EU audit reform – prohibition of certain non-audit services

Summary of adopted legislation regarding the prohibition of certain non-audit services to public interest entities

EU legislation providing a new EU regulatory framework for statutory audit was adopted in April 2014. The laws will apply on or 17 June 2016 – with the exception of MFR, which is subject to transition arrangements.

Below is a summary of the measures regarding the introduction of prohibitions on the provision of certain non-audit services (NAS) by a statutory auditor to their PIE audit clients. The new measures prohibit a statutory auditor of a PIE “directly or indirectly to provide to the audit entity, to its parent undertaking or to its controlled undertaking within the EU any prohibited non-audit services.”

Summary of requirements

Table 1: Prohibited non-audit services

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<tr>
<th>Requirement</th>
<th>Description</th>
<th>Note</th>
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<tr>
<td>a. Tax and tax compliance services:</td>
<td>a) Preparation of tax forms</td>
<td>• They have no direct or have immaterial effect on the audited financial statements. (Note: needs further definition)</td>
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<td>b) Payroll tax</td>
<td>• Audit committee to set guidelines with regard to provision of such services</td>
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<td>c) Customs duties</td>
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<td>d) Identification of public subsidies and tax incentives unless support from the statutory auditor or audit firm in respect of such services is required by law</td>
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<td>e) Support regarding tax inspections by tax authorities unless support from the statutory auditor in respect of such inspections is required by law</td>
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<td>f) Calculation of direct and indirect tax and deferred tax</td>
<td>Note: Tax work on b) payroll tax and c) customs duties are not included in the Member State option and are therefore never permitted</td>
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<td>g) Provision of tax advice</td>
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<td>b. ‘Services that involve playing any part in the management or decision-making of the audited entity’. This definition is open to interpretation; it could include such things as “working capital management, providing financial information, business process optimization, cash management, transfer pricing and creating supply chain efficiency”</td>
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<td>c. ‘Services linked to the financing, capital structure and allocation, and investment strategy of the audit client’. These are also not clearly defined. Due diligence services would be allowed</td>
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<td>d. Promoting, dealing in, or under-writing shares in the audited entity</td>
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<td>e. Legal services with respect to:</td>
<td>• The provision of general counsel (Note: some lack of clarity regarding definition, may cover general legal advice)</td>
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<td>• Negotiating on behalf of the audit client</td>
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<td>• Acting in an advocacy role in the resolution of litigation</td>
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1The following entities are categorised as public interest entities:
• All entities that are both governed by the law of a Member State and listed on a regulated market
• All credit institutions in the EU, irrespective of whether they are listed or not
• All insurance undertakings in the EU, irrespective of whether they are listed or not and irrespective of whether they are life, non-life, insurance or reinsurance undertakings

Note: the latter two categories exclude branches of non-EU based credit institutions and insurance undertakings
• Entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees
f. Book-keeping and preparing accounting records and financial statement

g. Payroll services

h. Designing and implementing internal control or risk management procedures or financial information technology systems

i. Valuation services
   - Member States can allow these services as long as:
     - they have no direct or have immaterial effect separately or in aggregate on the audited financial statements
     - estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee

j. Services related to the audit client’s internal audit function (Note: awaiting clarification on definition)

k. Human resources services relating to:
   - Management in a position to exert significant influence over the preparation of the accounting records or financial statements subject to statutory audit, where such services for such positions involve:
     - searching for or seeking out candidates
     - undertaking reference checks on candidates
   - Structuring of the organisation
   - Cost control (Note: awaiting clarification on definition)

The statutory auditor cannot provide these services during the period of the audit up to the release of the audit report. For internal control related services, there is also a restriction on provision during the financial year immediately preceding the start of the audit.

Table 2: Permissible non-audit services

a. All other services are allowed, subject to the approval of the audit committee following an assessment of the threats to independence and the safeguards in place to mitigate or eliminate those threats

b. A cap on permissible NAS of 70% of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertaking, its controlled undertakings and of the consolidated financial statements of that group of undertakings. Regarding application of the cap:
   - The cap would only apply in the fourth consecutive year; the understanding is that the clock will be reset if in one year no NAS were provided. During the three consecutive years, no cap applies
   - Services required by national or EU legislation are exempted from the calculation of the cap
   - Operation of the cap is the responsibility of the statutory auditor, with oversight by the audit committee

Table 3: Member state options

a. Add services to the list of prohibited services

b. Allow specified tax and valuation services subject to conditions (see Table 1, section a) above

Note: It remains unclear at this stage which Member States will adopt the option to allow these services. This may in turn lead to a ‘patchwork’ of approaches, which may impact multi-territory service provision. There also remains some uncertainty regarding the definition of ‘direct’ and ‘immaterial’ and over who will make such a decision. This is expected to be included in the guidelines to be issued by the audit committee, which in turn will be influenced by the views of national regulators and supervisors.