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# *EU audit reform*
# Providing non-audit services

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*In December 2013, the European Commission, Parliament and Council of Ministers reached political agreement on draft legislation to reform the audit market within the EU. The legislation was voted through the Parliament in April and it came into force in mid-2014.*

*The legislation introduces new restrictions on the non-audit services that auditors can provide to their EU public interest entity audit clients. The restrictions take the form of a cap on the amount of non-audit fees that can be billed, and a list of prohibited services that the auditor can't provide.*

*These changes are significant and may cause complexity for business. There's also a lot of uncertainty in how the final rules will actually be applied, much of which will take some time to resolve. We'll keep you updated on the latest developments. In the meantime, our focus remains on delivering high-quality professional services to all of our clients.*

## Background

EU audit regulation reform has been a recurring topic of discussion for over a decade. Following the financial crisis there was an increasing push to bring about audit reform. In November 2011, Michel Barnier, as EU Commissioner for Internal Markets, began the legislative process by proposing that a number of radical reforms should become part of EU law.

*"Investor confidence in audit has been shaken by the crisis and I believe changes in this sector are necessary: we need to restore confidence in the financial statements of companies."*

Michel Barnier, November 2011

Since then, the various parties who contribute to the development of EU legislation have been considering his proposals. The debate has been complex and many differing views considered.

## What reforms have been proposed?

The legislation covers many areas, including European-level supervision of auditors and changes to European audit opinions. However, the reforms that will have the greatest impact on UK business are in the areas of mandatory audit firm rotation for public interest entities and provision of non-audit services by auditors of public interest entities.

The legislation defines public interest entities as including all EU-domiciled entities with instruments listed on a regulated EU exchange, all banks and all insurance undertakings. There are no exemptions for subsidiaries of groups owned outside the EU.

We've discussed the implementation of mandatory audit firm rotation in a separate document. In this document, we've analysed the detail of the proposals to restrict the provision of non-audit services. The restrictions have two forms: a cap on the level of non-audit fees that the statutory auditor of a public-interest entity can earn, and the introduction of a prohibited list of non-audit services that the auditor can never provide.

## When will the new rules be implemented?

The European legislation consists of a Directive and a Regulation. The non-audit service restrictions are contained in the Regulation which came into force in mid-2014. Importantly, however, the Regulation includes a two year transition period which means none of its provisions will become binding until mid-2016. It is important to note that the transition period is different for the mandatory firm rotation requirements (please see separate briefing note).

This Regulation is unusual in that it contains numerous Member State options allowing Member States to decide exactly how the new provisions should be applied in their country. The national implementation decisions will be made during the two year transition period.

## Who will be impacted?

The new legislation applies to audits of EU public interest entities. A 'public interest entity' includes:

| | |
|---|---|
| ***Entities governed by the law of an EU member state with transferable securities listed on an EU regulated exchange*** | Entities incorporated outside the EU, for example, in the Channel Islands, will not be caught by this part of the definition.<br>ESMA, the European markets regulator, publishes a list of regulated exchanges. Exchanges such as AIM and the lower Luxembourg Bourse are not included. |
| ***Credit institutions*** | This will include all firms licensed by a financial services regulator to take deposits within the EU. |
| ***Insurance undertakings*** | This will include all firms who undertake regulated insurance activities but not, for example, insurance brokers. |

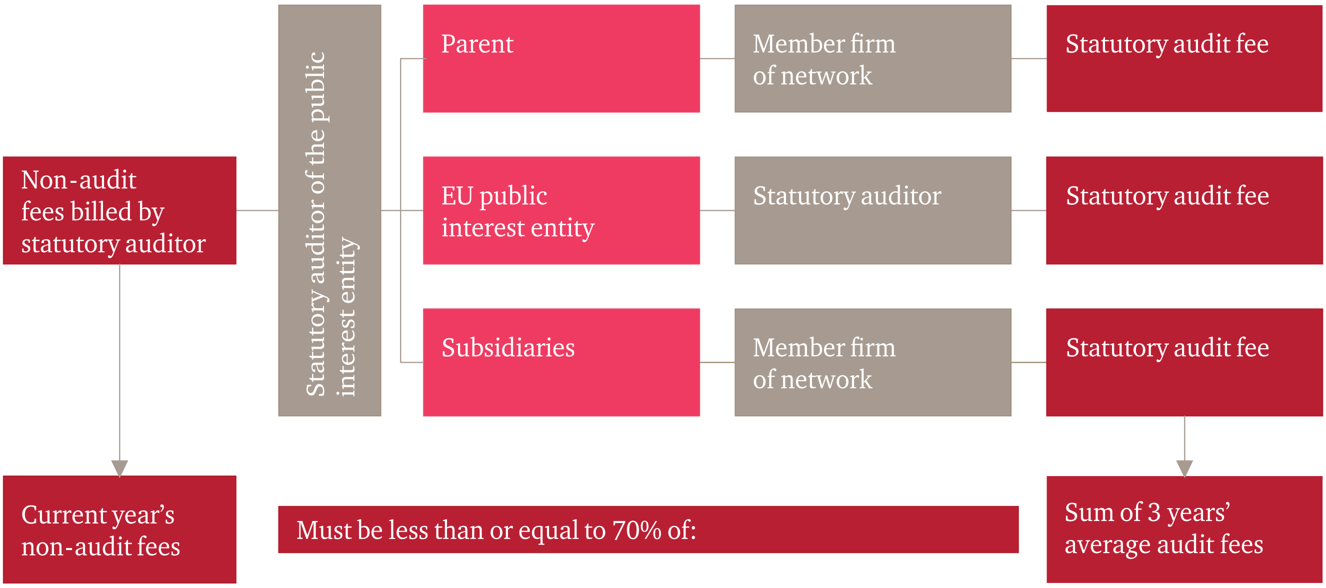
The public interest entity definition applies even where a company is part of a group listed outside Europe. EU subsidiaries of US groups, for example, are caught if they have securities listed on an EU regulated exchange, an EU banking licence, or if they undertake insurance activities.

The impacts of the cap and the non-audit service restrictions on the group companies of an EU public interest entity are different. We've explained this further below.

## How will the cap on non-audit services be calculated?

This is an area where there's been uncertainty since the political agreement in December. During the ongoing process to correct and translate the legislative text, this area has been clarified and we can now be more definitive about the calculation.

The maximum non-audit fees that the statutory auditor of a public interest entity can bill in any one year is set at 70% of the average of the audit fees billed over the last three year period to the PIE, its parent and its susidiaries. The relevant fees to be included in the calculation are illustrated below.




Important points to note are:

- Non-audit fees must include all those billed by the statutory auditor of the public interest entity, whether to the public interest entity itself, or to the entity's parent or subsidiaries.
- Non audit fees do not include any billed by other firms within the statutory auditor's network. For example, consider a UK public interest entity which is audited by PwC UK. PwC in the US provides various non-audit services to the company. Fees paid to PwC US for these services are not included in the calculation of the cap.
- Audit fees must include the statutory audit fees for the audits of the public interest entity, its parent and its subsidiaries (together with any consolidation audit fee, where relevant).
- If the public interest entity has 'sister' companies within the EU, which are not themselves public interest entities, then fees paid to these sisters are not included in the calculation.

Consequences of this calculation include:

- Non-audit fees billed by network firms of the statutory auditor are not capped.
- In order to apply the cap, a 3 year track record of statutory audit fees is required. This suggests that when an entity becomes a PIE (for instance, after an IPO), then the cap cannot become binding until the 4th year after the IPO. Member States do, however, have the option of making the application of the cap more stringent.

## What gets included in statutory audit fees and non-audit fees?

The draft legislation is very clear that audit fees can only include those fees paid for the statutory audits of the public interest entity, its parent and its subsidiaries.

Fees for audit related services, such as half year reviews, or opinions on regulatory returns, cannot be included.

Non-audit fees, however, can exclude any services which are required by national or EU legislation. This means that fees for services that an entity is legally required to obtain (such as public comfort on a shareholders' circular, for example) do not need to be included in the non-audit fees considered.

## When will the cap first apply?

The cap will become applicable in mid-2016. The calculation of the cap requires a three year history of audit fees. For a December year end company, therefore, the cap for the year ending 31 December 2020 will be 70% of the average audit fees for the years ending 31 December 2017, 2018 and 2019.

It's less clear how the cap provision should be applied for the year ending 31 December 2016, as the provision will only incept midway through this financial year. The uncertainty will be resolved by Member States during the implementation process. The UK government could well address this issue through deeming that the cap will apply for accounting periods beginning on or after 1 July 2016.

## What if the cap is breached?

The legislation allows that Member States may take an option to allow an auditor to apply to the local audit regulator for exemption from the cap, for up to two financial years. In the UK, the relevant regulator would be the FRC. The regulator would not be required to allow the breach, but could well be sympathetic to cases where an unusual event or transaction prompts the unavoidable use of the auditor to provide non-audit services.

*The cap calculation is very complex and for most groups, it will not be possible to calculate the cap from publicly disclosed financial information. Market commentators might ignore the complexities of the calculation and make a simple comparison of disclosed audit fees to disclosed non-audit fees in order to perform a crude assessment of cap compliance.*

## *What non-audit services will be prohibited in the future?*

The proposed legislation includes a list of non-audit services that cannot be provided by the auditor of a public interest entity (or by its network firms) to the public interest entity, its parent and subsidiaries within the EU.

The prohibited services are summarised in the table below. In many places, the text is imprecise. Member State interpretation of the ambiguous text will be very important, and could differ between different Member States.

| *Prohibited non-audit service* | *Comment* |
|---|---|
| **Tax advice and compliance** | Member states can allow some tax services if they are deemed to have no direct effect on, or are immaterial to, the audited financial statements. We are not yet clear whether the UK government will choose to take advantage of this option, although we understand that it is likely that the German government will do so. Services involving payroll tax and customs duties can never be permitted. |
| **Services that involve playing any part in the management or decision-making process of the audited entity** | These words are particularly vague. Member States will likely issue additional guidance on the interpretation of this clause. |
| **Book-keeping and preparing accounting records and financial statements/payroll services** | These restrictions will be similar to those already imposed by existing regulation. |
| **Designing and implementing internal controls related to financial information or designing and implementing financial information technology systems** | These services are all prohibited in the 12 months prior to an audit appointment, and throughout the audit appointment period. |
| **Valuation services** | As for tax services, member states can allow these services if they are deemed to have no direct effect on, or are immaterial to, the audited financial statements. |
| **Legal services/Internal audit/Human resource services** | Restrictions may be more extensive than those currently applied, depending on Member State interpretation of the legislation. |
| **Services linked to financing, capital structure and allocation, and investment strategy of the audited entity** | The draft text confirms that providing assurance services, including the provision of comfort letters on prospectuses, will still be permitted. The introductory text to the proposed legislation also suggests that due diligence services will be permissible. |
| **Promoting, dealing in or underwriting shares in the audited entity** | This restriction will be similar to that already imposed by existing regulation. |

In addition to this list, Member States have the option to add any other non-audit services to the prohibited list if it is believed that the service presents a particular threat to independence. So far, we don't expect the UK government to add significant numbers of services to the list, but this position could change in the future.

Other non-audit services may be provided, as long as the audit committee of the public interest entity approves the provision of these services after assessing the potential threats to independence that could arise, and the safeguards that have been applied.

## How are EU public interest entities impacted by these restrictions?

Unlike the cap calculation, the prohibited list of services applies to all EU member firms of an audit network when they are providing non-audit services to the public interest entity and its EU parent and subsidiaries within the EU.

| | | |
|---|---|---|
| EU parent | EU member firm of network | Prohibited list applies |
| EU public interest entity | Statutory auditor | Prohibited list applies |
| EU subsidiaries | EU member firm of network | Prohibited list applies |

If the public interest entity has sister entities within the EU, however, which are not themselves public interest entities, the prohibited list does not apply to provision of services to those entities.

## Are there any restrictions on the provision of non-audit services to group companies outside of the EU?

The list of prohibited services applies to services supplied to the EU public interest entity, its parent within the EU, and its subsidiaries within the EU.

Where non-audit services are provided to subsidiaries of the public interest entity outside of the EU, the auditor of the public interest entity must assess whether independence has been threatened, and apply safeguards if so. For services on the prohibited list, it is assumed that additional safeguards will be needed. However, for the following categories of services, the Regulation states that independence threats are incapable of mitigation by safeguards, and therefore provision of these services is prohibited to non-EU subsidiaries of the public interest entity:

- Being involved in the decision taking of the audited entity;
- Services that involve playing any part in the management or decision making process of the audited entity;
- Book-keeping and preparing accounting records and financial statements; and
- Designing or implementing internal control/risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems.

## What are the rules around using auditors before or after an appointment?

As the legislation was being finalised, there was much debate about so-called ‘cooling-in’ and ‘cooling-off’ periods. These would have been set periods before and after appointment as auditor during which prohibited non-audit services could not be provided.

In the final agreed text, cooling-in and cooling-off periods were largely removed, with the exception of one category of service: designing or implementing internal control over financial information or systems or designing and implementing financial information technology systems. Auditors of public interest entities cannot provide these services for the 12 months preceding the first financial year for which they are appointed auditor.

Where companies are planning major systems implementations, the choice of supplier will need careful consideration in case it restricts the appointment of auditor in the future.

## *Can audit firms be used for deals work?*

Many companies periodically use their audit firm for support on deal and transaction work. In some cases, this approach can save time and cost, as the audit firm will be familiar with the financial systems and controls of the company.

The text states that “providing assurance services in relation to the financial statements, including the issuing of comfort letters in connection with prospectuses issued by the audited entity” will continue to be permitted, and the introductory text to the Regulation explains that due diligence will still be a permitted service. The reference to “comfort letters in connection with prospectuses” suggests that at least some reporting accountants’ services will be allowed. Here, UK interpretation and application will be important as UK protocols require that reporting accountants perform a wider range of services than solely issuing comfort letters on prospectuses.

## *What will happen to non-audit services completed in the first half of 2016?*

The Regulation includes a two year transition period, so its provisions will become binding in mid-2016. For companies with December year ends, it’s not clear how non-audit services supplied during the first half of 2016 will be treated. It’s possible that the UK government may resolve this uncertainty by deeming that the prohibitions will apply to accounting periods beginning on or after 1 July 2016.

## *What happens next?*

National implementation decisions will now begin. We expect that in the UK, changes to existing legislation will be made to introduce the new requirements, and that these will be put to Parliament after the 2015 general election, probably in early 2016. Alongside legislative changes, we anticipate that the FRC will issue explanatory guidance for Audit Committees, setting out the expected interpretation of the requirements. BIS have convened a steering group to advise on the legislative changes, with representatives from PwC and the FRC included.

## Keeping informed

This is a complex area where we're looking at new issues every day. When significant developments take place, we'll keep you informed. But if you have questions in the meantime, please contact your usual PwC contact, or any of the PwC experts listed below.

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