher than our estimates suggest.

135. Definition or guidance changes introduced by the regulator could mean that companies may face additional costs that we have not explicitly considered in our assessment.

136. Under option 2, we assess costs as being broadly similar for components (i) and (ii). However, it is likely that parent companies, under component (ii), may incur higher costs than our estimates suggest from having to process a greater volume of information than individual companies would under component (i).

137. We assess increased audit work, and hence fees, as being negligible. We recognise, however, that the scale of additional work is subject to significant variations between companies, and that some companies may face higher costs than others. We also note that, based on the final specification of the requirements, audit costs are likely to be higher than our estimates suggest.

138. Under option 3, we note that company directors would not be required to carry out new assessments of risk, resilience and performance. However, we expect this to vary, to some degree, across companies. Some companies might already be doing enough to not warrant extra work, but others may not have adequate underpinning processes in place and will

therefore need to implement them before issuing the relevant confirmations. This could lead to higher costs for these companies.

139. The purpose of the reform proposed in this section is to instil greater responsibility for dividend decisions and payments in company directors. A potential further impact of the measures proposed here, therefore, could be a reduction in dividends, as directors subject to greater accountability might adopt a more cautious approach and lower dividend payments to limit their risk.

Summary: Analysis & Evidence — Internal controls option 1

Description: *Requirement for management in-scope companies to report on effectiveness of internal controls*

Price Base Year 2016	**PV Base Year** 2017	**Time Period Years** 10	**Net Benefit (Present Value (PV)) (£m)**		
			Low:	**High:**	**Best Estimate: -1452.9**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1-4		
High				
Best Estimate	**580.4**		**108.7**	**1452.9**

Description and scale of key monetised costs by 'main affected groups'

Companies in scope will likely face compliance costs for the management to be satisfied about the effectiveness of internal controls. For example, companies may invest in new internal financial reporting systems. Costs are significantly higher in the first few years due to large transition costs. We adjust these costs to reflect that the UK already has some requirements related to internal controls. We expect the regulator to face costs from developing and issuing guidance for companies' use in developing the required attestations.

Other key non-monetised costs by 'main affected groups'

The new requirement could reduce management focus on other risks, for example environmental and reputational risks, if the requirement were limited to controls on financial reporting. There is also a risk that listings may decline, due to the increased regulatory cost of listing on the London Stock Exchange Main Market.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

The proposals would incentivise improvements in companies' internal controls systems. There would be benefits to companies in scope, such as more effective internal decision-making and a decreased cost of capital. Investors in these companies might experience reduced costs as a result of fewer frauds and corporate failures. They might also face reduced precautionary costs. The wider market could benefit from greater stability, more efficient allocation of investment and a decreased cost of capital across the market.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

We use survey data, which may not be an accurate reflection of the actual costs experienced by companies. We assess the costs of compliance using a US SOX benchmark. We assume that current UK internal control requirements already go some way towards full compliance with an improved internal control regime. Hence, we assume companies would face between 25% and 50% of the costs associated with assessing the effectiveness of their internal controls according to a US SOX benchmark. We make extensive use of data from Fame in developing this assessment. However, there are gaps in this data which mean that not all in-scope companies are represented in our dataset. We therefore treat our estimates as a lower bound.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 843.9**
Costs: 168.8	**Benefits: 0**	**Net: -168.8**	

Summary: Analysis & Evidence — Internal controls option 2

Description: *Option 1 + requirement for auditors to report more about their views on the effectiveness of companies' internal control systems*

Price Base Year 2016	**PV Base Year** 2017	**Time Period Years** 10	**Net Benefit (Present Value (PV)) (£m)**		
			Low:	**High:**	**Best Estimate: -1459.6**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1-4		
High				
Best Estimate	**580.4**		**109.5**	**1459.6**

Description and scale of key monetised costs by 'main affected groups'

Companies would experience compliance costs as in option 1. Additionally, we expect that audit fees would rise as a result of the increased work auditors must do to produce reports covering their work to understand the company's internal controls system and how that has influenced their approach to the audit. It is likely that these costs would ultimately be passed on to the companies through increased audit fees.

Other key non-monetised costs by 'main affected groups'

We expect the same non-monetised cost as outlined for option 1.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

There would be similar non-monetised benefits as in option 1. However, this option also allows for auditor consistency checks, and therefore strengthened company reporting, and greater clarity to investors and wider stakeholders on company internal controls.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

In addition to the main assumptions under option 1, we assume auditors of in-scope companies will each need to produce a report covering their work in understanding the companies' internal controls and in developing their approach to the audit. We develop our cost estimates on the basis set out in Annex D of IA BIS016(F)-16-BE.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 844.6**
Costs: 168.9	**Benefits: 0**	**Net: -168.9**	

Summary: Analysis & Evidence — Internal controls option 3

Description: *Option 1 + Requirement for external auditors to provide an opinion on internal controls*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -2322.3

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1-4		
High				
Best Estimate	930.0		173.7	2322.3

Description and scale of key monetised costs by 'main affected groups'

Companies would experience compliance costs as in option 1. Additionally, we expect that audit fees would rise by 5-35%, due to the increased work auditors must do to be satisfied with the effectiveness of internal controls. We expect there to be significant transition costs for auditors, as with the companies themselves. It is likely that the costs to the auditor would ultimately be passed on to the companies through increased audit fees.

Other key non-monetised costs by 'main affected groups'

There would be similar non-monetised costs as in option 1, though possibly to a greater extent, since the overall regulatory cost of option 2 is greater.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

There would be similar non-monetised benefits as in option 1. Though to a greater extent since the requirement for external auditor assessment would increase the incentives for company management to invest in effective internal controls.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

We assess the costs of compliance using a US SOX benchmark. We assume that current UK internal control requirements already go some way towards full compliance with an improved internal control regime. Hence, we assume companies would face between 25% and 50% of the costs associated with assessing the effectiveness of their internal controls according to a US SOX benchmark. Estimates of the increase in audit fees vary significantly. Therefore, there is a large confidence interval for the costs of this option. We use the best estimate of 15% for this increase.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 1348.9
Costs: 269.8	Benefits: 0	Net: -269.8	

Assessment of internal controls measures

Policy Overview

140. Internal controls are the processes within a company that enable it to identify and manage risks and ensure the integrity and reliability of its reporting. In the US, under section 404 of the Sarbanes-Oxley Act (SOX), CEOs and CFOs are required to report annually on the effectiveness of the company's internal controls over its financial reporting and for the company's auditor to attest to, and report on, management's assessment of its internal controls. To comply with SOX most US companies evaluate the effectiveness of internal controls against the COSO framework[62]. This covers five elements:

- The control environment,
- Risk assessment,
- Control activities,
- Information and communication, and
- Monitoring activities.

141. The US arrangements are supported by the senior audit committee chairs of some UK companies with a dual listing in the US and who therefore have experience of both regimes. The Independent Review noted that they are perceived to have led to better financial reporting, fewer significant accounting restatements and stronger reassurances for audit committee members. The provisions also clearly underline that the primary responsibility for internal financial controls and the accuracy of financial reporting rests with the board and management of a company.

142. The UK's current regulatory framework does not require company directors to make a specific statement about the effectiveness of a company's internal controls, nor for the auditor to certify the effectiveness of a company's internal controls on financial reporting. However, UK companies are required to maintain systems of internal control although the requirements derive from several sources:

- Requirements to keep adequate accounting records and preparation of financial statements under UK company law.
- Requirements in the UK Corporate Governance Code.
- Internal controls required for companies seeking admission to listing under the listing rules[63].

143. The Independent Review recommended that *BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any lessons from operation of the Sarbanes-Oxley regime in the US. The pros and cons of options for change should be analysed and consulted upon, giving special consideration to the importance of proportionality in relation to the size of the company.*

Options considered

144. We consider three options.

[62] COSO stands for the Committee of Sponsoring Organisations of the Treadway Commission.

[63] ICAEW (2019), Internal control effectiveness: who needs to know? ICAEW Thought Leadership, Future of Audit.

Option 1 (*preferred)* – Board assessment of controls

145. This would require the company's board to provide an assessment of the effectiveness of the company's internal controls. As noted above, the UK already has requirements relating to internal controls though these differ in significant respects from SOX. For example, in the UK the Board is responsible for effective controls; in the US the CEO and CFO are responsible for the effectiveness of controls. There is an alignment between the COSO framework used under SOX and the FRC's guidance on internal controls[64]. But the scope of the UK's control framework is wider as it applies to all material controls, including financial, operational and compliance controls, whereas SOX only applies to financial controls.

146. Under this option and in accordance with principles and guidance provided by the regulator, directors would be required to undertake an annual review of the company's internal controls framework, and to set out the findings of the review in the company's annual report and accounts. They would also need to set out details of the benchmarks against which the assessments were conducted, along with an assessment of their appropriateness.

147. This option does not require any external audit and assurance but allows audit committees and shareholders to decide on whether the internal controls effectiveness statement should be subject to external audit and assurance. This would be a matter of consideration in the development of company's audit and assurance policies.

Option 2 – Board assessment of controls with a requirement for auditors to report more about their views on the effectiveness of companies' internal control systems

148. Option 1, plus a requirement for the external auditor to report on the work they have undertaken to understand the companies' internal control systems, and how that has influenced their approach to auditing these companies, but without requiring a formal audit opinion on whether they regard the controls as effective or not. We treat these auditor reporting costs as wholly additional, as auditors are not currently required to report on their approach to internal controls assessments, or their views on the effectiveness of internal controls[65].

Option 3 – Board and auditor assessment of controls

149. Option 1, plus a requirement for the external auditor to provide a formal opinion on the effectiveness of the company's internal controls. There is currently no requirement for auditor attestation of control effectiveness in the UK. Therefore, we treat these costs as wholly additional.

Entities in scope

150. For the purposes of this analysis, options 1, 2 and 3 are assumed to apply to UK premium listed companies from the first year of implementation[66], and to all other eligible UK PIEs two years later. The final scope and implementation plan of any new internal control requirements will require further consideration as policy develops.

151. Some of the premium listed companies and PIEs in scope are listed in the US, so are already compliant with SOX Section 404. Using Fame data, we obtained a list of UK companies that have

[64] Deloitte (2019), Internal control and the board: what is all the fuss about? The Deloitte Academy, November 2019.

[65] We use this as a simplifying assumption. In practice, these costs may not be wholly additional because auditors of premium listed companies are already required to report to the audit committee their views on the effectiveness of internal controls relevant to the risks that may affect financial reporting (under ISA(UK) 260 requirements). We expect that this will offset auditor reporting costs.

[66] We consider only those companies classified as "Premium Equity Commercial Companies" incorporated in the UK in this grouping. Premium equity closed ended investment funds are grouped with all other eligible PIEs for this assessment. We welcome views and evidence on whether compliance costs for closed ended investment funds would be similar to, or lower than, for commercial trading companies.

issued securities on US markets. From Fame, there are 148 UK premium listed companies listed on US exchanges, and around 20 PIEs. Therefore, we expect managers of these companies must already provide an assurance of internal controls and get these assurances signed off by their auditors. Accounting for these companies, we estimate around **250 UK premium listed companies and around 1,520 other PIEs**[67] **in scope**. We also expect some options to apply to the auditors of these companies. The Government's consultation is seeking views on the companies included in the PIE definition, and we hope to use responses to the consultation to inform the scoping for future iterations of this assessment.

152. We assume for the purposes of this impact assessment that UK requirements would be broadly like SOX section 404 requirements and that therefore these companies listed on US exchanges would not have to do anything further to comply with any new UK requirements. They are excluded from the number of companies affected by the measure.

Assessment of monetised and non-monetised costs of each option

153. Given that the population is the same under Options 1, 2 and 3, the difference in costs between each of the options is due to the requirements that are being placed on each entity.

<u>Costs</u>

154. Estimates of costs are tentative at this stage. More policy work and responses to the consultation will help us refine our estimates. One challenge is the extent to which the costs are likely to be additional. We will be doing more work to assess the additionality of likely costs and benefits, which we hope will be informed by the responses we receive to this consultation. To estimate costs, we take the following approach:

- We assume that under each option, the regulator will face costs from setting guidance for companies to use in deciding the approach to be taken in developing the required attestations. We use information provided to BEIS by FRC in developing our estimate of the associated cost[68].
- We estimate the costs of full SOX compliance based on US evidence. We therefore assume that SOX, and the COSO framework, represents the desired level of internal control performance.
- We then estimate the extent to which current UK regulations deviate from SOX requirements.

Assessing the cost of SOX compliance

155. *Direct Costs, including familiarisation costs:*

- Under option 1, the direct costs of the management reporting requirement would be, where necessary, the costs of documenting and improving the company's internal controls system to a level where the management is satisfied that it can report a judgement of their effectiveness. We assume that there would be no additional external audit costs since there would be no additional requirements for the external auditor. Option 1 has similarities with the requirements for non-accelerated US filers under SOX Section 404A. Therefore, we use US data to estimate the business costs of this option.

[67] Based on the FRC's PIE population estimate of 1,945 UK PIEs from February 2020, which includes premium listed companies.

[68] Information from the FRC suggests a standard cost of £250k for guidance-setting.

- The costs of option 2 include the costs of option 1, plus additional costs from auditors' reports on their work to understand their client companies' internal controls systems, and the resulting effect on their approach to the audit. In estimating these audit costs, we follow the approach outlined in *Annex D* of *IA BIS016(F)-16-BE*. Our estimates consider the costs of auditor preparation and presentation time, and the number of entities in scope.
- The estimates of costs under option 3 include the costs of option 1 plus increased audit costs. To estimate audit costs, we use estimates from economic literature[69] that suggest that SOX 404B compliance increases the average audit fee by 5-35%. We use 15% as the best estimate, since the lower estimate controls for other factors, such as company characteristics. We uplift the audit fees of companies in scope (obtained using FAME) to reflect this increased audit fee.
- Our sources do not permit us to estimate transition costs separately. However, US evidence[70] suggests that compliance costs were higher during the first few years of SOX compliance as companies had to improve their systems to comply with the new requirements. To capture the costs of transitioning to the new system we adopt the following approach:
    i. We assume that the compliance costs reported in the Protiviti surveys[71] and estimated audit fee increases are representative of the 'steady state' costs. SOX requirements have been in place for over a decade, so most companies will already be familiar with the requirements and will already experience a 'steady state' annual cost.
    ii. We assume a transition period of 4 years before companies reach the steady state. We use evidence reported in Alexander et al (2013)[72] to estimate the ratio of costs per company over the first 4 years of operation to the costs experienced in year 5, the first year of the steady state. We find the average ratio across the three reported size terciles. We assume that the ratio is the same for internal compliance and external audit costs.
    iii. We apply the ratio of transition costs to steady state costs to uplift the annual costs from the Protiviti survey in order to account for additional transition, including familiarisation, costs over the first 4 years of compliance. Transition costs are high: in year 1, total internal compliance costs are estimated as approximately 3x the steady state costs. This is because some companies may need to invest up front in new accounting systems, to satisfy the management that the company's internal controls are effective.

156. It is likely that the direct internal control costs incurred by companies will vary with entity size. We use the Protiviti survey data on SOX compliance to estimate the relationship between company size and the size of its compliance costs (excluding external audit fees) – *Figure 2*.

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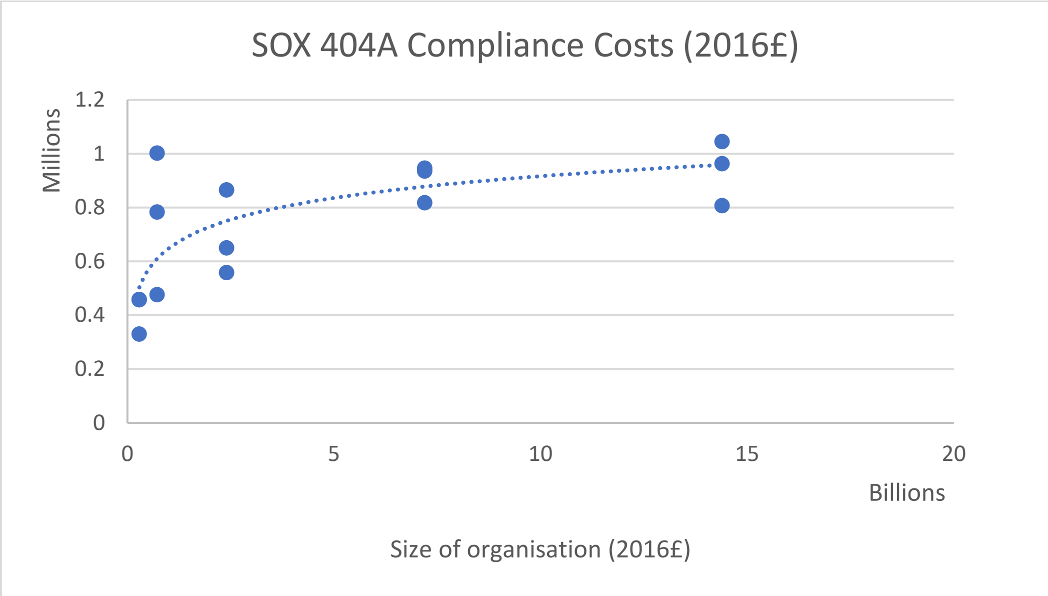
[69] Ge et al (2017): http://faculty.washington.edu/smcvay/GKM_2017.pdf, Iliev et al (2010): https://www.jstor.org/stable/25656324, Jia et al (2014): https://www.lsu.edu/business/accounting/files/researchseries/20141027JXZ.PDF

[70] Alexander et al (2013): https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?article=4660&context=lkcsb_research

[71] Protiviti surveyed 500-1,500 respondents from public companies each year from 2016 to 2018 on the costs of complying with SOX. We assume that most of these costs relate to complying with SOX 404, and therefore these costs represent an adequate proxy for non-audit compliance costs. The Protiviti survey data provides information on 'internal compliance costs' (compliance costs excluding external audit fees). The data is presented in size bands, according to company revenue. https://www.protiviti.com/sites/default/files/united_states/insights/2018-sox-survey_protiviti.pdf

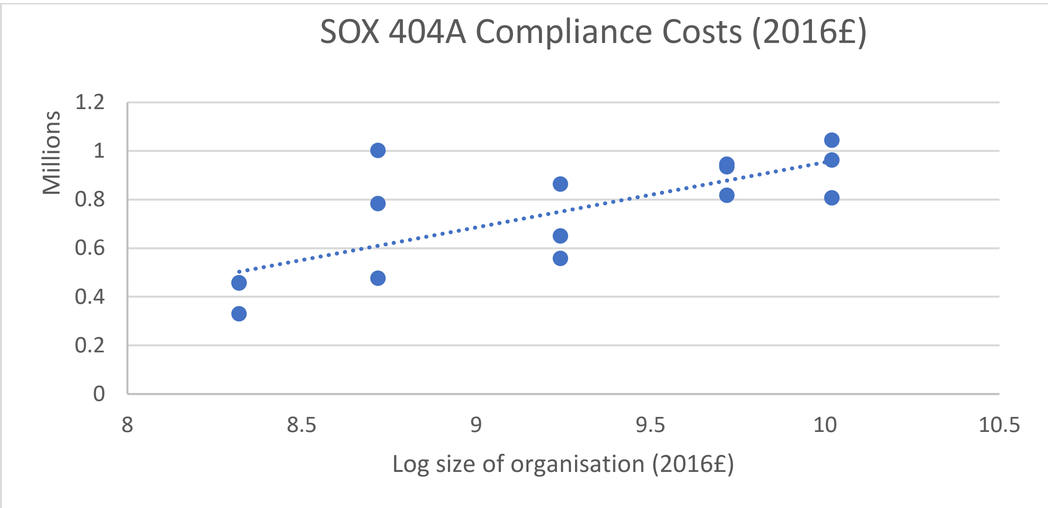
[72] Alexander et al (2013): https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?article=4660&context=lkcsb_research

Figure 2 - SOX 404A Compliance Costs (1)



157. The data shows that costs increase with size, but at a diminishing rate. A logarithmic curve provides a reasonable line of best fit; therefore, we regress compliance costs on the logarithm of company size (by revenue) – see *Figure 3*.

Figure 3 - SOX 404A Compliance Costs (2)



158. This relationship is used to estimate compliance costs for companies in scope. We calculate the logarithm of the companies' revenues, then use the estimated relationship between revenue and compliance costs to estimate compliance costs for each company. Where data on company revenue is not available in FAME, we use the median compliance cost to estimate the compliance costs for that company.

Assessing the additional cost for UK companies

159. It is unlikely that UK companies are wholly non-compliant with a SOX-like internal control regime. Therefore, we assume the following:

- For option 1, we assume that current UK requirements on companies meet between 50% and 75% of all SOX like requirements, i.e. companies would face between 25%

and 50% of the costs associated with assessing the effectiveness of their internal controls.

- For option 2, we build on the core assumptions in option 1 by adding the additional cost of auditor reporting, which we expect to be wholly additional, since auditors are not currently required to prepare these reports[73].
- For option 3, we assume the same as an in options 1, but also assume that the costs related to auditor attestation are wholly additional. This is because auditor attestation is not required under the UK's current internal control framework. To model the resulting rise in audit fees we use a 15% increase as the best estimate. We use estimates from economic literature to calculate the audit fee increase for companies in scope.

160. These assumptions give the costs in *Table 26*. We will seek to refine these assumptions during the consultation process.

161. We make extensive use of data from Fame in developing these estimates. However, there are gaps in this data which mean that not all in-scope companies are represented in our cost calculations. We therefore treat our estimates as a lower bound.

Table 26 - Additional Direct Cost for Internal Controls as mandated by SOX

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1 *(Preferred)*	1,777 companies	£1.5bn	£168.8m
Option 2	1,777 companies and their auditors	£1.5bn	£168.9m
Option 3	1,777 companies and their auditors	£2.3bn	£269.8m

[73] Although note footnote 65.

Section 3: Reporting

162. This section covers the following measures:

- Requirement for an annual Resilience Statement, as set out in the Brydon Review. This explains the Director's approach to maintain or strengthen a company's resilience over the short, medium and long-term.
- Requirement on Directors of PIEs to establish an Audit and Assurance policy at least once every three years. The policy would describe the approach the company plans to take over the next three years to seeking assurance of its reported information beyond that required by the annual statutory audit.
- Requirement for annual reports of PIEs to provide a summary of how the company - or group in the case of a parent company – has performed with regard to supplier payments over the previous reporting year, and to comment on how this compares to the year before that.
- Measures to strengthen the regulator's corporate reporting review.

163. The Brydon Review recommended that Director's should set out in a public interest statement how they view the company's legal, financial, social and environmental responsibilities to be in the public interest. The Government does not currently propose to mandate such a statement. It is therefore not included in this IA.

Summary: Analysis & Evidence — Resilience reporting option 1

Description: *require a change in formatting for current going concern and viability reporting information, while giving companies the option to prepare enhanced disclosures.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -1.5

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1		
High				
Best Estimate	1.6			1.5

Description and scale of key monetised costs by 'main affected groups'

The regulator would face costs from developing and issuing guidance for companies covering the minimum requirements of the Resilience Statement. Companies in scope are expected to face familiarisation costs from having to assess and interpret new resilience report formatting requirements.
We expect costs to the regulator and familiarisation costs to companies to be one-off costs.

Other key non-monetised costs by 'main affected groups'

Companies in scope are expected to face costs from implementing formatting changes (one-off costs, in the first year of implementation) and from any increase in reporting activity, relative to current reporting practices, that arise in compliance with these changes on an ongoing basis. We lack evidence on current reporting costs against which these additional costs could be assessed.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

We expect this option to result in information on companies' resilience that is packaged in a more meaningful way for shareholders. The repackaged reports will allow shareholders to assess key aspects of company resilience that are not set out in current Viability and Going Concern reporting. However, key internal and external uncertainties faced by the company are not expected to be routinely generated in these reports due to formatting changes alone, so we expect this benefit to be limited.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- Our monetised estimates only capture one-off costs to companies and the regulator. We are unable to monetise key (and potentially significant) ongoing costs.
- For the ongoing preparation of the Resilience Statement, we expect that companies are already routinely collecting most of the information they would need as part of their Viability and Going Concern and risk reporting. We assume that they would not need to collect and collate new information but would need to repackage information they already hold.
- We assume that the complexity of the requirements under this option is broadly like that of measures introduced under the EU Non-Financial Reporting Directive (e.g. as assessed in IA No: BISCFA001.
- We are unable to monetise the cost of ongoing reporting due to a lack of evidence. However, we assume that these costs are likely to be small, since they will be offset by the fact that companies would not need to collect and collate significant volumes of new information.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 0.7
Costs: 0.1	Benefits: 0	Net: -0.1	

Summary: Analysis & Evidence — Resilience reporting option 2

Description: *Mandating enhanced disclosures that build on current Going Concern and Viability Statements*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -8.4

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High		1		
Best Estimate	8.8			8.4

Description and scale of key monetised costs by 'main affected groups'

The regulator would face costs from preparing and issuing guidance and reporting standards. We expect that the regulator would need to prepare an overarching standard, stress-testing guidance, and guidance on long-term resilience reporting. Companies are expected to face costs from having to familiarise themselves with the reporting guidance and standards. We expect costs to the regulator and familiarisation costs to companies to be one-off costs. Further, we expect stress-testing (in the medium-term) to impose significant costs on companies (currently unquantified). We expect costs to the regulator and familiarisation costs to companies to be one-off costs.

Other key non-monetised costs by 'main affected groups'

We have not been able to monetise annual ongoing costs to companies due to evidence gaps (as noted for option 1), and because the specific design of measures proposed is not yet finalised. Companies will need to prepare annual Resilience Statements covering their short, medium and long-term risk and resilience. We expect costs to be driven mainly by additional work to collect and collate information for each reporting time-horizon.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

The benefits from this option are expected to build on those outlined for option 1. The enhanced disclosures required by this option will provide comprehensive information, around companies' risk and resilience, to shareholders and wider stakeholders, and the companies themselves. We therefore expect this option to deliver significant benefits to these users of corporate reporting information, which could translate to higher better investment decisions, greater confidence in corporate reporting information, likely reductions in the cost of capital faced by these companies because of greater risk transparency, and wider economic benefits.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- We assume that companies in scope are not currently collecting the information they would need to satisfy these requirements.
- We are not able to monetise key areas of cost due to gaps in evidence, related primarily to ongoing reporting costs to companies. Some of these costs are potentially large (e.g. stress testing costs).
- We make assumptions about some costs based on our understanding of the requirements. However, as they are still being finalised, we lack certainty about their final design. Costs to companies are therefore likely to deviate from our estimates.
- We note a potential significant overlap with TCFD requirements which are subject to a separate consultation.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 4.5
Costs: 0.9	Benefits: 0	Net: -0.9	

Assessment of resilience reporting measures

Policy Overview

164. The resilience of a business is its ability to absorb stress and shocks arising in an uncertain and constantly changing operating environment, while continuing to function and meet directors' duty to promote the success of the company. The concept of resilience covers sudden, unforeseen shocks, such as pandemics, as well as longer-term, gradual threats to business model sustainability – for example, the need for energy companies to adapt their business models to climate change risks and mitigation requirements. Companies' ability to assess and manage risks to their survival is, therefore, paramount to their resilience.

165. Existing and potential investors, and wider stakeholders, place considerable importance on reassurances about companies' resilience, and there is also a clear public interest in how companies can reduce the risk of disorderly corporate failure, and more widely, the economic shocks that could result from them. Under current reporting requirements, investors and stakeholders receive these reassurances through:

    - the existing requirement for an annual Going Concern Statement, set out in international accounting standards[74] and underpinned in law, in which all large and medium-sized companies must disclose any 'material uncertainties' that could affect their ability to continue operating or meet their financial obligations, and any strategic reporting requirements related to risks and uncertainties they may face;
    - in addition to the Going Concern Statement, premium listed companies are required to prepare a Viability Statement in accordance with the UK Corporate Governance Code[75], underpinned by the UK Listing Rules[76].

166. The Review noted that, in preparing going concern and viability statements, company directors must consider varying risks and challenges and make judgements about the future, but the context in which these issues are considered, and judgements are made, is not always made clear to stakeholders. It concluded that providing information about this context and how directors have exercised their judgement would be of considerable value to stakeholders[77].

167. In the main, respondents to the Review's Call for Views indicated that there was room to strengthen current going concern and viability reporting requirements:

    - Current going concern requirements arguably do not provide for the disclosure of material uncertainties that are no longer considered material due to mitigating action and/or the use of significant judgement.
    - Whilst current viability statements provide useful information, they are not fit for purpose as they do not provide robust analysis of the companies' future viability – companies tend to produce limited detail on budget and cashflow covering only 3 years in the typical case.

168. The Review noted further that stakeholders demand more meaningful information on the risks to the survival and success of companies further into the future, where internal and external operating conditions are subject to greater uncertainty. This has been heightened by the COVID 19 pandemic, which may result in greater regulatory, parliamentary, media and wider public interest in how companies are thinking about and preparing for future financial and business continuity shocks.

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[74] International Financial Reporting Standards (IFRS) in the case of UK listed and AIM companies, and either IFRS or UK Generally Accepted Accounting Principles (UK GAAP) for other companies.

[75] https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code

[76] https://www.handbook.fca.org.uk/handbook

[77] Brydon Report, para 18.0.1

169. To address these issues, the Review recommended the introduction of a new Resilience Statement, which would build on Going Concern and Viability Statements in giving clarity on companies' approach to assessing and managing challenges, and building business resilience, over the short, medium and longer term. We note that such a statement would also address a key recommendation of the Independent Review of the FRC – that the existing viability statement should be strengthened or abolished[78].

170. Moreover, the existing reporting requirements stem from multiple sources, which limits the extent to which users of the reports can develop a coherent picture of companies' risk assessment and management, and resilience planning. A Resilience Statement that integrates these areas across the short, medium and longer term could be an effective way of addressing this, as it would provide better clarity on resilience planning and highlight links to the company's annual risk report and risk management, and internal control processes.

171. The Review proposed that the Resilience Statement should report on risks and uncertainties over:

- *the short term (1-2 years)* – building on the Going Concern through disclosure of material uncertainties whether or not mitigating action has been proposed, undertaken, or have rendered these uncertainties no longer material.
- *the medium term (5 years)* – a report that captures tests of plausible but severe stress scenarios that go beyond the standard of current viability reporting; and
- *the long term* – no mandatory reporting elements have been prescribed for long term reporting, however, the Review highlighted climate change as a key area that could be addressed. For the purposes of the Resilience Statement, the long term is taken to be over 5 years, but we expect the precise length to be determined individually by each reporting company.

172. The Government supports the view that going concern and viability reporting need to be strengthened and that measures should be taken to make these reports more meaningful to investors and wider stakeholders. Options for doing so are proposed and assessed below. The Government's consultation seeks views on these.

Entities in scope

173. The options proposed here will, initially, apply only to UK premium listed companies - a subset of UK public interest entities (PIEs). **There are 698 UK premium listed companies on the FCA Official List**[79]. From the 3rd year of implementation onward, the scope of these requirements will be extended to include all other PIEs, as defined at that point in time. For this assessment, **we use the total PIE population estimate of 1,945 UK PIEs** under the current definition[80].

174. The Government's consultation is also seeking views on proposals for a new PIE definition. We will update our analysis to reflect any changes to the PIE definition that arise as a result.

[78] Recommendation 52, Independent Review of the Financial Reporting Council (2019)

[79] Based the FCA Official List as at October 2020. We consider those companies classified as "Premium Equity Commercial Companies" and "Premium Equity Closed Ended Investment Funds" incorporated in the UK.

[80] Based on the FRC's PIE population estimate of 1,945 UK PIEs from February 2020, which includes premium listed companies.

Options considered

175. We propose two options in this section. The Government's consultation will seek views on these options.

176. Our estimates of costs are tentative at this stage, and we hope responses to the consultation will help us to refine these.

<u>Option 1 – Resilience Statement to require a change in formatting only, while giving companies the option to prepare enhanced disclosures.</u>

177. Under this option, companies would be required to change the formatting of their reports to ensure they are coherent and comprehensive, but existing minimum content requirements would remain in place. In-scope companies would be able to continue using the material they currently use in their Going Concern Statements, Strategic Reports under Section 172 of the Companies Act 2006, and Viability Statements.

178. Companies would be given the option to go further – i.e. to prepare enhanced disclosures. Guidance would be provided by the regulator detailing areas for enhanced reporting and what this could mean for them in practice.

179. For example, for the medium-term statement, enhanced disclosures could include:

    - information on the company's approach to capital maintenance and wider financing over the 5-year period, including how it is balancing dividends and other distributions with the company's capacity to withstand a liquidity shock, and its approach to managing its debt to net assets ratio[81];
    - the company's contingency plans for refinancing, including scope for increased credit facilities and relaxation of covenants.
    - supply chain resilience and any other areas of significant business dependency (e.g. on markets, products or services); and
    - potential cyber security challenges (both from external threats, and the risk of major data breaches arising from internal lapses).

    For long-term reports, directors could set out potential long-term threats to the business and explain their assessment of long-term resilience and plans or actions taken to mitigate them.

<u>Option 2 (*Preferred Option*) – Mandating enhanced disclosures that build on current Going Concern and Viability Statements</u>

180. Under this option, reporting for each time horizon would be enhanced.

181. The short-term reporting time-horizon would be set to cover a maximum of 2 years, and directors would be obliged to state whether, in their opinion, the company will have access to the necessary financial resource to ensure its survival over this period. This option would require:

    - enhanced disclosure around risks to the company continuing as a going concern (in line with IFRS Interpretation Committee's conclusion in 2014 that the use of significant judgements in assessing potential material uncertainties should be disclosed).

[81] This is expected to be informed by companies' reporting on their capital maintenance and dividend policies.

- contingency and recovery plans for a range of business interruption scenarios (such as, refinancing options and scope for contractual flexibilities in the face of sudden but temporary falls in revenue, and business continuity solutions; and
- details of processes underpinning contingency and recovery plans, including how the plans have been, or will be, tested.

182. Medium term reporting would cover a period of up to 5 years, and would include:
    - the existing viability statement requirements – i.e. reasonable expectations of company's prospects to stay in business based on growth, profit and debt financing forecasts and the assumptions on which those forecasts are based –will continue to apply.
    - information on the company's approach to capital maintenance and wider financing over the 5-year period, including how it is balancing dividends and other distributions with the company's capacity to withstand a liquidity shock, and its approach to managing its debt to net assets ratio.
    - the company's contingency plans for refinancing, including scope for increased credit facilities and relaxation of covenants.
    - supply chain resilience and any other areas of significant business dependency (e.g. on markets, products or services).
    - potential cyber security challenges (both from external threats, and the risk of major data breaches arising from internal lapses); and
    - stress-testing. Some financial institutions are already required to do so by the Bank of England Prudential Regulation Authority (PRA)[82], but this requirement would be extended to all in-scope companies that are not currently included in PRA stress tests. This will draw on ICAEW's stress testing guidance and the FRC's non-statutory guidance on stress testing scenarios or outcomes as appropriate[83]. Company directors would be required to prepare a statement verifying that they have tested the probability of company survival under a range of both plausible and remote but possible future scenarios which could cause the business to fail. The medium-term report would document the board's assessment of the resilience of the company considering the findings of this testing.
183. Long-term reporting would cover a period greater than 5 years to be determined individually by each reporting company. Directors would be required to set out what they perceive to be the potential long-term threats to the business – for example, the impact of climate change on the company's business strategy and financial planning, and the impact of wider long-term changes in demographics, technology, consumer preferences – and to explain their assessment of resilience in the face of these threats and the systems in place, or in planning, to enable the company to effectively mitigate them.
184. The Government is also consulting on whether this Resilience Statement could be a vehicle for the implementation of Task Force on Climate-related Financial Disclosures (TCFD) reporting requirements. However, the specific requirements of TCFD are being consulted on separately, and are, therefore, not assessed in this IA.

[82] https://www.bankofengland.co.uk/stress-testing
[83] https://www.icaew.com/technical/audit-and-assurance/professional-scepticism/stress-testing

Assessment of monetised and non-monetised costs for each option

185. For each option, we assess costs to the regulator and to the companies in scope. We assume that the costs to the regulator will be covered by an increase in the FRC levy, which is outside the scope of the Better Regulation Framework. Therefore, we do not include regulator costs in our Business Impact Target (BIT) calculations. For the purposes of this assessment, we assume that measures will apply from 2023[84].

186. Gaps in our evidence base prevent us from monetising some key areas of impact, so we present cost estimates where possible, and explain our approach for other areas. We hope to use responses to this consultation, and further research, to inform our analysis for future iterations of this IA. Monetised cost estimates are summarised in *Table 27* below.

Table 27 - Summary of cost impact of options assessed

	Cost Summary[85]	
	PVC, 10-yr period	**EANDCB**
Option 1	£1.5m	£0.1m
Option 2 *(preferred)*	£8.4m	£0.9m

Option 1: Costs to the regulator

187. This option will require the regulator to develop and issue guidance for companies to use in the preparation of their resilience statements, and in assessing the steps they could take in going beyond minimum requirements. We use FRC estimates that developing guidance or a set of standards for use by companies will impose a one-off cost to the regulator of £250k[86]. This cost will apply in the first year of implementation only.

188. Therefore, the PVC to the regulator from preparing company reporting guidance is estimated to be £0.2m over the 10-year appraisal period.

Option 1: Costs to companies in scope

189. We expect companies in scope to face additional costs from familiarisation with new report formatting requirements, and from any additional administrative and review work required in preparing reports to satisfy these requirements. We do not consider any potential costs arising from any action companies may choose to take in going beyond minimum reporting requirements. Whilst reports that go beyond the standard are likely to be more informative, these are not mandatory, and companies can be fully compliant with the requirements of this option without them.

Familiarisation costs

190. We expect all companies in scope to face familiarisation costs related to understanding and implementing new report formatting requirements. We take these to be one-off costs. Given the

84 There is still some uncertainty over the implementation timeline, but we use 2023 as the starting year for this assessment. The actual implementation timeline will be finalised post-consultation.

85 These estimates exclude potentially significant costs due to gaps in evidence. Therefore, they should be treated as under-estimates of the true costs.

86 This estimate reflects the staff and other costs of preparing the guidance and engaging with stakeholders at all stages, as appropriate, to prepare, consult, communicate and embed the new guidance.

staggered implementation for premium listed companies and all other PIEs, we assess these costs as arising in 2023 for premium listed companies, and in 2025 for all other PIEs.

191. Our estimates are based on the approach used in the NFRD IA, which was developed in 2016 to assess the impact of implementing EU non-financial reporting directive for PIEs. We apply adjustments to this approach to account for the differences in the complexity and duration of familiarisation we expect under these requirements[87]. We assume that familiarisation would require 5 hours of director's time; 10 hours of professional staff time; and 5 hours from administrative staff. We use ONS ASHE data to estimate costs for each staff level[88]. These are provided in *Table 28* below[89].

Table 28 - Option 1 Familiarisation Costs

	Time (hrs)	Total cost per hour (£)	Total cost per PIE (£)
Director	**5**	**71**	**354**
Professional	**10**	**26**	**384**
Administrative	**5**	**14**	**69**
Total cost per company			**0.8k**

192. We estimate the PVC of familiarisation for all companies in scope to be £1.3m over the 10-year appraisal period. The EANDCB is estimated to be £0.1m.

Cost of preparing reports in line with new reporting requirements

193. We expect companies in scope to incur ongoing annual costs from implementing the formatting changes that would be required under this option. We assume that some administrative and professional accounting staff effort would be dedicated to this, and that new reports would need to be reviewed by senior staff and directors. Additionally, we expect the new requirements, given their aim to generate more and better-quality information, would require more time and effort than current reports, and would therefore impose some additional annual cost. However, since companies will be able to continue using the material they package into their Going Concern Statements, Strategic Reports under Section 172 of the Companies Act 2006, and Viability Statements, we do not expect these additional costs to be significant.

194. However, we lack evidence of companies' current reporting costs against which we could develop estimates of the additional reporting costs imposed by this option. We are working with the FRC to develop our evidence base, and welcome responses related to assumptions and sources of relevant data we could use to inform future iterations of this IA.

195. **Therefore, our monetised cost estimates for this option capture only the familiarisation costs to firms and costs to the regulator. From these two types of cost, we estimate a PVC of £1.5m over the 10-year appraisal period, with an EANDCB of 0.1m.**

[87] This is based on a high-level assessment. We welcome views on the suitability of this approach.

[88] We have used the 75th percentile of hourly wages for the positions indicated in ONS ASHE 2018 data, with a non-wage uplift of 20%.

[89] We assume that premium equity closed ended investment funds will face on average around half of the costs faced by in-scope commercial companies (i.e. £0.4k), since additional reporting activity, and hence, familiarisation, for them is expected to be in general less complex owing to the size and nature of their business - these companies are typically very simple, and they do not produce complex accounts.

Option 2: Costs to the regulator

196. As in option 1, we expect costs to the regulator to stem from preparing and issuing guidance and reporting standards. Given that this option mandates reporting for three time-horizons, each having different core requirements, we assume that the regulator will need to prepare and issue:

    i. An overarching resilience reporting standard.

    ii. Guidance on the development of stress testing (including reverse stress-testing).

    iii. Guidance on the preparation of long-term resilience statements.

197. We consider that stress testing and long-term reporting guidance will be particularly important, since companies will need to exercise judgement in determining what compliance would mean for them. The regulator will need to provide them with a comprehensive guide that will allow them to do so in a way that meets its own tests of scope and validity.

198. As in option 1, we treat costs related to guidance and standards as one-off costs applying in the first year of implementation only. The estimated cost to the regulator from preparing and issuing guidance and standards is £250k per set, totalling £750k for this option overall. Therefore, the estimated PVC to the regulator from this option is estimated to be £0.6m over the 10-year appraisal period.

Option 2: Costs to companies in scope

199. Under this option, we expect companies in scope to incur costs from familiarisation with new reporting requirements, from gap analysis to identify required areas that are not covered in their current reports, and from the additional work required in preparing the resilience statement in accordance with the requirements.

Familiarisation costs

200. We expect all companies in scope to incur costs from familiarisation with new reporting requirements and from gap analysis. We take these to be one-off costs arising in 2023 for premium listed companies, and in 2025 for all other PIEs.

201. We take the same approach used in option 1, but apply adjustments to account for the scale of additional requirements with which companies will need to familiarise themselves:

    - For short-term reporting requirements, we expect familiarisation to require at least 10 hours of directors' time, 20 hours of professional staff time, and 10 hours of administrative staff time.
    - Medium-term reporting requirements add considerably to the duration and complexity of familiarisation activities. A key area that companies would be required to familiarise themselves with is stress testing. We therefore assume that familiarisation with these requirements will take 15 hours of director's time, 40 hours of professional staff time, and 20 hours of administrative staff time.
    - We expect familiarisation with long-term reporting requirements to take roughly the same time and effort as short-term reporting, on the basis that companies will have considerable flexibility in deciding what to include and what time horizon to use based on their business model and other specific characteristics. They would therefore need only to familiarise themselves with what would constitute compliance for them.

Our familiarisation cost estimates are set out in *Table 29* below[90].

Table 29 - Option 2 Familiarisation Costs

		Time (hrs)	Total cost per hour (£)	Total cost per PIE (£)
Short-term reporting	Director	10	71	709
	Professional	20	26	512
	Administrative	10	14	138
	Sub-total			**1.4k**
Medium-term reporting	Director	15	71	1.1k
	Professional	40	26	1.0k
	Administrative	20	14	276
	Sub-total			**2.4k**
Long-term reporting	Director	10	71	709
	Professional	20	26	512
	Administrative	10	14	138
	Sub-total			**1.4k**
	Total cost per company			**5.0k**

202. We estimate the PVC of familiarisation costs for all companies in scope to be £7.8m over the 10-year appraisal period. The EANDCB is estimated to be £0.9m.

Cost of preparing reports in line with new reporting requirements

203. We expect companies in scope to incur ongoing annual reporting costs. We consider these separately for short, medium and long-term reporting. Due to gaps in our evidence base, and in the absence of any published guidance, we present a qualitative assessment of costs at this stage. We welcome feedback on the assumptions we make here and any further detail we could use to develop the analysis.

Short-term reporting

204. Under this option, in addition to current areas of short-term reporting, companies would be required to prepare enhanced disclosures covering risks, contingency and recovery plans for business interruption scenarios, and to present greater detail of the processes and assumptions that underpin these assessments. This would need to cover a one to two-year outlook.

205. Additional costs are likely to be driven by additional activity to collect and collate the information required involving mixed teams drawn from all parts of the company. It is likely to involve co-ordination costs and board oversight. We expect most companies in scope to already collect and assess some of the information required for this reporting component, which will reduce the overall cost of collecting new information.

[90] As above, we assume that premium equity closed ended investment funds will face around half of the costs faced by other in-scope companies (i.e. £2.5k), since additional reporting activity, and hence, familiarisation, for them is expected to be limited and less complex.

Medium-term reporting

206. Companies' medium-term statement will need to cover a 5-year maximum outlook, and would require additional reporting on capital maintenance and financing arrangements; contingency plans for refinancing; coverage of supply chain resilience and other areas of business dependency; cyber-security risks and mitigation; and stress testing. Due to its complexity, we consider stress testing elements separately in this discussion.

207. For all requirements except those related to stress testing, we expect reporting to require a considerable amount of additional activity. Whilst companies may already consider some of these areas and capture some of this information, the level of detail, scope of information, and the way this information is currently presented, fall short of resilience statement requirements.

Stress testing

208. We consider two types of stress testing – conventional stress testing and reverse stress testing.

209. Conventional stress testing typically involves forward looking analysis to identify and test the impact of scenarios of varying type, severity, complexity, and duration on business operations[91]. The aim of stress testing is to expose the company's capacity to respond to shocks, thereby helping to inform measures to strengthen its business model and planning.

210. Reverse stress testing, as the name suggests, is a type of stress test that moves in the opposite direction to conventional stress testing – i.e. it starts from a pre-defined outcome or impact, typically a point at which the company fails, and works backward[92]. Reverse stress testing identifies a plausible sequence of events that leads to this outcome, with a view to understanding what can be done to avoid it occurring in practice. In this way, it explains what would need to happen for the company to reach a critical breaking point, identifies weaknesses in the business model, and can be used to inform plans and measures to address those weaknesses.

211. Typically, stress testing, whether conventional or reverse, is made up of 5 key elements[93]:

- planning and scenario development;
- collation and quality assurance of scenario data;
- preparation and deployment of calculation models;
- internal review of modelling results and governance; and
- documentation of results.

212. Some available reports[94] on stress testing indicate that the data collation and quality assurance component generate the greatest cost, followed by modelling work, with internal review and governance being the third highest contributor due to its significant senior management involvement. We expect companies in scope of medium-term reporting requirements to experience a similar distribution of costs across the stress testing process.

213. We expect stress testing guidance to suggest that companies take a proportionate approach that considers their size, complexity and potential risk. We also expect that companies in scope will take different approaches to delivering their stress tests, and therefore expect to see significant variability in the associated cost from one company to the next. For example, some companies may choose to develop their models in-house or to use existing staff resources to

91 https://www.icaew.com/technical/audit-and-assurance/professional-scepticism/stress-testing

92 Ibid.

93 Compiled based on feedback from companies provided via surveys. For example, PwC's 2013 stress testing survey report and KPMG's stress testing benchmarking report

94 Ibid.

deliver tests, while others may choose to contract external providers or increase staff resourcing to carry out the necessary activity.

214. Regardless to the approach taken, the time and effort required to deliver an end-to-end stress test could also be expected to be significant. In the case of banks and financial institutions, the process can take anywhere from 1 month to over 3 months[95], and generates significant costs. The KPMG report noted that 25% of the global systemically important financial institutions included in their survey reported costs over $100m USD for annual testing. We can reasonably expect significantly lower costs for smaller financial institutions that are not of the same global significance, but that costs are commensurate with company size, and therefore relatively large.

215. Generally, whilst we do not expect stress testing under these requirements to be as complex or time and labour intensive as those applied to banks and financial institutions, we do expect them to present significant challenges to in-scope companies, especially for the first and second years of implementation (before any automation of processes). We therefore expect companies to face significant costs from this requirement.

216. There are some limitations to our ability to develop estimates of these costs. Firstly, the full stress-testing policy has not yet been developed and therefore, the scale of testing to be proposed remains uncertain; and secondly, there are evidence gaps related to the costs of stress testing because companies that are currently subject to testing do not conduct detailed cost assessments, and in many cases, do not regularly monitor these costs.

217. We hope to conduct further research in this area as the policy evolves and to use responses to the consultation to further develop our assessment.

Long-term reporting

218. The long-term reporting component of the resilience statement requires companies to set out what they perceive to be the potential long-term threats to the business – for example, the impact of climate change on the company's business strategy and long-term changes in demographics and consumer preferences – and to explain their assessment of resilience in the face of these threats and the systems in place to effectively mitigate them. The statement should cover a period over 5 years to be determined by each company based on their individual circumstances – for example, their business model, organisational complexity, and risks they may face.

219. We expect reporting to introduce the following key areas of activity:

- Investigating potential risks and threats to business operations.
- Identifying adaptations to reduce any identified risks or threats.
- Collecting and collating the relevant information for reporting; and
- Preparing the long-term resilience statement.

220. Whilst the information collected for the long-term resilience statement will ultimately inform the company's plans and mitigations, we do not consider the steps taken by companies to implement these in our assessment, as this is not a specific requirement of this option.

221. We expect activities related to information-gathering to be the greatest cost contributor. It is likely that companies already consider longer-term risks and conduct risk assessments more generally, that could inform this statement. The cost of investigations is therefore likely to be at least partially reduced by existing activities. Moreover, we expect investigation costs to be highest in the first year of implementation, since the nature of the key threats identified are

[95] Ibid.

unlikely to change from year to year, except in cases where large-scale business model changes are implemented. We expect preparation of the statement to be the least costly activity grouping.

222. We anticipate a wide range of reporting costs from companies, driven by variations in the extent of investigation and information-gathering activity from one company to the next, which are themselves due to differences in companies' business models and long-term risks and threats.

223. For the reasons outlined above, we are unable to develop estimates of overall reporting costs from preparing reports in line with new requirements, and as such, we are not able to provide EANDCB or PVC estimates for this impact at this stage.

224. **Our monetised cost estimates for this option capture only the familiarisation costs to firms and costs to the regulator. From these two types of cost, we estimate a PVC of £8.4m over the 10-year appraisal period, with an EANDCB of £0.9m.** The cost estimates presented for this option are therefore an under-estimate of the true costs.

Risks and uncertainties

225. In addition to the risks and uncertainties indicated in the sections above, we have identified the following:

- Several areas of potentially significant cost have not been monetised due to gaps in evidence and the fact that key aspects of the policy are yet to be defined. If the ultimate policy design is such that these costs are closer to the higher end of some reported costs (for example, in the case of medium-term stress testing under option 2, it may lead some companies that are premium-listed, or PIEs by virtue of their listing status, to delist, or even incorporate overseas, in order to avoid the regulatory cost burden.
- We make broad assumptions about some impacts (for example, familiarisation costs or some short and medium-term reporting elements) on the basis of our understanding of what the reporting requirements will be and how they may differ from existing requirements. However, in practice, companies may need to do more (or less than) our assumptions suggest, and therefore, may incur higher (or lower) costs. The outcome would ultimately be determined by the policy design, which, to some extent, is still being developed.
- There is potential for significant overlap between long-term reporting requirements assessed in this IA and those reporting requirements being considered under the proposed Task Force on Climate-related Financial Disclosure. Future assessments of long-term reporting would therefore need to assess the extent of this overlap to avoid double counting.
- Under option 1, there is a risk that guidance on how companies may enhance some aspects of their reporting could be taken as a de facto reporting standard, in that it may ultimately be seen as the main way to demonstrate compliance to the regulator. Whilst any additional cost incurred in treating this guidance as a reporting standard would be self-imposed, doing so could mean that costs may be higher in practice than our assessment indicates.

Summary: Analysis & Evidence — Audit and assurance policy option 1

Description: *A statutory requirement for in-scope audit committees to prepare and publish an annual Audit and Assurance Policy covering a 3-year rolling outlook, and for listed companies, subject to an annual advisory shareholder vote.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -20.5

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1		
High				
Best Estimate	16.5		0.6	20.5

Description and scale of key monetised costs by 'main affected groups'

We expect companies in scope to face familiarisation costs from having to assess and understand new Audit and Assurance policy requirements and from making the necessary adjustments to their reporting system. We also expect that companies will face some costs from the ongoing requirement to update their audit and assurance policies on an annual basis. For the latter, costs are expected to be greatest in the first year, after which companies need only make small incremental changes to their policies. Therefore, companies are expected to incur a fraction of first-year costs in subsequent years. We expect costs to the regulator and familiarisation costs to companies to be one-off costs.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	0
High	0		0	0
Best Estimate	0		0	0

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

The reporting requirements would deliver much needed improvement in clarity to investors and other stakeholders on the scope and conditions of the company's audits (including auditor remuneration), the company's approach to internal controls assurance, and the audit committee's decisions on materiality. The wider benefit is that this information would allow users of corporate reporting information to better assess the information provided by audits, and therefore would strengthen their decision-making.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

We assume the following:

- The regulator would face no additional costs from reviewing or processing companies' Audit and Assurance policies. We expect that, where necessary, this would be delivered through its business as usual activity.
- Most of the information required for the preparation of the Audit and Assurance policy is readily available to audit committees at limited additional cost.
- The cost to listed companies from conducting the shareholder advisory vote is negligible.
- Costs from preparing and publishing the Audit and Assurance policy are greatest in the first reporting year. We expect that in subsequent years, annual costs would amount to around 10% of first-year costs.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 11.9
Costs: 2.4	Benefits: 0	Net: -2.4	

Summary: Analysis & Evidence — Audit and Assurance policy option 2

Description: *Require in-scope audit committees to prepare and publish a triennial Audit and Assurance Policy covering a 3-year rolling outlook, and listed companies subject to a triennial advisory shareholder vote.*

Price Base Year 2016	**PV Base Year** 2017	**Time Period Years** 10	**Net Benefit (Present Value (PV)) (£m)**		
			Low:	**High:**	**Best Estimate: -26.8**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low				
High		1		
Best Estimate	**16.5**		1.5	**26.8**

Description and scale of key monetised costs by 'main affected groups'

We expect the same types of costs as under option 1 to apply here. The sole difference under this option is the triennial reporting frequency. Here too, costs are expected to be highest in the first reporting year, however, because with triennial reporting companies would need to undertake significant work to update their Audit and Assurance policies, we expect costs in subsequent years to still be significant. We estimate costs in subsequent reporting years to be roughly 75% of first-year costs.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

We expect benefits under this option to be the same as in option 1, but on a smaller scale. This is because, with a triennial reporting period, companies are likely to effectively "shelve" their Audit and Assurance policies at some point during the intervening period.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- We make the same key assumptions as in option 1 with one key difference: costs from preparing and publishing the Audit and Assurance policy are expected to be highest in the first reporting year, but we expect that that in subsequent years, annual costs would amount to around 75% of first-year costs due to the scale of work needed to refresh the policy after a 3-year period.
- We make the simplifying assumption that whilst companies will have the flexibility to report on a more frequent basis, they will stick to the proposed triennial reporting cycle.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 15.6**
Costs: 3.1	**Benefits: 0**	**Net: -3.1**	

Assessment of audit and assurance policy measures

Policy Overview

226. Historically, the users of company reporting information – existing and potential shareholders, and wider stakeholders – have been primarily interested in company financial information, and in the assurance from company auditors that this information provides an accurate and reliable assessment of company performance. Whilst this continues to be the case, in recent times, they have shown an increasing interest in companies' non-financial information, or the "front end" of annual reports. The main areas of interest are the strategic report, the director's report and, in the case of quoted companies, the corporate governance statement. These areas cover disclosures related to the companies' business model and corporate strategy, its approach to assessing and managing risks, and information on how it complies with statutory requirements to report its corporate governance arrangements, among other non-financial matters.

227. Statutory audits mainly focus on company financial information and some sections of the director's remuneration report. Limited emphasis is placed on the non-financial sections of annual reports beyond checks to ensure that there are no significant inconsistencies between matters presented in these sections and in the company's financial statements. For example, under the requirements of the UK Corporate Governance Code, auditors are required to state whether, based on their knowledge of the company, there is any material inconsistency with the director's statement that the annual report, taken as a whole, is fair, balanced and understandable.

228. This level of assessment and verification does not meet the standard of assurance that auditors are required to apply to company financial statements[96]. However, given the heightened investor and stakeholder interest in non-financial information, the need for this information to be assessed, verified, and assured has become increasingly important.

229. Against this backdrop, the Brydon Review suggested that there is room for improvement in the dialogue between audit committees and the users of corporate reporting information, on the scope of company audits and all related matters[97].

230. The Review noted that there was considerable variability in how auditors interpreted their responsibility to assess the congruence of directors' declaration that the annual report is fair, balanced and understandable and the accounts presented, and therefore, in how they treat this responsibility within, and between, firms[98]. This places practical limitations on the impact of these assessments. Indeed, the Review found that auditors invariably declare that they have nothing to report in this regard[99], further highlighting these limitations.

231. Moreover, the variability in auditors' interpretation of the requirement translates into a lack of clarity for users of this information around the assurances that auditors are required to provide on non-financial information. The wider implication of this is that users of this information may assume that the non-financial areas have been audited, where in fact it might not have been thoroughly assessed and verified and may therefore factor this incorrect assumption into their decision-making.

232. To address this issue, the Review recommended the introduction of a requirement for audit committees to prepare and publish an Audit and Assurance Policy, akin to the director's

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[96] International Standard on Assurance Engagements (ISAE) 3000 recognise two types of assurance opinion – limited assurance and reasonable assurance.

[97] The Brydon Report paras 10.0.1 and 10.0.2 indicated, an improvement in dialogue and clarity around audit issues could be achieved using a measure that functioned in a similar way to the 2013 requirement for director's remuneration reporting.

[98] Brydon Report para 10.1.2

[99] Brydon Report para 10.1.1

remuneration requirements introduced in 2013[100]. This policy is expected to provide greater clarity to investors and other stakeholders on, among other things:

- the scope of, and conditions applied to, the auditors work, and how shareholders should interpret the audit reports.
- auditor appointment and remuneration matters.
- the company's approach to internal controls reporting assurance; and
- the company's approach to decisions on materiality.

233. In so doing, the policy should go beyond the narrow scope of financial information assurance, and will:

  - provide companies with a framework for determining whether further assurances should be sought on any areas or process of reporting that might be of further interest to the users of this information or to the company itself.
  - allow companies to provide clarity, to users of corporate reporting information, about the disclosures that have been assessed and assured, and the process by which this was done (whether via internal audit, statutory audit, or other independent audit); and
  - allow users of this information to track how the company has changed its approach to assurances over time in response to changes in circumstances, as well as how the company has considered their needs where the integrity and reliability of reporting is concerned.

234. The Review recommended that this policy be produced on a three-year rolling basis, and that it should be subject to a shareholder advisory vote at the Annual General Meeting (AGM).

235. The Government supports the Review's recommendation for an Audit and Assurance Policy, and by extension, a framework through which companies can consider and respond to heightened user expectations for assurances on all aspects of company annual reports. Options for an audit and assurance policy are proposed and assessed below. The Government's consultation will seek views on these.

Entities in scope

236. The options proposed here will apply to the same set of companies covered by resilience reporting proposals above, but with differences in the timing of implementation. The options proposed will apply to the **698 premium listed companies in the second year of implementation, allowing a 1-year period for familiarisation and necessary adjustments. All 1,247 other PIEs**[101] **are expected to be added to scope from year 4.**

237. We will update our analysis to reflect any changes to the PIE definition arising from the consultation.

Options considered

238. We propose two options in this section. The Government's consultation will seek views on these options. Our estimates of costs are tentative at this stage, and responses to the consultation will help us to refine these.

100 The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013

101 Based on the FRC's PIE population estimate of 1,945 UK PIEs from February 2020, which includes premium listed companies.

Option 1 (*preferred option)* – a statutory requirement for audit committees of in-scope companies to prepare and publish an annual Audit and Assurance Policy covering a 3-year rolling outlook, and for listed companies, for the Policy to be subject to an annual advisory shareholder vote.

239. This option is in keeping with the Review's recommendation that audit committees should prepare an **annual** Audit and Assurance policy that provides a **3-year rolling out look** on their company's approach to seeking assurance on its disclosures. For listed companies, this option would require the Audit and Assurance Policy to be subject to a shareholder advisory vote at the company's AGM.

240. This option does not require an extension of statutory audit itself, but would be built around a set of minimum reporting requirements that are informed by recommendations in the Review[102] and provides companies with flexibility over what additional assurance, if any, they may choose beyond the statutory audit. Under these requirements, companies, through their audit committees, would be required to:

- make clear the company's approach to ensuring the integrity and reliability of its reporting on:
    - i. internal controls over financial reporting[103]; and
    - ii. risk and resilience reporting, beyond the consistency checks already provided by auditors.
- Prepare a statement on the external assurance planned, setting out the nature of that assurance and where relevant reports will be found. If external assurance is not planned for any of these areas, the statement should also explain why this assurance was deemed unnecessary by company directors.
- Provide a description of the company's approach to internal audit, which sets out whether the company has an internal audit function and its approach to challenging the management's judgements and conclusions in the annual report and accounts, and details whether, and if so, how the company is proposing to strengthen its internal audit capabilities during the period covered by the policy.
- Prepare a statement on how employees' and, for listed companies, shareholders' views have been considered in the development of the Audit and Assurance Policy.
- Provide a description of the company's audit tendering policy.
- In the case of listed companies, ensure that the Audit and Assurance Policy is developed through extensive shareholder engagement (including employee feedback)[104]. This should include shareholder views on how a company's approach to audit and assurance has worked over more than just the previous reporting year.

241. Companies will also have the flexibility to include other areas not captured in (i) and (ii) above in their plans for external assurance, based on the interest shown in these areas by users of their annual report and accounts. Such additional areas could, for example, include non-financial key performance indicators (KPIs) and alternative performance measures (APMs), or directors' Section 172 compliance statements.

[102] Brydon Report, Chap 10.

[103] The Government is also consulting on whether auditors should be required to assure companies' internal controls statements. The outcome of that consultation will determine the coverage given to the effectiveness of internal controls in their audit and assurance policies.

[104] There are interactions between shareholder engagement proposed under this recommendation and wider stakeholder engagement recommendations made by the Review (Brydon Report, Chapter 9). We expect that the policies that will ultimately implement these stakeholder engagement measures will be developed by the FRC, and would therefore be subject to assessments conducted by the FRC at the time of implementation, if deemed appropriate. As such, we do not capture the impact of stakeholder engagement activity in this IA.

Option 2 – Require in-scope audit committees to prepare and publish a triennial Audit and Assurance Policy covering a 3-year rolling outlook, and for listed companies, subject to a triennial advisory shareholder vote.

242. This option proposes the same minimum requirements set out in Option 1. The sole difference between the two options is the frequency of reporting and, for listed companies, the timing of the shareholder advisory vote on the policy.

243. In-scope audit committees would be required to prepare and publish an Audit and Assurance policy **at least once every 3 years**, which captures all changes to companies' audit and assurance approach over the 3-year period. For listed companies, this option would require the Audit and Assurance Policy to be subject to a shareholder advisory vote at the AGM that coincides with the timing of publication (therefore, roughly, every 3 years). However, companies would be allowed the flexibility to provide an updated policy on a more frequent basis, if deemed appropriate.

Assessment of monetised and non-monetised costs

244. Our estimates of cost are tentative at this stage. We hope to use responses to this consultation, and further research, to inform the development of our analysis for future iterations of this IA. Cost estimates are summarised in *Table 30* below, and calculation tables are provided in *Annex IV.*

245. **We do not consider costs to the regulator in this assessment.** We consider any additional activity by the regulator from processing and reviewing additional reports to be included in the scope of their current BAU activity, and therefore, take any associated increases in cost to be negligible. For the purposes of this assessment, we assume that measures will apply from 2023[105].

Table 30 - Summary of cost impact of options assessed

	Cost Summary	
	PVC, 10-yr period	**EANDCB**
Option 1 *(preferred)*	£20.5m	£2.4m
Option 2	£26.8m	£3.1m

Option 1: Costs to companies in scope

246. Under this option, we expect all companies in scope to face familiarisation costs from assessing and understanding requirements for the Audit and Assurance policy, and from any additional work required in adjusting to them and preparing the necessary statements and reports at the required frequency.

247. This is our preferred option, since some stakeholders have advised that annual publication will mean that after the first year of implementation, companies need only update their Audit and Assurance policies where necessary. This is expected to minimise potential costs after year 1.

[105] There is still some uncertainty over the implementation time, but we use 2023 as the starting year for this assessment. The actual implementation timeline will be finalised post-consultation.

Familiarisation costs

248. All companies in scope are expected to face familiarisation costs from work undertaken to understand the Audit and Assurance policy requirements and what compliance would mean for them in practice. We take familiarisation costs to be one-off costs, and given the staggered implementation proposed, assess them as applying in year 2 of implementation for premium listed companies, and year 4 for all other PIEs. We expect familiarisation activity to be carried out by in-scope companies' audit committees, company directors and professional accounting staff.

249. For audit committees, our cost estimates are based on the hourly remuneration rate of audit committee chairs, members[106] and their support teams, and the estimated time they will require for familiarisation. We make the simplifying assumption that the average audit committee consists of 1 committee chair and 3 members supported by an administrative team of four[107]. We consider all audit committee familiarisation costs to be generated through in-house activity – given audit committees' extensive engagement in this area, we assume that they would not seek external professional advice in understanding compliance. Further, we recognise that the company board, including its chairman, may wish to familiarise themselves with these new requirements, but since the measures assessed here do not require them to do so, we do not account for any associated costs in our assessment.

250. For company directors and professional accounting staff[108], we follow the approach set out in the NFRD IA, with appropriate adjustments to account for the complexity of Audit and Assurance policy requirements.

251. We estimate the PVC of familiarisation costs for all companies in scope to be £6.2m. The EANDCB is estimated to be £0.7m.

Cost of preparing and publishing the Audit and Assurance policy

252. We expect in-scope companies to incur costs from the ongoing requirement to prepare the Audit and Assurance policy. We expect that the associated activities will be delivered in-house[109], by companies' audit committees, directors, and their support teams.

253. Under this option, we assume that companies in scope will face the highest costs in their first year of reporting. In developing our estimate, we assume the following:

    i. In the first reporting year, each company will need to collect and collate the information that will inform their first Audit and Assurance policy, and to prepare the required statements and reports for publication.

    ii. Given the proposed annual reporting frequency, on an ongoing basis, stakeholders have stated that companies will need only to make incremental changes, if necessary, to the Audit and Assurance policy to account for changes in approach that arise in that reporting year – as opposed to collecting and collating an entirely new body of information. We also expect ongoing publication costs to be small, since reporting templates and formats would not need to be changed[110]. Therefore, we assume that

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[106] Audit committee chair and members' remuneration based on non-executive director base fees and audit committee additional fees provide in Deloitte's 2018 director remuneration guides for FTSE 250 companies.

[107] For administrative team member costs, we use the 75th percentile of hourly wages in ONS ASHE table 14.5a for level 4 – admin staff, with a non-wage uplift of 20%.

[108] We use the 75th percentile of hourly wages in ONS ASHE table 14.5a for level 11 – corporate managers and directors and level 2421 - accountants, with a non-wage uplift of 20%.

[109] As with familiarisation costs, we consider this a reasonable assumption, given audit committees current engagement with this area and the policy developments within it.

[110] Assuming no changes are introduced to formatting requirements in the intervening period.

annual costs from the second reporting year onward would amount to around 10% of costs incurred in the first year.

iii. Most of the information required for the development of the Audit and Assurance policy is readily available at limited additional cost to the audit committee, given that this is their key area of focus within the company.

iv. Based on evidence provided in the Shareholder Votes on Executive Remuneration Impact Assessment[111], we take the cost to listed companies of making the Audit and Assurance policy subject to an annual advisory shareholder vote to be negligible. We also assume no associated costs for shareholders, on the basis that voting is voluntary, and the information provided to them for the vote will give them more certainty about the company's approach, and in so doing, offset the cost of their future engagement with the company.

254. We estimate the PVC to companies from preparing and publishing the Audit and Assurance policy to be £14.3 m. The EANDCB is estimated to be £1.7m.

255. Overall, option 1 delivers a **PVC of £20.5m over the 10-year appraisal period** and an **EANDCB of £2.4m.**

Option 2: Costs to companies in scope

256. This option proposes the same minimum requirements set out in option 1, with the difference between the two options being the frequency of reporting and, for listed companies, the timing of the shareholder advisory vote on the policy.

257. Therefore, as in option 1 above, we expect all companies in scope to face familiarisation costs from assessing and understanding requirements for the Audit and Assurance policy, and from any additional work required in adjusting to them and preparing the necessary statements and reports at the required frequency.

Familiarisation costs

258. For this option, we expect familiarisation costs to be the same as for option 1, since minimum requirements, and hence, the scale and complexity of familiarisation activity, are the same under both options.

259. Therefore, we estimate the PVC of familiarisation costs for all companies in scope to be £6.2m. The EANDCB is estimated to be £0.7m.

Cost of preparing and publishing the Audit and Assurance policy

260. Under this option, we expect costs in the first year of reporting to be the same as set out for option 1 above. Here too, we assume that the first year of reporting will be year 2 of implementation for premium listed companies and year 4 for all other PIEs. In developing our estimate, we draw the following further assumptions:

i. Given that the Audit and Assurance policy will need to be refreshed in the fourth year of reporting (in line with a triennial reporting frequency) we expect companies to experience costs similar to those arising in the first year, albeit smaller, since the reporting template and formatting arrangements would not need to be updated[112] and

[111] Shareholder votes on executive remuneration IA, BIS, 2012. The IA assumed that adding a vote to the order paper at AGM imposed a marginal cost tending to zero, based on information provided by registrars.

[112] Assuming no changes are introduced to formatting requirements in the intervening period.

the refresh would only need to cover aspects of the Audit and Assurance policy that change from one reporting period to the next. We therefore estimate annual costs in subsequent reporting years to amount to around 75% of costs incurred in the first reporting year.

ii. In the intervening years, companies will face no additional cost from Audit and Assurance policy requirements.

iii. Most of the information required for the development of the Audit and Assurance policy is readily available at limited additional cost to the audit committee, given that this is their key area of focus within the company.

iv. For the reasons outlined above, we take the cost to listed companies from making the Audit and Assurance policy subject to an annual advisory shareholder vote to be negligible.

261. We estimate the PVC to companies from preparing and publishing the Audit and Assurance policy to be £20.7m. The EANDCB is estimated to be £2.4m.

262. Overall, **option 2 delivers a PVC of £26.8 over the 10-year appraisal period** and an **EANDCB of £3.1m.**

263. Whilst option 2 appears to present a more proportionate approach – since it requires triennial reporting as opposed to annual – it would require companies to produce a new report every three years. Based on our assumptions, companies would therefore face slightly higher costs than they would if they made only incremental changes as and when necessary, as in option 1. We do recognise however, that triennial reporting would allow companies the time and space for greater engagement with shareholders and other stakeholders.

264. Moreover, with triennial reporting (i.e. option 2) due to the length of the intervening period between reporting years, there is a risk that companies' Audit and Assurance policies will be effectively "shelved" and therefore fall out of focus, which would ultimately limit the benefit of having an Audit and Assurance policy. We do not consider this risk to apply to option 1, since there is a greater chance that the policies will remain relevant and in focus under an annual reporting frequency.

Risks and uncertainties

265. In this assessment, we assume that most of the information required for the preparation of the Audit and Assurance policy would be readily available to audit committees at limited additional cost. However, we recognise that due to variable practices across companies (and their audit committees), some companies may face higher costs from having to collect this information. This could mean that companies may face higher costs than our estimates suggest.

266. For both options, we assume that costs from preparing and publishing the Audit and Assurance policy are greatest in the first reporting year. For option 1, we assume that reporting in subsequent years would cost around 10% of first-year reporting costs, and for option 2, we assume 75% of first year costs. We make these assumptions based on our understanding of the potential scale of work required under annual and triennial Audit and Assurance policy updating, which is based, in part, on information provided to BEIS by key stakeholders. However, in practice, it is possible that triennial reporting costs are lower than we estimate here, or that annual updating costs are higher than our estimates suggest.

Summary: Analysis & Evidence — Payment practices option 1

Description: *Introducing new payment practices reporting requirements for ALL large PIEs (Companies Act 2006 definition)*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -9.3

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High		1		
Best Estimate	5.4		0.5	9.3

Description and scale of key monetised costs by 'main affected groups'

We expect companies in scope – reporting companies and their auditors – to face costs from familiarisation. We expect these to be one-off costs in the first year of implementation only. Reporting companies are expected to face ongoing costs from preparation of their payment practices summary, from packaging information they already hold. We take costs related to verification of payment practices information to be negligible, since the scale of additional audit work is expected to be minimal.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	0
High	0		0	0
Best Estimate	0		0	0

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Measures under this option are expected to limit the potential for significant administrative and financial costs to supplier companies resulting from late payments. The reporting requirements proposed here are meant to encourage company boards to take further responsibility for their companies' payment practices, and their wider duties in this regard. These measures will also provide important information on the health of companies (by indicating their ability to service payment agreements) to stakeholders.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

We make the following key assumptions:

- The regulator would face no additional costs from reviewing or processing companies' payment practices summaries. We expect that, where necessary, this would be delivered through its business as usual activity.
- The information needed for payment practices summaries is already collected through the companies' other payment reporting activities.
- In assessing familiarisation costs, we assume each PIE audit is delivered by a different audit team, and that all audit teams will need to familiarise themselves with the content of payment practices summaries.
- Costs from additional audit work to verify payment practices summaries is negligible.

We also recognise that there is a significant challenge in determining the extent to which costs of these reporting requirements would be additional, given existing reporting requirements in this space.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 5.4
Costs: 1.1	Benefits: 0	Net: -1.1	

Summary: Analysis & Evidence **Payment practices option 2**

Description: *Introducing new payment practices reporting requirements to PIEs with 500 or more employees*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -5.6

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1		
High				
Best Estimate	**3.3**		0.3	**5.6**

Description and scale of key monetised costs by 'main affected groups'

Key monetised costs are the same as in option 1. The key difference in the scale of costs is driven by the smaller number of companies in scope.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Key benefits are expected to be the same in nature as those in option 1. However, under this option, a smaller set of companies is brought into scope, and therefore, this option is likely to generate a smaller benefit than option 1.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

Key assumptions and risks are the same as in option 1.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 3.3
Costs: 0.7	**Benefits: 0**	**Net: -0.7**	

Assessment of reporting on payment practices

Policy Overview

267. Through business-to-business agreements referred to as "trade credit", UK companies often supply goods and services to purchasers while payment is deferred to some point after delivery. Whilst such credit agreements can be mutually beneficial to the parties involved, suppliers are left vulnerable to significant administrative and financial burdens if purchasers fail to make payment at the agreed time.

268. Late payments can have significant adverse effects on suppliers' cash flow and, by extension, their ability to continue trading – at worst, late payments can lead to the failure of a business. These adverse effects are especially pronounced for small businesses.

269. Over time, the Government and regulator, recognising this potential for significant loss, have taken steps to address the issue of late payment. These measures include:

    i. The 2017 Payment Practices Reporting Duty (PPRD)[113] – A requirement for the directors of large companies to approve their company's payment practice reports, thereby encouraging company boards to take greater responsibility for payment practices.

    ii. From 2019, a requirement for large companies to report on how they meet their duty under Section 172 of the Companies Act 2006 to have regard to how the company encourages good business relationships with its suppliers and the progress made in this regard[114].

    iii. Direct encouragement from the FRC to include information on their payment practices in their Section 172 statements[115].

270. The Brydon Review noted, however, that despite these steps, late payments remain a common phenomenon for UK businesses. Based on responses to a Government[116], 97% of suppliers surveyed experienced late payments, and only 11% believed that payment practices have improved over the previous 3 years.

271. The Review considered late payment a matter of significant concern not only because of its potential impact on companies' cash flow, but because poor payment practices are an indicator of companies' underlying performance[117]. On this basis, the report noted shareholders, wider users of company financial information, and the suppliers themselves, would benefit from more information on companies' payment practices.

272. Whilst reporting requirements are already in place to allow for this information to be provided by companies, compliance has been found to be inconsistent across companies, and where companies do report, issues related to the level of reporting may make the reports difficult to interpret[118]. There is also no requirement for these reports to be included in the company's annual accounts.

273. To address these issues, the Review recommended that company directors should report to shareholders on their company's payment practices and performance, and that these reports should be subject to some level of audit and assurance. The Government supports this recommendation.

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[113] Business payment practices and performance: reporting requirements

[114] The Companies (Miscellaneous Reporting) Regulations 2018

[115] Summary of key developments for 2019/20 annual reports

[116] Creating a responsible payment culture: a call for evidence on tackling late payment

[117] Brydon Report para 21.2

[118] For example, where companies have multiple subsidiaries, it can be challenging for users to understand how the company is performing at the group level, since PPRD is applied at the subsidiary level.

274. Options for improving company payment practices reporting, which would increase transparency and accountability in supplier payment reporting, are assessed below. The Government's consultation will seek views on these.

Options considered

275. We consider two options to meet the Brydon Review recommendation in this section. The reporting requirements proposed are the same for both options, with the only difference being the entities in scope. These are set out below.

276. Our estimates of costs are tentative at this stage, and responses to the consultation will help us to refine these.

Option 1 – Applying payment practices reporting to ALL large PIEs.

277. As indicated, under this option, all UK PIEs classified as large by the definition set out in the Companies Act 2006[119] would need to include payment practices reports in line with the proposed requirements, for inclusion in their Strategic Reports[120]. There are up to 765 large UK PIEs in scope[121].

278. This group of entities is being considered because they already meet the large company criteria for reporting under the PPRD, and therefore, should already be doing the necessary information gathering and some reporting. This option would therefore require their existing reports to be summarised in a more meaningful and straightforward way.

Option 2 – Applying payment practices reporting to PIEs with 500 or more employees.

279. The reporting requirements and implementation plan for this option are the same as in option 1, but the scope of coverage is narrowed to include only those PIEs with a minimum of 500 employees. There are up to 460 such UK PIEs[122].

280. These entities are proposed for inclusion since they are already in scope of non-financial reporting requirements under Section 414CB of the Companies Act.

Assessment of monetised and non-monetised costs of each option

281. For each of the options, the key elements of the costs payment practices reporting are the same, with the only differences being the number and characteristics of the set of entities affected. The costs are expected to stem from the additional activities that in-scope companies, and their auditors are expected to undertake.

282. We do not consider costs to the regulator in this assessment. We consider any additional activity by the regulator from processing and reviewing additional reports to be included in the scope of their current BAU activity, and therefore, take any associated increases in cost to be negligible.

283. At a minimum, **the companies in scope** will be required to provide a summary, within their Strategic Report, that covers:

[119] By Companies Act definition, a large company is any company that meets any two of the following: turnover of more that £36m, balance sheet of more than £18, and more than 250 employees.

[120] The reporting obligation would be introduced by amendment to either section 414C (Contents of the Strategic Report) or section 414CB (Contents of non-financial information statement) of the Companies Act 2006.

[121] Based on the FRC's PIE population estimate February 2020 and Fame data.

[122] Ibid.

- their supplier payment policy, including details on their standard payment terms and the maximum and minimum payment periods used.
- the percentage of its supplier payments that met the standard payment terms and, where this falls below 80%, an explanation of the reasons for underperformance and measures planned by the company to address them; and
- where companies identified and explained underperformance in a previous reporting period, details on the action taken by the company to address the underlying issues, and any additional steps planned.

284. Given the inclusion of the payment practices summary in the Strategic Report, **the auditors of companies** in scope will be required to include them in checks to verify that they were prepared in accordance with the relevant legal requirements, and in any consistency checks against the company's financial statements.

285. Companies would be able to consult with their shareholders on whether to include additional assurance on their payment practices through their audit and assurance policy. However, we do not account for any related costs in this assessment, since doing so is not mandatory.

286. Additionally, we expect some additional costs faced by auditors brought into scope to be passed on to their clients. We have, however, accounted for all additional costs to auditors as being incident on the auditors, and have not treated these as passed on costs. As burdens on auditors and audited companies are both within scope of the BIT target, this assumption has no effect on the BIT score.

287. **We do not consider costs to the regulator in this assessment.** We consider any additional activity by the regulator stemming from this measure to be included in the scope of their current BAU activity, and therefore, take any associated increases in cost to be negligible. We assume that measures will apply from 2023[123].

Costs

288. We expect all entities in scope to face **familiarisation costs.** These will be incurred by companies in scope in understanding and interpreting the new reporting requirements, and by their auditors, in understanding both the requirements and the assurances they would need to provide as a result.

289. We set out our approach to estimating familiarisation costs for companies and their auditors below.

Familiarisation costs to companies in scope

290. For companies in scope, we expect this cost to be a one-off, applying in the first year of implementation only, as companies are expected to understand, and comply with, the reporting requirements from the first year of implementation.

291. Given the nature of the measures proposed, we expect that for each company, familiarisation will require activities by directors, professional accounting staff, and administrative staff. For each staff level, we consider the time required for familiarisation, and the associated cost. We use ONS ASHE[124] data in developing our cost estimates.

[123] There is still some uncertainty over the implementation time, but we use 2023 as the starting year for this assessment. The actual implementation timeline will be finalised post-consultation.

[124] In this impact assessment, we have used the 75th percentile of hourly wages for the positions indicated in ONS ASHE 2018 data, with a non-wage uplift of 20%.

292. Our estimates of familiarisation costs to companies are provided for each option in *Table 31* below. Further details are provided in *Annex V.*

Table 31 - Familiarisation costs to companies in scope

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	765 Large PIEs	£0.5m	£50k
Option 2	462 PIEs (emp. ≥ 500)	£0.3m	£30k

Familiarisation costs to auditors in scope

293. Here too, we expect familiarisation costs to be one-off and to apply in the first year of implementation only. Our estimates are based on the expected familiarisation activity of audit principals and audit firm accounting staff.

294. We assume that only those audit teams engaged with in-scope companies would need to familiarise themselves with new requirements, and that each audit engagement is delivered by one audit team.

295. Further, we assume that each audit team comprises 2 audit principals, each leading a team of 8 accounting staff, and 1 non-audit principal supported by 5 admin staff[125]. We use ONS ASHE data in developing our cost estimates of the associated cost.

296. Our estimates of the familiarisation cost to auditors are provided for each option in *Table 32* and further details are provided in *Annex V*.

Table 32 - Familiarisation costs to auditors in scope

	Entities in scope	PVC, 10 yr-period	EANDCB
Option 1	765 audit teams	£4.9m	£0.6m
Option 2	462 audit teams	£3.0m	£0.3m

297. Companies and their auditors are also expected to face **ongoing costs from the preparation payment practices reports and the verification of the information they provide**, respectively.

298. In assessing the ongoing cost of reporting to companies, we follow the approach used in the NFRD IA to assess the cost of additional elements of non-financial reporting. We expect the preparation of the summary report to be carried out by professional accounting staff, administrative staff and company directors. We use ONS ASHE data for hourly wage estimates for each of these staff levels.

299. The total cost to companies in scope from ongoing reporting is provided in *Table 33* below for each option. Further details are provided in *Annex V*.

300. In this assessment we take additional ongoing costs from additional audit work to be negligible. Based on the minimum content requirements outlined, we expect additional audit costs from

[125] Our assumptions about audit team composition are the same as those used in our assessment of changes to the PIE definition in section 1, which are themselves based on the methodology in IA No: BIS016(F)-16-BE.

verification and consistency checks to be negligible. We expect the extent of additional work to fall within the scale of normal variations in audit work that auditors could reasonably expect.

Table 33 - Ongoing reporting costs to companies in scope

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	765 Large PIEs	£3.9m	£0.5m
Option 2	462 PIEs (emp. ≥ 500)	£2.4m	£0.3m

Overall Estimates of Costs for Options Considered

301. Estimates of overall costs (Present Value Costs and Equivalent Annual Net Direct Cost to Business) for each option are provided in *Table 34* below.

Table 34 - Overall Costs of Options Considered

	Entities in scope	PVC, 10-yr period	EANDCB
Option 1	765 Large PIEs and their audit teams	£9.3m	£1.1m
Option 2	462 PIEs (emp. ≥ 500) and their audit teams	£5.6m	£0.7m

Risks and uncertainties

302. There are several risks to the effectiveness of the measures assessed in this section:

- A significant challenge is in determining the extent to which the costs estimated here are likely to be additional, since companies in scope are expected to already be complying with PPRD requirements. We develop our assessment on the expectation that companies will not need to collect any new information but will need to repackage some of the contents of their PPRD reports. However, it may be the case that companies are not collecting all the information needed for PPRD reporting, and so our estimates here are likely to underestimate the true costs.
- We assume that each PIE audit will be delivered by a completely different audit team. Whilst this could be the case, it is also likely that some audit principals and accounting staff would work on more than one in-scope audit. It is therefore likely that our auditor familiarisation costs overestimate the true impact.
- We assess ongoing costs from additional audit work as being negligible. We recognise, however, that the scale of additional work in completing consistency checks is subject to significant variations between companies, and that some companies may face higher related costs than others. Ongoing audit costs may therefore be higher than our estimates suggest. We hope to use responses to this consultation to inform our analysis for future iterations of this IA.

Strengthening the regulator's powers related to reporting

Policy Overview

303. The regulator monitors corporate reporting through its corporate reporting review (CRR) activities. The regulator checks the director's report, strategic report and annual accounts of public and large private companies for compliance with the Companies Act 2006 and applicable reporting standards. The FRC Review found that the regulator's CRR activities were valuable, but hindered by a "lack of visibility, low levels of review activity and cumbersome enforcement mechanisms."

304. The measures covered under this heading are powers for the regulator to:

- Require Directors to amend their report and accounts.
- Publish CRR correspondence and summary findings (subject to safeguards to protect commercially confidential information).
- Review and direct changes to the entire contents of annual reports, both the legally required and voluntary elements such as the chairman and CEO's report.
- And provide a pre-clearance service for novel and contentious reporting matters. The decision on whether to offer such a service, however, will be a matter for the regulator, based on its priorities and likely demand.

Policy Objective

305. The objective of the regulator is to increase the accuracy and reliability of corporate reporting ensuring that it meets agreed reporting and accounting standards. In doing so the regulator will increase the quality of information provided to investors and wider stakeholders and which helps underpin well-functioning capital markets.

Description of options covered

306. In section 9 we provide different options for increasing regulator powers where options build upon each other and reflect increasing levels of policy ambition.

Monetised and non-monetised costs of each option

307. Section 9 sets out the costs of establishing the regulator and the costs to the regulator and compliance costs for business from the exercise of its powers. The powers in this section are included in those estimates, though for convenience we show estimates in *Table 35* below.

Table 35 - costs arising from strengthening regulator powers relating to reporting

FRC #	Measure	Costs to the regulator		Costs to the business	
		Non-recurrent	Recurrent	Non-recurrent	Recurrent
24	The regulator should expand the volume of CRR activity		£6.4m		£14.7m
25	The regulator should have the power to direct changes to accounts				
26	CRR correspondence should be published		£0.2m		£4.1m
27	CRR should be limited to PIEs as far as possible				
28	The new regulator should introduce a pre-clearance procedure		£3.7m		
29	CRR work should cover the annual report		£3.3m		£7.8m
30	The Government should consider the need for strengthening qualitative regulation around investor information		£3.3m		£7.8m
31	The regulator should be sparing and disciplined in the issuing of guidance				

308. As these costs are already considered in Section 9, we do not present a separate summary sheet for these measures or provide estimates of NPV or impact on the BIT target.

Section 4: Enforcement against Directors

Policy Overview

309. Under Part 15 and Part 16 of the Companies Act (2006) company directors have statutory duties relating to the preparation of their company's accounts and reports and the auditing of those accounts and reports. The regulator has no direct powers to enforce these duties. It may under limited circumstances act against a director if they are a chartered accountant who under voluntary arrangements with the chartered accountancy bodies are subject to the regulator's disciplinary scheme for accountants.

310. The FRC Review recommended that there should be an effective enforcement regime that holds directors of PIEs to account for their duties in relation to corporate reporting and audits. It recommended that this should apply to the company's CEO, CFO, Chair and audit committee chair.

311. The measures covered in this section are:

    - Powers for the regulator to investigate and sanction breaches of corporate reporting and audit related responsibilities by PIE directors, including directors of PIEs which are not companies. The intention is that all Directors would be in scope of the power. This goes beyond the recommendation of the FRC Review, because under the Companies Act the company accounts need to be signed off by the entire Board.
    - The regulator's powers will apply to breaches by directors of certain existing statutory duties such as, *inter alia*, duties to keep adequate accounting records, to approve accounts and the director's report and to provide a statement as to disclosure to auditors.
    - The regulator will have power to gather information and carry out investigations to establish whether a director has breached a relevant duty, and to impose appropriate and proportionate sanctions in cases where a breach is found to have occurred.

Policy objective

312. The objective of this measure is to ensure the credibility of the regulatory regime by extending the enforcement regime to those who are responsible for producing a company's accounts and reports.

Description of options covered

313. In section 9 we provide different options for increasing regulator powers where options build upon each other and reflect increasing levels of policy ambition.

Monetised and non-monetised costs of each option

314. Section 9 sets out the costs of establishing the regulator and the costs to the regulator and compliance costs for business from the exercise of its powers. The powers in this section are included in those estimates, though for convenience we show estimates in *Table 36* below.

Table 36 - costs arising from enforcement against Directors

FRC #	Measure	Costs to the regulator		Costs to the business	
		Non-recurrent	Recurrent	Non-recurrent	Recurrent
36	An enforcement regime for non-member Directors	£0.2m	£5.3m		£3.5m
37	Principles of the enforcement regime				
38	Power to investigate Directors and refer to the Insolvency Service	£0.1m	£2.6m		

315. As these costs are already considered in section 9 we do not present a separate summary sheet for these measures or provide estimates of NPV or impact on the BIT target. Further, the Government proposes to strengthen malus and clawback arrangements to provide better reassurance against rewards for failure. This is discussed further below.

Policy Overview

316. The ability to recover remuneration already paid to directors (clawback) or to withhold pending awards (malus) are mechanisms in directors' contracts which can be exercised by renumeration committees and, where relevant, administrators and liquidators in the event of insolvency.

317. Outside of the financial services sector there are no mandatory requirements for companies to include clawback provisions in directors' contracts, though the UK Corporate Governance Code states that directors' renumeration policies should include similar provisions. As a result, research suggests that 90% of FTSE 350 companies already have some malus and clawback provisions in place.

318. The Government proposes to strengthen these arrangements to provide better safeguards against rewards for failure. It will do this by ensuring that certain minimum clawback conditions or trigger points are included in directors' contracts and service agreements and should have a minimum period of application of at least two years after an award is made.

Policy objective

319. The objective is to ensure that executive pay reflects performance, and that poor performance is not rewarded.

Descriptions of options covered

320. The consultation will be used to refine options, for example to identify the minimum conditions relating to the exercise of malus or clawback provisions that all companies would be expected or required to adopt, and for the mechanism for introducing standardised provisions in directors'

employment contracts. Options could also include different coverage of companies – at present the Government is minded for the regulator to consult on applying stronger requirements to premium listed companies through amendments to the UK Corporate Governance Code, though these could be extended to all listed companies through the listing rules.

Monetised and non-monetised costs of each option

321. This proposal has not been costed yet. We will do so following responses to the consultation. We would welcome views on whether there are significant compliance costs for businesses from this measure.

Section 5: Audit

Changes to audit purpose and scope

Policy Overview

322. The Brydon Review set out a vision for what audit is for and what should be expected of it. The Brydon Review concluded that "audit is not broken but has lost its way". The Review argued that "the concept of audit needs to be rethought and redefined…rooted in a widely accepted clarification of its purpose".

323. The objective of the measures in this section is to improve the usefulness of the audit product: for auditors to be more sceptical, more informative, and hence more trustworthy. This is in keeping with the Government's view that auditors should seek to report in a clear, concise, and transparent manner to increase the value of their reports to shareholders and other users.

324. The measures are:

- The Government will give the regulator powers to make specific requirements of auditors and the relevant professional body (or bodies), including overarching binding principles of auditing.
- Widening the potential scope of audit for companies either choosing to publish an Audit and Assurance Policy or being required to do so by virtue of being a PIE. Company directors would decide what other information should be audited/assured, taking account of shareholders' views but also the interests of other stakeholders such as lenders, suppliers, and employees.
- To engender a stronger ethos of scepticism, challenge and informativeness, the Government proposes that new principles for audit should be set by the regulator and should be overarching principles to which the relevant standards and rules are subject.
- A new user guide for audit which the regulator will take forward. This would explain how the true and fair requirement is applied by auditors in practice, making clear that this involves an assessment of whether key accounting estimates and judgements underlying the numbers reported in the financial statements are both reasonable and adequately disclosed.
- Companies and shareholders will decide the need for specific assurance on Alternative Performance Measures (APMs) and Key Performance Indicators (KPIs), beyond the scope of statutory audit, through the Audit and Assurance policy.
- That company directors and auditors should remain free to agree whatever liability arrangements they consider appropriate for all non-statutory engagements to "assure and inform" the users of corporate information.
- The Government to put an appropriate framework in place to facilitate the establishment of a new professional body for external auditors of all types of corporate information.
- A package of measures in relation to the detection and prevention of fraud (see below).

325. It has not been possible to estimate the impact of these measures at this stage as these measures are still in development. One measure is however relatively well advanced, reporting on actions taken by the directors to detect and prevent fraud, which we assess in detail below.

Summary: Analysis & Evidence — Fraud option 1

Description: *Require directors to issue a statement outlining the actions taken to prevent and detect material fraud*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -7.1

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1		
High				
Best Estimate	**1.4**		0.7	**7.1**

Description and scale of key monetised costs by 'main affected groups'

We expect companies to face costs from familiarisation with fraud reporting requirements in the first year of implementation only. Company directors are also expected to face annual costs from reporting on actions they have taken in meeting their obligation to prevent and detect material fraud. We assume limited costs will arise from information collection as directors are expected to have the required information readily available to them.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

These reporting requirements are aimed at delivering greater clarity to investors and other stakeholders on the actions of directors in preventing and detecting fraud. Directors typically acknowledge their responsibility for this in company accounts, but do not report on actions they have taken in this regard. Therefore, these reporting requirements will help to keep directors accountable for fraud prevention and detection and will help to provide reassurances to investors and other stakeholders that they are fulfilling their key obligations.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

We make the following key assumptions:

- The director's statement on actions to prevent and detect fraud is similar in complexity to the anti-corruption and bribery statement currently required of PIEs.
- The director's statement would be a repackaging of information that firms already hold. We recognise, however, that some firms may not be doing enough currently to collect this information and could stand to face significant costs from the necessary assessments and information gathering.

We are unable, at this stage, to take account of all potential interdependencies between internal controls requirements (proposed under implementation of the Independent Review of the FRC) and these fraud reporting requirements. It is likely that our estimates here may double-count some costs as a result.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 4.1
Costs: 0.8	Benefits: 0	Net: -0.8	

Summary: Analysis & Evidence **Fraud option 2**

Description: *Option 1 + a requirement for auditors to report on the directors' statement*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -17.8	**High: -10.1**	**Best Estimate: -13.2**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	2.0	1	0.9	**10.1**
High	3.5		1.7	**17.8**
Best Estimate	**2.6**		1.2	**13.2**

Description and scale of key monetised costs by 'main affected groups'

This option builds on option 1. We therefore expect the costs of option 1 to also apply here. In addition to these, we expect costs to arise from auditors' assessment and verification of the disclosures produced in option 1. We expect auditors to face familiarisation costs and costs from their ongoing assessment (including reviews and consistency checks) of directors' statements.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

We expect the benefits under this option to build on those outlined for option 1. Through the addition of auditor attestation, auditors would contribute to the improvement in the quality of information, provided to investors and stakeholders, on directors' actions to prevent and detect fraud. The requirement for these attestations would further enhance directors' accountability, as well as investor's confidence in the information provided to them by reporting companies.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

In addition to the assumptions outlined for option 1:

- for auditor costs, we assume that the relationship between directors' reporting costs and auditor attestation costs, identified in our analysis of internal controls measures in this IA, also applies to directors' reporting and auditor attestation under the measures assessed here. We use the relationship as an uplift to determine auditor costs.
- We assume that auditors are already assessing companies' anti-fraud systems under relevant internal controls measures, so to avoid double-counting we do not consider additional costs from auditors' assessments of these systems.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 7.7
Costs: 1.5	**Benefits: 0**	**Net: -1.5**	

Assessment of reporting on measures taken to detect and prevent fraud

Policy Overview

326. Fraud in the UK amounts to between £130 – £190 billion per year[126]. Recently, fraud has featured heavily in the news both nationally and internationally. For instance, in 2019, the FRC began investigating the audit of Patisserie Valerie following the discovery of fraud worth £40m at the company[127]. Moreover, in 2020, Wirecard's auditors have been criticised for failing to detect the major fraud that led to the company reporting inflated revenues, profits, and assets for many years.

327. A company's directors are responsible for approving its annual accounts and safeguarding its assets, including taking steps to prevent and detect material fraud.[128] Directors typically acknowledge the latter responsibility in annual reports but do not report on the related actions they took. Such actions may include undertaking an appropriate fraud risk assessment and responding appropriately to identified risks; promoting an appropriate corporate culture and corporate values; and ensuring appropriate controls are in place and operating effectively.

328. Internal controls over financial reporting are the systems and processes within a company that ensure the integrity of financial information; promote accountability; and prevent fraud. In 2002, the US Government passed the Sarbanes-Oxley Act (SOX) in response to a series of major accounting and audit failures, including Enron and WorldCom. Section 404(a) of SOX required certain companies to implement a system of internal controls for financial accounting and to publish an assessment of this system in their annual report. Moreover, Section 404(b) of SOX requires companies' auditors to attest to and report on the management's assessment of the internal control structure and procedures for financial accounting. The Government has consulted on the introduction of a similar internal controls framework for the UK, based on recommendations in the Independent Review of the Financial Reporting Council (FRC). This proposal is assessed in this Impact Assessment in section 2.

329. The Brydon review noted that, among the topics that were examined, fraud and auditors' related responsibilities were "the most complex and most misunderstood in relation to auditors' duties"[129]. For example, Business, Energy and Industrial Strategy Committee (BEISCOM) were told that, because fraud is difficult to detect, the public should not expect auditors to find it[130], and that auditors operate under a 'mythology'[131] whereby they do not believe they are likely to find fraud.

330. The Government's consultation highlights several measures that would have an impact on detecting corporate fraud. These are:

- internal controls over financial reporting; and

[126] Crowe. (2019). The Financial Cost of Fraud 2019. Available at: https://www.crowe.com/uk/croweuk/-/media/Crowe/Firms/Europe/uk/CroweUK/PDF-publications/The-Financial-Cost-of-Fraud-2019.pdf?la=en-GB&modified=20190711123330&hash=AF17B852C4ACFB31258C39F0703D60A8400CCB92

[127] FRC, 21 November 2018. Investigations in connection with the financial statements of Patisseries Holdings Plc. https://www.frc.org.uk/news/november-2018/investigations-in-connection-with-the-financial-st

[128] Companies must also keep adequate accounting records, and directors commit an offence if a company fails to comply with that duty (Companies Act 2006, ss 386 and 387). It is also a criminal offence to make false statements to auditors (Companies Act 2006, s 501).

[129] Brydon review, p.65. para. 14.0.1

[130] House of Commons, (2019). The Future of Audit, p. 15 para 30. Available at: https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf

[131] Ibid, p. 16 para 30.

- proposals in the Brydon Review for a package of measures to deliver greater clarity regarding the respective roles of directors and auditors in relation to fraud prevention and detection. This section covers these proposals.

Entities in scope

331. **We assess the options proposed here as applied to UK PIEs and their auditors**. There are currently 1,945 UK PIEs and 40 auditors in scope[132]. The Government's consultation is also seeking views on proposals for a new PIE definition. Further iterations of our analysis will be updated to reflect any changes to the PIE population arising as a result.

Options considered

332. We propose two options in this section. The Government's consultation will seek views on these options.

<u>Option 1 – require directors to issue a statement outlining the actions taken to prevent and detect material fraud</u>

333. Under this option, directors would be required to report on the actions they have taken to fulfil their obligation to prevent and detect material fraud. Such actions may include undertaking an appropriate fraud risk assessment and responding appropriately to identified risks; promoting an appropriate corporate culture and corporate values; and ensuring appropriate controls are in place and operating effectively.
334. Directors would not be required to take any additional action to prevent and detect fraud – although some may choose to do so if they felt their current work was insufficient – and need only to report on actions taken to do so. Therefore, we expect costs to arise only from the preparation of the statement, which, in the main, would involve the repackaging of existing information.

<u>Option 2 (*preferred*) – in addition to the requirements under option 1, require auditors to report on the directors' statement.</u>

335. This option builds on option 1, in that it would require auditors to report whether the directors' statement on the actions they took is factually accurate.

336. We expect costs to arise from the additional work done by auditors to report on the directors' statement, including obtaining specific evidence of the actions taken by the directors to prevent and detect material fraud. This could involve, for example, further work in relation to areas such as corporate culture and corporate values.

Assessment of monetised and non-monetised costs of each option

337. For each option, we assess the costs to the companies in scope– PIEs and their auditors. We assume that the measures will apply from 2023[133].

[132] Estimate of PIEs provided to BEIS by FRC and correct as at February 2020. Number of PIE auditors based on Fame data.
[133] There is still some uncertainty over the implementation time, but we use 2023 as the starting year for this assessment. The actual implementation timeline will be finalised post-consultation.

338. We do not consider costs to the regulator in this assessment. We consider any additional activity by the regulator from processing and reviewing additional reports to be included in the scope of their current BAU activity, and therefore, take any associated increases in cost to be negligible. Further, the FRC is currently consulting on proposed amendments to the relevant auditing standard, ISA (UK) 240. The costs likely to arise from these proposed amendments, and the cost to the FRC of consulting on and implementing them, are beyond the scope of this IA.

339. We would be grateful for any views on the approaches and assumptions used in the analysis that follows. Monetised costs are summarised in *Table 37* below.

Table 37 - Summary of cost impact of options assessed

	Cost Summary	
	PVC, 10-yr period	**EANDCB**
Option 1	£7.1m	£0.8m
Option 2 *(preferred)*	£13.2m	£1.5m

Option 1: Costs to companies in scope

340. To avoid double counting, we assume that the costs to companies from the methods, systems and controls used to prevent and detect material fraud are covered by the costs of implementing the FRC Review's recommendation on internal controls. Our analysis in section 2 recognised that in implementing internal controls, some companies will choose to improve their framework for preventing and detecting material fraud.

341. However, the option requires companies to provide an enhanced disclosure on fraud which goes beyond that which would be required under the FRC Review's recommendation on internal controls. In addition to undertaking a fraud risk assessment and responding appropriately to identified risks, the disclosure could also cover actions to promote an appropriate corporate culture and corporate values.

342. We expect companies in scope to face one-off costs, from familiarisation, in the first year only, and ongoing costs from annual reporting. Here too, we use the methodology and core assumptions made in the NFRD IA to estimate costs. We consider the Anti-Bribery and Corruption Statement to be of a similar nature and complexity to the enhanced directors' statement on fraud[134]. Our estimates are based on the time taken for familiarisation in the first year, and the time taken in the first and subsequent years to prepare the required reports. In all cases we have used ONS ASHE data[135] on hourly earnings for the directors, professionals, and administrative staff. These are provided in *Table 38* and *Table* 39 below.

Table 38 - Directors' Statement on Fraud Familiarisation Costs

	Familiarisation (hr)	Total cost per hour (£)	Total cost per PIE (£)
Director	**5**	**71**	**354**

[134] We believe the directors' statement on fraud would be broadly similar to the Anti-Bribery and Corruption Statement, but we welcome views on the suitability of this approach.

[135] We used the 75th percentile of hourly wages for the positions indicated in ONS ASHE 2018 data, specifically table 14.5a for levels 1115, 11, and 4 for senior officials, team managers, and admin staff respectively. We also apply a non-wage uplift of 20%.

	Familiarisation (hr)	Total cost per hour (£)	Total cost per PIE (£)
Professional	**20**	**26**	**512**
Administrative	**1**	**14**	**14**
Total cost per PIE			**£880**
Total cost for all PIEs			**£1.7m**

Table 39 - Directors' Statement on Fraud Ongoing Costs

	Avg annual time cost Low (hr)	Avg annual time cost High (hr)	Avg annual time cost Best (hr)	Total cost per hour (£)	Total cost per firm (£)
Director	1	3	2	71	142
Professional	3	10	7	26	166
Administrative	2	14	8	14	110
Total cost per PIE					**£418**
Total cost for all PIEs					**£0.8m**

343. For option 1, familiarisation costs generate a PVC to the companies in scope of £1.4m over the 10-year appraisal period, with an EANDCB of £0.2m.

344. For option 1, ongoing costs generate a PVC to the companies in scope of £5.7m over the 10-year appraisal period, with an EANDCB of £0.7m.

345. **In total, the PVC to the companies in scope from this option is estimated to be £7.1m over the 10-year appraisal period, with an EANDCB of £0.8m.**

<u>Option 2: Costs to companies in scope</u>

346. This option builds on option 1. Therefore, in addition to costs estimated under option 1, we expect further costs to arise from auditors' verification that the enhanced disclosure is supported by their findings. As in option 1, to avoid double counting, we assume that costs to auditors from assessing the anti-fraud systems in a company – to determine whether the actions taken by the directors to prevent and detect fraud are appropriate – are covered by the costs of implementing the FRC review's recommendation on internal controls. Auditors already carry out some work to seek to detect material fraud – though the extent of this work varies from one audit to another, depending on the auditor's risk assessment – but the responsibility for fraud prevention and detection ultimately lies with company management and the Board.

347. To measure the cost of auditor attestation, we consider the cost of auditor attestation for internal controls over financial reporting, based on data covering the US experience of SOX requirements, expressed as an uplift to the cost of internal controls themselves. More precisely, we use the following equation to calculate the cost of auditor attestation:

$$Auditor\ Attestation\ Uplift = \frac{Cost\ of\ Auditor\ Attestation\ for\ Internal\ Controls}{Cost\ of\ Internal\ Controls}$$

348. Using the assessment of internal controls developed in section 2, we calculate low, central and high auditor attestation uplift estimates of 43%, 86% and 150%, respectively. We apply these uplifts to the familiarisation and ongoing costs under option 1 to estimate costs for this option.

349. Taking this approach, we estimate that auditor attestation would impose further familiarisation costs with a PVC to the companies in scope in the range of £0.6m - £2.1m (best estimate £1.2m) over the 10-year appraisal period and an EANDCB of £0.1m.

350. We estimate a PVC from further ongoing annual costs to the companies in scope in the range of £2.4m - £8.6m (best estimate £4.9m) over the 10-year appraisal period and an EANDCB of £0.6m.

351. **Overall, option 2 delivers a PVC to the companies in scope in the range of £10.5m – £17.8m (best estimate £13.2m) over the 10-year appraisal period and an EANDCB of £1.5m.**

Risks and uncertainties

352. We assume that the directors' statement on fraud is broadly similar in complexity to the anti-corruption and bribery statements that PIEs already publish. However, this is a very high-level assumption based on an early understanding of the reporting requirements. If more complex requirements are implemented, the associated costs are likely to be higher than those we estimate here.

353. We assume that the pattern of costs for auditor attestation of the directors' statement are like those for auditor attestation of internal controls in the US SOX experience. We scale these down to account for the narrower scope of fraud reporting, but if the transition and steady-state costs follow a different pattern in practice, then our approach would need to be modified appropriately.

354. The directors' statement is a repackaging of existing information, not a requirement for directors to do more to prevent and detect fraud. Directors may decide they need to do more, given the recent spotlight on fraud in the media, which would of course lead to greater costs on business.

355. The interdependencies between internal controls (as proposed under the Independent Review of the FRC) and the requirements proposed here may mean that any auditor attestation of internal controls, could reduce any additional work that auditors need to do regarding internal controls relating to fraud.

Section 6: Audit Committee Oversight

356. This section covers the following measures on the oversight of Audit Committees, including:

- Powers for the regulator to require information and reports from audit committees. Most of this information would be information that committees have available or are already providing, for example to the board. These reports would be used by the regulator to ascertain that audit committees are complying with minimum standards.
- A duty for the regulator to mandate standards for both the appointment and oversight of auditors.
- A duty for the regulator to monitor compliance with these standards, including the ability to require information and/or reports from audit committees, as well as placing an observer on a committee if necessary.
- Powers for the regulator to issue guidance to audit committees.
- Powers for the regulator to seek remedial action to act in relation to breaches of the new audit committee requirements, where necessary.

357. Our analysis of these is set out below.

Summary: Analysis & Evidence — Policy option 1

Description: *Mandating, monitoring and enforcing minimum standards for audit committee tendering, oversight and reporting for ALL FTSE 350 audit committees.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -72.5**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**1.4**		8.2	**72.5**

Description and scale of key monetised costs by 'main affected groups'

The regulator would face costs from developing and issuing minimum standards of tendering, oversight and reporting for audit committees, and from monitoring audit committee tenders, their oversight of ongoing audit engagements, and their conduct of meetings and discussions. Audit committees in scope would face costs from responding to the increase in regulatory oversight, from preparing and submitting audit tender reports and annual reports on their oversight and management of their ongoing audit engagement.

Other key non-monetised costs by 'main affected groups'

The regulator and audit committees are likely to face costs from issuing and responding to remedial action, respectively. However, we do not assess additional costs imposed on the regulator and companies from remedial action in this IA. We take this to be included in the assessment of changes to the regulator in section 9.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Increased regulatory scrutiny of audit committees, coupled with the threat of public reprimand for underperformance, provides a strong incentive for audit committees to prioritise audit quality. With increasing audit quality, there would be benefits to companies in scope, such as more effective internal decision-making and lower costs of capital. Also, investors in these companies might experience reduced costs as a result of fewer instances of fraud and uncontrolled corporate failures, as well as lower precautionary costs. The wider market could also benefit from greater stability and more efficient investment allocation.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- For the preparation of tender and ongoing audit reports, we assume that audit committees are largely already complying with the FRC's guidance for audit committees, and so would not need to collect and collate new information but would need to repackage information they already hold.
- We assume an average of 35 audit tenders per year since mandatory retendering is required every 10 years for all audit engagements and there are 350 companies in scope. There is likely to be some variation in the number of audit tenders from one year to the next.
- We assume that, on average, only two cases per year would warrant direct observation of the audit committee.
- We assume parameters for typical audit committee composition based on the minimum requirements for audit committees set by the FRC.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 7.6
Costs: 1.5	**Benefits: 0**	**Net: -1.5**	

Summary: Analysis & Evidence — Policy option 2

Description: *Mandating, monitoring and enforcing minimum standards for audit committee tendering, oversight and reporting, using a risk-based monitoring approach.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -12.0**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**1.4**		1.2	**12.0**

Description and scale of key monetised costs by 'main affected groups'

The areas of cost under this option are the same as in option 1, barring one key difference. This option takes a risk-based approach to tender and ongoing audit monitoring. In practice, only those audits assessed as high-risk would be subject to this monitoring. Therefore, the costs of this option are smaller than in option 1.

Other key non-monetised costs by 'main affected groups'

Same as in Option 1.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Same as in option 1, but could be more cost effective as a result of the risk-based narrowing of scope.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

These are the same as in option 1, except the number of entities in scope:

- We assume that the risk assessment of tenders would be aligned to the FRC's existing AQR risk assessment framework.
- For risk-based tender monitoring, we assume that out of an average of 35 audit tenders per year (*see assumption under option 1)*, 5 tenders (14%) would be subject to risk-based monitoring in line with the average AQR sample size.
- For ongoing audit monitoring, we assume that 50 out of 350 FTSE 350 audits (14%) would be subject to risk-based monitoring in line with the average AQR sample size.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 1.8
Costs: 0.4	**Benefits: 0**	**Net: -0.4**	

Summary: Analysis & Evidence — Policy option 3

Description: *Using a non-mandatory standard for tendering, oversight and reporting, with a "comply or explain" approach.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -1.4**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**1.4**			**1.4**

Description and scale of key monetised costs by 'main affected groups'

We do not expect any material costs to the regulator under this option, since the measure would be based on a non-mandatory standard and a "comply or explain approach". The regulator's monitoring of compliance would be conducted by the same monitoring function used for the UK Corporate Governance Code. Similarly, we expect audit committees in scope to face only the cost of familiarising themselves with the requirements introduced, as they are not mandated to take any action in compliance.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Same in nature as in options 1 and 2. However, we expect the scale of benefits under this option to be limited, as audit committee compliance is not mandatory, and therefore, may not go far enough in changing audit committee behaviour.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- We assume that monitoring of companies' compliance would be carried out via the UK Corporate Governance Code monitoring function and would therefore require no expansion of FRC resources.
- For audit committees in scope, we assume no additional ongoing compliance costs as it will be for shareholders to assess the compliance performance of companies they own shares in and act on information provided by the regulator.
- The mechanics of this option rely on shareholders being engaged enough to act against underperforming audit committees. However, the level of shareholder coordination required for this is extremely difficult to achieve in practice.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 0.8**
Costs: 0.2	**Benefits: 0**	**Net: -0.2**	

Assessment of Audit Committee oversight measures

Policy Overview

358. The CMA recommended that audit committees should be placed under greater scrutiny by the regulator, which should have the power, and a requirement, to mandate minimum standards for both the appointment and oversight of auditors[136]. The FRC's Guidance on Audit Committees and Audit Quality Practice Aid[137] provide guidance on what audit committees should be doing in relation to the annual audit cycle. Among other key responsibilities[138], audit committees are responsible for the selection, appointment, remuneration and removal of a company's external auditor, and for oversight and management of the engagement with the external auditor. The latter function includes their responsibility to assess the independence of the external auditor and the quality of the audits they produce. The effective independent conduct of the activities of audit committees is, therefore, critical to the overall quality of external audits.

359. The CMA study found two main issues around the *appointment* of auditors:

- The CMA found that audit committees were not consistently prioritising independence, scepticism and challenge in making their audit appointments[139]. The current FRC guidance on audit tenders is focused on supporting an effective tender process. However, whilst audit committees used selection criteria like those in the FRC's good practice tender guidelines, cultural fit/chemistry was also a common selection criterion in audit tenders[140.]
- Despite audit committees' responsibility for tender and auditor appointment, management still plays a significant role in the tender process and in advising the audit committee[141], and could therefore have significant influence over the audit committee and in their recommendations.

360. The CMA therefore concluded that the auditor selection process would be a more effective driver of audit quality if the criteria applied were consistently focused on audit quality and the participation of company senior management was kept to the minimum necessary for an effective selection process[142].

361. Similarly, on *oversight* of auditors, the CMA identified two main issues:

- It is difficult for audit committees to directly observe the quality of the audit work undertaken; instead, they focus their discussion with auditors on perceived higher risk areas, supplemented by their other interactions with the auditors[143]. The auditor and management are closer to the day-to-day work undertaken than the audit committee and so are better informed about the quality of the audit[144]; and
- While some audit committees are effective in overseeing the activities of auditors, there was significant variability among audit committees in the FTSE 350 – both in relation to resources (amount of time spent)[145] and effectiveness[146].

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136 CMA Report, paras 5.17-5.20

137 FRC Guidance on Audit Committees (Apr 2016); Audit Quality: Practice aid for audit committees (December 2019).

138 These relate to the review of the company's financial information, its internal financial controls, and internal audit processes.

139 CMA report, para 3.38

140 CMA report, paras 3.27, 3.37.

141 CMA report, para 3.42

142 CMA report, para 3.45.

143 CMA report, para 3.53

144 CMA report, para 3.54

145 CMA report, para 5.58

146 CMA report, paras 3.61-3.63

362. The CMA also considered how far shareholders act as a constraint on audit committees and are directly engaged in audit matters. They found that investors overall have little engagement with audit matters[147], but that more disclosures in the audit report or in the audit committee report could make it easier for them to engage[148].

363. Current UK regulations[149] requires shareholders to be informed about the recommended choice of auditor and justification. Respondents to the BEIS consultation[150] recognised that there were other barriers to shareholder engagement, such as limited resources and/or time, commercial confidentiality of audit firms, and investors wanted to avoid being treated as having inside knowledge. There also was no consensus about what reliable or useful indicators of quality would be. Examples of information which could be mandated in reporting requirements are: which firms were invited to tender; which responded; the selection criteria; why the selected firm was chosen; and how the audit committee ensured independence and sceptical challenge were prioritised.

364. The CMA recommended that the regulator should mandate all audit committees to report, explaining how they have complied with minimum standards during the tender selection process[151]; and focus its scrutiny in relation to audit committee oversight on particular audit committees[152]. The regulator would require new powers to allow it to obtain sufficient information on which to grade audit committees' performance, and ultimately highlight both poor and good performance[153]. These powers would include the ability to request information and reports from audit committees; and, if necessary, place an observer on the audit committee or in another part of the audit process. Although companies are already required to provide some information to the regulator on request[154], this is related to the fairness of the auditor selection procedure and does not cover the audit quality issues that the CMA was concerned about.

365. To reinforce this, the CMA considered that the regulator needed the ability to take remedial action in cases of underperformance[155], which could include:

- Publishing its findings, or summaries of its findings, on both poorly/high performing audit committees.
- Writing to audit committees, highlighting any specific areas of deficiency; and
- Writing to shareholders, giving them the information needed for them to challenge audit committees and auditors, for example at AGMs.

366. Responses to the BEIS consultation[156] supported the view that some measures are required to focus audit committees on audit quality in their appointment and oversight of auditors. **The proposed measures to increase audit committee scrutiny hold committees directly accountable to the regulator and give shareholders the information they need to hold committees account. The Government therefore agrees with Sir John Kingman's**

[147] CMA report, para 3.67.

[148] CMA report, para 3.80.

[149] Via the implementation of Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC. The regulation was implemented before the UK left the EU.

[150] https://www.gov.uk/government/consultations/statutory-audit-services-initial-consultation-on-the-competition-and-markets-authority-recommendations

[151] CMA report, para 5.19. In practice, according to the CMA's framing, monitoring "all" audit committees will mean ~35 audit tenders per year and taking a risk-based approach to monitoring audit tenures.

[152] CMA report, para 5.20

[153] CMA report, para 5.21

[154] Under Article 16(3)(f) of Regulation (EU) No 537/2014, which was implemented before the UK left the EU.

[155] CMA report, para 5.22

[156] https://www.gov.uk/government/consultations/statutory-audit-services-initial-consultation-on-the-competition-and-markets-authority-recommendations

conclusion that the regulator should not be given broad powers to appoint PIE auditors at this time.

Entities in scope

367. We assess the options proposed here as applied to the audit committees of FTSE 350 companies[157]. Further details on what this means in practice are provided in the assessments of options presented below. These options can also be applied more widely to include UK public interest entities (PIEs). The CMA suggested that the remedy should be expanded to all PIEs once a new PIE definition is established. However, for the purposes of this assessment, we consider the FTSE 350 only.

Options considered

368. We propose three options in this section. The Government's consultation will seek views on these options.

<u>Option 1 – mandating, monitoring and enforcing minimum standards for ALL audit committees in scope.</u>

369. This option is built on three (3) key elements: the establishment and enforcement of minimum standards with which all audit committees in scope would have to comply; monitoring of their compliance and performance; and where required, remedial action.

370. Under this option, the regulator would mandate minimum standards for tendering, oversight and reporting to shareholders, with which all audit committees in scope would need to comply. Currently, compliance with the FRC's Guidance on Audit Committees and Audit Quality Practice Aid is not mandatory, and where the guidance is followed, it is applied to varying degrees by audit committees.

371. The minimum standards would be demonstrated through good practice examples made available to companies in scope and would allow a degree of discretion and judgment in relation to individual company circumstances. This would be expected to prevent a "one size fits all" approach by the regulator and would avoid the level of audit committee disempowerment that would otherwise result from too prescriptive a set of minimum standards (for example, decisions on the skills required by the audit team will be left to the judgement of the audit committee as opposed to being made by the regulator).

372. This option would require <u>ALL</u> companies in scope, through their appointed audit committees, to report to the regulator on their audit tenders and their oversight and management of ongoing audits; and would allow an observer appointed by the regulator to attend audit committee meetings in exceptional cases. Where deemed necessary, the regulator would also be able to commission skilled person reviews, but this would only apply in cases of extreme underperformance, which are expected to be limited[158].

373. The regulator would also be given the power to publicly intervene in cases where audit committee non-compliance with the standards has been identified. The threat of remedial action in the form of public reprimand would have the potential to be a strong deterrent to the activities that contribute to underperformance. Therefore, it is proposed on the basis that it could be an effective means of getting audit committees to make any required changes for improving their performance.

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[157] This grouping captures FTSE 100 and FTSE 250 constituents of the LSE and includes investment trusts.

[158] "Skilled person reviews" in this case are taken to mean expert reviews of companies to examine underlying issues that may fall within the scope of the regulator's strategic objectives. The use and meaning are the same as in the FCA and PRA context.

374. This option would be the most stringent of the three substantive options proposed in this section.

Option 2 (*Preferred Option*) – mandating and enforcing minimum standards using a risk-based monitoring approach.

375. This option applies the same key elements as option 1, but with an adapted approach to monitoring and remedial action. As in option 1, the regulator would mandate minimum standards for tendering, oversight and reporting to shareholders, with which all audit committees in scope would need to comply.

376. The regulator would, however, take a risk-based approach to monitoring audit tenders and ongoing audits, as opposed to monitoring all tenders and ongoing audits. Where audits are assessed as "high risk", and therefore, subject to the regulator's audit monitoring activity – audit committees would need to report to the regulator on their tendering, oversight and management of the audit. Similarly, a risk-based approach would be taken to audit committee monitoring, with audit committee observers to be assigned mainly to high-risk cases. As in option 1, the regulator, if it finds it appropriate, would also have the power to commission skilled person reviews.

377. Where audit committee underperformance has been identified, this would allow the regulator to privately engage with companies and proceed to public intervention as needed.

Option 3 – using a non-mandatory standard for tendering, oversight and reporting, with a "comply or explain" approach to enforcement.

378. This option deviates from the mandatory minimum standards in options 1 and 2, and proposes a non-mandatory standard, along with a more passive "comply or explain" approach to enforcement akin to that currently applied under the UK Corporate Governance Code.

379. Under this option, monitoring would take the same approach as the regulator's monitoring of the UK Corporate Governance Code and would be delivered by the same monitoring function.

380. As per the framework under which the UK Corporate Governance Code is applied, there would be no requirement for, or facility through which, the regulator could take remedial action against companies deemed to be underperforming. It would be for the shareholders in these companies to judge the level of their companies' compliance and to act accordingly.

381. This is the least stringent option proposed in this section.

Assessment of monetised and non-monetised costs of each option

382. For each option, we assess costs to the regulator and to the companies in scope. We assume that the costs to the regulator will be covered by an increase in the FRC levy. Therefore, we do not include regulator costs in our Business Impact Target (BIT) calculations.

383. In **options 1 and 2**, the key elements of the required changes to current regulator and company activities are the same, with the key difference in the expected impact being related to the scale of monitoring activities and the range of remedial actions allowed.

384. **The regulator** would be required to:

- Develop and issue minimum standards of tendering, oversight and reporting for audit committees.
- Undertake reviews of audit committees' conduct of audit tenders.
- Monitor audit committees' engagement with ongoing audits.

- Place observers on audit committees; and
- Require remedial action from underperforming audit committees.

385. **Audit committees** in scope would be required to:

- At the outset, familiarise themselves with new reporting requirements imposed by the regulator.
- Prepare reports on tendering once every 10 years (or whenever a tender is undertaken if a company opts for a shorter period) and on ongoing audits on an annual basis; and
- In exceptional cases of underperformance, undertake remedial action as required by the regulator. We recognise that this could have a wider impact on audit firms and their shareholders, but we lack sufficient information with which to model this since the actual scale of cost will vary according to the extent of underperformance.

386. For audit tender and ongoing audit reporting, our preparation and review time estimates assume that the information to be contained in the reports is already captured by audit committees. The CMA noted that existing practices within audit committees, and hence the information they collect, are variable, but where necessary, we expect capturing the additional information will require minimal additional activity. We therefore assume that any additional costs from obtaining and collating the relevant information will be negligible. We base this assumption on the understanding that audit committees in scope are already undertaking the activities necessary to comply with the requirements and responsibilities of audit committees set out in the FRC's Guidance on Audit Committees. These responsibilities include, but are not limited to: conducting the tender process and advising on auditor appointment, reviewing auditor independence and objectivity, monitoring non-audit services provided by external auditors and the related impact on independence, and taking into account other ethical guidance for audit committees.

387. We do not assess additional costs imposed on the regulator and companies from remedial action in this IA. The regulator's use of the power to request remedial action, and costs incurred by companies in responding to it, are included in section 9. It assesses costs to both the regulator and companies in scope based on five (5) cases per year[159] for which remedial action will be required.

388. **For option 3**, there will be some level of additional activity required of **the regulator** under the "comply or explain" approach, but we expect this activity – mainly monitoring – to be delivered through the same function that is currently used to monitor compliance with the UK Corporate Governance Code. We do not expect any expansion of resourcing or ongoing activity for the regulator. We therefore expect no significant additional cost to the regulator[160].

389. For **companies in scope**, we assume no additional ongoing compliance costs as it will be for shareholders to assess the compliance performance of the companies they own shares in, and act accordingly. We do, however, assess the one-off familiarisation cost imposed on these companies from having to understand and adjust to the requirements of the non-mandatory standard.

390. Cost estimates are summarised in *Table 40* below, and calculation tables are provided in Annex *VI*. Our estimates of costs are tentative at this stage. More policy work and responses to the consultation will help us refine these, where possible.

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[159] We base this assumption on information provided to BEIS by the FRC.

[160] We have tested this assumption with the FRC, who have confirmed that it is in line with their understanding of how the option will be implemented in practice.

Table 40 - Summary of cost impact of options assessed

	Cost Summary	
	PVC, 10-yr period	**EANDCB**
Option 1	72.5m	1.5m
Option 2 *(preferred)*	12.0m	0.4m
Option 3	1.4m	0.2m

Option 1: Costs to the regulator

391. As indicated above, we expect the regulator to face additional costs from developing and issuing minimum standards for audit committees; and from the three components of additional monitoring: audit tender monitoring, ongoing audit monitoring, and placing an observer on audit committees. We have used estimates and assumptions provided by the Financial Reporting Council (FRC) to develop the estimates presented below.

- *Cost of developing and issuing minimum standards for tendering, oversight and reporting:* BEIS and FRC estimates suggest that developing a set of standards with which audit committees must comply will impose a one-off cost of £250k[161], that will apply in year 1 of implementation only. Therefore, the PVC to the regulator is estimated to be £0.2m over the 10-year appraisal period.

- *Cost of tender monitoring:* given that there are 350 audit committees that conduct an audit tender every 10 years, and that these tenders occur at varying points within the 10-year period for different companies, we assume that:

  i. the regulator will need to review 35 audit tenders per year, on average.

  ii. In practice, each tender review is expected to take 4–6 weeks, and will consist of a desk-based review of the tender (focusing on the audit committees report to the regulator) and field work (in the form of audit committee interviews). The latter may require international travel.

  iii. Each review will be led by senior staff with experience working on audit committees, supported by a team of 3 experienced staff and one administrator. We assume a very detailed level of scrutiny, and extensive engagement with the audit committee, including the lead reviewer having to attend audit committee meetings.

  The present value cost (PVC) to the regulator from tender monitoring is estimated to be £24.2m over the 10-year appraisal period.

- *Cost of ongoing audit monitoring*: Under this option, we expect the regulator will need to:

  i. Review the ongoing audits of all FTSE 350 companies on an annual basis.

  ii. Each audit review is expected to take 4 weeks and will consist of a desk-based review focusing on the audit committee's audit report. There may be some travel involved for direct engagement with the audit committee, but this is expected to be the exception rather than the norm, so we do not consider the cost of travel in our estimates.

[161] This estimate reflects the staff and other costs of preparing the guidance and engaging with stakeholders at all stages, as appropriate, to prepare, consult, communicate and embed the new guidance. We aim to capture more detail for future iterations of this IA.

iii. Each audit review will be delivered by a review team of three (3) experienced staff, supported by an administrator.

The PVC to the regulator from monitoring ongoing audits is estimated to be £34.6m over the 10-year appraisal period.

- *Cost of observer on audit committee*: As part of its monitoring of compliance with the standard, we assume that:

i. In exceptional circumstances, the regulator will appoint an observer to attend audit committee meetings. Based on information provided to us by the FRC, we assume this to be necessary for two (2) FTSE 350 audit committees per year.

ii. We expect observers to be senior staff with experience of audit and of sitting on audit committees, but no conflicts of interest. For each selected FTSE 350 company, we assume that an observer will need to attend 6 meetings – each of roughly 6 hours duration and requiring around 1 – 2 hours of preparatory work per meeting, and on average, will need to travel internationally for around 25% of meetings[162].

The PVC to the regulator from placing observers on all audit committees in scope is estimated to be £0.4m over the 10-year appraisal period.

Option 1: Costs to companies in scope

392. We would expect companies in scope, through their audit committees, to face additional costs from familiarisation with new reporting requirements and from preparing the necessary reports. We expect audit committees' costs from accommodating the regulator-appointed observer to be negligible.

- *Familiarisation costs*: We expect all FTSE 350 audit committees to face familiarisation costs related to understanding and implementing minimum standards and the new reporting requirements. Familiarisation costs are expected to be one-off costs that will apply in year 1 of implementation, as audit committees are expected to comply with the standard from the first year of implementation.
- We assess FTSE 100 and 250 familiarisation costs separately. Our estimates are based on the hourly remuneration rate of audit committee chairs[163], review and support teams, and the estimated time they will require for familiarisation. We make the simplifying assumption that the average FTSE 350 audit committee consists of 1 committee chair and 3 members supported by an administrative team of four[164]. We recognise that the company board, including its chairman, may wish to familiarise themselves with these new requirements, but since the measures assessed here do not require them to do so, we do not account for any associated costs in our assessment. We estimate the PVC of familiarisation costs for all companies in scope to be £1.4m. The EANDCB is estimated to be £0.2m.
- *Cost of preparing tendering reports*: Each FTSE 350 audit committee would need to prepare and submit a report to the regulator detailing the tender process, including, but

[162] The FRC noted that some FTSE 350 companies will hold audit committee meetings outside of the UK, but were not able to provide more detailed assumptions, since it is impossible to know which companies will be subject to observations in a given year and which of these will choose to have meetings abroad. Further, they noted that travel within the UK would also impose costs on the regulator but considered these to be negligible.

[163] Audit committee chair and members' remuneration based on non-executive director base fees and audit committee additional fees provide in Deloitte's 2018 director remuneration guides for FTSE 100 and 250 companies.

[164] For administrative team member cost, we use the 75th percentile of hourly wages in ONS ASHE table 14.5a for level 4 – admin staff, with a non-wage uplift of 20%.

not limited to, auditor assessment and selection criteria, details of the bidding auditors and, more generally, information required by the regulator on the general conduct of the business of the audit committee. In developing our estimate, we assume:

i. Costs would be driven by audit committee chair, member and support team time spent in preparing and reviewing the report.

ii. In addition to preparation and review, the audit committee would spend some time discussing the content of the report. The company board may also choose to review the report, but we have not accounted for this in our analysis since the requirement falls on the audit committee. In any event, the time spent by the board reviewing the report will be rolled into the time they would ordinarily spend reviewing the work of the audit committee.

iii. For each company, the cost of tender reporting will be incurred every 10 years, although the length of the interval may vary slightly in practice.

The PVC of tender reporting is estimated to be £1.3m, and the EANDCB is estimated to be £0.2m.

- *Cost of ongoing audit reporting*: Each FTSE 350 audit committee would need to prepare and submit an annual report on their oversight of their audit contract. As with tender reporting above, we base our estimate on audit committee chair, members and support team time spent on reporting. Here too, we assume some additional costs would stem from discussion and debate on the contents of the report. The PVC of ongoing audit reporting is estimated to be £10.4m, and the EANDCB is estimated to be £1.2m.

393. Option 1 delivers a **PVC of £72.5m over the 10-year appraisal period** and an **EANDCB of £1.5m.**

<u>Option 2: Costs to the regulator</u>

394. As in option 1, we would expect the regulator to face additional costs from developing and issuing standards, audit tender monitoring, ongoing audit monitoring and, in exceptional cases, placing an observer on audit committees.

395. However, this option takes a risk-based approach to tender and ongoing audit monitoring and appointing audit committee observers, as recommended by the CMA. In practice, only those audits assessed as high-risk would be subject to this monitoring. Barring this key difference, we use the same assumptions applied in option 1 to develop the estimates presented below.

- *Cost of developing and issuing minimum standards for tendering, oversight and reporting:* As in option 1, we assume a one-off cost of £250k from the issuing of standards for audit committees.

- For risk-based tender and audit monitoring, we assume that some standardised criteria would be used to assess risk. The regulator already uses a framework for assessing risk when selecting auditor engagements to be subject to its Audit Quality Reviews (AQR). The criteria for selecting companies for AQR include factors such as whether the company is under economic pressure, operates in an FRC priority sector, and out of cycle audit changes, among others. The AQR approach requires all individual audit engagements of the FTSE 350 to be reviewed every 7 years, which means the average annual AQR sample size is around 14% of the population. We therefore assume that for the purpose of tender and audit monitoring, the risk assessment would be aligned to the AQR framework, and the expected proportion of companies subject to monitoring would be the same as the proportion of companies sampled for the AQR (i.e. 14%).

- *Cost of tender monitoring*: Given that on average, 35 FTSE 350 audit tenders are conducted annually, we assume that with a risk-based approach, the regulator will need to review 5 tenders per year (14%). All other assumptions are the same as those applied under option 1. The PVC to the regulator from conducting audit tender reviews is estimated to be £3.5m over the 10-year appraisal period.
- *Cost of ongoing audit monitoring*: Similarly, a risk-based approach will mean that the regulator will need to review 14% of FTSE 350 audits, or 50 audits per year. Applying all other assumptions used under option 1 for audit monitoring, the PVC to the regulator from this component of monitoring is estimated to be £4.9m over the 10-year appraisal period.
- *Observer on audit committee*: To assess these costs, we apply the same assumptions used for option 1 above. Here too we assume that observers would be appointed for two (2) FTSE 350 audit committees per year. The PVC to the regulator from this component is estimated to be £0.4m over the 10-year appraisal period.

<u>Option 2: Costs to companies in scope</u>

396. The companies in scope would incur additional audit committee costs from familiarisation with new requirements and preparing tender and ongoing audit reports. As with regulator costs, we use the same underlying assumptions used in option 1 but apply these to the number of audit committees in scope of this option.

- *Familiarisation costs*: As in option 1, all FTSE 350 audit committees would need to familiarise themselves with the mandatory minimum standards applied to them. As a result, we expect familiarisation costs to be the same as in option 1. Therefore, the PVC to companies from familiarisation is estimated to be £1.4m. The EANDCB is estimated to be £0.2m.
- *Cost of preparing tendering reports*: Each of the 5 selected FTSE 350 companies would need to prepare a tender report for review by the regulator, that includes auditor assessment and selection criteria, details of the bidding auditors and, more generally, information required by the regulator on the general conduct of the business of the audit committee. This would require preparation and review by the audit committee and their support team. The PVC to companies from preparing tender reports is estimated to be £0.2m. The EANDCB is estimated to be £21k.
- *Cost of ongoing audit reporting*: The 50 companies assessed as high risk would each need to prepare and submit an annual report on their oversight of their ongoing audit. Our estimate considers the work of the audit committee and their support team in preparing and reviewing this report. The PVC to companies from ongoing audit reporting is estimated to be £1.5m, and the EANDCB is estimated to be £0.2m.

397. Option 2 delivers a **PVC of £12.0m over the 10-year appraisal period** and an **EANDCB of £0.4m.**

<u>Option 3: Costs to companies in scope</u>

398. As we do not expect any additional cost to be imposed on the regulator under this option, we consider the associated cost to companies only. This cost would be related to audit committees' familiarisation with the non-mandatory standard brought into force. These costs have been calculated in line with the estimation model used for options 1 and 2 above.

399. We would expect all FTSE 350 audit committees to be in scope of familiarisation with the requirements under this option. The PVC of familiarisation is estimated to be £1.4m, and the EANDCB is estimated to be £0.2m. We would not expect any cost beyond familiarisation, as compliance with the standard under this option is non-mandatory, and therefore, the duty to assess and treat non-compliance and under-performance rests with shareholders and not the regulator.

400. Option 3 delivers a **PVC of £1.4m over the 10-year appraisal period** and an **EANDCB of £0.2m.**

Risks and uncertainties

401. The main risks relate to:

- Guidance that is too prescriptive which, through reducing the scope for audit committee members to exercise judgement, could disincentivise high-quality individuals from sitting on audit committees. This risk could, however, be mitigated through careful drafting.
- The regulator's announcements relating to audit quality or audit committee performance could be market sensitive. The issuing of unfounded or partially informed announcements could therefore have an impact on a firm's share price and the potential for economic losses.

Engagement with shareholders on audit

Policy Overview

402. Shareholders are the primary users of company accounts and reports and rely on them to make informed, long-term investment and engagement decisions. The accounts also serve the public interest and are important for a range of other stakeholders. The Brydon Review was concerned that asset managers as stewards of investment may not in general be giving sufficient attention to the quality and robustness of audit and believed that audit might deliver more if shareholders were interested and involved.

403. The Brydon and CMA Reviews made several recommendations to improve shareholder engagement with auditors and audit committees. To facilitate greater shareholder engagement the Government is proposing to proceed with several measures. These are:

    - Audit committees of premium listed companies to provide an annual opportunity for shareholders to suggest areas of emphasis for the audit plan. To assist shareholders, companies would also be expected to publish an updated report on principal risks and uncertainties, where there has been a material change in risk since the last annual or interim report. The Government will invite the regulator to initially consult on changes to the UK Corporate Governance Code (and associated guidance). Following a suitable period, the Government will work with the regulator to review these obligations and consider whether they need to be extended more widely.
    - That audit committees ask the auditor, as part of its contractual 'terms of engagement', to consider all shareholder suggestions for the audit plan. The auditor would set out its rationale for accepting or rejecting shareholder proposals to the audit committee chair, who would then publish the most material suggestions within the audit committee report.
    - Audit committees should update the auditor's 'terms of engagement' to require auditors to attend AGMs and answer questions from shareholders. The regulator should also consider revising its guidance to audit committees to encourage questions from shareholders about audit matters. In addition, the Government will ask the regulator to consider updating its guidance on the recently revised UK Stewardship Code to promote greater engagement from investors on matters relating to audit quality.
    - The Government expects the regulator to publicise existing confidential channels through which shareholders will be able to raise issues regarding individual audits.
    - The Government agrees with the Brydon Review that the outgoing auditor of a PIE should be required to provide more substantive information when they cease to hold office to ensure that shareholders and others are properly informed of the circumstances of the change.
    - The Government agrees with the CMA that it would be appropriate for the regulator to consider investigating options to improve shareholder engagement with audit committees once it has been established.

404. It has not yet been possible to estimate the impact of these measures at this stage as these measures are still in development.

Section 7: Competition, choice and resilience in the audit market

405. This section covers the following measures:

- Providing statutory powers for the regulator to proactively monitor the resilience of the audit market and engage with audit firms to address concerns.
- Greater regulatory powers and duties intended to increase choice and competition in the FTSE 350 audit market, initially through a managed shared audit regime and, as needed, a market share cap.
- Creating a regulatory requirement of operational separation between audit and non-audit arms for certain firms, as determined by the new regulator. This will include separate governance, financial statements prepared on an arms-length basis and regulatory oversight of audit partner remuneration and audit practice governance.

Resilience of audit firms and the audit market – audit firm supervision

Policy Overview

406. The CMA and FRC Reviews recommended that the regulator be given a more powerful role in monitoring and supervising the activities of the largest audit firms. The CMA review specifically focused on the need to mitigate the risk, and address the consequences, of the failure of one of the Big Four audit firms. The FRC Review focused on giving the regulator the powers to monitor audit firms to address broader structural problems within those firms as well as a duty to report regularly on market and competition developments in the PIE audit market.

407. In response to these Reviews the Government is proposing to:

- Build on the regulator's existing market review function by requiring the regulator to report more extensively on market and competition developments, including trends in audit pricing, the extent of any cross subsidy from non-audit work and any implications for the quality of audit.
- Give powers to the regulator to require PIE auditors to provide information which is reasonably required by the regulator for the purposes of discharging its market review duty.
- Give the regulator statutory powers to monitor the health of FTSE 350 audit firms. This would include powers to require audit firms to provide information about their ongoing financial viability, including in relation to their performance, risk management and internal controls, so that the regulator can assess any potential risk of financial distress and the likely impact of failure.
- The Government also proposes to give the regulator powers to require audit firms to address any viability concerns it identifies. Those powers would require audit firms to put in place appropriate plans to address any viability risks identified including modelling distress scenarios the regulator judges appropriate, setting contingency plans for staff transfers, and setting and monitoring indicators of financial stability.

Policy objective

408. The policy objective from increased supervision of PIE audit firms is to address the adverse consequences which would result from systematic deficiencies, anti-competitive behaviour, or audit firm failure.

Options considered

409. There is an overlap between this option and the FRC Review's recommendation for the regulator to develop a robust market intelligence function. This function is covered in Section 9.

Monetised and non-monetised costs of options

410. For the purposes of this assessment we have assumed that the additional costs to the regulator would be subsumed with the costs involved in developing a "robust market intelligence function" (FRC recommendation #44). We will revisit this assumption as policy work develops.

Summary: Analysis & Evidence — Market Opening option 1

Description: *Mandating joint audit for all companies in the FTSE 350 except simple, single-entity companies, such as investment trusts. The 50 largest in scope companies would be subject to peer review only.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -389.6	**High: -144.0**	**Best Estimate: -266.8**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1	17.0	**144.0**
High			47.2	**389.6**
Best Estimate			**32.1**	**266.8**

Description and scale of key monetised costs by 'main affected groups'

Under joint audit, companies face additional costs due to the duplication of work by the additional auditor at the planning, cross-review and reporting stages of an audit, as well as through the implications of joint and several liability in a joint audit system. Under peer review, the costs to companies come from a challenger firm effectively providing an independent review of the audit of a very large, complex entity in order to develop their capabilities.

Other key non-monetised costs by 'main affected groups'

We do not explicitly model transition costs because the literature only looks at cost increases, not their source. Instead, we use the 'high' cost estimate in the first year for each engagement as they rotate. We do this in all three scenarios to account for familiarisation costs.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Increasing the market share of challenger audit firms would increase choice and resilience in the audit market. This would help to mitigate the impact of a Big Four failure. While the probability of a Big Four firm failure is low, its potential impact would be high. Measures proposed here to increase choice and resilience in the audit market would mitigate against the impact of such a contraction in the market, should one occur, and therefore, would reduce the related cost. However a change to the composition of the market could lead to a loss in consumer surplus (from firms not having their choice of preferred auditor), and higher audit fees, in addition to costs imposed on both the regulator and Government.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- Our calculations are based on the number of UK-incorporated FTSE 350 companies in scope using 2018 audit fee and rotation year data from Audit Analytics.
- We estimate that 195 companies are in scope and that these account for 23% of FTSE 350 audit fees (pre-intervention).
- Challengers receive 30-50% of the audit fee paid for the group audit.
- Auditors rotate every ten years in accordance with the projected pipeline of upcoming auditor rotations.
- If many companies chose to instead appoint challengers as the sole auditor, costs would be lower.
- There is no cost to the regulator because no additional monitoring would be required.
- Challengers may not tender for joint audits if they believe the risk posed by joint and several liability is too great.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 155.0
Costs: 31.0	**Benefits: 0**	**Net: -31.0**	

Summary: Analysis & Evidence — Market Opening option 2

Description: *Require a managed shared audit for clients having subsidiaries which make up a significant component of the audit that could be performed by a challenger firm. Progress will be reviewed after 5 - 9 years, and if found to be below the expected level, a managed market share cap, in which the regulator will identify suitable 'challenger only' audit tenders, can be introduced as a supplementary measure.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -286.8 – 292.4	High: -133.3 – 136.5	Best Estimate: -210.0 – 214.4

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1	15.8 – 16.1	**133.3 – 136.5**
High			34.6 – 35.3	**286.8 – 292.4**
Best Estimate			**25.2 – 25.7**	**210.0 – 214.4**

Description and scale of key monetised costs by 'main affected groups'

As in option 1, costs would arise from the duplication of work. Specifically, there would be additional costs associated with the challenger firm planning, reviewing and reporting the audit. However, these would be on a much smaller scale as only one party (the lead auditor) is checking the work of the other (the component auditor). Other additional costs are expected to arise from challengers investing in building capacity and capability; potential "congestion costs" during the most common year-ends for the companies in scope; and potential upward pressure on fees from supply constraints (if challengers choose not to tender). The regulator would face costs from analysing the pipeline of future audit tenders and identifying those that have suitable subsidiaries; engaging with audit committees to identify suitable subsidiaries, and with challenger firms to monitor their capability and plans for growth; managing any legal issues; and assessing compliance. In addition, in the event of legal challenge, the regulator would require legal reserves.

Other key non-monetised costs by 'main affected groups'

As in option 1, plus the cost to the audited company from identifying suitable, material, UK-incorporated subsidiaries that can be audited by the component auditor, and the cost to the component auditor from complying with AQRs.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Same as in option 1.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- Our calculations are based on the number of UK-incorporated FTSE 350 companies in scope using 2018 audit fee and rotation year data from Audit Analytics.
- For managed shared audit, we estimate that 149 companies are in scope and that these account for 50% of FTSE 350 audit fees (pre-intervention).
- For managed shared audit, challengers receive, on average, 20% of the audit fees paid for the group audit.
- For the managed market share cap, we estimate that 27 companies are in scope and that these account for 1.7% of FTSE 350 audit fees (pre-intervention).
- Auditors rotate every ten years in accordance with the projected pipeline of upcoming auditor rotations.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 114.9 – 116.5
Costs: 23.0 – 23.3	Benefits: 0	Net: -23.0 – 23.3	

Assessment of Market Opening Measures

Policy Overview

411. In their report, the CMA gave five key reasons why the audit market was not working well, three of which related to choice:

- regulatory requirements, auditor specialisation and conflicts of interest rules can restrict choice, as some auditors must exclude themselves from audit tender exercises[165];
- audit committees have a strong preference for selecting Big Four auditors in tender exercises, because they are perceived to be more experienced in complex audits[166]; and
- as a result, challenger firms have little incentive to tender or develop the capabilities required to be a credible contender in a tender exercise. In other words, challengers face the classic '*chicken and egg*' problem – they need experience to develop the capability to deliver FTSE 350 audits but must demonstrate capability before they can access opportunities to develop that experience[167].

412. As a result, there is a notable lack of resilience in the market. If, for any reason, a Big Four auditor were to exit the market, many companies would face severely constrained choice, and may not be able to conduct a competitive tender. Audit committee chairs consider a choice of three auditors to be the minimum number to ensure a competitive tender[168]. The FRC recommends the same in its Audit Tenders: Notes on Best Practice[169].

413. Against this backdrop, the CMA study proposed several options for increasing choice in the market, among which, a system of mandatory joint audit was considered the most suitable.

414. In this proposal, a Big Four and a challenger audit firm would jointly audit the client company and would both sign off the accounts. In the CMA's assessment, this system would increase the number of credible firms in the market by building the credibility and capability of challenger firms, and in so doing, remove the supply and demand-side barriers that currently prevent challenger firms from auditing large companies.

415. The CMA argued that alternatives to joint audit would fall short of achieving the desired goals:

   i. *Shared audit*: a shared audit system, wherein components of the audit are outsourced to a challenger firm, would result in the smaller firm being very clearly subsidiary to the larger firm. This would limit the extent to which challengers could develop their credibility and capability and would therefore be far less effective in delivering increased choice and resilience. It would also introduce risks to audit quality as the 'second' auditor would not sign the audit report[170].

   ii. *Traditional market share cap*: under a market share cap, the market share of the Big Four would be restricted either individually or collectively. This would increase market share for challenger firms, as challengers would be able to 'capture' the FTSE 350 audits that the Big Four cannot undertake under the cap. Such a system could, however, introduce significant risks to audit quality because it may create situations in which challengers must act as sole auditors for companies that are significantly more

[165] CMA report p84-87.
[166] CMA report, p88 para 3.134
[167] CMA report, p88.
[168] CMA report, p81, para 3.101.
[169] FRC Audit Tenders Notes on Best Practice, February 2007
[170] CMA report, page 146, para 6.3

complex or specialised than their current clients[171], and therefore require greater capability than they are currently able to deliver. There is also a significant risk that a market share cap would result in the cherry picking of audit clients by the Big Four, who would have strong incentives to shed their highest risk or lowest profit clients.

416. BEIS conducted a public consultation on the CMA's recommendations in 2019, and met with interested parties such as investors, audit firms, professional bodies and audited companies to seek views. This formed the core of our evidence base and understanding of the issues and potential remedies. There was no clear consensus on joint audit, with:

- Opposition to the proposal from the Big Four, smaller accounting firms, almost all companies, professional bodies and most trade bodies.
- Five smaller accounting firms, one company, half of the investors and some consumer advocate groups, and a trade body favoured joint audit. The largest of the smaller accounting firms noted a preference for market share caps.
- Almost all parties submitted that the joint and several liability regime would be inappropriate for joint audit as it would constrain the appetite of challengers and the Big Four to undertake joint audit on scale. However, in theory, joint and several liability could provide an incentive to both auditors to do a good job and ensures that, under joint audit, when both auditors sign an opinion that they have carried out robust checks on each other's work. On the other hand, it could also give rise to free riding by the less experienced auditor.

417. Though the responses were mixed, we recognise that all respondents had vested interests which might have influenced their stated views. We therefore considered a range of alternatives to joint audit, which we have packaged into a second option. Both options are assessed below.

Entities in scope

418. The options proposed here would apply to the UK-incorporated constituents of the FTSE 350 and their auditors.

Options considered

419. We propose two options in this section. The Government's consultation will seek views on these options.

<u>Option 1 – Joint audit and peer review of the largest FTSE 350 company audits.</u>

420. This option would require UK-incorporated FTSE 350 companies to have joint audits comprising at least one challenger firm. Both auditors will be held responsible for signing off the audit opinion. Under the UK system of joint and several liability, both auditors would therefore be liable to the risk of litigation if there was a major fault in the audit.

421. The CMA recommended several exclusions from the joint audit regime. It exempted:

- FTSE 100 companies that are particularly large or complex. The CMA implies that they envisage exemption for approximately the top 50 FTSE companies[172].

[171] CMA report, page 146, para 6.4

[172] CMA report: p.159, footnote 467.

- Companies that have very simple, single-entity accounts, such as investment trusts. These companies together make up 71 of the FTSE 350 companies[173].
- Companies that have appointed a challenger firm as their sole auditor. In 2019, 13 FTSE 350 companies were audited by a non-Big Four auditor[174].
- Companies that need an exemption on a limited basis as determined by the regulator.

422. **We estimate that 195 companies would be in scope** for joint audit, including those that are currently audited by a challenger firm. The actual number may be smaller as we have not accounted for possible behavioural effects in our estimate. For example, companies might appoint more challenger firms if they wish to avoid the higher costs of joint audit.

423. Further, the CMA recommended that the largest company audits, i.e. the top 50 by audit fee, should be subject to periodic peer review.

Option 2 (*Preferred Option)* – Managed shared audit plus managed market share cap

424. This option would require certain UK-incorporated FTSE 350 companies to have managed shared audits, in which a 'material' component of the audit is contracted to a challenger firm. In delivering this component of the audit, the challenger firm would need to provide assurance in respect of that component to the group auditor.

425. Traditional shared audit is a more established practice in the UK, with approximately 43 shared audits taking place in 2018[175]. It is more commonly used when the group auditor lacks expertise in a highly specialised sector (mining or life sciences, for example) or geographical coverage in markets where local audit firms must audit subsidiaries in that region (India or China, for example).

426. Managed shared audit builds on the basic framework of shared audit, with a specific requirement that the component auditor – the challenger audit firm – carries out a meaningful proportion of the company's audit, and expresses an audit opinion on the financial statements of the component, which would fall under the scope of the regulator's AQR activity.

427. Managed shared audit would be reviewed after 5 - 9 years, with a view to assessing whether key performance indicators (which are yet to be determined) have been met. If they have, the system of shared audit would remain in place; or if not, a managed market share cap would be activated and run in tandem, unless a different, more effective measure that addresses the objectives of the remedy is identified. For the purposes of this IA, we assume that this review would be conducted after 5 years.

428. We expect managed shared audit to be less risky for challengers than joint audit because challengers would not be subject to joint and several liability, as the group auditor – a Big Four firm – would ultimately be responsible for the audit. The component auditor would still be liable for the quality of its own work however, thereby preserving the incentive to provide a high-quality audit.

429. The key differences between joint audit and shared audit are as follows:

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[173] Audit Analytics data.

[174] FRC (2020), Key Facts and Trends in the Accountancy Profession. Available at:https://www.frc.org.uk/getattachment/0f7be411-fb89-4afc-8e8c-281529cf76fc/Key-Facts-and-Trends-2020.pdf

[175] Audit Analytics

- In a shared audit, challengers will have less responsibility for the audit because they will be delivering a smaller share of the work, on average.
- The group auditor establishes guidelines and a unified approach, which the component auditor will follow, rather than agreeing a common approach under joint audit;
- Joint audit, as specified in our model, would include more companies, but these will be smaller in size (as measured by audit fee), while shared audit would include fewer companies, some of which will be much larger (i.e. falling within the upper quartiles of the FTSE 100)

430. Under the managed market share cap, the regulator would impose a market share cap on the Big Four, but this would differ from the traditional market share cap model in the following ways:
    - The cap would be adjustable over time by the regulator, with the regulator setting the cap based on judgements about the capability of challengers to meet the requirement of upcoming audit tenders. As challengers grow in capability, the cap on Big Four audits would be progressively tightened.
    - The regulator would consult with challengers and the client companies' audit committees in assessing the measure.
    - Where the regulator determines that a forthcoming company audit could be carried out by a challenger or challengers, the Big Four auditors would be prohibited from bidding for these audits.
    - When the regulator determines that enough challengers are capable enough to be credible alternatives to the Big Four, the cap would be removed, and the market will be allowed to continue to operate normally.
    - This measure would apply to a subset of the FTSE 350, see below.

Assessment of monetised and non-monetised costs for each option

431. For each option we assess the costs to the regulator and the companies in scope. We assume that the costs to the regulator will be covered by an increase in the FRC levy. Therefore, we do not include regulator costs in our Business Impact Target (BIT) calculations.

<u>Audit cost structures</u>

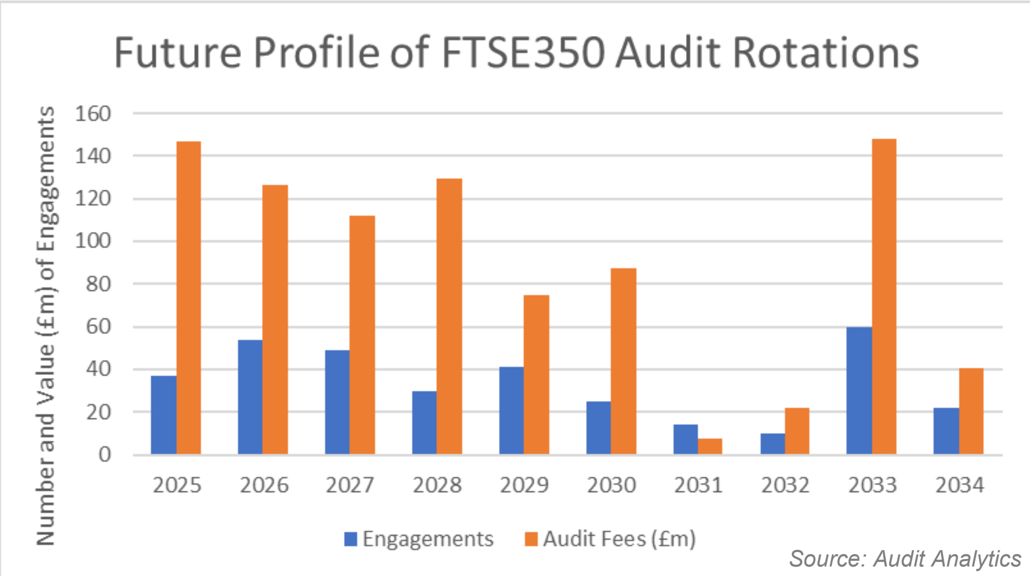
432. Based on consultation responses and discussions with auditors, we assume a simplified audit cost structure which is used to construct some estimates of costs. We assume that an audit has three phases:
    - A planning stage which accounts for, on average, 10% of all audit costs.
    - A fieldwork stage including testing and a cross review (by other auditors in the same firm) which accounts for, on average, 70% of all costs. Of this, we assume that cross review accounts for on average 20% of all audit costs; and
    - A reporting stage which accounts for on average 20% of all audit costs.

<u>Auditor rotation</u>

433. Under mandatory auditor rotation rules, companies are required to retender their audit engagement after 10 years and rotate their auditor after 20 years. In this analysis we assume that:

- Obligations on eligible companies to implement the measures assessed here are introduced in 2023.
- That the measures will apply to companies that start a new tender process after 2023, i.e. those that are close to the end of the 10-year audit engagement.
- Therefore, the measures would bite in 2025 when auditors have been selected to operate in the new regime, noting that tenders usually happen two years before the existing contract ends.

Figure 4 - Profile of Upcoming FTSE 350 Audit Rotations



<u>Option 1: Costs</u>

434. Under this option, we do not expect the regulator to face additional costs, as any monitoring of compliance would likely fall under their current monitoring function.

435. We expect that only companies in scope will face additional costs under this option. These are outlined below.

<u>Option 1: Costs to companies in scope</u>

Joint audit

436. In developing our evidence base on joint audit, we identified a range of sources on the additional costs of joint audit. These generally conclude that audit costs would be higher under joint audit, and are summarised below:

- The CMA judged, based on a literature review[176], that joint audit would lead to a 25-50% increase in audit fees[177].
- The audit firm Mazars suggested that, as a result of limited duplication of work, they would expect a 2-5%[2] increase in work, and hence costs, under joint audit[178].

[176] Ratzinger-Sakel, N. V. S., S. Audousset-Coulier, J. Kettunene, and C. Lesage (2013). Joint Audit: Issues and Challenges for Researchers and Policy-Makers, Accounting in Europe, 10(2).
[177] CMA Report, page 170, para 6.74.
[178] https://www.mazars.co.uk/Home/News-Events/Audit-Reform/Joint-Audit-in-the-UK/Joint-Audit-The-Facts

- A member of the Big Four suggested that audit costs would be substantially higher under joint audit and estimated a 60 –100% increase in costs.
- Academic studies generally suggest that joint audit costs are higher than solo audits:
  i. Francis, Richard and Vanstraelen (2009)[179] found no statistically significant difference in the audit fees paid by joint audited companies among those companies cross-listed in the US and Europe.
  ii. Lesage, Ratzinger-Sakel and Kettunen (2012)[180] found a non-significant association between audit/total fees and joint audit in Denmark, which abandoned mandatory joint audit in 2005. In addition, they compare audit fees in France and Germany. Although they find that audit fees are higher in France, they note that this cannot be attributed to joint audit alone as France has six-year fixed-term appointments and a ban on the joint provision of audit and non-audit services.
  iii. An update to the study by Lesage, Ratzinger-Sakel and Kettunen (2017)[181] found that joint audit in Denmark was associated with higher audit fees. Danish companies with joint auditors were found to have paid around 20-25% more than companies with a sole auditor. If their analysis is restricted only to changes directly experienced by companies that switched from joint to single audit, the observed increase in audit fees was between 11% and 16%.[182]
  iv. Using data on voluntary joint audits in Sweden, Zerni et al (2012)[183] found that joint audits are 13% more expensive than sole Big Four audits and 77% more expensive than sole challenger audits.
  v. André, Pong, Broye and Schatt (2016)[184] found that Big-Small joint audits in France cost 27% more than sole Big Four audits in the UK and 55% more than sole Big Four audits in Italy. Meanwhile, Big-Big joint audits in France cost 48% more than sole Big Four audits in the UK and 81% more than sole Big Four audits in Italy. Further, using matched sampling based on industry data, they found that joint audits in France with at least one Big Four auditor cost 35-70% more than equivalent British or Italian Big Four audits.
  vi. Willekens, Dekeyser and Simac (2019)[185], in a study for the European Parliament's Committee on Economic and Monetary Affairs (ECON), estimated that audit fees of non-financial PIEs appointing joint auditors were 53% higher than those that appointed sole auditors.

[179] Francis, Jere., Richard, Chrystelle. and Vanstraelen, Ann. (2009). Assessing France's Joint Audit Requirement: Are Two Heads Better than One? Auditing A Journal of Practice & Theory, 28(2).

[180] Lesage, Cédric., Ratzinger-Sakel, Nicole. and Kettunen, Jaana. (2012). Struggle over joint audit: on behalf of public interest? Comptabilités et innovation.

[181] Lesage, Cédric., Ratzinger-Sakel, Nicole. and Kettunen, Jaana. (2017) Consequences of the Abandonment of Mandatory Joint Audit: An Empirical Study of Audit Costs and Audit Quality Effects, European Accounting Review, v 26, 2017 – Issue 2.

[182] The two results are based on the analysis of two different samples and analyses. The first comes from a multivariate analysis of the full sample of firms and year observations, including those who retained joint audit after the regulatory change; fees are regressed over the presence of joint audit and several control variables. The second result measures the direct impact of switching from joint to single audit and is based on the sample of firms that actually switched.

[183] Zerni, M. (2012). Do Joint Audits Improve Audit Quality? Evidence from Voluntary Joint Audits. European Accounting Review, 21(4), 731-765.

[184] André, Paul., Pong, Christopher., Broye, Géraldine. and Schatt, Alain. (2016). Are Joint Audits Associated with Higher Audit Fees. European Accounting Review.

[185] Willekens M, S Dekeyser, I Simic (2019), EU Statutory Audit Reform, Impact on costs, concentration and competition, study requested by the ECON committee.

vii. Using evidence from the French audit market, Haak et al (2018) found that more balanced audit work allocation between joint auditors reduces audit quality and enhances the fees, when compared to an unbalanced work allocation[186].

437. One of the justifications for joint audit is that it leads to higher quality audits – for example, because of the opportunity for cross review of one auditor's work by the other (based on the idea that four eyes are better than two). If this were the case, then higher audit fees under joint audit would be offset by the benefits of the higher quality that joint audit produced. The evidence on joint audit and audit quality is, therefore, of critical importance.

438. However, there is limited empirical support for the notion that joint audit leads to increased audit quality. For example:

i. Lesage et al. (2017)[187] studied the impact of the abandonment of mandatory joint audit in Denmark in 2005. Most companies (66.6%) switched to single audit in the first year; by 2010, only 4.5% companies still had joint audit arrangements. As a proxy for audit quality, Lesage et al. (2017) use abnormal accruals. They do not find any association between joint audit and the level of abnormal accruals.

ii. Andre et al. (2016)[188] compare audit quality in France, Italy and the UK, and also use abnormal accruals as a proxy. Their results do not show any significant differences between the three countries[189]. A similar result is obtained by Lesage et al. (2011)[190], who compare matched samples of French and German companies.

iii. A positive impact of joint audit on audit quality has been observed in some voluntary joint audit settings. For example, Zerni et al. (2012)[191] observe that, in Sweden, joint audit leads to greater earning conservatism, smaller abnormal accruals and better credit ratings. Zerni et al. (2012) use a propensity score matching technique to address the endogeneity of the choice of joint audit[192]. However, such an approach can never consider all the relevant attributes for the choice of joint audit. As a result, it cannot be ruled out that the observed differences in audit quality are a result of uncontrolled differences in the characteristics of the audited companies choosing joint or single audit[193].

iv. Quick and Schmidt (2018)[194] sent questionnaires to a sample of German bank directors and institutional investors. Participants were presented with the case of a fictitious company in which a misstatement is discovered. The case is structured so that the misstatement is minor but would reduce earnings per share below the analysts' forecast, creating an incentive for the management not to correct the misstatement. Participants are asked to assess the likelihood that the auditor communicates the misstatement (a proxy for perceived auditor independence) and the most likely reported earnings per share (proxy for perceived audit quality). The results suggest that participants consider it more likely that the misstatement is reported if presented with

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[186] Haak M, M Muraz and R Ziesenis (2018), Joint Audits: Does the Allocation of Audit Work Affect Audit Quality and Audit Fees? Accounting in Europe, v 15, 2018 Issue 1.

[187] Ibid.

[188] Ibid.

[189] The authors recognise that, despite the control variables used in their analysis, it is tricky to isolate the effect of a specific factor (in this case, joint audit). In particular, their analysis does not control for the impact of auditor tenure or the potential different impacts of mandatory (as in Italy) versus voluntary auditor rotation.

[190] Lesage, C., N.V.S. Ratzinger-Sakel, and J. Kettunen (2011) Is joint audit bad or good? Efficiency perspective evidence from three European countries, CAAA Annual Conference 2012, available at SSRN:

[191] Ibid.

[192] A similar result has been found by Ittonen and Tronnes (2015), who looked at joint audits in Finland and Sweden.

[193] In addition, the impact on credit ratings can be due to a combination of better perceived quality and higher insurance value of joint audit due to the simple fact that two auditors have deeper pockets than either of them alone.

[194] Quick, R., and F. Schmidt (2018) Do audit firm rotation, auditor retention, and joint audit matter? – An experimental investigation of bank directors' and institutional investors' perceptions, Journal of Accounting Literature, 41, 1-21.

the case of single audit than in the case of joint audit, while no significant relation is observed with respect to perceived quality. The authors, however, note that the specificities of the German context may limit the validity of the results in other jurisdictions.

439. As a result of this evidence, we do not treat the additional costs of joint audit as a payment in exchange for additional audit quality. Therefore, we have developed three cost scenarios: low, central and high.

- In the low-cost case, we assume that audit costs are 10% higher under joint audit. In this scenario, the additional costs involved with joint audit are not much larger than those associated with a conventional shared audit.
- In the central cost case, we assume that audit costs are 30% higher under joint audit. This is broadly consistent with the results by Andre et al, and the upper bound of the range proposed by Lesage et al (2017). It would also be consistent with duplication of costs at the planning and cross review stages of the audit where both auditors are likely to have to work together closely to ensure that all material issues are addressed and that they both have confidence in each other's work (as both have a potential liability under joint and several liability).
- In the high cost case, we assume that audit costs are 50% higher under joint audit, consistent with Willekens et al. and the upper end of the range cited by the CMA. It is also consistent with duplication of costs at planning, cross review and reporting stages.

440. We assume that there will be some costs from auditor familiarisation. Joint audit requires two auditors to work together. Their cultures and processes are likely to differ, thus creating scope for inefficiencies and possible misunderstandings, which both auditors must work to understand. To proxy for this, we assume:

- That in the low and central cost scenarios, the costs in the first year of each audit engagement would be significantly higher. To account for this in these two scenarios, we model costs in the first year of each engagement using the cost increase from the high scenario (50%). In subsequent years, as teams would have learned to work together, we use the cost assumptions as they are set out above for each scenario.
- That in the high-cost scenario, there are no additional familiarisation costs. Additional costs in this scenario are already high and, to a certain extent, represent a situation in which cultural, institutional, and organisational differences between firms make co-operation more challenging.

441. We assume that any additional costs to the regulator from monitoring joint audit are negligible because the regulator already monitors auditors' compliance with tender rotations. Any increase in monitoring activities is likely to be small.

442. We estimate that a system of mandatory joint audit would deliver a PVC of £127.7 – £373.3m (Central Estimate £250.5.5m) over the 10-year appraisal period and an EANDCB of £29.1m.

Peer Review

443. Although excluded from the CMA's joint audit recommendation, the largest FTSE companies would be subject to a system of peer review. Based on the CMA's recommendations we assume that:

- Peer review would apply to the top 50 FTSE companies.
- Peer review is periodic, i.e. not every FTSE company is peer reviewed every year.

- It is the responsibility of the regulator to determine the number of peer reviews that would be required in any given year.
- That the peer review would be "hot" i.e. would be carried out in real time alongside the auditor's cross review; and
- That the peer review would be carried out by a challenger firm.

444. On this basis, we expect peer review to be an adjunct to the regulator's wider powers such as the Independent Review of the FRC's recommendation to require a skilled person review of a particular audit. In this sense, the peer review of an audit could be an essential part of a skilled person review. In section 9, we assume that there would be five skilled person reviews of Public Interest Entities (PIEs) per year, on average. Scaling this assumption for an audit peer review system for the largest 50 companies, we assume that there will be one peer review per year.

445. Although peer review would likely lead to additional costs for the regulator we do not include these as we assesses regulator and compliance costs related to skilled person reviews, and by extension peer reviews elsewhere in this IA (see section 9).

446. We assume that the "hot" peer review effectively requires an additional review stage by the peer reviewer in parallel with the auditor. Using our assumptions about the breakdown of costs over the duration of the audit, this implies a 20% increase in audit costs for a peer reviewed audit. These costs would be borne by the company being audited.

447. We estimate that a peer review system would deliver a PVC of £16.3m over the 10-year appraisal period and an EANDCB of £1.9m.

Option 1: Overall costs

448. Option 1 delivers a **PVC in the range of £144.0m – £389.6m (Central Estimate £266.8m) over the 10-year appraisal period** and an **EANDCB of £31.0m.**

449. At the end of the 10-year appraisal period under option 1, we estimate challenger firms could have a market share, in terms of audit fees, in the range of 8.5% - 14.2% of the FTSE 350. We provide a range because we expect challengers would receive at least 30% of the total fee per FTSE 350 audit, but could receive up to 50% (or more, though this is less likely) in a joint audit depending on the allocation of work. This market share range is purely indicative and relies on the companies we identify as in scope and the cost increases we apply.

Option 2: Costs to the regulator

450. Under this option, both the regulator and companies in scope will face additional costs. These are outlined below.

451. This option would impose additional costs on the regulator from the need to:

    - Undertake work to analyse the pipeline of future audit tenders (an average of 35 per year) and identify those that have suitable subsidiaries that challenger firms could audit while also developing their capacity and capability.
    - Engage with audit committees to identify suitable subsidiaries, and with challenger firms to monitor their capability and plans for growth.
    - Manage any civil and legal issues arising from the system; and
    - Assess compliance with the requirements of the system.

452. Based on information provided by the FRC, we would expect the full-time engagement of a team of:

- Three (3) FRC staff working on assessing tender and auditor suitability.
- Two (2) FRC staff working on managing any civil and legal issues.
- Two (2) FRC staff working on administration and data management; and
- One (1) FRC staff providing competition policy input.

453. Therefore, staff costs to the regulator are estimated to total £1.4m per year[195]. The PVC to the regulator from staff costs is estimated to be £8.9m over the 10-year appraisal period.

454. In addition, in the event of legal challenge, further costs could arise. We model this by assuming five challenges over the 10-year period at £1m per case for managed shared audit only. If the managed market share cap is activated, we expect this cost to increase to £1.5m per case. On this basis, we estimate that possible costs from legal challenge could impose a PVC of £3.3m-£5.0 on the regulator over the 10-year appraisal period.

455. Under this option, component auditors would be subject to the regulator's AQR review. However, at this stage, we do not estimate these costs, as we believe they would not be additional. This is because existing AQRs of group auditors could become less burdensome if there are fewer subsidiaries to review.

456. **The total PVC to the regulator is therefore £12.2m - £13.9 for option 2**.

<u>Option 2: Costs to companies in scope</u>

Managed shared audit

457. We have identified three main drivers of cost to companies from managed shared audit:
    - The cost to the group auditor and component auditor from planning how the component auditor will carry out and document its work. Our model assumes that planning accounts for 10%, on average, of the audit fee in a sole audit.
    - The cost to the group auditor from reviewing the work of the component auditor. Our model assumes that cross review accounts for 20%, on average, of the audit fee in a sole audit.
    - The cost to the component auditor from presenting their findings to the audit committee. Our model assumes that presenting findings at the end of an audit accounts for 20% on average of the audit fee in a sole audit.

458. We assume that the other sources of costs are negligible. These are:
    - The cost to the audited company from identifying suitable, material, UK-incorporated subsidiaries that can be audited by the component auditor.
    - The cost to the component auditor from complying with AQRs.

459. We assume that component auditors would do 20% of the work and receive an audit fee equal to approximately 20% of the engagement. In reality, the component auditors would likely do 10-30% of the audit work on each engagement (proxied by audit fee). This is because:
    - Not all companies will have enough suitable, material subsidiaries that account for 20% or more of their audit work.
    - Challenger firms may lack the capability to do 20% or more of the work on the largest and most complex audits.

[195] Costs include pension and National Insurance contributions, and costs incurred in the provision of office space (rent on desks, etc.)

- The FRC Revised Ethical Standards 2019[196] state that audit firms should not derive more than 10% of their audit income from any single engagement with a PIE or listed entity. Challenger firms risk violating this rule if they audited more than 10% of the most complex companies (assuming they had the capacity and capability to do so in the first place).

460. In the planning, cross review, and reporting stages: we assume the additional cost per phase of work is 100%, i.e. if there was one auditor working on planning in a sole audit, then there would effectively be two under shared audit.

461. In the fieldwork phase: we assume there would be no duplication during the fieldwork phase and that the component auditor's fee rates are broadly similar to the Big Four auditor's fee rates.

462. Therefore, the additional costs are estimated by:

*Percentage of work carried out by junior auditor * the share of audit costs accounted by planning, cross review and reporting * the additional cost per phase of work.*

i.e. 20% * 50% * 100% = 10%

463. For the purposes of our analysis, we use a cost range of 5%- 15% of the audit fee[197]**.** In the low and central scenarios, we use the higher estimate of costs in the first year of each engagement to account for familiarisation.

464. In total, we expect **149 companies to be in scope** across the FTSE 350 based on analysis developed by BEIS and the FRC. This is a working assumption for modelling purposes only, the actual number will depend on the exact criteria used by the regulator to identify eligible companies and subsidiaries.

    - Of these we identified 46 FTSE 100 companies who have suitable, material, UK-incorporated subsidiaries that a challenger firm could comfortably audit. **For managed shared audit applied to the FTSE 100**, **we estimate a PVC in the range of £100.1m - £228.0m (Central Estimate £164.1m) over the 10-year appraisal period** and an **EANDCB of £19.1m**. At the end of the 10-year appraisal period, we estimate challenger firms could have a market share, in terms of audit fee income, of 10.1% for the FTSE 100.
    - We estimate that there are 103 FTSE 250 companies who have suitable, material, UK-incorporated subsidiaries that a challenger firm could comfortably audit. **For managed shared audit applied to the FTSE 250, we estimate a PVC in the range of £20.9m - £46.5m (Central Estimate £33.7m) over the 10-year appraisal period** and an **EANDCB of £3.9m**. At the end of the 10-year appraisal period, we estimate challenger firms could have a market share, in terms of audit fee income, of 7.9% for the FTSE 250.

465. These estimates are the lower bound of costs from this option, since in the event that the 5-year review shows underperformance, managed shared audit will be supplemented with the managed market share cap, which we assess below.

Managed market share cap

466. For the purposes of this assessment, we assume that if deemed necessary, a managed market share cap will be introduced in the sixth year of implementation (immediately following the review of progress after 5 years). Therefore, once this measure is applied, additional costs will apply from year 6 of implementation onwards.

[196] Para 4.23

[197] This is consistent with evidence that a Big Four firm provided in its response to the BEIS consultation. They estimated that the costs of shared audit would be between 0-10% of current audit fees. However, managed shared audit would involve additional work because the component auditor would rotate around the business, be subject to AQRs and present their findings to the audit committee.

467. A traditional market share cap would take the form of a maximum limit for the FTSE 350 audits undertaken by one of more audit firms. For example, a 20% market share could be applied to each of the Big Four firms so that individually, they could only take on 20% of audits (proxied by either fees or engagements). Collectively, this would give the Big Four 80% of audits and make the remaining 20% available to challenger firms.

468. A managed market share cap differs from the traditional model, in that it is not set at a specific level. It is instead adjusted over time, so that challenger firms are given the opportunity to develop the capacity and capability to take on increasingly complex audits.

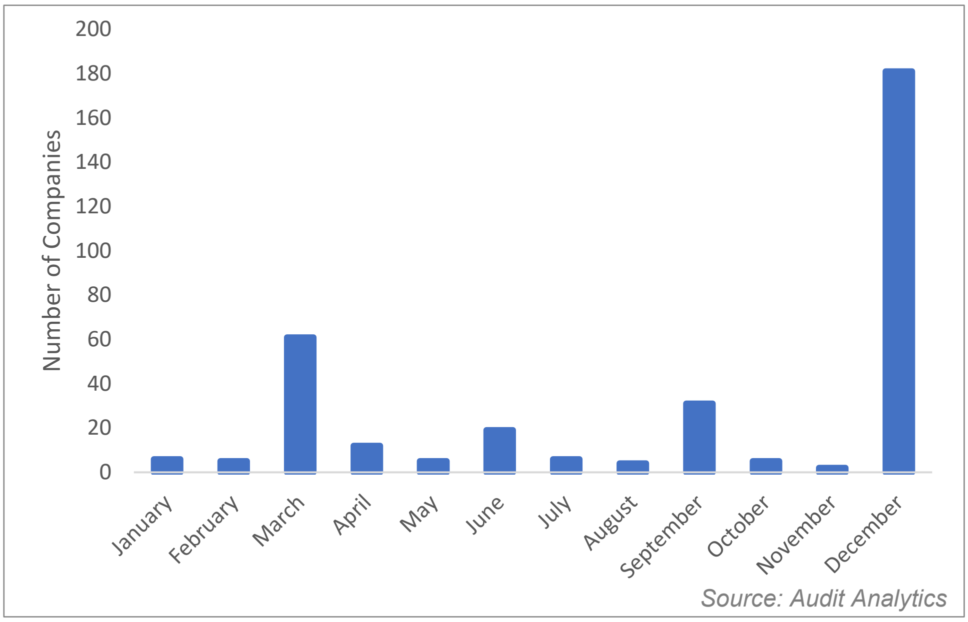
469. Our analysis is informed by the following assumptions and observations:

- A traditional market share cap, if applied to the stock of all audits at a given time (as measured by audit fees), would likely lead to large audit price increases as audit firms would raise prices to bring themselves into conformity with the cap, perhaps by cherry-picking smaller or less risky clients[198].
- If the traditional market share cap applied to the flow of new audit engagements at the point of mandatory retendering, then Big Four firms that were already exceeding their cap would be unable to bid, reducing the choice for auditees and allowing other Big Four firms – who were below their cap – to charge higher audit fees.
- Setting a traditional market share cap based on engagements could leave challenger firms with the least expensive audits at the bottom end of the FTSE 350, which would reinforce the notion that only the Big Four could audit the largest and most complex companies. Meanwhile, setting a traditional market share cap based on audit fees would be difficult as audit fees change over time as companies expand and contract.
- The proposed managed market share cap would have the following significant differences from the traditional market share cap:
    - *i.* Firstly, there would be no fixed market share cap, thus avoiding the risk of cherry picking by the Big Four. This is likely to lead to higher levels of audit quality than a traditional market share cap, as risky audits are less likely to be left to challenger firms.
    - *ii.* Secondly, the lack of a fixed market share cap would remove the issue of audit fees changing over time, which ordinarily makes it difficult to reinforce a hard cap and could increase the regularity of tenders or pressure to keep audit fees low at the expense of quality.
    - *iii.* Thirdly, the market share cap would be regulator-led, not market-led. In this way, the regulator would match the capacity and capability of challenger firms with the complexity of an audit client. The regulator would only allow challengers to tender for certain audits: where it considered an audit to be suitable for challengers and the challengers that tendered possessed the capacity and capability to deliver the audit.

[198] The cap is effectively a restriction to the supply of audits by the Big Four. Given the evidence that the market is segmented between those that place a high value on a Big Four audit and those that place a lower value on a Big Four audit, then price rises close to the cap are a likely response. Also, Big Four firms might cherry pick audits, dispensing with their smallest or riskiest clients.

- By having a greater role for the regulator in the matching of audits to auditors, we would expect less scope for a price response by Big Four firms, as there would be no artificial scarcity.
- However, there would still be scope for a price response by challenger firms. This would arise for three reasons:
    - *i.* Firstly, challenger firms might need to invest in capabilities to deliver audits for a wider range of FTSE 350 companies. An increase in demand for challenger audits could lead to audit fee increases due to the high investment that challenger firms would need to make.
    - *ii.* Secondly, an audit fee increase is more likely if the increase in demand occurs at a time of the year when audits are concentrated. Audits are well known to experience a year-end effect as most companies have a similar year end. *Figure 5*[199] shows that FTSE 350 year-ends are typically in December. Therefore, if challenger firms were exclusively winning audits with December year ends, they would charge more for further audits with December year ends and less for those with year ends in March (the second most popular year-end).
    - *iii.* Finally, despite the regulator's best efforts, it may not be possible, initially, to secure a wide choice of challengers for a "challenger only" audit tender. This could create upward pressure on audit fees.

Figure 5 - FTSE 350 Year Ends



470. To assess the cost impact on audit fees, we use three scenarios:

- The *low-cost scenario* assumes that the regulator can develop a field of challenger firms for future tenders and that the capability of challengers matches the needs of auditees. In this scenario there is no increase in audit fee.
- *The high cost scenario* assumes there are additional "congestion costs" and that these are broadly similar to the cost premia identified for audits that take place in the busy

[199] Fame Database

season. Hooi Ying Ng et al (2017)[200] estimate that the "busy season" audit premium is around 10% of the audit fee. We use this as our high estimate.

- The central scenario assumes an audit fee increase of 5%.

471. In the low and central scenarios, we use the higher estimate of costs in the first year of each engagement to account for familiarisation costs.

472. We assume that the cost to companies and their audit committees would be minimal as they would likely receive the same number of tenders as they do now. Any costs from additional communication with the regulator is also expected to be negligible and would only arise prior to tender, and not after the appointment.

473. To facilitate the identification and selection of "challenger only" audits, the regulator would develop a formal process for determining tender difficulty. While the regulator would consult on exactly which factors to include, it is likely to look at the sector the company operates in, the geographical spread of its operations, its legal structure and financials.

474. For now, we create an indicative scenario based on the data we have. We look at complexity proxied by the audit fee and sector, as well as the legal structure proxied by the number of subsidiaries.

475. In total, we expect **27 companies to be in scope**. This is a working assumption for modelling purposes only, the actual number will depend on the exact criteria used by the regulator to identify eligible companies.

476. We identified eligible companies in three steps. First, we removed the top 50 largest companies by audit fee. Second, we excluded companies that operate in the mining or finance sector. Third, we excluded companies with more than 100 subsidiaries. This means that the manged market share cap would be expected to, initially, match challengers to less complex audit engagements.

477. In this scenario, the managed market share cap will deliver an additional **PVC to companies in the range of £1.6m – £4.0m (Central Estimate £2.8m) over the 5 years of its application** and a **central estimate EANDCB of £0.3m.** In the low scenario, there is a positive cost, despite there being no increase in audit fee, because we assume there would be familiarisation costs in the first year of each engagement.

478. We use the central estimate of costs to determine the upper bound of costs from this option.

<u>Option 2: Overall costs</u>

479. **Overall, option 2 delivers an estimated PVC of £210.0m - £214.4m over the 10-year appraisal period** and an **EANDCB of £23.0m - £23.3m.** The range shows the costs for managed shared audit only (lower bound) and for managed shared audit with a managed market share cap (upper bound).

480. At the end of the 10-year appraisal period under option 2, we estimate challenger firms could have a market share, in terms of audit fee income, of 9.6%-12.5% for the FTSE 350. This market share is purely indicative and relies on the companies we identify as in scope and the cost increases we model.

[200] Hooi Ying Ng, Per Christen Tronnes, Leon Wong (2017), Audit Seasonality and Pricing of Audit Services: Theory and Evidence from a Meta Analysis, https://doi.org/10.1016/j.acclit.2017.11.003.

Table 41 - Summary of cost impact of options assessed

	Cost Summary – Central estimates	
	PVC, 10-yr period	**EANDCB**
Option 1	£266.8m	£31.0m
Option 2 (preferred)	£210.0m - £214.4m	£23.0m - £23.3m

Risks and uncertainties

481. The risks and uncertainties vary by option:

- For option 1 (joint audit), we have identified two main risks:
  - Joint and several liability could deter challengers from bidding for joint audit contracts due to the higher risk that large fines would pose to challenger firms on account of their smaller size. Alternatively, challengers may bid for joint audit contracts but only those for smaller, less-risky companies, which would limit the development of their capacity and capability.
  - The intervention may not lead to more choice:
    a. In the short run the measure does not create more choice. Instead of auditees selecting a Big Four they would be required to choose a Big Four/Challenger pair.
    b. Choice would only increase when the joint audit requirement is switched off, and if at least one challenger firm had developed the capabilities to be a substitute for one of the current Big Four. Otherwise, once the requirement for joint audit was turned off, most companies could switch back to having a sole Big Four auditor.
    c. Whether challengers can grow to compete with the Big Four depends on the investment strategies of challenger firms and their willingness to invest in new capabilities. However, some may opt for a lower risk path by investing enough to remain a credible joint audit partner but not enough to be a credible challenger to a Big Four[201].
    d. In other countries, requirements for joint audit have tended to be maintained for a long time before being stopped and have never led to the emergence of a credible competitor to the Big Four in large sole audits. For example, the Bank Act of Canada introduced the requirement for joint audit in 1923 and only abandoned it in 1991 after the failure of two regional banks. In France, joint audit was introduced for listed companies in 1966 and remains. In Denmark, joint audit was abandoned in 2005 after being introduced in 1930.
- For option 2 (managed shared audit), we have identified two main risks:
  - Managed shared audit could reinforce the status quo. Challenger firms would continue to remain subordinate to one of the Big Four and this would likely reinforce the demand-side barriers to challenger firm expansion. It would also place a low ceiling on the extent to which challenger firms could develop

[201] For example, Bedard et al (2014) conclude that the French experience suggests that gains in competition are of weak economic magnitude due to the bounded production capacities of non-Big Four auditors. See J Bedard, C Piot and A Schatt (2014), An Evaluation of the French Experience with Joint Auditing. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2165595

capacity and capability and would thus have a limited impact on supply side barriers to recruiting a challenger firm as a sole auditor.

  - The subsidiaries identified may not be suitable. Our estimates are based on the size of subsidiaries' group total assets or turnover relative to those of the group (See *Annex VII*). In other words, no companies have been excluded based on industry. This means banks have been included, even though they fall within one of the most complex sectors to audit. At the same time, the banking sector is also one of the most concentrated sectors for auditing and therefore most in need of change.

- For option 2 (managed market share cap), the main risk is that the regulator may struggle to identify audits that are suitable for challenger only tenders and to accurately assess the capacity of challenger firms for expansion, whilst ensuring high levels of audit quality and minimising the risk of legal challenge.
- For option 2, the pipeline of upcoming tenders poses a risk in the final years of the appraisal period. For example, in 2031 and 2032, we expect there to be much fewer audits than in the preceding years. This is especially problematic for our modelling of managed market share cap, which has few companies in scope due to the years selected. However, growth does not need to be the same every year, it is possible challengers will grow more in some years and less in others in response to audit demand.
- For options 1 and 2, we do not account for challenger-only audits. Under the two options, audits that are conducted entirely by challengers would be exempt. We do not model this in our analysis, but it is possible that companies would choose to simply have a sole challenger as their auditor, rather than two auditors under a joint or managed shared audit. This could lead to challengers developing an even larger market share than we estimate here, and could solve the issue of there being few tenders in some years for the managed market share cap.
- For both options, there is a trade-off between delivering change where it is most needed (i.e. in the FTSE 100 and most complex sectors), and preventing harm in the market – for example, from poor audit quality – by ensuring challengers are only appointed as auditors for companies that they are capable of auditing.
- In addition, both options rely on challengers actively investing in building their capacity and capability to take on the additional work allocated to challengers. For a consideration of the growth that our proposed remedies require, see *Inset 1*.
- Finally, there is a general risk that market opening measures might be limited in their intended effects due to underlying market dynamics. John Sutton suggested that in many markets, competition is influenced by fixed costs. Firms, by incurring additional fixed costs (as opposed to variable costs), can raise consumers' willingness to pay for its products, or cut their unit variable costs. This places a limit on the extent to which a fragmented industry structure can be maintained as all firms have an incentive to raise their fixed cost outlays, reduce variable costs and increase concentration[202].

  - Sirois and Simunic (2016)[203] noted that Big Four firms invest in fixed costs to increase "technology"[204]. This technology allows them to produce higher audit

[202] Sutton J (2006), Market Structure: Theory and Evidence. Available at: https://doi.org/10.1016/S1573-448X(06)03035-4

[203] Sirois L-P and D A Simunic (2016), Auditor Size and Audit Quality Revisited: The Importance of Audit Technology. 22: 111-114. doi:10.3917/cca.223.0111

[204] "Technology" in this case refers to a catch-all term to cover fixed costs which could include teams dedicated to quality assurance; investments in skills; publications issued for free to inform clients, and potential clients, of changes in audit regulation or practice. In addition, it can also include fixed investments e.g. offices to achieve a global presence to match the presence of large clients.

quality[205], as judged by the audited company, or reduce variable costs e.g. audit hours.

- Some competitors who have not invested in fixed costs to the same degree cannot compete on the same terms. Also, if audit clients are heterogeneous (i.e. they do not value the technology to the same degree), then competitors may not have a strong incentive to invest in fixed costs as they can serve those clients that place less value on technology.
- This model leads to concentration in parts of the audit market, where companies demand higher levels of quality.
- If this model of the market holds in practice, then the increase in the number of audit firms from any market opening measure could be limited, but could result in higher audit fees, since the Big Four must spread their fixed costs across fewer audit clients, or lower levels of quality as the incentive to invest in fixed costs is reduced.

Inset 1 - Modelling challenger growth

How much can we expect challengers to grow?

Under both scenarios, we expect challengers to invest in growing their capacity and capability to deliver high-quality audits to their FTSE 350 clients. To check whether our models are feasible, we looked at how much challengers grew between 2014-2018; how much we think they can reasonably grow without risking audit quality; and how much they would need to grow to meet the new demand created in our models. For this analysis, we look at the combined audit fee income of the five[206] largest challenger firms (BDO, Grant Thornton, RSM, Mazars and Crowe). From 2014 to 2018, the annual growth rate of challengers' audit fee income[207] ranged from 1-4% (See *Table 42*).

Table 42 - Audit fee growth for the five largest challengers 2014-2018

	Audit Fee (£m in 2016 prices)				
	2018	**2017**	**2016**	**2015**	**2014**
Audit Fee Income of Five Largest Challengers	£430	£426	£416	£412	£394
Annual Growth Rate	1.07%	2.39%	1.07%	4.34%	-

In developing our estimate of safe, sustainable challenger capacity growth, we considered varying estimates of achievable challenger growth: one challenger noted that it was able to achieve 13% growth in one year, and that 7% growth per year was easily sustainable; the CMA modelled 5-10% annual growth in its assessment of the joint audit remedy; and other sources suggested 2-4% per year. Recognising that not all challengers may be able to realise and sustain 5-10% growth per year, and in consultation with the FRC, we made the conservative assumption that annual capacity growth of 2-4% can be safely sustained by challenger firms.

205 In this case higher quality could be higher levels of assurance.

206 We estimate that the five largest challenger firms would operate in the FTSE 350 audit market, but more or less could choose to depending on their assessment of the costs and benefits of tendering for and auditing a FTSE 350 company.

207 FRC (2015-2019), Key Facts and Trends in the Accountancy Profession.

To take on the additional work expected to go to challengers in our models, the combined audit fee income of the five largest challengers would need to grow at an annualised rate in the range 1.7-2.7% (See *Table 43*).

Table 43 - Required annualised challenger' growth rate

	Total Challenger Annualised Growth Rate Required
Option 1 (Joint audit)	1.7%-2.7%
Option 2 (Managed shared audit plus managed market share cap)	1.9%-2.4%

Therefore, our models do not place extraordinary expectations of growth on challenger firms, but they are slightly above the growth achieved in 2016 and 2018. However, the premise for the market opening measures is that challengers are willing to grow but face barriers in the market. Hence, we are confident that they could maintain the 2-4% required under our models to achieve the increase in FTSE 350 market share of circa 10% that we model.

Summary: Analysis & Evidence — Operational Separation option 1

Description: *Require multi-disciplinary audit firms to establish separate governance arrangements for the audit practice.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -11.1

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1		
High				
Best Estimate	**0.4**		1.2	**11.1**

Description and scale of key monetised costs by 'main affected groups'

The regulator will face costs from developing standards for assessing audit quality and audit partner performance and from preparing guidance on how these standards should be adopted into firms' governance structures and appraisal systems. Audit firms will likely face costs from having to appoint a separate audit practice board at the outset, and from the ongoing work of the board.

Other key non-monetised costs by 'main affected groups'

Firms will likely face costs from having to adapt their existing internal quality control and appraisal systems, or where necessary, create new systems to comply with this measure. However, we lack sufficient information – in particular, about the scale of the changes that would be necessary – on which to model these costs.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

Having separate audit practice governance arrangements is expected to largely address the conflict between the incentives for delivering quality audits from the incentive to generate high non-audit services sales. We expect this to translate into an increase in audit quality. This would lead to more effective internal decision-making, resulting in possibly lower costs of capital for companies, and investors might experience reduced costs as a result of fewer instances of fraud and uncontrolled corporate failures. These benefits may, in turn, cascade into improvements across the wider economy.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- We assume that costs to the regulator from monitoring firms' compliance will be negligible
- We assume that some resourcing costs to firms would be negligible. This might not be the case for all firms in practice.
- We model audit board composition using information provided by firms in their 2018 transparency reports, on the basis that audit board composition and costs would reflect that of the multi-disciplinary firm.
- Our estimates are likely to be underestimates of the true costs, as we are not able to model some of the direct costs identified, as well as some potential wider costs from the unwinding of economies of scale or scope that would exist in the multi-disciplinary firm.
- As some firms are already voluntarily separating their audit and non-audit businesses, some of these costs will not be additional.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 6.3
Costs: 1.3	Benefits: 0	Net: -1.3	

Summary: Analysis & Evidence **Operational Separation option 2**

Description: *Option 1 + require multi-disciplinary audit firms to prepare separate income statements and a transfer pricing manual.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -22.6**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**0.6**		2.6	**22.6**

Description and scale of key monetised costs by 'main affected groups'

As this option builds on option 1, we expect the same costs to apply here. In addition, we expect the regulator would face costs from monitoring firm's transfer pricing arrangements. We expect this cost to be significant, as it will involve the full time engagement of two FRC staff per audit firm. Firms in scope would face costs from the preparation of income statements, and from reporting on transfer pricing arrangements to the regulator. We expect the latter to be significant in the first year and negligible in subsequent years.

Other key non-monetised costs by 'main affected groups'

In addition to non-monetised costs described under option 1, the additional reports produced by firms would need to be audited during their regular annual audit. This means additional work for auditors in covering these reports and verifying their contents, and therefore, an increase in audit fees. We have not been able to model these costs because of the variability in audit and audit fee arrangements between firms. This is something we plan to develop as we conduct further analysis.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

As this option builds on option 1, we expect the same benefits to apply here.
This option will reinforce the benefits described under option 1, as the increased transparency of the nature and performance of audit businesses (the costs of audit, how investments in audit quality flow across the firm, the pricing of audit, etc.) will strengthen the regulator's oversight of audit more broadly.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

In addition to assumptions/sensitivities/risks under option 1:

- We assume that costs to the regulator from monitoring income statements would be negligible as the activity would not add materially to ongoing monitoring activity.
- For firms' transfer pricing reporting, we assume that reporting costs from the second year onward would be negligible as transfer pricing arrangements, once set, are unlikely to change significantly from one year to the next.
- Our estimate of the additional cost of preparing income statements may underestimate the true costs because we have not been able to account for the full scale of some of the changes required

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 7.2**
Costs: 1.4	**Benefits: 0**	**Net: -1.4**	

Summary: Analysis & Evidence — Operational Separation option 3

Description: *Option 2 + require multi-disciplinary audit firms to separate the profit pools of their audit and non-audit businesses.*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: -22.6

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low		1		
High				
Best Estimate	**0.6**		2.6	**22.6**

Description and scale of key monetised costs by 'main affected groups'

As this option builds on option 2, we expect the same costs to apply here. We assessed additional costs to the regulator (from verifying the separation of firms' profit pools) and to firms (from separating their profit pools and reporting on these arrangements to the regulator) to be negligible (*see assumptions below*).

Other key non-monetised costs by 'main affected groups'

In addition to non-monetised costs described under option 2, we recognise that firms may face costs from having to develop and test new remuneration policies but lack sufficient information on which to model these costs. We plan to develop this as we conduct further analysis. Most importantly, the separation of profit pools could result in significant unintended impacts on audit quality and audit firm resilience, which would undermine the aims of an operational separation.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

As this option builds on option 2, we expect the same benefits to apply here. Additionally, the separation of profit pools would reduce the possibility of cross-subsidisation of audit by the non-audit business. This would further strengthen incentives for auditors to prioritise audit quality and be less concerned about the performance of the non-audit business.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

In addition to assumptions/sensitivities/risks under option 2:

- We assess the cost to the regulator as negligible, but it could be the case that in practice, transfer pricing reviews especially for larger firms, would require costly technical expertise in investigating how firms' profit pools are calculated, and how their audit partners are remunerated (especially since audit firms' incentive to game profit pools is likely to be higher if partners' pay depends on it.
- We assess the costs to firms as negligible, but it could be the case that in practice, firms may face significant costs from developing and testing new and modified internal accounting systems and policies.
- This level of operational separation could introduce significant wider threats to audit quality since firms would have smaller profit pools from which they could maintain their audit business, invest in quality, and absorb shocks. The exposure to varying types of risks could be significant.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 7.2
Costs: 1.4	**Benefits: 0**	**Net: -1.4**	

Assessment of operational separation of multi-disciplinary firms

Policy Overview

482. In addition to their audit businesses, the Big Four auditors are also large suppliers of non-audit services (e.g. consultancy), and therefore operate a multidisciplinary model. The CMA argued that, whilst there were restrictions on cross-selling of non-audit services by audit partners at an engagement level, there were firm-wide tensions between audit and non-audit services which affected the incentives of auditors to focus on quality. Indeed, recent UK audit reforms – including the introduction of limitations on the provision of non-audit services to audit clients[208] – recognised this issue, but residual concerns remain about the nature of firm-level incentives. The main adverse influences on auditor incentives identified were:

- Non-audit work represents a much higher proportion of revenues and profits within firms. They also found that audit partners were a minority both as a proportion of all partners (19% of total partners) and in terms of board representation. Audit partners' profit share includes profits earned by non-audit services. This incentivises audit partners to consider the whole business when performing their work. For example, they may not challenge a client's view in the last year of audit if they perceive the firm to be in a better position to win non-audit work the following year as a result of the favourable audit.
- As a result of profit sharing, the audit partners may not be incentivised to bid in an audit tender if the firm may lose lucrative non-audit services that it is either already providing to the client or can win instead of the audit work. This leads to less choice for the audit client and, potentially, a softening of competition in the market.
- Big Four firms encourage a 'one firm' culture. This is potentially detrimental to audit quality as the dominant non-audit services have a service-orientated culture, whereas audit has a public interest role that requires objectivity.
- Finally, an audit partner's expertise or existing relationships within a sector may be used in bids for non-audit services (not for the current audit client). These demands on audit partners' time potentially detract the focus from audit quality, given that this can also form part of an audit partner's appraisal.
- In addition, the CMA argued that the way costs are shared in firms with audit and non-audit practices could reduce the apparent cost of audit – the full cost of audit could, effectively, be "cross-subsidised" through access to the firm's non-audit services[209].

483. The CMA recommended that an operational separation should be put in place for the Big Four auditors, to ensure that strategic decision-making and audit partner financial incentives are aligned with the needs of the audit practice and the aim of increasing audit quality. For this assessment, we consider operational separation to involve:

- separate governance for the audit practice.
- separate accounts and transfer pricing; and
- separate profit pools for the audit and non-audit parts of the business.

484. There was no consensus among respondents to the CMA's invitation to comment on whether the issue identified was significant: some respondents agreed that audit partner incentives are

208 Amendments to the Statutory Audit Directive (EU Directive 2014/56/EU) in 2016 capped the provision of non-audit services to existing audit clients to 70% of the average of audit fees received from the client over the preceding three financial years.

209 The CMA did not find evidence of cross-subsidisation. This would be nearly impossible to find given the absence of transparent transfer pricing arrangements between the audit and non-audit businesses within multi-disciplinary firms.

misaligned; some said that the issues are mitigated by existing rules; and some thought that whilst there is a perception of conflict, it does not arise in practice.

Entities in scope

485. We assess the options proposed here as applying to audit firms with a 5% or greater share of the FTSE 350 audit market by audit fee. Currently, only the Big Four auditors meet this market share threshold.

486. Whilst challenger firms, all of which fall below this threshold, also have significant non-audit practices, and the same criticism – that their incentives to provide high quality audits may be affected adversely by the influence of the non-audit practice – could be levelled at them, we do not include them in scope of the options considered here. These firms are likely to face high costs and disruption from scaling-up to respond to the measures for market opening proposed in the consultation. Requiring an operational separation of these firms would add further costs and disruption, which would limit the extent to which they could scale up, and thereby limit the effectiveness of the market opening measures proposed. However, the Government's consultation does consider whether the remedy should be extended to include challenger firms.

Options considered

487. We propose three options for consideration. The Government's consultation will seek views on these options.

<u>Option 1 – require multi-disciplinary firms to establish separate governance arrangements for the audit practice.</u>

488. In this option, each firm would be required to appoint a separate CEO and Board for their audit practice. The board would be composed of a majority of independent non-executives answerable to investors and the regulator, and would:

- set and oversee key performance indicators in relation to audit quality standards; and
- be responsible for all remuneration and career progression decisions in the audit practice and ensure these are strongly linked to audit quality.

489. The regulator would be required to scale up two areas of activity. It would need to:

- establish principles for the objective assessment of audit quality, and to prepare and publish guidance on how these should apply to the assessment of audits and audit partner performance; and
- monitor separate governance arrangements, annual reporting by individual firms and compliance of quality control policies and audit partner appraisals with the regulatory guidance.

<u>Option 2 (*preferred option*) – in addition to the requirements under Option 1, require multi-disciplinary audit firms to prepare separate income statements and a transfer pricing manual.</u>

490. This option would be as option 1, but would also require the audit practice board to:

- prepare a separate, full income statement for submission to the regulator; and
- ensure their accounts are based on arm's length transfer pricing, and to this end, prepare and submit to the regulator a transfer pricing manual that makes clear the costs of using the firm's non-audit specialists to support work on their audit engagements, as

well as other costs for each cost category in the accounts.

491. Under this option, the regulator would, therefore, be required to increase the scope of its firm-level monitoring to include scrutiny of audit practice financial statements and transfer pricing.

Option 3 – in addition to the requirements under option 2, require Big Four firms in scope to separate the profit pools of their audit and non-audit businesses.

492. This option builds on option 2 in that it would also require the separation of firms' audit and non-audit profit pools. Under this option, audit partners would be paid from the separate, audit-only profit pool.

493. The separation of profit pools would be captured in financial statements produced to satisfy the requirements of option 2, so no additional reporting is required of firms under this option.

494. This is the most onerous of the options proposed, and in effect, creates an operational separation of the Big Four firms, as recommended by the CMA.

Assessment of monetised and non-monetised costs of each option

495. For each option, we assess the costs to the regulator and to the companies in scope. We assume that the costs to the regulator will be covered by an increase in the FRC levy. Therefore, we do not include regulator costs in our Business Impact Target (BIT) calculations. We also assume that the measures apply from 2023[210].

496. Cost estimates are summarised in *Table 44* below, and calculation tables are provided, where necessary, in *Annex VIII.* Our estimates of costs are tentative at this stage. More policy work and responses to the consultation will help us refine these, where possible.

Table 44 - Summary of cost impact of options assessed

	Cost Summary	
	PVC, 10-yr period)	**EANDCB**
Option 1	11.1m	1.3m
Option 2 *(preferred)*	22.6m	1.4m
Option 3	22.6m	1.4m

Option 1: Costs to the regulator

497. We expect the regulator to face additional costs from the need to establish principles for measuring audit quality and assessing audit partner performance; prepare and publish guidance on how these principles should be used in practice; and monitor the implementation of the above principles into the governance arrangements of individual firms and appraisal systems that link audit partner performance to remuneration.

498. For this assessment, based on information provided by the FRC, we assume that any cost arising from the monitoring of governance structures and audit partner appraisals will be negligible on the basis that:

- the additional activity involved in verifying whether a firm has in place a separate board and CEO for its audit practice is expected to be minimal; and

[210] There is still some uncertainty over the implementation time, but we use 2023 as the starting year for this assessment. The actual implementation timeline will be finalised post-consultation.

- the FRC already review audit partner appraisals, so whilst the assessment criteria will be new, the reviews themselves will not be additional to the current level of activity[211].

We therefore consider only the cost to the regulator from preparing and publishing guidance on the principles for assessing audit quality and appraising audit partner performance.

499. We have engaged with the FRC in developing our estimate of the cost of preparing and publishing guidance. Estimates suggest that this requirement will impose a one-off cost of £250k[212], that will apply in year 1 of implementation only. On this basis, the PVC to the regulator is estimated to be £0.2m over the 10-year appraisal period.

Option 1: Costs to firms in scope

500. We would expect firms in scope to face additional costs from the need to familiarise themselves with the new requirements; the appointment and ongoing remuneration of a separate CEO and board for the firm's audit practice; changes to internal quality control and appraisal systems; and the additional reporting and BAU activity of the audit practice board and CEO.

501. *Familiarisation costs:* For this assessment, we consider familiarisation costs to firms in scope to be negligible. Information provided by the FRC suggests that the FRC (the regulator) and firms are already engaged in ongoing dialogue on matters such as those assessed here, and therefore, firms will have advanced warning of any regulatory changes, and hence minimal need for additional familiarisation, after measures are brought into force.

502. *CEO recruitment and remuneration:* We also do not include recruitment and ongoing remuneration costs for the CEO of the audit practice in this assessment, as we expect that firms in scope would already have a "lead audit partner" who, broadly, functions in the capacity of audit practice CEO. We expect no change in the ongoing remuneration of this partner, and that any transitional costs incurred in formalising this role would be negligible.

503. *Audit practice board appointment and remuneration:* In estimating the appointment costs for the audit practice board, we assume that the board composition for the separate audit and non-audit businesses would reflect that of the multidisciplinary firm (i.e. a direct duplication). Based on 2018 transparency reports[213], multi-disciplinary firm's board sizes range from five Independent Non-Executive (INE) board members (at PwC) to three board members (at Deloitte, and EY). KPMG reported a board size of four members. We therefore assume that the average audit practice board would consist of four members.

504. Information provided by the FRC suggests that recruitment of such a board, via a search firm, would cost between £28k and £66k. We have taken the mid-point of this range, £47k, to be our best estimate. This figure includes conduct of the recruitment campaign, the review of applications, and other appointment costs. We consider board appointments costs to apply in the first year of implementation only.

505. In estimating annual board remuneration costs, we use the average of annual board costs provided by firms in their 2018 transparency reports for their UK firms (see *Table 45* below). These figures include the uplift paid to board chairpersons and the cost of the activities of the board (e.g. the conduct of an AGM and the preparation of an annual report).

[211] We assume that these reviews will fall within scope of the FRC's Audit Firm Monitoring and Supervision (AFMAS). More detail of AFMAS's supervision activities can be found in the FRC's draft plan and budget 2020/21.

[212] This estimate reflects the staff and other costs of preparing the guidance and engaging with stakeholders at all stages, as appropriate, to prepare, consult, communicate and embed the new guidance. We aim to capture more detail for future iterations of this IA.

[213] The FRC provided BEIS with the relevant details from these transparency reports.

Table 45 - Annual board costs for multi-disciplinary firms

Annual Board Costs		
Audit Firm	**Board Size**	**Annual Board Cost (£, 2016)**
PwC	5	500k
KPMG	4	408k
Deloitte	3	216k
EY	3	230k
Average	**4 (3.75)**	**340k**

506. In our calculations, we use a conservative estimate of £385k per firm to account for any additional fees that might be paid to board members with specific specialist functions, such as that of the Independent Remuneration Committee chair.

507. On this basis, the PVC from board appointment and remuneration over the 10-year appraisal period is estimated to be £10.9m, and the EANDCB is estimated to be £1.3m.

508. *Internal quality control and appraisal systems costs*: At this stage, we lack sufficient information – in particular, about the scale of the changes that would be necessary – on which to model costs to companies from reorganising their internal quality controls and appraisal systems, and where necessary, introducing new ones. We recognise that this could present significant costs to companies, and we will undertake further work to develop our assumptions in this area.

<u>Option 1: Overall Costs</u>

509. Option 1 **delivers an estimated PVC of £11.1m over the 10-year appraisal period** and an **EANDCB of £1.3m per year.** Due to the inability to model some of the key areas of cost mentioned above, we consider the estimates presented here to represent the lower bound. Additionally, we do not account for the potential wider costs, for example, from the unwinding of economies of scale that would exist in the multidisciplinary model. We welcome additional information to develop our assumptions in these areas.

<u>Option 2: Costs to the regulator</u>

510. In this option, in addition to the requirements under option 1, the regulator would be required to monitor whether firms in scope have prepared separate income statements for their audit and non-audit businesses; and monitor firms' transfer pricing arrangements and practices.

511. *Cost of monitoring income statements:* The regulator would be required to check that audit firms in scope have filed full income statements in respect of the activities of the audit business. We expect the additional cost of this requirement to be negligible. The additional activity required to conduct these checks could easily be included as part of the regulator's annual routine monitoring of audit firms with a negligible impact on the time, and therefore, the cost involved. We have tested this assumption with the FRC, and they have confirmed that this would be their approach in practice.

512. *Cost of monitoring firms' transfer pricing* arrangements: We expect this cost to be significant. Based on estimates provided by the FRC, we would expect monitoring of each firm's transfer pricing to require the full-time engagement of a team of two (2) FRC staff. Assuming that each staff member is employed at a cost of c.£185k[214] per year, monitoring transfer pricing arrangements would cost the regulator around £370k per firm per year.

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[214] Based on information provided by the FRC. This includes pension and National Insurance contributions, and costs incurred in the provision of office space (rent on desks, etc.).

513. The PVC to the regulator for this option is therefore estimated to be £10.0m over the 10-year assessment period. Given that transfer pricing arrangements are bespoke for each firm and could vary considerably in complexity, we recognise that annual monitoring costs could be higher than our estimates suggest, especially in the initial monitoring period.

Option 2: Costs to firms in scope

514. In addition to the requirements under option 1, firms in scope would be required to prepare full income statements in respect of the activities of their audit businesses on an annual basis; and report annually on their transfer pricing arrangements and practices.

515. *Cost of preparing full audit business income statements:* Whilst firms in scope already produce income statements in respect of their audit businesses, these do not qualify as "full" income statements for the purposes of the measure assessed here. Firms would therefore incur some additional costs from this requirement. This additional cost would be driven by the need to collect and collate additional information, and to review and amend the final statements in preparation for submission to the regulator. BEIS and FRC estimates suggest an annual cost of around £50k per firm per year on top of what they currently incur in reporting on their audit business. We recognise, however, that this is likely to be an underestimate of the true costs, as it does not include the cost of having this new information audited. We are not able to include audit costs at this stage, as audit arrangements, and hence audit costs, may vary significantly between firms, and we lack sufficient evidence on which to develop robust modelling assumptions. We intend to undertake further work to develop these as we conduct further analysis.

516. *Cost of reporting on transfer pricing arrangements:* We consider costs from reporting on transfer pricing arrangements for the first year of implementation only. Whilst firms already collect, and to some degree, report on their transfer pricing arrangements and practices, they would need to formally adopt transfer pricing policies (to include company accounting and reporting) and would need to collate new and existing information in a comprehensive report to the regulator. In estimating the cost of preparing and reviewing this report, we assume:

    i. That information collection and the preparation of the report (including initial review) would be conducted by a team comprising 2 senior managers and 6 mid-level accounting staff, each working over a 4-week period.

    ii. That final review would be carried out by the board, with each member dedicating 10 hours to reviewing and discussing the report.

    From the second year onward, we consider these reporting costs to be negligible on the basis that once transfer pricing arrangements are set, they are unlikely to change significantly from one year to the next. Therefore, firms will need only to repackage existing information and, where necessary, include incremental changes in their reports.

517. The PVC to firms in scope from this option is estimated to be £12.4m over the 10-year appraisal period and the EANDCB is estimated to be £1.4m per year.

Option 2: Overall Costs

518. **Option 2 delivers an estimated PVC of £22.6m over the 10-year appraisal period** and an **EANDCB of £1.4m per year.** We take these estimates to be lower than the true costs on the basis that we have not been able to model the full scale of some of the changes required by the measures assessed.

Option 3: Costs to the regulator

519. Building on costs under option 2, under this option, the regulator will need to verify firms' audit profit pools are calculated correctly, and that that the profit pools from which audit partners are remunerated are separate from those of the non-audit businesses in individual firms. Whilst this requirement will impose some incremental costs on the regulator, we expect these to be negligible, as the additional activity required could be delivered through their existing mechanisms for audit firm monitoring.

Option 3: Costs to firms in scope

520. Firms in scope would be required to demonstrate their use of separate, audit-only profit pools used for the remuneration of audit partners. In practice, no additional activity would be required of firms, as these arrangements would be made clear in the accounts produced to satisfy the reporting requirements under option 2. Further, for firms' internal accounting, the profit pools of the audit and non-audit businesses are already kept separate (although these are consolidated prior to remuneration calculations). Therefore, we do not consider any additional compliance costs to firms in scope from the specific requirements of this option.

Option 3: Overall Cost

521. As no additional costs are imposed on the regulator or firms in scope by the specific requirement for firms to maintain separate audit and non-audit profit pools, overall costs are the same as under option 2.

522. Option 3 **delivers an estimated PVC of £22.6m over the 10-year appraisal period** and an **EANDCB of £1.4m per year.** Here too, we consider costs to represent the lower bound, since we lack detailed information on the extent to which firms will need to change their remuneration policy and accounting practices. At the very least, there is likely to be some cost of developing and testing policies for profit pool separation that we are not able to model at this stage. We will consider these further as we develop our analysis.

523. Whilst this option appears attractive – as it delivers a more stringent version of an operational separation on a broadly similar scale of costs as the accounting separation proposed under option 2 – it could generate significant unintended consequences that would undermine the aims of an operational separation:

- All firms in scope would have a smaller profit pool through which to invest and maintain their ongoing operation. They may also lose the ability to attract and retain high-calibre audit partners. Firms may respond to these limitations by reducing expenditure on maintaining quality (for example by cutting their expenditure on the procurement of high-quality non-audit services). Moreover, smaller profit pools would also limit the extent to which firms can invest in growth and could affect how they respond to market opening measures.
- Smaller profit pools may also mean that audit firms would be less able to absorb shocks. Given their relatively small size and lower profitability, audit-only practices are likely to be less resilient and less able to absorb the potential impact of litigation or changes in the wider economy, and their audit partners are more likely to face higher costs of personal indemnity insurance.

Risks and uncertainties

524. There are several risks to the effectiveness of the measures assessed in this section.

- Firstly, given the current level of interconnectivity between audit and non-audit services across multi-disciplinary firms, it would be difficult for the firms to draw a clear line of demarcation along which the split will occur. This also complicates the process of understanding how exactly an operational separation would affect the ongoing operation of audit-only practices.
- Secondly, across the three options considered, we make broad assumptions that some cost components related to resourcing arrangements for audit-only practices would be negligible in practice. It may be the case, however, that firms would need to expend considerable resources to appoint and maintain the ongoing operation of audit-only boards, especially for challenger firms in scope.
- Thirdly, some firms have already undertaken work to separate their audit and non-audit businesses. It is therefore difficult for us to assess the extent to which costs estimated for the measures assessed here are truly additional. This also means that it would be equally difficult for us to assess the extent to which these measures deliver their expected benefits.

Section 8: Supervision of auditors and audits

Policy Overview

525. The regulator has delegated the power to professional accountancy bodies (so-called Recognised Supervisory Bodies or RSBs) to determine whether individuals and firms are eligible for appointment as a statutory auditor and register those eligible for appointment. The FRC Review was concerned that the delegation of the approval and registration of statutory auditors and audit firms conducting PIE audits leaves the regulator without sufficient power to act where systemic audit quality issues are identified.

526. In addition, the regulator is required to carry out inspections of statutory auditors of PIEs. These inspections are known as Audit Quality Reviews (AQRs). Individual AQR reports are shared with the relevant audit firms on a confidential basis before being finalised. The regulator is required to publish aggregated findings of its AQR reports but there is no requirement to publish individual AQR inspection reports. The FRC Review called for greater transparency around the results of the regulator's quality monitoring, currently reported annually, as well as putting the FRC's existing monitoring approach on a statutory footing.

527. Further, the FRC review identified a potential source of difficulty where a UK group auditor depends on the work of one or more auditors of overseas components to assess a UK entity's group accounts. A UK registered entity may have components overseas that form part of its group level financial statements and for which the component audit work was conducted overseas by component auditors. The UK regulator does not have the direct remit to inspect the audit work performed by the auditors of overseas components. It can however access overseas component working papers under RSB rules. The Government does not consider it appropriate for the regulator to rely on other bodies' rules to effectively carry out its regulatory functions.

528. The measures covered in this section are:

    a. The regulator will carry out the task of determining whether individuals and firms are eligible for appointment as statutory auditors of PIEs, rather than continuing the present delegation of this task to the RSBs. The RSBs would continue to carry out the delegated task of determining whether individuals and firms are eligible to be appointed as statutory auditors of other entities.

    b. The Government will legislate to allow un-anonymised AQR reports to be published by the regulator without the need for consent from the audit firm and audit client. The Government will put in place safeguards to prohibit the publication of commercially sensitive information about audit clients.

    c. The regulator will have powers to require a UK group auditor to provide it with access to overseas component working papers. If the regulator has concerns about a UK group's engagement with the overseas component auditors or could conclude that a material breach by the UK auditor of an audit requirement had occurred, then the regulator could act against the UK group auditor using existing powers.

529. Further, the Government will work with the FRC to determine whether any future powers are needed because of the new regulator directly approving individuals and firms as eligible to carry out PIE statutory audits.

Policy objective

530. The objective of these measures is to strengthen the regulator's capability to monitor and increase audit quality.

Description of options covered

531. In section 9 we provide different options for increasing regulator powers where options build upon each other and reflect increasing levels of policy ambition.

Monetised and non-monetised costs of each option

532. Section 9 sets out the costs of establishing the regulator and the costs to the regulator and compliance costs for business from the exercise of its powers. The powers in this section are included in those estimates, though for convenience we show estimates in *Table 46* below.

Table 46 - costs arising from supervision of auditors and audits

FRC #	Measure	Costs to the regulator		Costs to the business	
		Non-recurrent	Recurrent	Non-recurrent	Recurrent
15, 16	The regulator should approve and register audit firms carrying out PIE audits and have a range of sanctions	£1.0m	£1.2m	Those sanctioned will face costs.	
20	AQR reports should be published in full		£0.2m	Higher cost to conducting audits, but difficult to give a quantifiable estimate.	
21, 34	The international reach of the regulator should be extended	£0.2m	£2.8m		£2.5m

533. As these costs are already considered in Section 9 we do not present a separate summary sheet for these measures or provide estimates of NPV or impact on the BIT target.

Section 9: A strengthened regulator

534. This section assesses different options for the remit of the regulator. Each option groups different recommendations contained within the FRC Review and has different implications for the scale and scope of the regulator's work. Some of the FRC review recommendations have, to allow ready comparison with the Government's preferred option in the consultation document, been considered in previous and subsequent sections. The analysis in this section brings all recommendations from the Independent Review of the FRC together, and therefore provides a BIT score for the entire package.

Summary: Analysis & Evidence — New regulator option 1

Description: *Create a new statutory regulator, greater in scale than the FRC*

Price Base Year 2016	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate: -214.8**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**0.5**		24.9	**214.8**

Description and scale of key monetised costs by 'main affected groups'

There would be transition and recurring annual costs for the regulator. The costs include additional regulatory activities that will be funded either by a statutory levy or on a cost recovery basis. These costs will be passed on to business but do not count towards the BIT target. There will also be compliance costs for business in responding to the regulator, for example the costs of responding to a higher volume of corporate reporting reviews (CRR).

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

This option would bring the operations and processes of the regulator more closely in line with the public interest. It would also improve the reliability and predictability of the regulator's funding, increasing its incentive to act in the long-term public interest and improving its ability to plan. This option would also increase the scale of operations, increasing the scrutiny it can place on those involved in the production of company information.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

The estimated compliance costs, which make up 59% of the overall costs, are uncertain. However, the costs to the regulator refer primarily to an increase in the scale of regulatory activity. Since the FRC already undertakes existing activities of the same nature, costs to the regulator are less uncertain.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 77.5**
Costs: 15.5	**Benefits: 0**	**Net: -15.5**	

Summary: Analysis & Evidence — New regulator option 2

Description: *Option 1 + expand the scope of the regulator.*

Price Base Year 2016	**PV Base Year** 2017	**Time Period Years** 10	**Net Benefit (Present Value (PV)) (£m)**		
			Low:	**High:**	**Best Estimate: -378.5**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**2.7**		43.7	**378.5**

Description and scale of key monetised costs by 'main affected groups'

As in option 1, there would be costs for the regulator, which will fall on business via the levy or cost recovery. Similarly, there will be compliance costs for businesses who need to comply with expanded regulator activity. This would include the strengthened oversight and review of the actuarial profession by the statutory regulator. These costs will be greater than in option 1, since all option 1 costs would occur as well as the costs of additional activities.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

In addition to the benefits of option 1, option 2 would increase the scope of the regulator's activity, closing gaps in the regulatory framework, and applying regulatory scrutiny to more company information. The regulator would operate its own regime for registration and approval of firms conducting PIE audits from the Recognised Supervisory Bodies and take a strengthened role in reviewing the work of the actuarial profession. This was recommended by the Independent Review so that the regime can operate more in the public interest, in line with the interests of users of financial information.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Where the regulator will undertake new activities, cost estimates are uncertain. Since this option involves an increase in the scope of regulatory activity, the FRC has been required to estimate the costs of new activities. As with option 1, compliance costs, which are particularly uncertain, make up 59% of the overall costs.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m: 131.2**
Costs: 26.2	**Benefits: 0**	**Net: -26.2**	

Summary: Analysis & Evidence — New regulator option 3

Description: *Full Implementation of the Independent Review Recommendations.*

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2016	**Year** 2017	**Years** 10	**Low:**	**High:**	**Best Estimate: -599.1**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low		1		
High				
Best Estimate	**3.0**		69.3	**599.1**

Description and scale of key monetised costs by 'main affected groups'

As in the previous options, there would be additional costs for the regulator, which will fall on business via the levy or cost recovery. Similarly, there will be compliance costs for businesses who need to comply with the expanded regulator activity. The costs will be greater in this option, since all the costs in the previous options will occur, as well as the costs of additional activities.

Other key non-monetised costs by 'main affected groups'

No other sources of cost identified.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

No benefits monetised

Other key non-monetised benefits by 'main affected groups'

This option would further ensure that all relevant company information undergoes regulatory scrutiny, further reducing gaps in the regulatory framework. The enforcement powers of the regulator would increase. For example, the regulator would be given the power to direct changes to company accounts. This would strengthen the regulatory feedback loop, improving the incentives for producers of financial information to produce accurate information.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Compliance costs make up less (54%) of the overall costs than in options 1 and 2. However, the nature of regulatory activity is more different to the FRC's current activities, which makes the estimated costs to the regulator more uncertain than in options 1 and 2.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m: 196.4
Costs: 39.3	**Benefits: 0**	**Net: -39.3**	

Assessment of new regulator measures

535. This section assesses the other recommendations made by the FRC Review that are in scope of this IA (see *Annex I*), Most recommendations fall to BEIS to consider and implement, but a few are the responsibility of other Government Departments, such as recommendations on local audit, which will be considered by MHCLG. Recommendations on the actuarial profession (r74 and r75) are led by HMT but are considered as part of this impact assessment. Other recommendations are relevant to other completed reviews, such as the Brydon and CMA reviews.

Policy Overview

536. The Review recommended that the FRC be replaced by a new regulator, ARGA (the Audit, Reporting & Governance Authority) and that the new regulator should have a clear statutory base. Also, the Review recommended that the regulator should be funded by a statutory, rather than a voluntary, levy. The FRC's lack of a clear statutory base provided by Parliament is very unusual for a regulator.

537. For the purposes of this IA the recommendations have been brigaded into 3 broad sets. The first set covers:

- The administrative processes involved in establishing the new regulator (r1-6)
- The corporate governance of the new regulator (r7-14)
- Changes to the way the regulator conducts existing functions e.g. moving the Audit Firm Monitoring Approach to a statutory basis and increased resourcing of Audit Quality Reviews (r19, 22, 23, 24, 27, 31)
- Improving monitoring and dialogue (r32, 33, 43)
- Increasing accountability (r54-63)
- Reviewing resources, including the introduction of a statutory levy (r64-66, r68-70)

538. The second set includes measures that would increase the scope of the new regulator's work:

- Strengthening the regulation of audit firms (r15,16, 20)
- Extending the corporate reporting review (CRR) process to cover mainly non-audited, non-financial, parts of company annual reports and publishing CRR correspondence (r26, 29)
- Recruitment of new experts (r67)
- Moving enforcement action against accountants to a statutory basis (r35)
- More robust oversight of the accountancy profession in the public interest (r39, 40, 41)
- Developing a robust market intelligence function and powers to require rapid explanations from companies about reasonable concerns it raises (r44, 46)
- Reviewing the powers required to oversee the regulation of the actuarial profession effectively (r74)
- Consider whether the regulator is best placed to be the oversight body for actuaries (as a result of r75)

539. The third set includes measures which would extend the regulator's powers further still:

- Changing the approach to examining the quality of audit work conducted overseas (r21)
- Further measures to strengthen reporting, including the power to direct changes to accounts and strengthening qualitative regulation of investor information (r25, 30)

- Extending the regulator's international reach for enforcement (r34)
- Develop an enforcement regime for non-member directors (r36, 37, 38)
- Giving the regulator powers to commission experts to visit companies and examine any matter relating to the regulator's strategic objectives (r47-50)

540. The allocation of recommendations to each set is given in *Annex I*.

Description of options

541. We group the recommendations into 3 options:

- Option 1 contains the first set of measures that relate to the new regulator's purpose and internal operations, other than those which would significantly expand its scope. It also contains measures that would increase the scale of its work.
- Option 2 contains all measures in option 1 plus the measures in the second set, which would increase the scope of the new regulator's work.
- Option 3 contains all recommendations proposed by the Independent Review (other than those out of scope of this Impact Assessment or included in sections 1 (related to PIE definition changes) and 2 (related to the internal controls regime). **This is our preferred option**.

Assessment of monetised and non-monetised costs for each option

542. In assessing costs, we use a "do-nothing" counterfactual in which there was no Independent Review published. The FRC has already taken steps to alter its activity in response to the Independent Review; for example, the FRC's 2019/20 Budget is 11% greater than its 2018/19 outturn. Therefore, for the purpose of a do-nothing baseline, we use the FRC's activity in 2018/19, before implementation of the Independent Review began. We do not estimate the impact of recommendations that would have been implemented under the FRC's business-as-usual plans. For example, the FRC was conducting a review of the UK Stewardship Code before the Review made its recommendation that the Code should be reviewed (Rec. 42). We do not include this recommendation in scope of the analysis for this reason.

543. Estimates of costs were developed in consultation with FRC, and based on the FRC's projections from July 2020. These estimates are tentative at this stage and likely to change over time as the FRC refines the underpinning assumptions as the policy and their final plans develop. More policy work and responses to the consultation will help us to further refine our estimates for the Final Impact Assessment. One challenge is assessing how much additional work the new regulator would be taking on if its powers were extended compared to those of the FRC.

544. There are three categories of cost for each option:

   i. The first category includes the costs imposed on businesses through the levy. These do not count towards the Business Impact Target but are a cost to business. We consider only the *increase* in the levy relative to the counterfactual.

   ii. The second category includes the costs on business imposed on a cost recovery basis. For example, audit firms subject to AQR will pay for any additional inspections that the regulator undertakes. These costs also do not count towards the Business Impact Target but are a cost to business.

   iii. The third category includes the administrative burden that companies face when complying with new, or increased, regulatory powers. These do count towards the Business Impact Target.

545. In estimating these costs, we took the following approach:

- *Levy*: The FRC has provided estimates for the increase in the levy required to fund each of the new regulator's additional activities. Our default assumption is that new regulatory functions will not displace activity elsewhere, so the entire cost will be additional.
- *Recovery*: Similarly, the FRC has provided estimates for the increase in the costs of functions that operate on a cost recovery basis, such as the AQR regime.
- For our estimates of *Levy* and *Recovery* costs, we use input estimates provided by the FRC. These account for each recommendation as if they were implemented in isolation. However, in practice, the recommendations will not be implemented in isolation. We therefore expect significant synergies and economies of scale, due to savings on overhead costs, from the simultaneous implementation of multiple recommendations. To account for this, we apply a 15% discount to the input estimates provided for each recommendation. This approach was validated and approved by the FRC's finance team.
- *Regulatory*: BEIS has worked with the FRC to estimate compliance costs. Where evidence is not available for a recommendation, we have assumed that the costs of complying with regulatory activity is comparable to the costs of undertaking the additional activity to the regulator, or multiples thereof. For example, the costs of complying with a CRR investigation are assumed to be 1.5x the cost of the regulator's investigatory activities[215].
- More detail on assumptions can be found in annexes IX-XI.

546. Our estimate of levy costs by option is presented in *Table 47*. Since each option cumulatively adds to the former in terms of total regulator activity, the levy increases for each option.

Table 47 - Business costs arising from increase in levy required to deliver recommendations

	PVC, 10-yr period
Option 1	£45m
Option 2	£91m
Option 3	£113m

547. Our estimate of recovered costs by option is presented in *Table 48*. As with levy costs, recovered costs increase as each option builds on the former in terms of regulator activity.

Table 48 - Business costs arising from increase in recovered costs required to deliver recommendations

	PVC, 10-yr period
Option 1	£36m
Option 2	£62m
Option 3	£148m

[215] We assume that the magnitude of compliance costs will be comparable to the magnitude of the cost of regulator activity. This is because compliance with regulatory activity will require a similar amount of work to the regulatory activity itself and will be carried out by staff at a similar pay level. We, however, assume that companies will spend some additional time on compliance, on the assumption that it will take companies longer to respond to requests from the regulator than for the regulator to make such requests and review the company's response. Therefore, we generally use a 50% uplift to regulator costs to estimate compliance costs.

548. Our estimate of compliance costs is presented in *Table 49*. As the scale and scope of the regulator increases with each option, business compliance costs also increase with each option.

Table 49 - Business costs from complying with regulations (Best estimate)

	PVC, 10-yr period	EANDCB
Option 1	£133m	£15m
Option 2	£225m	£24m
Option 3	£338m	£34m

549. Since we are particularly uncertain about the magnitude of compliance costs, we provide a simple sensitivity analysis. If compliance costs are 50% more than estimated, the PVC and EANDCB would be as follows:

Table 50 - Business costs from complying with regulations – High estimate

	PVC, 10-yr period	EANDCB
Option 1	£200m	£23m
Option 2	£338m	£36m
Option 3	£506m	£51m

On the other hand, if compliance costs are 50% less than estimated, the PVC and EANDCB would be as follows:

Table 51 - Business costs from complying with regulations – Low estimate

	PVC, 10-yr period	EANDCB
Option 1	£67m	£8m
Option 2	£113m	£12m
Option 3	£169m	£17m

Section 10: Additional changes in the regulator’s responsibilities

This section covers the following measures:

- Stewardship and investor relations, and
- Oversight of their accountants and their professional bodies.

Stewardship and Investor relations

Policy Overview

550. The FRC Review considered that the UK Stewardship Code needed to differentiate “excellence in stewardship” and that signatories to the Code should be transparent about the activities and outcomes of their stewardship, rather than solely on their stated approach or policies.

551. The Government believes that the regulator’s work to ensure balanced, high quality and meaningful reporting needs to be complemented by informed, engaged and effective stewardship by investors. The Government therefore supports the revised UK Stewardship Code which took effect on 1st January 2020.

552. The revised UK Stewardship Code represents a significant shift and sets higher standards for stewardship by moving away from policy statements to focus on the reporting activities undertaken by signatories, and the outcomes. This addresses the Review’s recommendation in part but needs to be complemented by requiring the regulator to develop and apply a robust process for assessing the quality of signatories’ reporting against the Code.

553. The Review also recommended whether further powers are required to assess and promote compliance with the Code. Several regulators including the FCA and DWP are introducing the baseline regulatory standards for stewardship and reporting for those entities subject to FCA and DWP oversight. The Government believe that firms should be able to adapt to these changes before further powers are considered.

Policy objective

554. Stewardship by investors is intended to complement the regulator’s efforts to ensure balanced, high quality and meaningful reporting.

Description of options covered

555. In section 9 we provide different options for increasing regulator powers where options build upon each other and reflect increasing levels of policy ambition.

Monetised and non-monetised costs of each option

556. Section 9 sets out the costs of establishing the regulator and the costs to the regulator and compliance costs for business from the exercise of its powers. The powers in this section are included in those estimates, though for convenience we show estimates in *Table 52* below.

Table 52 - Cost estimates

FRC #	Measure	Costs to the regulator		Costs to the business	
		Non-recurrent	Recurrent	Non-recurrent	Recurrent
42	Revised UK Stewardship Code	Already in place			
43	Regulator should engage in deeper dialogue with UK investors	£0.1m			

557. As these costs are already considered in Section 9, we do not present a separate summary sheet for these measures or provide estimates of NPV or impact on the BIT target.

Oversight of accountants and their professional bodies, and other responsibilities

Policy Overview

558. The accounting profession in the UK largely operates on a self-regulatory basis. Although anyone can describe themselves as an accountant, the title "Chartered Accountant" is protected by the Royal Charters of the relevant professional bodies. The professional bodies can take legal action against those who use the title when not entitled; and there are various regulated activities that can only be carried out by a Chartered Accountant. The professional bodies require members to undertake training, pass exams and commit to further professional development. The bodies have their own ethical standards and disciplinary procedures.

559. The regulator has legislative powers in relation to the regulation of statutory auditors and the oversight of their supervisory bodies, but otherwise has no statutory powers in relation to accountants or their professional bodies. There are concerns that the existing self-regulatory regime does not operate completely satisfactorily, accommodating significant risks around money laundering and tax avoidance.

560. The FRC Review recommended several measures to ensure that the regulator was more effective at identifying issues of concern and could play a more forward-looking role in acting on its intelligence and concerns identified. It suggested that this could be achieved by giving the regulator a power to gather information at speed, combined with a power to investigate in greater depth where serious concerns remain. Furthermore, the Review recommended that the regulator should have the ability to publish a report of those findings and to act where necessary.

561. This section of the IA covers the following measures:

    a. That a stronger regulatory framework should be in place for the oversight of accountancy professional bodies.

    b. That regulator's oversight arrangements should be focused on matters relating to financial reporting and should work with other regulators in relation to issues which raise concerns in overlapping areas of responsibility.

    c. That the regulator should have the power to direct the professional accountancy bodies to act.

    d. The Government introduces legislation giving the regulator statutory powers to take enforcement action in relation to accountants, replacing a voluntary scheme.

    e. The regulator should develop a robust market intelligence function.

    f. The Government agrees and proposes that the regulator should have the power to require rapid explanations from PIEs where it has reasonable grounds for concern relating to PIE compliance with the corporate reporting or audit framework.

    g. The Government proposes to give the regulator a power to assess PIE's compliance with corporate reporting and audit requirements via the commissioning of an expert review; and that the regulator should have an additional power to require a company to procure additional assurance on the viability statement or any other aspect of company reports and account.

    h. The Government believes that the strategic oversight, technical standard-setting and monitoring of the actuarial profession may sit more appropriately with ARGA than the PRA.

These measures were developed in response to the FRC Review's recommendations 35, 39- 41, 44, 45, 46, 47-50 and 74-75.

562. This section does not include estimates of the impact of Sir Tony Redmond's review into public sector audit.

Policy objective

563. The Government's objective is to improve the corporate reporting undertaken by companies that are of public interest. To achieve this, it is necessary to have legal frameworks that apply to the accountants that produce corporate reports, and to give the regulator the powers it needs to monitor and enforce arrangements effectively.

Description of options considered

564. In section 9 we provide different options for increasing regulatory powers where options build upon each other and reflect increasing levels of policy ambition.

Monetised and non-monetised costs of each option

565. Section 9 sets out the costs of establishing the regulator and the costs to the regulator and compliance costs for business from the exercise of its powers. The powers in this section are included in those estimates, though for convenience we show estimates in *Table 53* below.

Table 53 - costs arising from additional changes to the regulator's responsibilities

FRC #	Measure	Costs to the regulator		Costs to the business	
		Non-recurrent	Recurrent	Non-recurrent	Recurrent
35, 39-41	Stronger enforcement powers in relation to accountancy profession	£0.3m	£0.5m	£0.1m	£1.8m
44	Market intelligence function		£0.6m		
45-50	Powers to investigate compliance with reporting and audit requirements		£1.3m	£0.6m	£3.4m
74-75	Oversight of the actuarial profession		£1.9m		£0.4m

566. As these costs are already considered in Section 9, we do not present a separate summary sheet for these measures or provide estimates of NPV or impact on the BIT target.

Benefits

567. The measures assessed in this IA aim to:

i. increase the quality of company reporting information and audit, thereby increasing confidence in the UK's regulatory framework and the operation of its markets.

ii. reform the regulator so that it sets high standards of statutory audit, corporate reporting and corporate governance, and is better able to hold to company directors and auditors to account for meeting those standards; and

iii. boost resilience and choice in the statutory audit market for the largest companies.

568. The potential benefits of pursuing these broad objectives are outlined below in general terms. In the main, the benefits we have identified are intangible, and not easily quantified. We aim to develop our approach using responses to this consultation and through wider engagement with relevant stakeholders.

Benefits of higher audit quality and a stronger regulator

569. Some measures in this IA are aimed at improving the quality of audits by, among other drivers, focusing the conduct of audit committees on the quality of auditors and the audit product they deliver, minimising auditors' incentives to compromise on audit quality to secure business for the other disciplines within their firms, and by placing more stringent audit requirements on companies. For example, the outcomes of expanding the PIE definition, set out in *Table 54* below, demonstrate how the measures applied may translate into better corporate reporting and audit quality, and ultimately, more accurate financial information.

Table 54 – Expected outcomes of expanding the scope of the PIE definition

Measure	Expected Outcome
Appointment of an audit committee	Clarity for shareholders regarding who in company management is responsible for the audit engagement. Increased investor confidence with increased audit committee independence.
Non-Financial Reporting Directive requirements	Allows investors to better assess financial, operational, and reputational risks. Increased investor confidence.
Regulatory reporting requirements	Increased transparency of audit firms, their activities, and the revenues they collect.
Additional audit committee report	The auditor's report to the audit committee will provide some assurance to the shareholders of the focus of the auditor-company relationship on shareholder's interests and will allow for greater accountability of the audit committee.
Mandatory rotation and retendering requirements	Increased independence and scepticism, with knock-on effects on the quality of audits provided, and greater investor confidence.
Surveillance of the auditors of new PIEs	Increased confidence for investors in the regulatory framework

570. Improvements in the quality of audit and standards of corporate reporting will mean that instances of earnings management[216] or fraud, which can have damaging effects on managerial reputation

[216] The practice of deliberately manipulating financial reports to boost the presentation of a company's financial position and underlying performance. This normally takes the form of earnings inflation or "smoothing".

and company value[217], will be more likely to be detected or revealed. Since managers do not want to risk this damage, they would be less likely to engage in earnings management, and more likely to produce more accurate financial information if audit quality is perceived to be high[218]. The potential damage acts as a deterrent from the practice of earnings management and as a disciplinary tool or incentive for managers to produce accurate financial statements[219].

571. For example, evidence from the implementation of internal controls reporting requirements in the US, under the Sarbanes-Oxley Act (SOX) suggests that SOX has resulted in more accurate financial information:

- Companies subject to SOX adopt more conservative accounting practices[220] and their accounts allow better prediction of future financial performance[221].
- Adverse auditor attestations have declined.
- Two studies estimate that SOX has decreased accounting fraud by 7%[222] or up to 10%[223] respectively.

572. And there is evidence that these effects are due to the importance of internal controls:

- The disclosure of internal controls weaknesses is associated with poorly performing accruals and more restatements[224].
- Investors react negatively to such disclosures[225].

573. Measures to improve the operation of the regulator also aim to improve standards of company reporting and corporate governance, as they would:

a) Increase the scale and legal force of the activity of the regulator. They would:
   i. Bring the operations and processes of the regulator more in line with the public interest, specifically the interests of users of financial information.
   ii. Enable the regulator to be more effective by putting more functions on a statutory footing, thereby strengthening its ability to set standards, monitor implementation of those standards and take remedial action in the event that standards have been inadequately applied.
   iii. Improve the reliability and predictability of the regulator's funding, increasing its incentive to act in the long-term public interest and improving its ability to plan.
   iv. Increase the scale of existing FRC operations, increasing the scrutiny it can place on Regulated entities.

b) Increase the scope of the regulator's activity:
   i. For example, the regulator's CRR work would cover the whole annual report. This would close gaps in the regulatory framework, ensuring that more company information receives regulatory oversight.
   ii. The regulator would operate its own regime for the registration and approval of firms conducting PIE audits. Currently full responsibility for this lies with the RSBs; this change would bring this activity more in line with the public interest.

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217 For example, Dechow et al (1996) noted that stock prices fall by 9% on average after earnings management is revealed. (https://doi.org/10.1111/j.1911-3846.1996.tb00489.x)

218 Becker et al (1998): https://doi.org/10.1111/j.1911-3846.1998.tb00547.x; Teoh & Wong (1993): https://www.jstor.org/stable/248405

219 Dechow et al (1996): https://doi.org/10.1111/j.1911-3846.1996.tb00489.x)

220 Iliev (2010): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=983772

221 Arping & Sautner (2013): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1561619

222 Chen (2014): https://urresearch.rochester.edu/fileDownloadForInstitutionalItem.action?itemId=29158&itemFileId=151215

223 Coates (2015): https://www.yalelawjournal.org/article/cost-benefit-analysis-of-financial-regulation

224 Coates & Srinivasan (2014): https://dash.harvard.edu/bitstream/handle/1/12175242/srinivasan_suraj_j2_soxaftertenyears-amultidisciplinaryreview.pdf?sequence=1

225 Ibid

iii. It would more effectively regulate the actuarial profession.

c) Help to ensure that all relevant company information undergoes regulatory scrutiny:
   i. For example, the regulator would conduct examinations of overseas audit components and would take enforcement action against directors who are not members of accountancy bodies. This would close gaps in the regulatory framework.
   ii. The enforcement powers of the regulator would increase. For example, the regulator would be given the power to direct changes to company accounts. This would strengthen the regulatory feedback loop, improving the incentives for producers of financial information to produce accurate information.

574. More accurate financial information, in turn, can deliver benefits through four different channels:

- *a decrease in the cost of capital for companies seeking to invest*: If investors are not confident in the accuracy of companies' financial statements, they may demand a higher return on investment to account for increased risk and/or any precautionary costs incurred by them[226]. Therefore, by increasing investors' confidence in financial information, these measures may decrease the cost of capital for companies[227]. Although investors largely have confidence in the UK financial auditing and reporting standards, the UK's position in the World Economic Forum's Global Competitiveness Index indicates that potential improvements can be made[228].

- *improvement of the allocative efficiency of investment across companies*: Improved financial reporting quality, which leads to lower risk premia or a more targeted risk premium, may drive greater investment efficiency by improving the allocation of investment across companies. Improved financial reporting quality can reduce both over-and under-investment by decreasing frictions such as moral hazard and adverse selection[229]. By reducing such market failures, economic output may increase.

- *a decrease in the expected cost of corporate failures*: Large corporate failures can generate significant first-order costs – for example, Carillion's insolvency cost the UK Government £148m[230]; and also large second-order market-wide impacts – the 2001 collapse of Enron, for example, took approximately 0.34% ($35bn) off US GDP in the first year following the collapse[231]. Poor financial reporting quality is often associated with such large-scale corporate failures, since these companies are often found to have withheld the true scale of their financial difficulties in the period leading up to the collapse. This means that even while in distress, struggling companies can continue to receive capital and grow. However, if investors receive a more accurate picture of their financial health, they may put pressure on management to reduce risks or may show less willingness to invest, which would increase the cost of capital, and limit the potential growth of the company. While this might not prevent the collapse of struggling companies, any collapse may be smaller and more controlled than it would have otherwise been.

- *improvement of decision-making within companies*: Improved financial reporting and better audit can improve company decision-making. This can happen in two ways.

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[226] The argument here is similar to the "market for lemons" problem where if it is costly to separate good and bad risks then all participants in the market are charged a risk premium.

[227] Jia et al (2014): https://www.lsu.edu/business/accounting/files/researchseries/20141027JXZ.PDF

[228] When asked how strong financial auditing and reporting standards are in the UK, business executives gave the UK an average score of 6.0/7.0. Finland, top of the ranking, received a score of 6.6/7.0

[229] Biddle et al (2009)

[230] NAO (2018): https://www.nao.org.uk/wp-content/uploads/2018/06/Investigation-into-the-Governments-handling-of-the-collapse-of-Carillion.pdf

[231] Brookings (2002): https://www.brookings.edu/research/cooking-the-books-the-cost-to-the-economy/

Firstly, better quality reporting and audits can deliver more comprehensive corporate information and insights that were previously unavailable to management. This wider information base could inform more efficient management decisions. For example, when surveyed, around half of company managers believed that the benefits of SOX to the company are at least as great as their compliance costs[232]. Secondly, by improving the flow of information from company management to shareholders, better audit and financial information may improve the ability of shareholders to hold the management to account. This would increase the incentives for company managers to act more in the interests of the shareholders.

575. The benefit of improved company decision-making is especially pronounced in the case of financial institutions. These companies act as financial intermediaries between households, the Government and companies, across different sectors. As such, they link all market participants, and they themselves are interlinked. Therefore, if a financial institution takes on too much risk and fails, it could have severe and wide-ranging impacts on the wider economy. Hence, higher audit quality and financial reporting quality could, ultimately, help to increase the resilience of financial markets, and reduce the spread of economic shocks:

i. the threat of a robust audit may discourage executives of financial institutions from taking on excessive risk; and

ii. debt investors, like equity investors in non-financial companies, would have access to better quality information with which to hold executives of financial companies to account. They could, for example, require improvements in internal decision-making which would prevent excessive risk-taking.

In this sense, high quality financial reporting could serve as a crucial building block in the resilience of financial institutions and the resilience of financial markets more widely[233].

576. In addition to these benefits, by placing the FRC's roles and responsibilities in relation to the actuarial profession on a statutory footing, the measures relating to regulation of the actuarial profession strengthen the ability of the FRC to set binding technical standards for the actuarial profession, monitor the applications of those standards and take remedial action should those standards be breached. These actions should boost the accuracy, quality and consistency of actuarial work, whether undertaken by organisations or individuals and, therefore, the decisions taken on the basis of actuarial work by the users of that work. Ultimately, public confidence in the work of the actuarial profession and, by extension, the position of organisations reliant on actuarial work as part of their operations, should increase.

577. It is not yet possible for us to accurately quantify the benefits of these measures. It is difficult to construct a robust counterfactual to estimate the potential benefits of more accurate financial reporting, although this is something we plan to consider further as we conduct further analysis. Moreover, many of the benefits are inherently qualitative and information does not exist to quantify them. Also, our estimates of the benefits of individual measures would need to take any potential interdependencies into account to avoid, inter alia, double counting of potential benefits.

578. With these caveats stated, we do suggest an example approach that could be taken to estimate the benefits of a decreased cost of capital (see *Inset 2*), and *Figure 6* illustrates the logic model for the benefits from this package of measures, taken as a whole.

[232] Protiviti (2012): https://www.protiviti.com/sites/default/files/united_states/insights/2012-sox-compliance-survey-protiviti.pdf

[233] Sowerbutts & Zimmerman (2013): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2379363

Estimating the potential decrease in the cost of capital

Non-US companies that appoint a Big 4 auditor can expect to experience a 23-basis point decrease in the cost of equity capital (Ghoul et al., 2016) [234]. Given that the average cost of equity capital for Ghoul et al.'s sample was 1247 basis points, this represented a 2% decrease in the cost of capital.

Similarly, Pittmann et al (2004)[235] find that appointing a Big 6 auditor reduces a young firm's cost of debt by 75 basis points. Given that the average cost of debt in Pittmann et al.'s sample was 980 basis points, this represents an 8% decrease in the cost of debt.

We take this as evidence that the confidence investors have in companies' financial information can cause changes in the (weighted average) cost of capital in the order of 1%. We estimate the impact of a 1% decrease in the weighted average cost of capital.

The elasticity of output with respect to firms' cost of capital

We use a constant-elasticity-of-substitution production function to estimate the impact of a 1% decrease in the cost of capital on GDP. We use a model presented in a Bank of International Settlements paper[236], which estimates the elasticity of output with respect to firms' cost of capital as follows:

$$\epsilon = \sigma \times \frac{\alpha}{\alpha - 1}$$

where ε is the elasticity of output with respect to the cost of capital,

σ is the elasticity of substitution between capital and labour, taken to be 0.4, and

α is the output elasticity of capital, taken to be 0.3.

The above parameter values are those used in the Bank of International Settlements paper. This results in an ε of -0.17.

Estimating the increase in UK GDP

The measures included in this impact assessment primarily relate to listed companies. To illustrate the potential increase in UK GDP, we assume that UK-registered groups listed on UK markets (including AIM) account for 25% of UK GDP.

Adjusting for this GDP contribution, the elasticity of national output with respect to the cost of capital for listed firms is -0.04. This implies that a 1% decrease in the cost of capital would result in a 0.04% annual increase in GDP. Applying this to UK GDP in 2018 (£2.0tr[237]), a 1% decrease in the cost of capital would have resulted in an increase in GDP of £860m.

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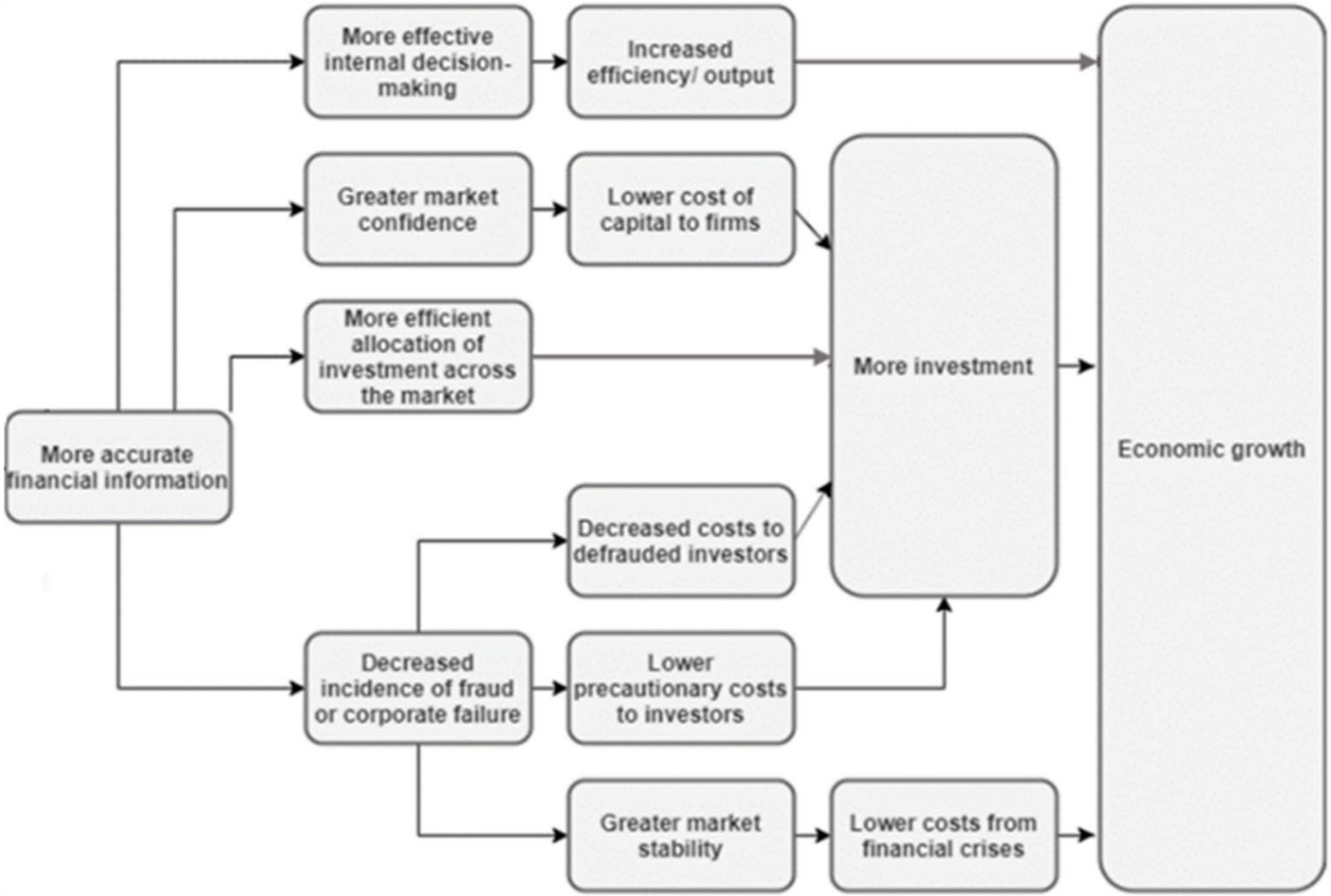
[234] Ghoul et al (2016): http://dx.doi.org/10.1016/j.aos.2016.03.002

[235] Pittmann et al (2004): https://www.sciencedirect.com/science/article/abs/pii/S0165410103000764

[236] Schanz et al (2015): https://www.bis.org/publ/bppdf/bispap60j.pdf

[237] ONS(2019): https://www.ons.gov.uk/economy/grossdomesticproductgdp

Figure 6 - Logic model for benefits arising from the proposals



Benefits of improved market resilience and choice

579. In this section we estimate the impact of a reduction in choice that would arise if the Big 4 auditors contracted to a Big 3. Whilst the probability of a Big Four firm failure is low, its potential impact would be high: such a change to the composition of the market would lead to a loss in consumer surplus (from firms not having their choice of preferred auditor), and higher audit fees, in addition to costs imposed on both the regulator and Government. Measures proposed here to increase choice and resilience in the audit market would mitigate against the impact of such a contraction in the market, should one occur, and therefore, would reduce the related cost. We provide an illustrative estimate of the potential scale of avoided costs to companies below.

Potential avoided costs to companies from increased market resilience

580. We draw assumptions on the probability of a Big Four firm failure to determine the expected cost. However, we recognise that the probability of such a failure, and its timing, cannot be predicted with any certainty, and note that the avoided costs estimated here are meant to be illustrative of the scale of costs companies may otherwise face[238].

581. To estimate the impact of a Big Four failure on FTSE 350 audit clients:

- We use estimates for the annual loss to client companies as developed by Gerakos and Syverson[239], with adjustments appropriate for the UK market (See *Annex XII)*. We make the broad assumption that Gerakos and Syverson's estimates of the audit fee increases and consumer surplus losses that arise from the exit of a Big Four firm are applicable to the UK market. We consider this appropriate since the US market is like the UK market, insofar as it too is dominated by the Big Four (*Figure 7)*[240].
- They estimated a total annual loss to companies of 14-21% of the total audit fee in the market. This loss is made up of two elements: an audit fee increase driven by the reduction in the number of audit firms in the market; and a loss of consumer surplus driven by the corresponding reduction in companies' ability to choose their preferred auditor[241]. Audit fee increases could be directly observed in markets, but the loss of consumer surplus would be less obvious. Whilst some of the consumer surplus lost would be observed in market transactions – for example, through staff recruitment or variations in audit fees, it would arise mainly through unpriced activities such as companies' efforts to build relationships with new auditors and other "hassle" costs.
- We assume that the incremental probability of a Big Four exit in any given year is either 1%, 5% or 10%, and the cumulative probability reaches 10%, 50% or 100% by year 10. This exit need not be the result of a corporate failure.
- We use this probability to calculate the probability-adjusted PVC separately for the consumer loss and impact of a fee increase on companies for 10 and 30-year appraisal periods.

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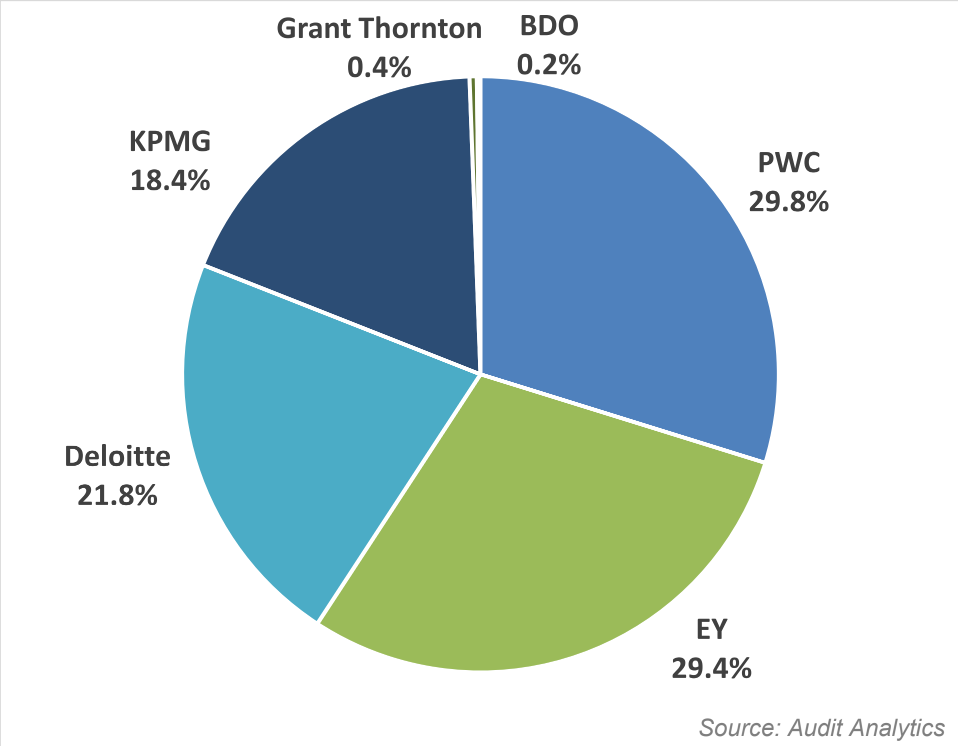
[237] A Big Four firm failure would impose some costs on the regulator, but we do not consider these in this example.

[239] Gerakos, J. and Syverson, C. (2015), Competition in the Audit Market: Policy Implications. Journal of Accounting Research, 53: 725-775. doi:10.1111/1475-679X.12087

[240] Source: https://blog.auditanalytics.com/auditor-market-share-of-the-sp-500/, accurate as of 28/02/2017

[241] We measure this as the amount of money audit clients would need to receive in order to be indifferent between being audited by their preferred auditor (that has left the market) and an the auditor that they would have had to employ as a result of the exit of their preferred choice.

Figure 7 - Auditor Market Share of the S&P 500



582. This approach resulted in an expected PVC to audited companies of £0.37 billion – £3.69 billion over a 30-year appraisal period, of which 27% is attributable to an increase in fees. Over the 10-year appraisal period, typically used for IAs, the PVC is lower – between £67m and £671m (see *Annex XII)*.

583. Because we assume that a Big Four exit would occur within a relatively short timescale, our estimates may represent an upper bound for direct audit-related costs to companies. However, as the Big Four are multidisciplinary firms, and likely to also provide some, limited non-audit services to their audit clients, the potential losses could be higher still than our estimates suggest.

584. Our example does not account for potential costs to the regulator and wider costs – such as economic costs arising from delays in company filings, and legal costs from claims against audit firms, among others – nevertheless the conclusion can be drawn that measures to increase resilience and choice in the audit market could have the potential to avoid significant future costs[242].

[242] This form of analysis provides a fair indication of the virtues of action because the estimates can be compared. However, given that it is based on limited information, other decision-making frameworks – such as least regrets analysis – may also be appropriate, especially since probabilities of Big Four failure cannot be reasonably estimated.

Wider Impacts

Statutory Equality Duties

585. We do not expect any impact on the Convention Rights of any person or class of persons arising from the measures assessed in this IA. Our view is that there would be no impact on race, disability, gender or any other protected characteristic from any of the measures in this IA. *Annex XIII* sets out our equalities impact assessment under the Public Sector Equality Duty. We would welcome views on this assessment.

Economic Impacts

Competition Impact Test

586. We do not expect a significant damaging impact on competition for the measures assessed here. Some auditors of new PIEs that do not have any current PIE clients may choose to stop auditing the new PIE rather than register as a PIE auditor if they consider the regulatory costs too great. This could increase concentration among firms providing audits to the new PIEs. However, given the number of new PIE auditors brought into scope under each option, this could be small.

587. US experience suggests that smaller audit firms may be less likely to enter the FTSE 350 audit market after the introduction of internal controls regulation. In the US one study showed that around a half of 1233 small audit firms (i.e. those with fewer than 100 SEC clients) exited the public audit market following SOX. The authors[243] conclude that PCAOB inspections under SOX improve audit quality by incentivising low quality auditors to exit the market.

588. The measures in this IA would be expected to increase choice and increase the range of auditors that would compete for FTSE 350 audits over time. Our analysis suggests that the increase in choice is likely to be accompanied by higher audit fees. For example, new entrants could require higher fees to invest in the capabilities required to be credible competitors to the Big Four and Big Four firms could require higher fees as their fixed costs are spread over fewer clients.

Small and Micro Business Assessment

589. The measures assessed here are targeted primarily at large businesses e.g. FTSE 350 or PIEs and the regulator.

    i. All options for PIE expansion relate to the treatment of "large" businesses – by market capitalisation in the case of AIM companies in scope, and by the criteria used in The Companies (Miscellaneous Reporting) Regulations 2018 in the case of large unquoted companies, and their auditors.

    ii. Most options relate to companies in the FTSE 350 – all of which are above the small and micro business thresholds.

    iii. The impact of measures to strengthen the regulator and regulatory compliance activities will largely fall on large businesses. Where costs to business apply, these are expected to be commensurate with company size and scale of operation, and therefore no disproportionate impact is expected on small and micro businesses.

590. The measures assessed here are targeted at large businesses, e.g. FTSE 350 and large auditors. We do not expect a significant impact on small and micro businesses. We recognise that:

- If challenger firms focus their efforts on securing FTSE 350 audits, they may drop some of

[243] Defond M L and C S Lennox (2011). The effects of SOX on Small Auditor Exits and Audit Quality, Journal of Accounting and Economics, vol 52, pp 21-40.

their smaller clients: and

- Some small clients may no longer be able to access integrated advice if their challenger auditor is subject to an operational separation.

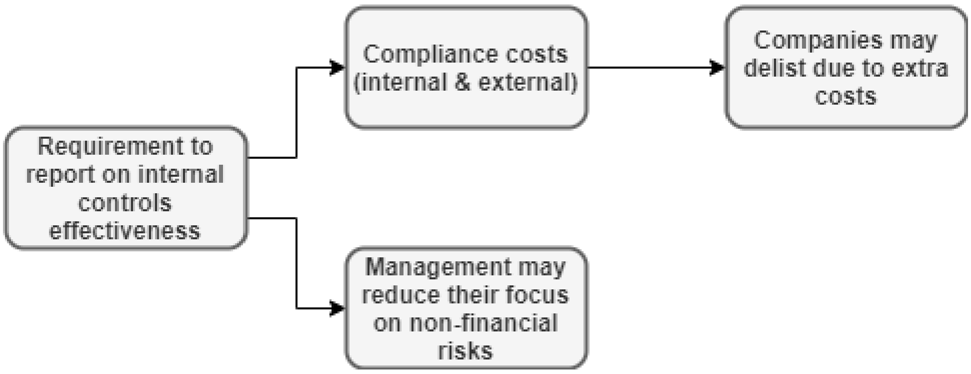
591. However, we note that there are several smaller firms that can provide audit and non-audit services to small businesses, so we do not anticipate any material disproportionate impact.

Other Impacts

592. Some indirect costs may arise, as the requirement for company management to report on internal controls effectiveness could reduce management focus on other risks (see *Figure 8)*. The current UK framework encourages a broad view of all risks (including non-financial risks). On the other hand, a SOX-style framework would necessitate a deeper focus on financial risks. However, the Government is not currently considering a reduction in requirements that relate to non-financial risks, so we expect new compliance activity to be additional to broader risk assessment, rather than a substitute.

593. The compliance costs may also reduce the incentive for companies to list on the LSE Main Market. The number of US public companies has decreased in the SOX era. However, numbers have also declined elsewhere where SOX did not apply e.g. in the UK, and it is difficult to isolate the effect of SOX itself. In their review of the evidence on SOX, Coates and Srinivasan (2014) [244] assessed that smaller, less liquid and more fraud-prone companies did exit US stock markets after the introduction of SOX – but the evidence that SOX reduced the number of IPOs is weak at best and is offset by evidence that IPO pricing improved. Interestingly most firms going private post SOX were small enough that they would never have had to comply with SOX section 404, raising a question about whether the delisting trend was a response to the introduction of SOX.

Figure 8 - Wider costs of reporting on internal controls



Environmental Impacts

594. The measures assessed in this IA present no obvious environmental concerns.

Social Impact

Health and Well-being

595. The measures assessed in this IA present no obvious direct health and well-being concerns. However, corporate and financial failures have been shown to be a risk factor for mental health

[244] J C Coates and S Srinivasan (2014), SOX after Ten Years: A Multidisciplinary Review, Accounting Horizons.

problems. If these proposals reduce the expected cost of corporate failures, there could be well-being benefits.

Human Rights

596. The measures assessed in this IA present no obvious human rights concerns.

Justice System

597. Our initial judgement is that the measures assessed in this IA require no significant changes to the justice system. Whilst some measures are aimed at increasing the stringency of criminal sanctions or civil penalties for non-compliance, these relate to enforcement regimes administered by the regulator itself and are expected to have a minimal impact on the justice system. However, at this stage, there is some uncertainty about the final package of measures, and there are potential interactions between these measures that we would not be able to assess until this is developed. Therefore, the impact of these measures on the justice system will be considered further by legal advisors when these measures are finalised, with a definitive view to be presented in a Justice Impact Test in the Final Impact Assessment (which will also consider responses to the consultation on these matters).

Local Authorities

598. Some of the measures assessed in this IA are expected to have an impact on Local Authorities (LAs) that are currently classified as PIEs. Based on the FRC's PIE population estimate as of February 2020, there are 24 LAs that are classified as PIEs by virtue of their debt listing activity. Therefore, some of the measures in this IA are likely to have an impact on their audit requirements, and on their audit costs, and we will be undertaking a new burdens assessment in consultation with the LGA and the affected LAs once the package of measures has been finalised.

Rural Proofing

599. The measures assessed in the IA present no obvious rural proofing concerns.

Monitoring and Evaluation Plan

600. The Department, working with the FRC, will monitor the outcomes of the proposed policies during, and after, the implementation process to assess whether the policies are being delivered as intended, and are working to deliver the intended outcomes. We will also continue to work with stakeholders in this area to develop our understanding of how the reforms have affected them.

601. We intend to use information collected during this phase of monitoring to inform a Post-Implementation Review (PIR) in line with statutory review requirements set out in The Small Business, Enterprise and Employment Act 2015. A full monitoring and evaluation plan will be set out in the Final Impact Assessment.

Further Plans

602. The analysis contained within this IA is tentative and will evolve as policy work continues in the light of consultation responses. We will also be carrying out further analysis to refine our estimates, especially with regards to quantifying benefits. **The Department would be grateful for any comments on this IA, including those related to assumption, sources of relevant data, and the costs and benefits that have been identified and assessed.**

Annex I: Full List of recommendations made by the Independent Review of the FRC

#	1-sentence Description	Impact Assessment Option
1	The FRC should be replaced with a new independent regulator.	1
2	The Government should issue a remit letter once per Parliament.	1
3	The regulator should be named the Audit, Reporting and Governance Authority	1
4	The regulator should have a new strategic objective.	1
5	The regulator should have statutory duties.	1
6	Regulator should have new functions.	1
7	The regulator should have a new board.	1
8	The regulator should have a smaller board.	1
9	The board should have a requisite mix of skills, experience and knowledge.	1
10	All board appointments should be public and approved by the Secretary of State for BEIS.	1
11	There should be a consistent, open, appointment process for Board, committee and senior posts.	1
12	The appointment of Chair and CEO should be subject to confirmation hearings with the BEIS Select Committee.	1
13	The sub-board structure should be reformed.	1
14	The board should exercise stronger ownership and oversight of the investigation and enforcement functions.	1
15	The approval and registration of audit firms conducting PIE audits should be reclaimed from Recognised Supervisory Bodies.	2
16	The new regime should have a range of sanctions.	2
17	Independent work should be done to explore the issues arising from the expectation gap.	*Not Included*
18	The Government should review the UK's definition of a PIE.	*Standalone treatment*
19	AFMA should be carried out on a statutory basis.	1
20	Audit quality inspection reports should be published in full.	2
21	The regulator should change its approach to overseas audit component work.	3
22	The regulator should strengthen AQR resourcing.	1
23	The regulator should be required to promote brevity in accounts and annual reports and to report once each Parliament on the statutory reporting framework.	1
24	The regulator should consider expanding the volume of CRR undertaken.	1
25	The regulator should have the power to direct changes to accounts.	3
26	CRR correspondence should be published.	2
27	CRR work should be limited to PIEs as far as possible.	1
28	The new regulator should introduce a pre-clearance procedure in advance of the publication of accounts.	3
29	CRR work should cover the entire annual report.	2
30	The Government should consider the need for strengthening qualitative regulation around investor information.	3
31	The regulator should be sparing and disciplined in the issuing of guidance.	1
32	The Government and board should monitor enforcement performance closely.	1
33	The regulator should revisit its publication policy in relation to concluded cases that result in undertakings.	1
34	The international reach of the regulator's statutory audit enforcement action should be extended.	3
35	Enforcement action against accountants in relation to apparent wrongdoing in PIEs should be undertaken on a statutory basis.	2

36	The regulator should develop an enforcement regime for non-member directors.	3
37	This regime should meet certain requirements.	3
38	The regulator should have the power to investigate directors and refer cases to Insolvency Service.	2
39	The regulator should continue in its oversight role of accountancy profession, but with a wider work programme.	2
40	The Government should put in place a backstop statutory power requiring professional body action to be taken if there was a need.	2
41	The regulator should replace letter exchanges with formal memoranda of understanding with the UK's professional accountancy bodies.	2
42	A revised stewardship code should focus on outcomes and effectiveness not on policy statements.	*Already being undertaken*
43	The regulator should engage in a deeper dialogue with UK investors.	1
44	The regulator should develop a robust market intelligence function.	2
45	The Government should introduce a duty of alert for auditors to report viability or other serious concerns.	*Not included*
46	The regulator should have the power to require rapid explanations from companies about reasonable concerns that it raises.	2
47	The regulator should have the power to commission a skilled person review.	3
48	The regulator should have the power to publish the skilled persons report if in the public interest.	3
49	The regulator should have the power to act upon the findings of such reports.	3
50	Action should flow from the skilled person report in the most serious cases.	3
51	BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK.	*Standalone treatment*
52	Viability statements should be reviewed and reformed with a view to making them substantially more effective.	*Standalone treatment*
53	The regulator should consider requiring 'graduated' audit findings.	*Not included*
54	The regulator should submit an Annual Report to Parliament.	1
55	The regulator to apply Managing Public Money; Regulators' Code; Public Contracts Regulations.	1
56	The regulator should actively promote diversity, especially in its work on corporate governance.	
57	The regulator should 'for the foreseeable future' not allow staff, board or committee members to work on any regulatory functions relating to a past employer. There should be written declarations for all staff members' conflicts of interests and financial interests to include proposed mitigations.	1
58	The regulator should establish a procurement policy that adheres to public contracting regulations, with an open tendering process.	1
59	The regulator should publish information on complaints.	1
60	The regulator should more proactively monitor trends on complaints.	1
61	The regulator should have a central complaints team.	1
62	The regulator should apply FOI in full.	1
63	The regulator should improve its information sharing and leak procedures.	1
64	The regulator should be funded by a statutory levy.	1
65	BEIS should agree a new budget consistent with the Review's recommendations.	1
66	BEIS should set the regulator's budget each year.	1

67	The regulator should recruit new experts.	2
68	Th regulator should develop a new staffing and resources strategy to achieve the vision set out in the Review.	1
69	The regulator's pay arrangement should mirror those of other financial regulators.	1
70	These pay arrangement should be set out in the new regulator's legal base, and mirror those of Ofcom.	1
71	The new regulator should be given a stronger competition duty.	*Not included*
72	The regulator should be given a specific statutory function to keep the statutory audit market review and to report regularly on market and competition developments.	*Standalone treatment (considered with market opening measures)*
73	The regulator should have the necessary powers to support a competition duty and an ongoing market review function.	*Standalone treatment (considered with market opening measures)*
74	The Government should review what powers are required to oversee effectively regulation of the actuarial profession.	*HMT-led, but included in* 2
75	The Review recommends that FRC/ARGA is not best placed to be the oversight body for actuaries.	*HMT-led, but included in* 2
76	The arrangements for local audit need to be fundamentally rethought.	*MHCLG-led*
77	Local audit oversight pocket undertaken by a separate body with deeper expertise in the local audit world.	*MHCLG-led*
78	The Government should review whether the arrangements in place for other public sector audits are genuinely robust and effective.	*DHSC-led*
79	The regulator's AQR reviews in relation to the NAO should be shared with the relevant audit committee and Parliament, and published.	*NAO-led*
80	All financial audits in scope of the NAO should be brought within the audit quality monitoring scope of the regulator.	*NAO-led*
81	The BEIS Secretary of State should reassess if the FRC remains the most appropriate body to be Independent Supervisor of Auditors General	*BEIS*
82	Responsibility for the local audit 'Code of Audit Practice' should be moved to the same body that monitors the quality of local audit work.	*MHCLG / NAO-led*
83	The FRC and Government should publish an interim implementation plan, considering which recommendations can be implemented without primary legislation.	*N/A*
X	The Government should consider whether auditors should be appointed by an independent body.	*Not included*

Annex II: Full list of recommendations made by the Independent Review into the Quality and Effectiveness of Audit

#	Para no.	Recommendation
1	3.20	That there should be an Independent Implementation Review in 2025 to report publicly on the progress made in relation to the recommendations made by each of these three Reviews [Review of the Financial Reporting Council, Review of the Statutory Audit Market, Review of the Quality and Effectiveness of Audit]
2	4.7	That the Audit, Reporting and Governance Authority (ARGA) together with auditors and the Plain English Campaign produce an appropriately concise guide to audit, explaining clearly what the different elements of an audit report mean as redefined in this Report, and what, just as importantly, they do not mean.
3	5.1.3-5.1.4	That the following statement be endorsed and adopted by ARGA and, insofar as it applies to statutory audit, the Government should consider how it may best be enshrined in the Companies Act ("CA06"): *"The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements."*
4	5.2.6	That auditing should provide information that is useful to present and potential investors, lenders, creditors and other users in making rational investment, credit and other decisions and assessments about the company.
5	5.3.2	That auditors should be free to include original information, materially useful to a wide range of users, in their audit report and at the AGM, and not be confined to commenting on that which has already been stated by directors.
6	5.3.12	Annual Report that is used in investor presentations and RNS announcements.
7	5.4.12	That ARGA determines a framework for all corporate auditing, whether of financial statements or of other information.
8	6.0.11	That ARGA acts as the midwife to create a new profession of corporate auditing, establishing the necessary professional body, to encompass today's auditors and others with appropriate education and authorisation. ARGA would be the statutory supervisory body for that profession.
9	6.0.16	That there is one encompassing descriptor with a newly minted definition - "corporate auditor".
10	6.1.2	That an auditor's authorisation to carry out audits in particular areas of activity should flow from tailored qualifications which they have achieved.
11	6.3.4	That the Principles of Corporate Auditing should be established to form an overarching framework governing the behaviour of corporate auditors, and that standards and rules should sit within this framework.
12	6.4.5	That each audit report contains a statement to the effect that in conducting the audit the auditor has acted faithfully in accordance with the Principles of Corporate Auditing.
13	6.6.2	That ARGA ensures that education, training and, if necessary, retraining, should take place consistently across this new profession.
14	6.6.14	That the development of a specific auditor qualification, including education and training, should become a high priority for ARGA over the coming years.
15	6.6.16	That ARGA develops an agreed definition of professional judgment which builds on ISA (UK) 200.
16	6.8.5	That the directors should set out in a Public Interest Statement (as part of the Strategic Report) how they view the company's legal, financial, social and environmental responsibilities to the public interest. This Statement should explain how the company has discharged its self-declared public interest obligations and responsibilities, what actions it has taken to mitigate any externalities it has caused during the period, and how effective these actions have been.
17	6.8.7	That the audit report should state the extent to which the audit has yielded sufficient evidence of consistency between the content of the Public Interest Statement and the Annual Report and Accounts as a whole. The auditor's opinion should state whether, based on the evidence reviewed, the directors' Public Interest Statement is presented fairly in all material respects

#	Para no.	Recommendation
18	8.4.3	That the audit report should include a new section in which the auditor states whether the company's section 172 statement is based on observed reality, on the basis of the auditor's knowledge of the company and its processes.
19	9.1.4	That the directors' Risk Report should be published prior to the audit committee meeting at which the scope of the next audit is determined and endorsed, leaving sufficient time for shareholders to comment. Alongside, the audit committee should publish a formal invitation to shareholders to express any requests they have regarding the areas of emphasis they wish the auditor to incorporate in the audit plan. The audit committee should state the auditor's proposed materiality levels for the forthcoming audit with this invitation.
20	9.1.6	That if the auditor considers there are other risks of similar or greater significance to those reported by the directors, based on its knowledge of the company, the auditor should report this fact.
21	9.1.11	That the audit committee and the auditor be required to publish the reasons why they accepted or rejected any such requests [for items to be included in the audit plan] in their Reports.
22	9.4.5	A change in the law to require the audit fees to be shown on the face of the profit and loss account as being struck, like the dividend, after the reporting of post-incentive compensation profit.
23	9.4.9	That the audit committee chair should be delegated to negotiate the fees for the relevant audit work. The Board, as a whole, should agree a budget for the audit committee - the assurance budget - within which the fees would be included.
24	9.4.14	That, similarly [to ratings agencies], audit firms establish an independent fee-setting function making its decisions separately from those conducting the audit.
25	9.5.6	That a standing item be added to AGM agendas: questions to the chair of the audit committee and to the auditor.
26	9.6.3	That a new body - the Audit Users Review Board - be established, comprising solely users of audit reports, to review proposals from and give advice to ARGA as to the evolution of audit.
27	10.0.3	That the audit committee publish a three-year rolling Audit and Assurance Policy which would be put to an annual advisory vote by shareholders for approval at the Annual General Meeting.
28	10.2.2	That a simple mechanism to enable the workforce to raise issues around risks and assurance should be developed in each company, so that the designated director (or other mechanism) be the recipient of those inputs. The company should then have an obligation to respond to the workforce as to the way in which it has reacted to their requests.
29	11.9	That the Companies Act and ISA (UK) 700 be amended to replace "true and fair" with "present fairly, in all material respects".
30	11.15	That auditors judge their opinion on any use or proposed use by directors of the (now) fairly presented override in the context of their obligation to be faithful to the Principles of Corporate Auditing.
31	12.4	That the Government review the Companies Act to see if it could be improved to give more clarity as to what is meant by "adequate accounting records". Given the complex requirements modern accounting creates, either through law or regulation, there should be an obligation for auditors to assess that the directors have maintained accounting records to a standard beyond the minimum level necessary for an audit to be performed. In doing so, the objective should be a High-Quality Audit as defined in this Report.
32	12.8	That ARGA promptly develop guidance for auditors around their responsibilities in relation to accounting records.
33	13.1.8	That the Government gives serious consideration to mandating a UK Internal Controls Statement consisting of a signed attestation by the CEO and CFO to the Board that an evaluation of the effectiveness of the company's internal controls over financial reporting has been completed and whether or not they were effective, as in SOX 302(c) and (d). This attestation should be received by the Board no later than 28 days before the accounts of the company for the relevant financial period are signed. The Board should then report to shareholders that it has received such an attestation.
34	13.1.11	That the Audit Committee Chairs Independent Forum (ACCIF) develops principles that should be followed by CEOs and CFOs in making an internal controls effectiveness attestation. Final endorsement of these principles should be made by ARGA.

#	Para no.	Recommendation
35	14.1.5	That ARGA amends ISA (UK) 240 to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways.
36	14.2.2	That directors should report on the actions they have taken to fulfil their obligations to prevent and detect material fraud against the background of their fraud risk assessment.
37	14.3.3	That training in both forensic accounting and fraud awareness be part of the formal qualification and continuous learning process to practise as a financial statements auditor. In developing qualifications for auditors of other areas of activity, parallel training should be established.
38	14.3.5	That the auditor's report state explicitly the work performed to conclude whether the directors' statement regarding the actions they have taken to prevent and detect material fraud is appropriate. Furthermore, the auditors should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.
39	14.4.3	That ARGA maintains an open access case study register detailing corporate frauds that have occurred in order that auditors can learn in real time from these frauds.
40	14.5.4	That ARGA establish an independent Auditor Fraud Panel to which it would refer the results of any investigations into auditor failure to detect material frauds and that such a Panel should be equipped with the ability to levy sanctions on auditors as appropriate.
41	16.4	That there should be an obligation on the auditors to report to both the audit committee and the shareholders on the extent to which their work has been influenced and informed (or not) by any external signals which might imply enhanced risk in the company whose financial statements are being audited.
42	16.7	That ARGA should develop a menu of possible signals [regarding enhanced risk] and the auditors should report against the relevant parts of that menu.
43	17.0.4	That the audit committee should describe the content of the debate [regarding differences of view between management and auditors] and its outcome, including the justification for the agreed treatment. For example, where the differences of view would have led to material changes in valuation, even when these differences have been resolved, the audit committee should report on the range of the initial views and where in that range the agreed valuation lies.
44	17.1.2	That the consequences of potential differences in treatment of goodwill and intangibles considered by management and the auditor should also be made transparent.
45	17.2.6	in their report where there is an observed disconnect between the culture of the company claimed by the directors and the behaviour observed by the auditors.
46	17.3.3	That the auditor explain in each of the two succeeding audit reports what procedures have been undertaken and what conclusions reached in relation to those matters [KAMs or identified deficiencies]; the auditor should also highlight what actions have been taken by the company in response to deficiencies identified in the prior year's audit.
47	17.5.9	That the evolution of graduated findings be left to the marketplace for audit services.
48	18.1.2	That the board should make a Resilience Statement that incorporates, enhances and builds on the [current] Going Concern and Viability Statements.
49	18.1.5	That ARGA requires auditors to report to the Board of Directors if they have encountered any information in the course of their audit which leads to an anxiety about the resilience of the business not reflected in the Resilience Statement. If they consider the Board does not pay sufficient attention to their anxieties, they should have an obligation to report to ARGA, or an alternative regulator depending on the circumstances.
50	20.1.5	That Alternative Performance Measures should be subject to audit.
51	20.2.8	That any Key Performance Indicators used for the purpose of calculating executive remuneration should be subject to audit.
52	21.5	That directors report to shareholders on their company's payment policies and performance and that this be subject to some level of audit, as described in the company's Audit and Assurance Policy.
53	22.7	That the relevant Statutory Auditor for a particular audited PIE be added to the list of Prescribed Persons under the Public Interest Disclosure Act.
54	22.9	That the protections available to employees should be extended to others with a direct economic relationship with the entities being audited. These would encompass shareholders, suppliers, customers and any other creditors. Such individuals should also be afforded protection when whistleblowing to ARGA.
55	23.0.12	That amendments are made to the Companies Act to clarify and strengthen the process by which auditors and companies inform shareholders and other stakeholders of an auditor's resignation, dismissal or decision not to participate in a retender

#	Para no.	Recommendation
56	23.1.2	That on the resignation or dismissal of its auditor the company would be required to hold a General Meeting, within 42 days of receiving the letter of resignation or sending a notice of dismissal, at which the departing auditor would be required to answer questions from shareholders; the Board would be required to explain how it proposes to appoint a new auditor and manage the transition, consistent with its Audit and Assurance Policy.
57	24.1.8	That BEIS and ARGA work with auditors to create the necessary protections and policies for audit to be able to use data from the companies they audit in order to promote better quality audits.
58	24.1.11	That, in the audit report, auditors should explain the reasons for the necessity and basis of any sampling techniques used in conducting the audit.
59	25.0.4	That s534 CA06 be explicit that a board that recommends, in good faith, the application of an LLA to its auditor is not in breach of its responsibilities.
60	25.1.3	That ARGA facilitates a structured dialogue between investors and auditors to define a liability regime that would cause fewer obstacles to a more informative audit.
61	25.2.3	That firms conducting statutory audits of Public Interest Entities should publish separated financial information, including profitability, of the audit practice and that such firms should publish a remuneration policy and the annual remuneration of each relevant Senior Statutory Auditor.
62	25.2.5	That individual statutory audit reports detail the number of hours spent in conducting the audit by grade of auditor.
63	26.3.2	That ARGA establish a formal confidential mechanism to interact with shareholders or other stakeholders to respond to concerns regarding particular audits.
64	27.1.7	That audit committee minutes be published with a time-lag of 12-18 months and with approved redactions.

Annex III: Costs related to PIE extension

Familiarisation costs to new PIEs

In estimating familiarisation costs to new PIEs brought into scope by changes in the PIE definition, we assume that all familiarisation activities will be carried out by senior officials, team managers, and administrative staff. We have drawn on assumptions in the 2016 IA to develop estimates of the number of each staff level that will need to familiarise with new requirements and the time they will require for doing so. We have estimated familiarisation costs per new PIE based on size. Details are provided in the table below.

Table 55 - Familiarisation costs to new PIEs

Familiarisation Costs for new PIEs				
		Large PIEs	**Medium PIEs**	**Small PIEs**
Senior Officials and Chief Execs	Number of Senior Officials Hours and Chief Exec hours	64	32	32
	Hourly cost of Senior Officials and Chief Execs (adjusted) (£)	71	71	71
	Cost per PIE of Senior Officials and Chief Exec time	**4.5k**	**2.3k**	**2.3k**
Managers and Directors	Number of Team Manager and Directors Hours	192	64	64
	Hourly Cost of Managers and Directors (adjusted) (£)	41	41	41
	Cost per PIE of Managers and Directors time	**7.8k**	**2.6k**	**2.6k**
Admin Staff	Number of Admin Staff Hours	1920	320	320
	Hourly Time Cost of Admin Staff (adjusted)	17	17	17
	Cost per PIE of Admin Staff time	**31.8k**	**5.3k**	**5.3k**
Total Familiarisation cost per PIE		**44.1k**	**10.2k**	**10.2k**
Calculated in accordance with the methodology outlined in Annex B of IA BIS016(F)-16-BE. Hourly cost is the 75th percentile of hourly wages in ONS ASHE 2018 table 14.5a for levels 1115, 11, and 4 for senior officials, team managers, and admin staff respectively.				

Familiarisation costs to auditors of new PIEs

In estimating familiarisation costs to the auditors of new PIEs brought into scope by changes in the PIE definition, we assume that all familiarisation activities will be carried out by audit principals and accountants in these audit firms. We have drawn on the methodology in the 2016 IA, but have updated assumptions around the number and composition of the teams that will need to familiarise themselves with the PIE audit regime. Given the specific context of the changes assessed here, we expect only the teams currently auditing the companies in scope to require some period of familiarisation, and not the entire firm (as assumed in the 2016 IA). In developing our estimates, we use the average number of new-PIE clients per audit firm brought into scope, and assume (based on information provided by the FRC) that each audit engagement (each client) will require 2 audit principals, each with a team of 8 accounting staff, and 1 non-audit principal supported by a team of 5 admin staff. Details are provided in the table below.

Table 56 - Familiarisation Costs to Auditors of New PIEs

Familiarisation Costs to Auditors of New PIEs		
Average number of new PIE clients per audit firm		2
Audit Principals	Average number of Audit principals per engagement	2
	Average number of audit principals per firm	4
	Time spent by each audit principal (hrs)	80
	Cost per hour of audit principal (£)	71
	Cost per firm of audit principal time (£)	**22.7k**
Accounting Staff	Assumed number of accounting staff in audit principal's team	8
	Accounting Staff required per firm	32
	Time spent by each audit principal team member (hrs)	75
	Cost per hour of accounting staff (£)	29
	Cost per firm of accounting staff time (£)	**70.5k**
Non-Audit Principals	Average number of non-audit principals per engagement	1
	Average number of non-audit principals per firm	2
	Time spent by each non-audit principal (hrs)	10
	Cost per hour of non-audit principal (£)	71
	Cost per firm of non-audit principal time (£)	**1.4k**
Non-Audit Principal Teams (admin staff)	Assumed number of members in non-audit principal's team	5
	Non-audit team members required per firm	10
	Time spent by each non-audit principal team member (hrs)	10
	Cost per hour of non-audit team members (£)	17
	Cost per firm of non-audit team member time (£)	**£1.7k**
Total familiarisation cost per audit firm (£)		**£96.3k**
Adapted from the methodology outlined in Annex B of IA BIS016(F)-16-BE. Hourly cost is the 75th percentile of hourly wages in ONS ASHE 2018 table 14.5a for levels 1115, 2421, and 4 for audit and non-audit principals, accountants, and admin staff respectively.		

Mandatory Retendering and Rotation

To estimate the cost to new PIEs and their auditors from mandatory retendering and rotation requirements, we have drawn on the cost assumptions used in the 2016 IA. These were originally based on estimated costs set out in the 2016 IA, which assessed the cost of the tendering exercise to PIEs and their auditors sized by turnover. We have used these estimated costs[245] to determine the linear relationship between the audit fees and tendering costs for companies in each turnover band on the basis that the cost of the tendering process can be expected to be directly linked to the value of audit service to be provided. The resulting costs to tender for new PIEs and their auditors are given in the table below.

We estimate familiarisation costs to the auditors of new PIEs on the basis that they will need to familiarise themselves with new audit clients at the end of the maximum appointment period (20 years). We have

[245] Converted from Euro to Sterling using the Bank of England Annual Average Spot rate for December 31st 2018, and appropriately adjusted for inflation.

drawn on the 2016 IA's assumptions on audit engagement profitability to determine the cost of the audit to auditors (by turnover classification), and hence the cost of familiarisation, on the assumption that familiarisation accounts for roughly 20% of the costs to the auditor[246]. Details are provided in the table below.

We also consider transitional costs (in year 1) to previously audit exempt subsidiaries brought into scope under both options. These subsidiaries will lose the current exemption and will be required to appoint auditors via competitive tenders.

Table 57 - Mandatory Retendering and Rotation Costs

Tender Exercise Costs to New PIEs and their Auditors					
		Very High TO PIEs	**High TO PIEs**	**Med TO PIEs**	**Low TO PIEs**
Cost to New PIEs	Cost to PIE (2016 £)	374.2k	65.5k	25.5k	21.3
	Annualised cost to PIE (2016 £)	**37.4k**	**6.6k**	**2.5k**	**2.1k**
Costs to Auditors of New PIEs	Cost to auditor (2016 £)	5.6m	1.0m	403k	147k
	Annualised cost to auditor (2016 £) - every 10 years	**0.6m**	**0.1m**	**40.3k**	**14.7k**
Additional familiarisation Costs to Auditors of New PIEs	Average annual audit fee	19.0m	3.0m	890k	672k
	Cost to auditor assuming profitability of 60% (2016 £)	7.6m	1.2m	356k	269k
	Additional familiarisation cost to new auditor (BEST) (£)	**1.5m**	**0.2m**	**71.2k**	**53.8k**
	Annualised familiarisation cost - every 20 years (£)	**76.0k**	**11.9k**	**3.6k**	**2.7k**

[246] The assumption that familiarisation costs account for 20% of the cost to the auditor of the audit was the best estimate in the 2016 IA.

Annex IV: Costs related to the preparation of Audit and Assurance Policies

Familiarisation Costs

In assessing familiarisation costs to companies in scope, we make the following assumptions:

- All companies in scope are expected to face familiarisation costs from Audit and Assurance policy. We take familiarisation costs to be one-off costs and assess them separately for premium listed companies and all other PIEs. For premium listed companies, we assume that these costs will apply in year 2 of implementation, and in year 4 for all other PIEs.
- We assume that premium equity closed ended investment funds will face on average around half of the costs faced by in-scope commercial companies (i.e. £0.4k), since additional reporting activity, and hence, familiarisation, for them is expected to be in general less complex owing to the size and nature of their business - these companies are typically very simple, and they do not produce complex accounts. There are 402 premium listed commercial companies, and 296 closed ended investment funds, included in our count.
- We assess familiarisation costs for audit committees, company directors, and professional accounting staff. For audit committees, we assume that the average audit committee consists of 1 committee chair and 3 audit committee members supported by an administrative team of four.
- Our cost estimates for audit committee chairs and members is based on Deloitte's director's remuneration guides for FTSE 250 companies (2018), which provides non-executive director base fees and additional fees for audit committee positions. Further we make the broad assumption that FTSE 250 audit committee costs are broadly representative of the companies brought into scope.
- For company directors and professional accounting staff and admin staff, we use ONS ASHE data for hourly earnings, with a 20% non-wage uplift.

Familiarisation cost calculation tables are provided below.

Table 58 - Total Familiarisation Costs for Premium Listed Companies

Total Familiarisation Costs for Premium Listed Companies	
Number of hours per AC chair	2
Hourly time cost of AC chair (£)	£323
Number of AC members	3
Number of hours per AC member	4
Hourly time Cost of AC member (£)	£298
Number of admin Staff	4
Number of admin Staff Hours	2
Hourly time cost of admin staff	£17
Number of professional hours	5
Hourly cost of professional staff (adjusted) (£)	29
Number of directors Hours	2
Hourly cost of directors (adjusted) (£)	41
Total cost per audit committee	£4.6k
Hourly cost for AC chair and members based on the assumption that audit committees work the equivalent of 24 eight-hour days per year (based on information provided to BEIS by FRC in 2019). Hourly cost for admin staff based on the 75th percentile of hourly wages in ONS ASHE 2018 table 14.5a for level 4 (Admin Staff).	

Table 59 - Total Familiarisation Costs for all other PIEs

Total Familiarisation Costs for all other PIEs	
Number of hours per AC chair	2
Hourly time cost of AC chair (£)	£323
Number of AC members	3
Number of hours per AC member	4
Hourly time Cost of AC member (£)	£298
Number of admin Staff	4
Number of admin Staff Hours	2
Hourly time cost of admin staff	£17
Number of professional hours	5
Hourly cost of professional staff (adjusted) (£)	29
Number of directors Hours	2
Hourly cost of directors (adjusted) (£)	41
Total cost per audit committee	£4.6k

Reporting costs

- For the first year of reporting, we assess costs separately for premium listed companies and all other PIEs. For premium listed companies, we assume that these costs will apply in year 2 of implementation, and in year 4 for all other PIEs.
- As with familiarisation costs, we assume that premium equity closed ended investment funds will face around half of the costs faced by other in-scope companies. There are 402 premium list commercial companies, and 296 closed ended investment funds, included in this count.
- We assume that additional reporting activity will be carried out by audit committees, company directors, and professional accounting staff.

We assume that cost in the first year of reporting will be the same under both options. Calculation tables for the first year of reporting are provided below.

Table 60 - Cost of Preparing Audit and Assurance Policy in first reporting year (Premium listed Cos)

Cost of Preparing Audit and Assurance Policy in first reporting year (Premium listed Cos)	
AC chair preparation and review time (hrs)	6
Hourly cost of AC chair time (£)	£323
AC member preparation and review time (hrs)	8
Hourly cost of AC Member time (£)	£298
AC debate and discussion time (hr)	3
Admin staff time	8
Hourly cost of Admin staff time	£17
Number of professional hours	8
Hourly cost of professional staff (adjusted) (£)	29
Number of directors Hours	4
Hourly cost of directors (adjusted) (£)	41
Reporting cost per company (every 10 years)	£6.7k

Table 61 - Cost of Preparing Audit and Assurance Policy in first reporting year (All other PIEs)

Cost of Preparing Audit and Assurance Policy in first reporting year (All other PIEs)	
AC chair preparation and review time (hrs)	6
Hourly cost of AC chair time (£)	£323
AC member preparation and review time (hrs)	8
Hourly cost of AC Member time (£)	£298
AC debate and discussion time (hr)	3
Admin staff time	8
Hourly cost of Admin staff time	£17
Number of professional hours	8
Hourly cost of professional staff (adjusted) (£)	29
Number of directors Hours	4
Hourly cost of directors (adjusted) (£)	41
Reporting cost per company (annually)	£6.7k

Under option 1, we assume that reporting in subsequent years would incur around 10% of costs imposed in the first year, due to the fact that only small incremental changes would need to be made to the policy from one year to the next. Our estimate of the annual cost is given below for premium listed companies and all other PIEs. We assume these costs will apply from the third year of reporting for premium listed companies, and from the fifth year of reporting for all other PIES.

Table 62a) and b) - Costs of Preparing Audit and Assurance Policy (opt. 1)

Cost of Preparing Audit and Assurance Policy (Premium listed Cos)	
Aggregate Audit and Assurance Reporting cost	£3.7m
Adjustment Factor	10%
Annual Reporting Cost	**£0.4m**

Cost of Preparing Audit and Assurance Policy (All other PIEs)	
Aggregate Audit and Assurance Reporting cost	£8.4m
Adjustment Factor	10%
Annual Reporting Cost	**£0.8m**

Under option 2, we assume that reporting will be required every 3 years – i.e. in years 5 and 8 of the 10-year appraisal period for premium listed companies, and years 7 and 10 for all other PIEs. Given the gap between reporting, we assume that each subsequent report will generate around 75% of costs imposed in the first year. Our estimate of the annual cost is given below for premium listed companies and all other PIEs.

Table 63 a) and b) - Costs of Preparing Audit and Assurance Policy (opt. 2)

Cost of Preparing Audit and Assurance Policy (Premium listed Cos)	
Aggregate Audit and Assurance Reporting cost	£3.7m
Adjustment Factor	75%
Annual Reporting Cost	**£2.8m**

Cost of Preparing Audit and Assurance Policy (All other PIEs)	
Aggregate Audit and Assurance Reporting cost	£8.4m
Adjustment Factor	75%
Annual Reporting Cost	**£6.3m**

Annex V: Costs related to the preparation of payment practices reports

Familiarisation costs calculation

We expect all companies in scope, and the audit teams delivering their audits to face familiarisation costs. Whilst companies and auditors will have some familiarity with the concept of payment practices reporting, we expect that they will need to take some time to assess and understand the specific requirements being introduced for their payment practices summary. Given that companies are expected to comply with these requirements from the first year of implementation, we take these costs to be one-off, applying in year 1.

The sources of familiarisation costs are the same in both options. The difference in aggregate costs under both options is driven by the number of companies in scope.

For auditor familiarisation, we use the approach set out in *IA No: BIS016(F)-16-BE* (the "2016 IA"), but have updated assumptions around the number and composition of the teams that will need to familiarise themselves with new requirements. Given the specific context of the changes assessed here, we expect only the teams currently auditing the companies in scope to require some period of familiarisation, and not the entire firm (as assumed in the 2016 IA). We assume (based on information provided by the FRC for our assessment of PIE definition changes) that each audit engagement (each client) will require 2 audit principals, each with a team of 8 accounting staff, and 1 non-audit principal supported by a team of 5 admin staff.

Cost calculation tables showing the familiarisation cost per company and audit team are provided below.

Table 64 - Company familiarisation costs (applicable to both options)

Familiarisation costs to companies in scope		
Directors	Number of directors Hours	5
	Hourly cost of directors (adjusted) (£)	41
	Cost per company of directors' time (£)	**204**
Professionals	Number of professional hours	15
	Hourly cost of professional staff (adjusted) (£)	29
	Cost per company of professional staff time (£)	**441**
Admin Staff	Number of admin staff hours	5
	Hourly Time Cost of Admin Staff (adjusted)	17
	Cost per company of admin staff time (£)	**83**
Total Familiarisation cost per company (£)		**0.7k**

Table 65 - Auditor familiarisation costs (applicable to both options)

Familiarisation Costs to Auditors		
Audit Principals	Average number of Audit principals per engagement	2
	Time spent by each audit principal (hrs)	15
	Cost per hour of audit principal (£)	71
	Cost per team of audit principal time (£)	**2.1k**
Accountants	Assumed number of accountants in each audit principal's team	8

Familiarisation Costs to Auditors		
	Time spent by each audit principal team member (hrs)	10
	Cost per hour of accountants (£)	29
	Cost per team of accountant time (£)	**4.7k**
Non-Audit Principals	Average number of non-audit principals per engagement	1
	Time spent by each non-audit principal (hrs)	10
	Cost per hour of non-audit principal (£)	71
	Cost per team of non-audit principal time (£)	**0.7k**
Non-Audit Principal Teams (admin staff)	Assumed number of members in non-audit principal's team	5
	Time spent by each non-audit principal team member (hrs)	5
	Cost per hour of non-audit team members (£)	17
	Cost per team of non-audit team member time (£)	**0.4k**
Total familiarisation cost per audit team (£)		**8.0k**
Calculated in accordance with the methodology outlined in Annex B of IA BIS016(F)-16-BE. Hourly cost is the 75th percentile of hourly wages in ONS ASHE 2018 table 14.5a for levels 1115, 2421, and 4 for audit and non-audit principals, accountants, and admin staff respectively.		

Ongoing cost calculation

Our assessment considers ongoing costs from company reporting only. We do not anticipate any material costs to auditors from their review of the additional material and consistency checks. Our assumptions about the level of activity that preparation of the summary report would require are provided in the table below.

Table 66 - Cost of ongoing company reporting

YEAR 1 AND SUBSEQUENT YEARS		**Avg annual time (hr)**	**Total cost per hour (£)**	**Total cost per firm (£)**
Payment Practices Reporting	Director	5	71	354
	Professional	10	29	294
	Administrative	5	17	83
	Total cost per company			**0.7k**

Annex VI: Cost estimates related to increasing the scrutiny of audit committees

Costs to the regulator

We make the following assumptions in estimating regulator costs:

- Each tender review will be completed over a 4 to 6-week period, recognising the size and complexity of the documentation and timescales for the tender process.
- Reviews would be more than desk-based reviews of paperwork and would require the lead reviewer to talk to audit committees (which will involve international travel).
- There will need to be senior experienced staff to lead tender reviews (with experience of audit and also experience of sitting on an audit committee, but with no conflicts of interest).
- Reviewers will need to be supported by experienced staff (2-3 FRC experienced hires) to carry out the initial desk-based reviews of paperwork to maximise the time of the reviewers, with support from one administrator.
- Estimates include other costs (legal or competition team inputs and travel budget) and costs for office overheads (IT, accommodation costs, etc).
- The review of ongoing audits would not involve a lead reviewer in the same way as the tender review. Only the full reviews of tenders will have a lead reviewer.
- Only the tender reviews would require the reviewer to attend audit committee meetings and travel if necessary.
- Ongoing audit reviews will be more desk based, so costs will be driven by the internal level of resourcing. There may also be some travel and oversight.
- Lead reviewer for tender review would be senior with audit/ audit committee experience with hourly remuneration costing ~£450 per hour.
- Team member will be FRC staff (~£185k annual employment cost).
- Support team member will be FRC level 1-2 (~£65k annual employment cost).

Cost calculation tables for options 1 and 2 are provided below.

Option 1 regulator cost calculation tables

Table 67 - Cost to the regulator from tender monitoring

Regulator Review Costs – Tenders	
Number of tenders reviewed (annually)	35
Duration of each review	4-6 weeks
Lead reviewer cost	£24k
Lead reviewer hours on review	150
Number of review team members	3
Number of support team members	1
Total Review team cost (including Admin support)	£66k
Travel costs for international engagement per review	£5k
Other costs, e.g. legal or competition input, travel budget and office overheads	£5k
Total cost to regulator per review	£99k
Aggregate annual review cost	**£3.5m**

Table 68 - Cost to the regulator of monitoring ongoing audits

Regulator Review Costs - Ongoing Audits	
Number of engagements reviewed (annually)	350
Duration of review	4 Weeks per review

Staff hours on review	100 hours per review
Number of review team members	3
Review team cost per review	£9k
Number of support team members	4
Support team member cost per review	£5k
Total cost to regulator per review	£14k
Aggregate annual cost	**£4.9m**

Table 69 - Audit committee observer costs

Cost of placing observers at Audit Committee Meetings	
Number of FTSE 350 ACs observed	2
Number of meetings attended annually (per FTSE 350 company)	6
Number of observers per AC meeting	1
Observer cost per hour	£468
Total time requirement per meeting (hrs)	8
Observer cost per meeting	£4k
Travel costs for international meetings	£5k
Total annual cost of AC observers	**£52k**

Option 2 regulator cost calculation tables.

Table 70 - Cost to the regulator from tender monitoring

Regulator Review Costs – Tenders	
Number of tenders reviewed (annually)	5
Duration of each review	4-6 weeks
Lead reviewer cost	£24k
Lead reviewer hours on review	150
Number of review team members	3
Number of support team members	1
Total Review team cost (including Admin support)	£66k
Travel costs for international engagement per review	£5k
Other costs, legal or competition input, travel budget and office overheads	£5k
Total cost to regulator per review	£99k
Aggregate annual review cost	**£494k**

Table 71 - Cost to the regulator of monitoring ongoing audits

Regulator Review Costs - Ongoing Audits	
Number of engagements reviewed (annually)	50
Duration of review	4 Weeks per review
Staff hours on review	100 hours per review

Regulator Review Costs - Ongoing Audits	
Number of review team members	3
Review team cost per review	£9k
Number of support team members	4
Support team member cost per review	£5k
Total cost to regulator per review	£14k
Aggregate annual cost	**£706k**

Table 72 - Audit committee observer costs

Cost of placing observers at Audit Committee Meetings	
Number of FTSE 350 ACs observed	2
Number of meetings attended annually (per FTSE 350 company)	6
Number of observers per AC meeting	1
Observer cost per hour	£468
Total time requirement per meeting (hrs)	8
Observer cost per meeting	£4k
Travel costs for international meetings	£5k
Total annual cost of AC observers	**£52k**

Costs to FTSE 350 companies

We make the following assumptions in estimating costs to companies in scope:

- We assume ALL audit committees will report on the ongoing audit engagement on an annual basis,
- For both tendering and ongoing reports, our preparation and review time estimates assume that the information to be contained in the reports will be focused on elements that are already well monitored by audit committees. We therefore assume that no additional costs will be incurred in obtaining and collating the relevant information. We base this assumption on the understanding that audit committees in scope are already undertaking the activities necessary for full compliance with the requirements and responsibilities of audit committees set out in the UK Corporate Governance Code and the Guidance on Audit Committees. These responsibilities include, but are not limited to:
  - conducting the tender process and advising on auditor appointment;
  - reviewing auditor independence and objectivity;
  - monitoring non-audit services provided by external auditors and the related impact on independence; and
  - taking into account other ethical guidance on audit committees.
- We assume audit committees for the FTSE 350 consist of 4 members on average – 1 chair and 3 members. Staff costs are provided in the tables below.

Table 73a) and b) - Audit committee staff costs

FTSE 100 Audit Committee Costs

FTSE 250 Audit Committee Costs

Non-exec director base fee	£67k		Non-exec director base fee	£52k
AC chairperson additional fee	£23k		AC chairperson additional fee	£10k
AC member additional Fee	£15k		AC member additional fee	£5k
Cost of AC chair and members = Non-exec director base fee + additional fees. Fees taken from Deloitte's director's remuneration guides for FTSE 100 and 250 (2018).				

Cost calculation tables for options 1 to 3 are provided below. Familiarisation costs are the same for all three options and are the only costs applicable to option 3.

Familiarisation costs calculation

Table 74a) and b) - FTSE 350 familiarisation costs (applicable to all three options)

Total Familiarisation Costs for FTSE 100 Audit Committees			**Total Familiarisation Costs for FTSE 250 Audit Committees**	
Number of ACs	100		Number of ACs	250
Number of hours per AC chair	2		Number of hours per AC chair	2
Hourly time cost of AC chair (£)	£468		Hourly time cost of AC chair	£323
Number of AC members	3		Number of AC members	3
Number of hours per AC member	4		Number of hours per AC member	4
Hourly time cost of AC member (£)	£425		Hourly time cost of AC member	£298
Number of admin staff	4		Number of admin Staff	4
Number of admin staff hours	2		Number of admin Staff Hours	2
Hourly time cost of admin Staff	£17		Hourly time cost of admin staff	£17
Total cost to per company	**£6k**		**Total cost per audit committee**	**£5k**
FTSE 100 aggregate cost	**£620k**		**FTSE 250 aggregate cost**	**£1m**
FTSE 350 aggregate familiarisation costs (year 1 ONLY)				**£1.7m**
Hourly costs for AC chair and members based on the assumption that audit committees work the equivalent of 24 eight-hour days per year. This was drawn from information provided to BEIS by FRC in 2019. Hourly cost for admin staff based on the 75th percentile of hourly wages in ONS ASHE 2018 table 14.5a for level 4 (Admin Staff)				

Option 1 company cost calculation tables.

Table 75 - Cost of company tender reporting

Cost of Preparing Tendering Reports		
	FTSE 100	**FTSE 250**
AC chair preparation and review time (hrs)	3	3
Hourly cost of AC chair time (£)	£468	£323
AC member preparation and review time (hrs)	6	6
Hourly cost of AC member time (£)	£425	£298
AC debate and discussion time (hr)	3	3
Admin staff time	6	6
Hourly cost of admin staff time	£17	£17
Reporting cost per company (every 10 years)	£7k	£5k
FTSE 350 aggregate tendering reporting costs (Annual)		**£185k**
FTSE 350 aggregate tendering reporting costs (every 10 years)		**£1.9m**

Table 76 - Cost company reporting on ongoing audits

Cost of Preparing Ongoing Audit Reports		
	FTSE 100	FTSE 250
AC chair preparation and review time (hrs)	2	2
Hourly cost of AC chair time (£)	£468	£323
AC member preparation and review time (hrs)	4	4
Hourly cost of AC member time (£)	£425	£298
AC debate and discussion time (hr)	3	3
Admin staff time	6	6
Hourly cost of admin staff time	£17	£17
Reporting cost per company (annually)	£5k	£4k
FTSE 350 aggregate ongoing audit reporting costs (annually)		**£1.5m**

Option 2 company cost calculation tables.

Table 77 - Cost of company tender reporting

Cost of Preparing Tendering Reports		
	FTSE 100	FTSE 250
AC chair preparation and review time (hrs)	3	3
Hourly cost of AC chair time (£)	468	323
AC member preparation and review time (hrs)	6	6
Hourly cost of AC member time (£)	425	298
AC debate and discussion time (hr)	3	3
Admin staff time	6	6
Hourly cost of admin staff time	17	17
Reporting cost per company (every 10 years)	£7k	£5k
FTSE 350 aggregate tendering reporting costs (Annual)		**£26k**
FTSE 350 aggregate tendering reporting costs (every 10 years)		**£260k**

Table 78 - Cost company reporting on ongoing audits

Cost of Preparing Ongoing Audit Reports		
	FTSE 100	FTSE 250
AC chair preparation and review time (hrs)	2	2
Hourly cost of AC chair time (£)	£468	£323
AC member preparation and review time (hrs)	4	4
Hourly cost of AC Member time (£)	£425	£298
AC debate and discussion time (hr)	3	3
Admin staff time	6	6
Hourly cost of Admin staff time	£17	£17
Reporting cost per company (annually)	£5k	£4k
FTSE 350 aggregate ongoing audit reporting costs (annually)		**£215k**

Annex VII: Cost estimates related to measures to boost resilience through increasing choice

Costs to the regulator

We make the following assumptions (based on information provided by the FRC) in estimating regulator costs:

- The regulator already monitors audit engagements, so any increase in costs under Option 1 is negligible.
- The regulator will decide which audits only challengers will be able to tender for as a component auditor, and/or as the sole auditor under Option 2, which would require a significant scaling up of the regulator's current capabilities.
- Under Options 2, eight FTE personnel will be required.
    I. Three FTE personnel to assess tender and auditor suitability.
    II. Two FTE personnel to provide legal counsel.
    III. Two FTE personnel to deal with administration and data management.
    IV. One FTE personnel to provide competition policy input.
- The FTE costs used are based on current FRC employment costs including pension and National Insurance contributions, and costs incurred in the provision of office space (rent on desks, etc.)
- Under Option 2, the regulator will require legal reserves of £1m - £1.5m every two years to fund external lawyers/ counsel when necessary. We assume this cost arises in year one and repeats every two years thereafter.

Option 2 regulator costs calculation tables

Table 79 - Costs of ongoing monitoring to the regulator under managed shared audit and a managed market share cap in 2016 prices

Task	Total cost (per annum)
Assessing tender and auditor suitability	£593k
Legal team	£408k
Administration and data management	£171k
Competition policy Input	£184k
Total Annual Costs	£1.4m

Costs to companies in scope

We take the following general approach to estimating costs to the FTSE 350:

- We use two datasets from Audit Analytics covering FTSE 350 audit fees in 2018 and mandatory rotation years respectively.
- After removing duplicate entries and ensuring there was only one audit fee per company included in the dataset, we obtained 342 unique entries.

- The audit fee data were then combined with the audit engagement data in order to model upcoming auditor rotations.
- For exclude those companies incorporated abroad. We do this by identifying country of incorporation using the first two digits of the ISIN (International Securities Identification Number) for each company and removing those companies with any ISIN other than GB.

Under Option 1:

- The top 50 companies by audit fee in the FTSE 350 are excluded from joint audit but are subject to peer review. After removing those companies incorporated abroad, we calculate the average audit fee for the UK-incorporated companies in the top 50 then multiply this by 20% to model the impact of peer review on audit fees.
- Investment trusts are identified and excluded based on the four SIC codes given in *Table 80*. These companies represent 1.2% of the FTSE 350 in terms of audit fees.
- Then, those companies incorporated abroad are identified and removed.
- This leaves 195 companies in scope.

Table 80 - SIC codes used to identify investment trusts

SIC Code	SIC Description
6722	Management Investment Offices, Open-end
6726	Unit Investment Trusts, Face-amount Certificate Offices, and Closed-end Management Investment Offices
6733	Trusts, Except Educational, Religious, and Charitable
6798	Real Estate Investment Trusts

Under the managed shared audit component of Option 2:

- We consider FTSE 100 companies having UK-incorporated subsidiaries that individually account for 20-60% of group total turnover or group total assets. We identified 25 and 45 FTSE 100 companies respectively. We combined these two company sets and removed duplicates. This left us with 49 companies. Next, we remove the three companies incorporated abroad. We use the pipeline of upcoming tenders to model the costs of shared audit for the 46 FTSE 100 companies in scope.
- We also looked at a sample of 49 FTSE 250 companies to see which have UK-incorporated subsidiaries that individually account for 20-60% of group total turnover or group total assets. We used this sample to estimate the number of FTSE 250 companies that have suitable, material subsidiaries that a challenger firm could comfortably audit. Using the same methods applied for the FTSE 100 above, the FRC identified 15 and 21 companies in the sample that would satisfy materiality requirements. Combining these two company sets and removing duplicates, we are left with 23 companies that satisfy the materiality criteria.
- We calculate the corresponding proportion of engagements and audit fees represented by these 23 companies. These amount to 46.9% and 44.8%, respectively. We take the mean of these two figures, 45.8%, to represent the proportion of all FTSE 250 companies that would have suitable, UK-incorporated subsidiaries.
- Next, we calculate that, for the FTSE 250, only 89.6% of companies are UK-incorporated. We use the pipeline of upcoming tenders to model the costs of managed shared audit by assuming that

45.8%x89.6% of the audit fees available each year rotate. Therefore, we expect 103 FTSE 250 companies to be in scope.

- The data was obtained from Eikon (Refinitiv – Thomas Reuters) and cross-checked, where possible, against Fame and Company Watch.
- It is important to highlight that the data on subsidiaries, particularly on both ownership and private companies, is limited. The data may not capture all subsidiaries of a company; company ownership structures are complex and can be opaque and therefore the database may not have picked them all up. There are also some instances where the turnover and total asset data for subsidiaries were missing.
- In total, 149 FTSE 350 companies were considered suitable for shared audit.

Under the managed market share cap component of Option 2:

- First, we removed the top 50 largest companies by audit fee.
- Second, we removed any companies that operate in the mining or finance sector based on the SIC code ranges given in *Table 81*.
- Third, those companies that had more than 100 subsidiaries were removed[247].
- This left 27 UK-incorporated companies in scope that are expected to rotate auditor between 2028 and 2032.

Table 81 - SIC codes used to identify companies in the mining and finance sectors

SIC Code Range	SIC Description
1000-1499	Mining
6000-6799	Finance, Insurance and Real Estate

We make the following assumptions in estimating costs to the FTSE 350 in options 1 and 2:

- The audit fees that each company pays do not increase over time (except for the relevant cost increases outlined for each Option).
- The companies in the FTSE 350 remain the same over the ten-year appraisal period.
- The audit fee data we have (which cover 342 companies) are sufficiently representative because the other 8 companies are likely to have small audit fees as they would be at the very bottom of the index.
- Auditors rotate at the beginning of their mandatory rotation year.
- Engagements are renewed for the full ten years allowed under mandatory retendering rules, so there is no early retendering to either delay or speed up implementation.
- Audit fee increases are phased in by applying the new requirements to companies as they rotate auditors.
    - Over the ten-year appraisal period, as audited companies rotate their auditors and are affected by the measure, the annual cost to business increases because the total number of companies affected increases.

[247] Based on data from Fame

- The total direct cost to business over the ten-year appraisal period under both options therefore forms a triangle, with the total cost in year ten repeating in subsequent years assuming that the companies affected remain unchanged.
- *Figure 9*, *Figure 10* and *Figure 11* illustrate this. We use our Central Estimates for the total direct cost to business under both Options.

Figure 9 - Total direct cost to business under Option 1

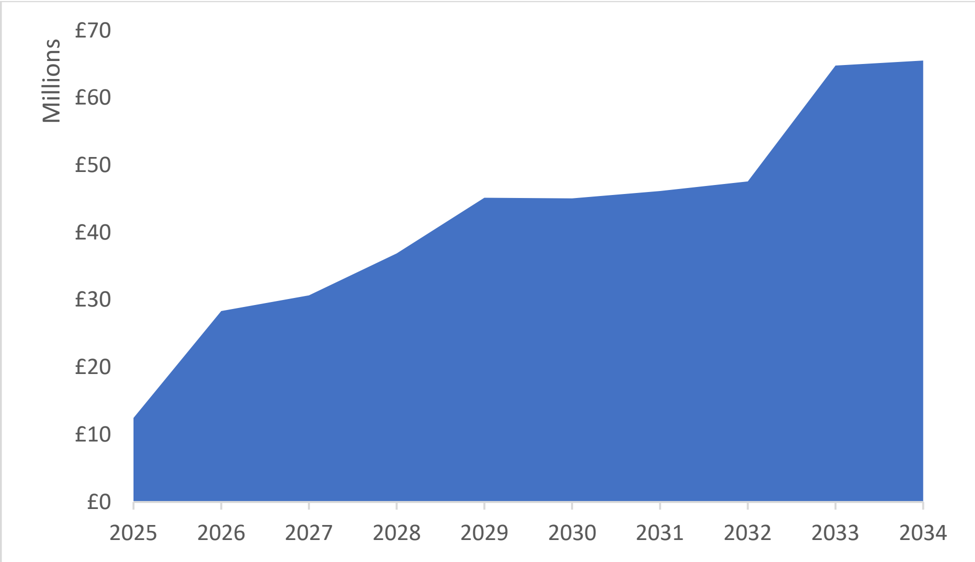


Figure 10 - Total direct cost to business under Option 2 (managed shared audit only)

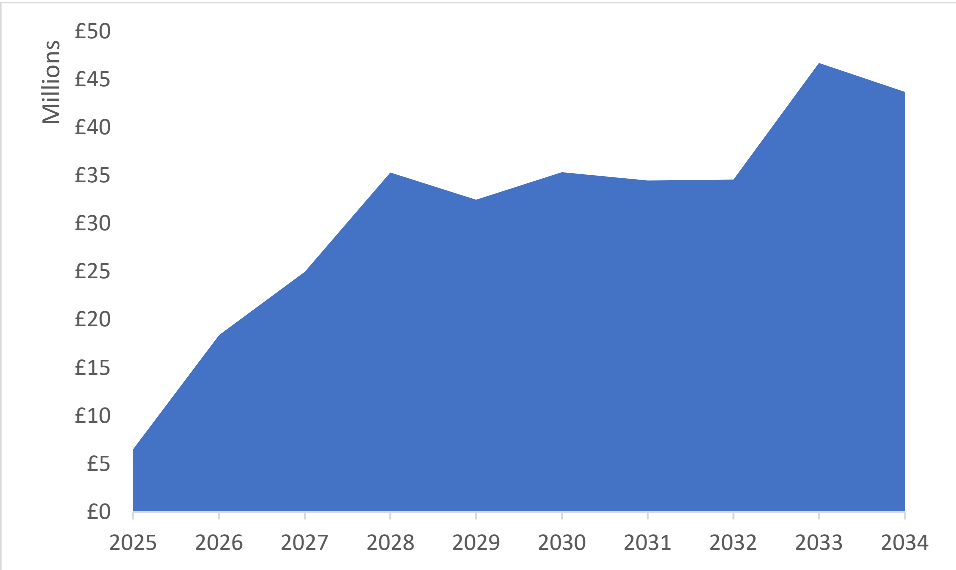
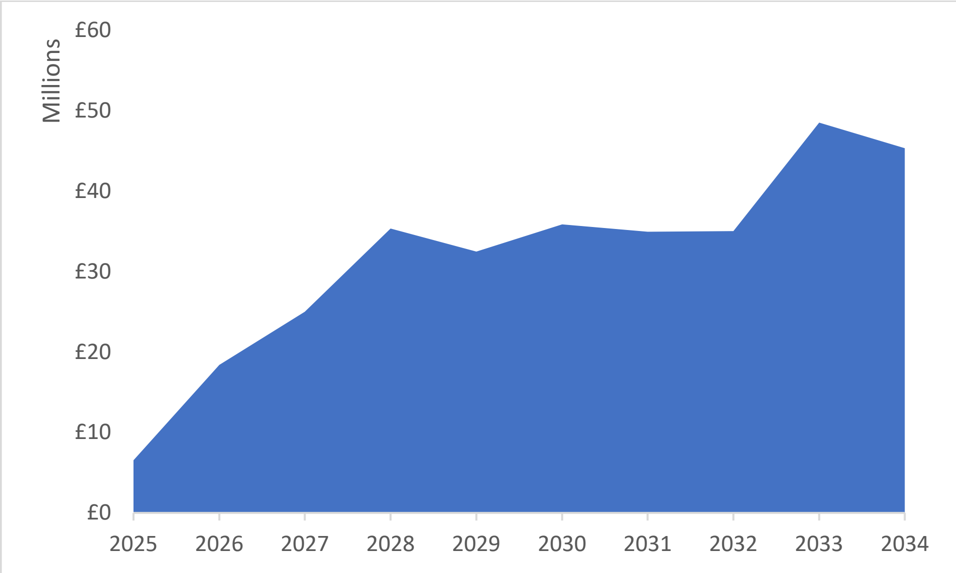


Figure 11 - Total direct cost to business under Option 2 (managed shared audit and managed market share cap)



Note: Audit fees are higher in the first year of each new engagement because of how we model familiarisation costs, where we use the high-cost estimate for the first year of each engagement under all Options and scenarios. For this reason, the graphs do not all form a perfect triangle.

Modelling market share

Under both options, we estimate the market share that challenger firms could have at the end of the 10-year appraisal period. We do this by adding up the sum of FTSE 350 audit fees paid to challenger firms and then dividing this by the total FTSE 350 audit fees at the end of the 10-year appraisal period. In practice, this means:

- Under Option 1 (joint audit), we added together the original audit fees of the companies in scope and the direct cost to business at the end of the 10-year appraisal period. We then multiplied this number by 30% and 50% to reflect the different distributions of work and audit fee that could be paid to the challenger firm. Then, we divided these numbers by the sum of the total direct cost to business at the end of the 10-year appraisal period and the original total audit fees for the FTSE 350. We do not include the direct cost to business generated by peer review in our calculations of market share.
- Under Option 2 (managed shared audit), we added together the original audit fees of the companies in scope and the direct cost to business at the end of the 10-year appraisal period. We then multiplied this number by 20% to reflect the average share of the audit fee we expect challenger firms to receive when working as a component auditor. Then, we divided this by the sum of the total direct cost to business at the end of the 10-year appraisal period and the original total audit fees for the FTSE 350.
- Under Option 2 (managed market share cap), we added together the original audit fees of the companies in scope and the direct cost to business at the end of the 10-year appraisal period. Then, we divided this by the sum of the total direct cost to business at the end of the 10-year appraisal period and the original total audit fees for the FTSE 350.

Annex VIII: Cost estimates related to the operational separation of multi-disciplinary firms

Cost of reporting on transfer pricing arrangements

In estimating the cost to companies from reporting on their transfer pricing arrangements, we assumed the following for each of the 4 firms in scope:

- Firms already collect and, to some extent, report on their transfer pricing arrangements.
- Information collection, the preparation of the report and the initial review will be conducted by a team of two (2) senior managers and six (6) mid-level accounting staff.
  - Each team member will spend 150 hours over a 4-week period on the report.
  - Senior managers are remunerated at £69.14 per hour (based on ONS ASHE 2018 Revised, table 14.5a) plus a 20% non-wage uplift.
  - Mid-level accounting staff are remunerated at £26.03 per hour (based on ONS ASHE 2018 Revised, table 14.5a) plus a 20% non-wage uplift.
- We also assume that a final review is conducted by the board. We assume that this review will require 10 hours of time from each board member for review and discussion, at a rate of £185 per hour (the average hourly rate based on our estimate of £385 total annual board remuneration costs).

The cost per firm from transfer pricing is provided below.

Table 82 - Costs of reporting on transfer pricing arrangements and practices

Transfer Pricing Reporting	
Senior managers engaged	2
Senior manager hours	150
Senior manager hourly rate	£82.97
Mid-level accounting staff engaged	6
Mid-level accounting staff hours	150
Mid-level accounting staff hourly rate	£31.24
Audit board members engaged	4
Audit board review time (Hrs)	10
Audit board hourly rate	£185.10
Total transfer pricing reporting cost per firm (£, 2019)	£60.4k
Total transfer pricing reporting cost per firm (£, 2016)	**£57.9k**

Annex IX: A new regulator option 1 (Detailed Costs)

Costs to regulator

#	Recommendation Description	Set up costs	On-going costs	Funding
1	The FRC should be replaced with a new independent regulator			
2	The Government should issue a remit letter once per Parliament.			
3	The regulator should be named the Audit, Reporting and Governance Authority	£42,500		Levy
4	The regulator should have a new strategic objective.			
5	The regulator should have statutory duties.	£42,500		Levy
6	Regulator should have new functions.			
7	The regulator should have a new board	£85,000		Levy
8	The regulator should have a smaller board.		-£85,000	Levy
9	The board should have a requisite mix of skills, experience and knowledge.			
10	All board appointments should be public and approved by the Secretary of State for BEIS.			
11	There should be a consistent, open, appointment process for Board, committee and senior posts			
12	The appointment of Chair and CEO should be subject to confirmation hearings with the BEIS Select Committee			
13	The sub-board structure should be reformed			
14	The board should exercise stronger ownership and oversight of the investigation and enforcement functions			
19	AFMAS should be carried out on a statutory basis	£42,500		Levy
22	The regulator should strengthen AQR resourcing		£5,525,000	Recovered
23	The regulator should be required to promote brevity in accounts and annual reports and to report once each Parliament on the statutory reporting framework.			
24	The regulator should consider expanding the volume of CRR undertaken.		£6,375,000	
27	CRR work should be limited to PIEs as far as possible.			
31	The regulator should be sparing and disciplined in the issuing of guidance			
32	The Government and board should monitor enforcement performance closely.			
33	The regulator should revisit publication policy in relation to undertakings			
42	A revised stewardship code should meet certain requirements.		£255,000	Levy
43	The regulator should engage in a deeper dialogue with UK investors.	£85,000		Levy
54	The regulator should submit an Annual Report to Parliament			

#	Recommendation Description	Set up costs	On-going costs	Funding
55	The regulator to apply Managing Public Money; Regulators' Code; Public Contracts Regulations			
56	The regulator should actively promote diversity, especially in work on corporate governance			
57	The regulator should 'for the foreseeable future' not allow staff, board or committee members to work on any regulatory functions relating to past employer. There should be written declarations for all staff members' conflicts of interests and financial interests to include proposed mitigations.			
58	The regulator should establish a procurement policy that adheres to public contracting regulations, with an open tendering process.			
59	The regulator should publish information on complaints			
60	The regulator should more proactively monitor trends on complaints			
61	The regulator should have a central complaints team	£85,000		Levy
62	The regulator should apply FOI in full	£42,500		Levy
63	The regulator should improve its information sharing and leak procedures			
64	The regulator should be funded by a statutory levy.	£127,500	£212,500	Levy
65	BEIS should agree a new budget consistent with the Review's recommendations.			
66	BEIS should set the regulator's budget each year.			
68	The regulator should develop a new staffing and resources strategy to achieve the vision set out in the Review.			
69	The regulator's pay arrangement should mirror those of other financial regulators.	£127,500		Levy
70	These pay arrangements should be set out in the new regulator's legal base, and mirror those of OfCom.			
TOTAL LEVY		**£680,000**	**£6,757,500**	
TOTAL RECOVERED			**£5,525,000**	

Compliance Costs

#	Compliance Costs	Regulated parties affected	Description of costs	Working of compliance costs
22	£5,525,000	Inspected firms		We assume that AQR will double its functions. We also assume that the resources spent by AQR on inspections is equal to the resource spent by audit firms in responding to the inspection. Therefore, the compliance cost of firms undergoing additional AQR inspections is equal to £5.5m.
24	£14,700,000	Firms who have corporate communications under review by CRR, and their auditors	Increasing volumes of CRR work will result in increased costs to companies and auditors responding to regulatory enquiries.	The cost of meeting ESMA equivalence requirements has been modelled as a 167% increase in costs (with staff numbers increasing from 15 to 40). Assume the costs to companies of responding to CRR requests is 1.5x the resource CRR spends on the reviews and that the auditor spends 0.5x the resource CRR spends on the reviews (which includes costing to firms at a higher outrate). CRR budget (18/19) £4.4m * 2.67 (the increase in CRR work to meet ESMA equivalence requirements) = £11.748m. This is a marginal increase of £7.348m from the 2018/19 budget of £4.4.m. £7.348m * 2 (cost to firm and auditor recharged to firm) = £14.696m
TOTAL	**£20,225,000.00**			

Annex X: A new regulator option 2 (Detailed Costs)

Costs to regulator

#	Recommendation Description	Set up costs	On-going costs	Funding
15	The approval and registration of audit firms conducting PIE audits should be reclaimed from RSBs.	£550,000	£800,000	Levy/Recovered
16	The new regime should have a range of sanctions.	£467,500	£425,000	Levy/Recovered
20	Audit quality inspection reports should be published in full		£170,000	Levy
26	CRR correspondence should be published.		£170,000	Levy
29	CRR work should cover the entire annual report.		£3,315,000	Levy
35	Enforcement action against accountants in relation to apparent wrongdoing in PIEs should be undertaken on a statutory basis.	£42,500	£170,000	
38	The regulator should have the power to investigate directors and refer cases to Insolvency Service	£85,000	£2,635,000	Levy/Recovered
39	The regulator should continue in its oversight role of accountancy profession, but with a wider work programme.	£255,000	£212,500	
40	The Government should put in place a backstop statutory requiring professional body action to be taken if there was a need.		£127,500	
41	The regulator should replace letter exchanges with formal memoranda of understanding.	£42,500		Levy
44	The regulator should develop robust market intelligence function.		£637,500	Levy
46	The regulator should have the power to require rapid explanations from companies about reasonable concerns that it raises.			
67	The regulator should recruit new experts.	£800,000[248]		Levy
74	The Government should review what powers are required to oversee effectively regulation of the actuarial profession.			
75	The Review recommends that FRC/ARGA is not best placed to be the oversight body for actuaries.		£1,865,000	Levy
TOTAL LEVY		**£2,242,500**	**£6,667,500**	
TOTAL RECOVERED			**£3,860,000**	

[248] No discount rate has been applied to this estimate as recruitment processes do not benefit from economies of scale when other recommendations are implemented alongside.

Compliance Costs

#	Year 1 costs	Ongoing Costs	Regulated parties affected	Description of costs	Working of compliance costs
16			Audit firms	Those sanctioned will face costs	We do not believe it possible to estimate these compliance costs, since we do not know how many audit firms will be sanctioned.
20			Audit firms, and audited entities via audit fees	Extra resource in conducting audits.	The impact of making AQR inspection reports and grades public will be large on both the auditors and the audited entity. However, it is extremely difficult to give a quantifiable estimate. We do not know by what factor this recommendation will push audit firms to pay greater attention to the quality of their audits, how much extra time and resource they would spend on each audit, and by what factor the audit fees they charge would increase.
26		£4,100,000	Extra resource in conducting audits. Cost of lower shares as a result of lower investor confidence in company whose audit has been revealed to have been sub-par.	Extra resource in considering wording of CRR replies. This is likely to include senior staff time, including in-house or external lawyers	1. We assume an average CFO of FTSE 350 earns £2m for 365 days of work and spends an extra 10 additional hours more on the CRR replies. 2. We assume an average Audit Committee chair earns £0.15m for 24 days of work and spends and extra 10 hours on CRR replies 3. We assume senior staff earn £0.4m for 365 days of work and spend an extra 20 hours extra on the CRR rely. CFO fee = (10*£2m/2080) = £9,615 Audit Committee Chair Fee = (10*£150,000/216) = £6944k Senior Staff fee = (20*400000/2080) = £3,846 Assume 200 CRR reviews Aggregate Costs = £4.081m

#	Year 1 costs	Ongoing Costs	Regulated parties affected	Description of costs	Working of compliance costs
29		£7,750,000	Firms reviewed by CRR	Firms will have to respond to CRR requests on all aspects of the annual report increasing time and resource spent responding to CRR queries	We assume that reviewing the entire Annual Report and Accounts will increase CRR workloads by 33% on top of the 167% increased size of CRR necessary to meet ESMA equivalence requirements. Assume that the costs to companies of responding to CRR requests is 1.5x the resource CRR spends on the reviews and that, since companies often involve their auditors in answering CRR queries, the auditor spends 0.5x the resource CRR spends on the reviews (which is then costed to the company at a higher outrate). CRR budget (18/19) £4.4m * 2.67 * 0.33 = £3.877m £3.877 * 2 (cost to firm and auditor recharged to firm) = £7.754m
35		£1,500,000	Accountants working in practice (in financial reporting activities for PIEs), accounting firms (providing non-audit assurance services to PIEs)	Potentially a new code to be familiar with, costs of defending action in extra cases (only in relation to breaches), administration costs	Cost defending enforcement action and legal advice is estimated to be between £0.08m - £2m: best estimate of £0.3m 5 additional cases which result in a total cost of £1.5m
39		£250,000	Professional bodies, firms providing accountancy activities, individual accountants	Costs to entities of servicing accountancy (non-audit) oversight activity by the regulator; providing evidence, responding to findings, implementing recommendations: potential increase for member in their subscriptions to cover the activities	We assume that Professional Oversight (POT) would increase in size by 10%. We assume that compliance costs would be equal to this additional cost. Therefore, the additional compliance costs of increased POT activity is £2.3m (taken from 19/20 budget) * 0.1 = £0.23m

#	Year 1 costs	Ongoing Costs	Regulated parties affected	Description of costs	Working of compliance costs
41	£50,000		Accountancy bodies would need to hold numerous discussions with the FRC to agree the content of the MoU	This would require meetings with accountancy bodies and correspondence to agree the details of the MoU, legal costs.	
46	£550,000	£177,350	Firms who must respond with a rapid explanation	Firms would be required to respond.	We assume that the regulator would request a maximum of 10 rapid explanations from firms. We assume that responding to a rapid explanation would take: 1) 80 hours of a senior manager's time. Assuming a salary of £100,000, this would cost £3846. 2) 20 hour of a board member's time. Assuming a salary of £150,000, this would cost £13,889 This results in a cost of £17,735 per firm. Assuming 10 rapid explanations, total would be £177,350. Familiarisation costs: Senior management would need to fully understand the implication of a Rapid Explanation and they would alert the Board to this requirement too. Assume two hours of a senior managers' time and explaining to the board for 15 minutes. 2 * £48 + 0.25 * £694 = £269.76 per company £269.76 * 2000 PIEs = £539,520 £539,520 + £177,350 = £716,870
75		£365,000	Individual actuaries and (potentially) organisations employing actuaries	Cost of engaging with expected increase in enforcement activity.	Cost based on estimated doubling of FRC's own budget for enforcement if playing a role in direct regulation of actuarial profession.
TOTAL	**£600,000**	**£13,965,000**			

Annex XI: A new regulator option 3 (Detailed Costs)

Costs to regulator

#	Recommendation Description	Set up costs	On-going costs	Funding
21	Examine overseas component audit work		£1,823,250	Recovered
25	Power to direct changes to accounts			
28	Pre-clearance of accounts [IU resource assisting]		£3,740,000	Recovered
30	Consider need for qualitative regulation of "investor information"		£3,315,000	Levy
34	International reach of enforcement action	£170,000	£977,500	Levy/Recovered/Registration fees
36	Enforcement regime for non-member directors	£170,000	£5,270,000	Levy/Recovered
37	a) Should follow AEP model, b) Range of sanctions, c) Set out relevant requirements			
47	Power to commission a skilled person review		£1,275,000	Recovered
48	Power to publish skilled person report			Recovered
49	Action to flow from skilled person report			Recovered
50	Action to flow from skilled person report in most serious cases			Recovered
TOTAL LEVY		**£340,000**	**£3,315,000**	
TOTAL RECOVERED/REGISTRATION FEES			**£13,085,750**	

Compliance Costs

#	Ongoing compliance Costs	Regulated parties affected	Description of costs	Working of compliance costs
21	£1,823,250	Overseas components of firms being inspected		FAME data shows that 115 (33%) of FTSE 350 companies have at least one overseas component (subsidiaries registered abroad) with revenues that make up at least 20% of the total revenue of the group (where the 20% revenue benchmark signifies that the overseas component is significant). We can therefore assume that 33% of current audit files inspected by AQR are audits of companies with significant overseas components (53 audit file reviews). This means AQR will inspect the overseas elements of these audits. We assume the additional cost of these inspections would be equal to 33% of AQR's current budget of £5,525,000 which is £1,823,250.
30	£7,750,000	Companies inspected by CRR	Increased number of CRR enquiries.	We assume that reviewing different types of investor information will increase CRR workloads by 33% on top of the 167% increased size of CRR necessary to meet ESMA equivalence requirements. Assume that the costs to companies of responding to CRR requests is 1.5x the resource CRR spends on the reviews and that, since companies often involve their auditors in answering CRR queries, the auditor spends 0.5x the resource CRR spends on the reviews (which includes costing to firms at a higher outrate). CRR budget (18/19) £4.4m * 2.67 * 0.33 = £3.877m £3.877 * 2 (cost to firm and auditor recharged to firm) = £7.754m
34	£700,000	Overseas component auditors of PIEs, potentially the UK group auditor, potentially the PIE entity and its subsidiaries		The cost of defending against an FRC investigation is estimated to be between £200,000 - £500,000 (mid-value of £350,000) for an assumed two overseas enforcement cases a year. This gives an enforcement compliance cost of 2 * £350,000 = £700,000
36	£3,500,000	PIEs and Individual directors	New regime and code to be familiar with; compliance with the new code; increased D&O insurance costs; costs of defending action in relation to breaches	We assume 5 additional cases a year. We assume that defending a case costs a firm £300,000 * 5 extra cases to be defended = £1,500,000 We also assume take up on D&O insurance of £1000 for every PIE (c2,000) = £2,000,000 Total compliance costs £3,500,000

#	Ongoing compliance Costs	Regulated parties affected	Description of costs	Working of compliance costs
47	£2,250,000	Firms required to undergo a skilled persons review		We assume the FRC would only use this power a maximum of 5 times a year and that each review would cost c.£300,000 on average (based on comparable FCA costs) or a total of £1.5m per year. If we also assume, as for CRR reviews, that the cost of compliance by the company is 1.5 times that of CRR's additional costs, the cost is estimated to be (£1.5m*1.5) = £2.25m.
TOTAL	**£16,023,250**			

Annex XII: Estimating potential avoided costs from measures to improve resilience and choice in the audit market.

We estimate the total annual loss to companies from a Big Four failure, which would create a Big Three. We do this based on estimates developed by Gerakos and Syverson (2015)[249]. They estimate:

a. The size of the annual loss to companies in the US, a market with a similar structure to the UK, from such an event. In our analysis, we assume that the US results are broadly applicable to the UK market.

b. How the collapse of each of the Big Four would affect the consumer surplus of the listed companies by first estimating the demand for audit services at listed companies, a segment in which the Big Four each provide different products.

c. A total annual loss of between 14-21% of the audit fee. This is a result of two factors.

    i. First, the listed companies that have to buy new audit services, would not be able to appoint their preferred auditor, and would in effect, be paying for a sub-optimal audit engagement (a loss of consumer surplus)

    ii. Second, reduced competition among auditors would likely lead to higher audit fees.

We apply Gerakos and Syverson's cost estimate to the total FTSE 350 audit fees, which were worth £865m in 2018 (at 2016 base prices) and estimate the present value cost (PVC) of the loss across thirty and ten-year appraisal periods.

We assume the incremental probability of exit in any given year to be either 1%, 5% or 10%. The cumulative probability reaches 10%, 50% or 100%, respectively, by year 10. We use these probabilities to calculate probability-adjusted PVCs for both appraisal period. We do so separately for the loss in consumer surplus and impact of a fee increase. The results are presented in *Table 83* and *Table 84* below.

Table 83 - PVC to client companies from a Big Four firm exit (30-year appraisal period)

Annual incremental probability of Big Four exit	PVC (£, 2016) lost consumer surplus over 30 years	PVC (£, 2016) fee cost over 30 years	Total PVC (£, 2016) over 30 years
1%	£291m	£78m	**£369m**
5%	£1,456m	£388m	**£1,844m**
10%	£2,912m	£777m	**£3,689m**

Table 84 - PVC to client companies from a Big Four firm exit (10-year appraisal period)

Annual incremental probability of Big Four exit	PVC (£, 2016) lost consumer surplus over 10 years	PVC (£, 2016) fee cost over 10 years	Total PVC (£, 2016) over 10 years
1%	£53m	£14m	**£67m**
5%	£265m	£71m	**£336m**
10%	£530m	£141m	**£671m**

[249] Gerakos, J. and Syverson, C. (2015), Competition in the Audit Market: Policy Implications. Journal of Accounting Research, 53: 725-775. doi:10.1111/1475-679X.12087

Annex XIII: Equality Analysis for proposals arising from the three Reviews of Audit in the UK

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Date: 22 October 2020

Scope

This document records the analysis undertaken by the Department for Business, Energy and Industrial Strategy (BEIS) to fulfil the requirements of the Public Sector Equality Duty ("the equality duty") as set out in section 149 of the Equality Act 2010. This requires the department to pay due regard to the need to:

i. eliminate unlawful discrimination, harassment and victimisation and other conduct prohibited by the Act.

ii. advance equality of opportunity between people who share a protected characteristic and those who do not.

iii. foster good relations between people who share a protected characteristic and those who do not.

The protected characteristics which should be considered are:

- age
- disability
- gender reassignment
- marriage or civil partnership[250]
- pregnancy and maternity
- race
- religion or belief
- sex
- sexual orientation.

Proposal Outline

In the wake of recent large corporate failures, such as that of BHS in 2015 and Carillion in 2018, the Government commissioned three independent audit-focused reviews: Sir John Kingman's Independent Review of the Financial Reporting Council (FRC)[251], the Competition and Market Authority (CMA)'s Statutory Audit Services Market Study[252], and Sir Donald Brydon's Independent Review of the Quality and Effectiveness of Audit[253].

In summary:

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[250] In relation to the protected characteristic of marriage and civil partnerships, the Department is required to have due regard only to point (i).

[251] The full Independent Review of the FRC can be found here: https://assets.publishing.service.gov.uk/Government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

[252] The full CMA market study can be found here: https://www.gov.uk/cma-cases/statutory-audit-market-study

[253] The full Brydon report can be found here: https://assets.publishing.service.gov.uk/Government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf

- The FRC Review found that the existing regulator lacked the necessary powers and clarity of purpose to hold auditors and corporate reporters sufficiently to account. It made recommendations for improving the operation of the regulator and corporate reporting regulation which centred on the creation of the Audit, Reporting and Governance Authority (ARGA).
- The CMA Audit Market Study found an unhealthy dominance of the statutory audit market, for larger companies, by a small number of audit firms, and identified a number of long-standing problems related to choice and switching, market resilience, and the incentives for quality between market players. It found that these issues undermine the role and purpose of audit, and that the market lacked the ability to self-correct. It therefore called for called for new measures to increase quality, competition and resilience in the delivery of audit.
- The Brydon Review identified considerable room for improvement in the quality of information provided by statutory audits, and for higher expectations to be placed both directors and auditors to deliver more useful corporate reporting information. It therefore made recommendations focusing on these improvements.

The proposals assessed in this Equalities Impact Assessment seek to address the findings of each review and are therefore central to audit and corporate reporting reform, and to the Government's wider aim to ensure the UK remains world-leading in its standards of corporate governance and stewardship, corporate reporting, audit and actuarial work, and as a place to do business.

We expect the outcomes of these proposals to apply to directors, auditors and audit firms, the audit regulator, and shareholders (who are expected to passively accrue any associated benefits). We have discussed these outcomes, equality considerations, and the applicability of the PSED to the proposal, with policy colleagues, PSED contacts in Human Resources, and with BEIS legal advisors. Based on these discussions, we do not expect the outcomes of this project to have any relevance to PSED. Therefore, we do not consider it necessary or proportionate to gather equality data for this assessment.

PSED Considerations

We considered potential and likely impacts of the proposal on the three aims of the PSED. Our findings are provided below.

Aim 1 – Eliminate unlawful discrimination, harassment, victimisation, and any other conduct prohibited by the 2010 Act.

Does your policy or service disadvantage some people or groups more than others?

The proposals assessed here are not expected to treat any individuals or groups more favourably (or unfavourably) than others, nor is it expected to result in any differential impact on groups or individuals with protected characteristics. We also do not expect it to have an impact on people with protected characteristics as a result of them possessing those characteristics, or any unintended impact on any of those groups.

Whilst affected entities (audit firms and their client companies) will employ individuals who have protected characteristics, the impact of this proposal will be on the entire firm or company and not on any specific individual or groups therein. We therefore expect the actual impact on employees to be the same regardless of their individual characteristics.

Where specific actions, arising as a result of the proposals assessed here, may affect individuals, such as in the case of measures related to company directors, it will be on the basis of their conduct and not their individual characteristics. Where shareholders are affected, we expect the impact to be positive, and to apply to shareholders equally, without regard to their individual characteristics.

Aim 1 Assessment

Protected Characteristic	Expected Impact
Disability	None
Race	None
Age	None
Gender reassignment	None
Religion or belief	None
Pregnancy & Maternity	None
Sexual orientation	None
Sex	None
*Marriage & Civil Partnership	None

Aim 2 – Advance equality of opportunity between people who share a particular protected characteristic and people who do not share it.

Will our actions deliver a less good outcome for any groups compared to others?

Given that measures introduced under these proposals will mainly affect directors, auditors and audit firms, and the audit regulator on the basis of their conduct and performance, we do not expect any disproportionate adverse impact on any individuals or groups who hold one or more protected characteristics.

Is there evidence that particular groups are less involved in this policy area and is this linked to a protected characteristic?

We have not undertaken any formal consultation specifically to investigate whether particular groups are less involved in the policy areas covered by these proposals, since there are no practical limitations, based on protected characteristics, to involvement in any of the activities therein. Whilst there may be some existing inequalities in this area, the measures introduced under these proposals are not expected to change any aspect of how individuals or groups with protected characteristics engage, and the individuals and groups that are already active in these policy areas are not expected to change as a result of how measures may interact with their protected characteristics. Measures to effect the changes that would address existing inequalities in this policy area are beyond the scope of the proposals assessed here.

Aim 2 Assessment

Protected Characteristic	Expected Impact
Disability	None
Race	None
Age	None
Gender reassignment	None
Religion or belief	None
Pregnancy & Maternity	None
Sexual orientation	None
Sex	None

Aim 3 – Foster good relations between people who share a particular protected characteristic and people who do not share it.

How is the policy going to be received by people who do not benefit from it?

We expect the entire UK population to benefit in some way or another from measures introduced under these proposals. We expect the key benefits to accrue from improvements in the effectiveness of the regulator and the operation of the statutory audit market, and from improvements in the quality of audit and corporate reporting information available to company shareholders, other users, and the wider UK public. We expect this to result, ultimately, in greater financial stability across the UK economy, and increased economic growth potential, as the UK's reputation and position as a world-leading place to do business is strengthened. These wider benefits will apply to everyone in the UK, regardless of whether they have one or more protected characteristics.

Will our actions help to tackle prejudice and promote understanding between different groups – can we take positive action in respect of the three aims of PSED?

These proposals are not intended to directly encourage actions to tackle prejudice or promote understanding between different groups. However, some of the changes to be introduced – in particular, those intended to align the appointment of the ARGA board with comparable public sector organisations (under the FRC Review) – *could* result in improved board diversity.

Additionally, we do not expect any of the measures taken under this proposal to hinder any action to tackle prejudice or promote understanding between different groups or give rise to, or create an increased risk of, discrimination, harassment, victimisation or any other conduct prohibited by or under the Equality Act 2010. We therefore expect a small but positive impact in this area, if any.

Aim 3 Assessment

Protected Characteristic	Expected Impact
Disability	None or small
Race	None or small
Age	None or small
Gender reassignment	None or small
Religion or belief	None or small
Pregnancy & Maternity	None or small
Sexual orientation	None or small
Sex	None or small

Conclusion

We conclude that the proposals assessed here should have no adverse or disproportionate negative impact on persons or groups with a protected characteristic, and no steps need to be taken to advance equality of opportunity and foster good relations because of, or in relation to, them.

The measures under these proposals are not expected to give rise to discrimination, harassment, victimisation, or any other conduct prohibited by or under the Equality Act 2010. Further, they do not make specific or direct provision in respect of any of the protected characteristics, and they are not expected to result in outcomes where people who share particular protected characteristics are treated differently from people who do not. They are not expected to give rise to a direct or indirect impact on individuals as a result of any protected characteristic they may have.

On this basis, we do not consider it is necessary or proportionate to seek further evidence to support this assessment, or to recommend any changes to our existing plans.

Approach to monitoring

The Department does not intend to monitor the outcomes of these proposals in relation to the PSED specifically. However, we recognise that once established, ARGA, as a public body, will be expected to demonstrate its compliance with the PSED.

Sign-off

Name: Mark Holmes

Job Title: Deputy Director, Business Frameworks

Date: 26/10/2020