

**STRENGTHENING THE INDEPENDENCE OF AUDIT REGULATION**

- It is important that there is investor and market confidence in the reliability and integrity of the financial reporting process.
- Effective oversight of the audit profession is critical to a key part of the financial reporting process: the impartiality and effectiveness of auditors.
- DTI's review of the regulatory regime of the accountancy and audit profession found concerns about perceived independence of key aspects of the current regulatory arrangements.

The Bill will:

- Increase the independence of the regulation of the audit profession.
- Give the independent regulator (prospectively the Financial Reporting Council and its associated bodies) the powers and resources it needs to do its job more effectively.

It will do this by:

- Requiring the professional bodies that supervise auditors to observe independent standard setting, audit monitoring and disciplinary processes.
- Enabling Government to contribute to the funding of the new activities that the Financial Reporting Council has taken on. Government already helps fund existing FRC activities, along with business (listed companies) and the accountancy profession, under a voluntary arrangement.
- Providing a power for the Secretary of State to impose a levy if necessary on business and the accountancy profession to fund FRC activities. The levy power is in case the existing voluntary funding arrangements broke down - such security of funding is important to safeguard the independence of the regulatory regime.

- Allowing the Secretary of State to delegate her powers in respect of audit supervision to an existing independent body with audit and professional oversight responsibilities and experience.

#### How do the Bill provisions interact with non-legislative measures?

- The FRC is currently expanding to take on the functions of the Accountancy Foundation, resulting in a single independent regulator with three clear areas of responsibility: setting of accounting and audit standards; their enforcement or monitoring; and the oversight of the major professional accountancy bodies.
- Government expects professional bodies that supervise auditors to comply with new independence requirements by signing up to arrangements established under new FRC work in respect of standard setting, monitoring and discipline.
- New levy power will give FRC security of funding to ensure their independence from business and the accountancy profession; will remove possibility that either businesses or the profession could wield undue influence over the FRC by threatening to withhold funding. The Government will continue to pay a third share of the FRC's new remit.
- Government intends to delegate oversight of audit supervision to an FRC Board.

**AUDITORS' RIGHTS IN OBTAINING INFORMATION**

- To increase the reliability of, and confidence in, the accounts of companies subject to audit.
- This builds on the Company Law Review and the Coordinating Group on Audit and Accounting Issues (CGAA), which concluded that there was a strong case for extending the existing rights of auditors to information.

The Bill will:

- Enable the company auditors to carry out their duties more effectively.

It will do this by:

- Entitling the auditor to require information and explanations from a wider group of people than at present, in particular from employees.
- Introducing a new offence, where a person fails to provide information or explanations.
- Requiring a statement in the company accounts to the effect that the directors have not withheld information necessary for the auditors to form their opinion. Directors will need to carefully consider if they have provided all the information necessary for a successful audit.

**NEW POWERS FOR THE FINANCIAL REPORTING REVIEW PANEL**

- These new powers will strengthen the enforcement regime that supports accurate financial reporting. The capital markets do not function properly unless there is confidence that companies are following accounting requirements when reporting their financial situation. The FRRP has a key role in ensuring that the requirements are complied with.
- Strengthening the FRRP was a recommendation of the Coordinating Group on Audit and Accounting Issues (CGAA), which reported to the Govt in January this year.

The Bill will:

- Give the FRRP a power to require companies to provide it with the information it needs to carry out its investigations. The FRRP currently has no statutory power of this kind.
- Extend the FRRP's role. The FRRP currently reviews the annual accounts and reports of public and large private UK companies. The Bill will allow the Government to extend this to reviewing the interim reports of listed companies. In such cases, it will report its findings to the Financial Services Authority, which is responsible for enforcing Listing Rules.
- Open an "information gateway" from the Inland Revenue to the FRRP, enabling tax investigators to pass on any information they uncover which could indicate that a company is not complying with accounting requirements.

The Bill will do this by:

- Providing the FRRP with a power to require relevant documents from companies and their auditors, enforceable by a court order.
- Providing the Secretary of State with a power to appoint the FRRP as a body to report to the FSA on any periodic accounts and reports of any issuer of listed securities (that is, any company or other entity which lists in the UK – this could include overseas companies listed here, and some UK issuers which are not companies). The detail of the FRRP's role in this regard will be set out in secondary legislation.
- Allowing the Inland Revenue to disclose tax information to the FRRP. The FRRP are not allowed to make any onward disclosure of this information

How do the Bill provisions interact with non-legislative measures?

The FRRP, as a result of a CGAA recommendation, is moving to a proactive approach to enforcement. This does not require legislation and the FRRP are already piloting this approach. The measures in the Bill complement the move to proactivity.

See also the provisions on audit regulation (Factsheet 1), which deal with funding of the Financial Reporting Council bodies, of which the FRRP is one.

**STRENGTHENING THE COMPANY INVESTIGATIONS REGIME**

- Effective means of uncovering fraud, breaches of company law and other misconduct make an essential contribution to ensuring investors, suppliers and consumers have the confidence to take part in the market.
- Investigators must have speedy access to all relevant information if investigations are to be targeted and effective.

The Bill will:

- Improve investigators' access to relevant information.
- Reduce the possibility of delay or obstruction by companies under investigation.
- Remove a possible deterrent to individuals volunteering information when complaints are vetted for possible investigation.
- Introduce more effective sanctions.

It will do this by:

- Giving investigators a new power to get relevant information from anyone and strengthening their document-gathering powers. However, the powers are subject to existing protection for legally privileged material and banking confidentiality.
- Giving investigators the power to require entry to, and remain on, a company's business premises without obtaining a warrant. This will make it easier to require documents and other information and to see the business in operation. But it is not a power to search and seize, which will still require a warrant from a magistrate.
- Providing statutory immunity from liability for breach of confidence for individuals and businesses volunteering information in specified

circumstances.

- Allowing a refusal to provide information to be punished as a contempt of court. This is a more flexible procedure and a more effective sanction than criminal proceedings, with a better prospect of getting the desired information.

The Bill will not make any change of substance to the grounds for an investigation.

**STRENGTHENING AUDITOR INDEPENDENCE - DISCLOSURE OF NON-AUDIT SERVICES**

- Auditors must be independent, and be seen to be independent, from the companies they are auditing. One concern, highlighted by events at Enron and the involvement of their auditors, Andersens, is where an audit firm is providing non-audit services to its client.
- The Coordinating Group on Audit and Accounting Issues (CGAA) looked at the issue last year in the wake of Enron and recommended a package of measures to strengthen the independence and objectivity of auditors. Most do not require legislation (see below).
- The provision on disclosure of non-audit services complements the non-legislative measures by increasing company transparency about its relationship with its auditors. This market-driven approach is considered by the CGAA, the UK Government and by the EU to be preferable to a blanket ban on the provision of non-audit services.

The Bill will:

- Require companies to publish detailed information in their annual accounts or reports on the types and costs of services bought from their auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided.

This will increase transparency, enabling shareholders and others to make well-informed judgements about whether the auditor may be subject to a conflict of interest when forming an opinion on whether the company accounts are “true and fair”.

This replaces the existing more general requirement to state the total amounts spent on audit and non-audit services respectively.

How do the Bill provisions interact with non-legislative measures?

This measure should not be seen in isolation. The CGAA considered that there were a number of ways to improve the independence and objectivity of auditors without resorting to a complete ban on the provision of non-audit services. The full details are in the CGAA report published in January. They addressed the problem from the perspective of the provider of the services (the audit firms) and the purchaser of the services (the company), and the oversight regime.

For auditors, they recommended:

- tougher ethical standards on independence and objectivity
- more frequent rotation of audit partners
- a longer “cooling-off” period before an auditor can be employed by a client
- greater transparency by the firms themselves in their annual reports

For the company, they recommended:

- a much stronger role for a company’s audit committee in monitoring the company-auditor relationship, to be formalised in a revised Combined Code
- greater transparency by the company about what other services it is purchasing from its auditor (*the subject of this factsheet*)

For the oversight regime they recommended

- the standard setter (the Auditing Practices Board) to be fully independent of the audit profession
- restructuring and strengthening of the Financial Reporting Council, with the Auditing Practices Board to become a part of it

The non-legislative measures are all either already implemented or in the process of being implemented. Most recently, the Auditing Practices Board (APB) published exposure drafts of 5 tough new Ethical Standards on independence, which cover audit partner rotation and the provision of non-audit services, among other things.

## **COMMUNITY INTEREST COMPANIES (CICs)**

### Key measures:

- The CIC will be a new type of company for use by not-for-profit organisations pursuing community benefit, also known as social enterprises. It will combine the flexibility of the company form with some special features.
- To ensure that CICs use their assets for the community benefit, they will be prevented from distributing profits and assets to their members. This is known as an ‘asset lock’ – a transparent and entrenched way of ensuring that assets cannot be used for private benefit.
- In order to become a CIC, a company will have to satisfy a community interest test, confirming that it will pursue purposes beneficial to the community and will not serve an unduly restricted group of beneficiaries. The test is whether a reasonable person could consider the CICs activities to benefit the community.
- Each CIC will be required to produce an annual community interest report, which will be made public. The report will record what the CIC has done to pursue the community interest and involve its stakeholders during the year.
- In order to raise investment for community purposes, CICs limited by shares will have the option of issuing shares that pay a dividend to investors. The dividend payable on these shares will be capped in order to protect the asset lock.
- A new independent regulator will have the job of maintaining public confidence in CICs, by ensuring that they comply with the law.
- CICs will be more lightly regulated than charities, and will not have the benefits and burdens of charitable status, even if their objects are entirely charitable. Charities, and all other organisations except political parties, will be able to establish CICs as subsidiaries.

## Why would an organisation want to become a CIC?

- The CIC is intended to be used by social enterprises - non-profit-distributing organisations providing benefit to a community (for more details see [www.dti.gov.uk/socialenterprise](http://www.dti.gov.uk/socialenterprise)). Such businesses are presently active in areas such as childcare, social housing, leisure and community transport. Many of them already incorporate as companies, while others take the form of industrial and provident societies, the legal form for co-operatives.
- The CIC will be an additional option, alongside existing forms. It will be particularly suitable for those social enterprises that wish to work within the relative freedom of the non-charitable company form, but with a clear assurance of non-profit-distribution status.
- Being a CIC will not confer any special tax status. Since CICs will be used primarily for non-charitable activity, often involving trading, they will be competing with commercial organisations that do not enjoy tax incentives. Where appropriate, along with other social enterprises, CICs will be able to take advantage of the fiscal measures which the Government has introduced to promote enterprise in deprived areas, such as the Community Investment Tax Relief (CITR) scheme.
- Two recent public consultations have demonstrated that the CIC proposals will answer a real need. The Cabinet Office Strategy Unit report on the voluntary sector (September 2002) first proposed the CIC, and a subsequent joint DTI/Home Office/Treasury consultation (March 2003) set out more detailed proposals.<sup>1</sup>
- Responses to the March 2003 consultation commented that:

*“It will be a valuable addition to the range of legal forms available for social enterprise”*

**Social Enterprise Coalition**

*“It fills a gap in the range of legal forms that are currently available. The CIC will combine the well-understood company model with a test of community benefit and a simple and transparent mechanism to lock profits into the company. As such the CIC will be a useful tool for many organisations undertaking social enterprise activities.”*

**National Council for Voluntary Organisations**

*“We welcome the introduction of the CIC since it expands the choice of legal forms for the social enterprise sector. The easy*

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<sup>1</sup> A report on the March 2003 consultation is available at [www.dti.gov.uk/cics](http://www.dti.gov.uk/cics)

***asset lock the CIC will provide is a highly desirable element of the proposed plans.. The CIC model will be of relevance to many organisations in the entire third sector and to some socially driven companies in the private sector, and not just to 'social enterprises'”***

***New Economics Foundation***