

FACT SHEET: RESTRICTIONS ON CERTAIN NON-AUDIT SERVICES TO PUBLIC INTEREST ENTITY AUDIT CLIENTS



The new EU legislation introduces additional requirements for EU public interest entities (PIEs¹), including non-audit services (NAS) prohibitions and fee capping.

The statutory auditor (and any member of their network) carrying out the statutory audit of a PIE is not allowed 'directly or indirectly to provide to the audited entity, to its parent undertaking or to its controlled undertaking within the EU any prohibited NAS.' The list of prohibited NAS will be more extensive for most EU Member States than it is today, with tax services significantly affected – unless Member States take the derogation to permit certain tax services. The table below lists the prohibited NAS:

 PROHIBITED NAS Article 5(1)	C. Bookkeeping and preparing accounting records and financial statements.	D. Payroll services.	E. Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial IT systems.	F. Valuation services, including valuations performed in connection with actuarial services or litigation support services.*	G. Legal services, with respect to: <ul style="list-style-type: none"> i. the provision of general counsel; ii. negotiating on behalf of the audit entity; and iii. acting in an advocacy role in the resolution of litigation. 	H. Services related to the audit entity's internal audit function.	I. Services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing	assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity.	J. Promoting, dealing in or underwriting shares in the audited entity.	K. Human resources services with respect to: <ul style="list-style-type: none"> i. management in a position to exert significant influence over the preparation of the accounting records or financial statements that are the subject of the statutory audit, where such services involve: <ul style="list-style-type: none"> a. searching for or seeking out candidates for such positions; or b. undertaking reference checks of candidates for such positions; ii. structuring the organisation design; and iii. cost control.
A. Tax services. <ul style="list-style-type: none"> i. Preparation of tax forms.* ii. Payroll tax. iii. Customs duties. iv. 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.* v. Support regarding tax inspections by tax authorities unless support from the statutory auditor or audit firm in respect of such inspections is required by law.* vi. Calculation of direct and indirect tax and deferred tax.* vii. Provision of tax advice.* B. Services that involve playing a part in the management or decision making of the audited entity.	C. Bookkeeping and preparing accounting records and financial statements.	D. Payroll services.	E. Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial IT systems.	F. Valuation services, including valuations performed in connection with actuarial services or litigation support services.*	G. Legal services, with respect to: <ul style="list-style-type: none"> i. the provision of general counsel; ii. negotiating on behalf of the audit entity; and iii. acting in an advocacy role in the resolution of litigation. 	H. Services related to the audit entity's internal audit function.	I. Services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing	assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity.	J. Promoting, dealing in or underwriting shares in the audited entity.	K. Human resources services with respect to: <ul style="list-style-type: none"> i. management in a position to exert significant influence over the preparation of the accounting records or financial statements that are the subject of the statutory audit, where such services involve: <ul style="list-style-type: none"> a. searching for or seeking out candidates for such positions; or b. undertaking reference checks of candidates for such positions; ii. structuring the organisation design; and iii. cost control.
										<small>* Services may still be provided in certain cases. See page 2.</small>

1 See Article 2(13) of the Directive for a full definition: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG.



When will the NAS restrictions apply?

The new requirements will apply to the first financial year starting after 17 June 2016.

Can Member States add to or reduce the list of prohibited NAS?

Yes – Member States may add to the NAS prohibitions and may adopt legislation to further restrict NAS. However, they may not reduce the prohibited list, which is therefore a minimum baseline.

What does 'playing any part in the management or decision-making' mean?

It is possible to interpret these words very widely, but it is thought that the logical interpretation would be the more familiar prohibition against the statutory auditor 'acting as management' or 'doing anything that is the responsibility of management'.

Recital (8) to the Regulation gives some guidance suggesting such services might include: 'working capital management, providing financial information, business process optimisation, cash management, transfer pricing, creating supply chain efficiency and the like.' However, further guidance is expected as Member States adopt the legislation.

How are 'services linked to the financing, capital structure and allocation, and investment strategy of the audit client' defined?

The wording is not clear on which precise services it is seeking to prohibit. However as the recitals to the Regulation specifically refer to due diligence services, such services would be permitted.

What is meant by 'cost control' in relation to human resources services?

The term 'cost control' applied to human resources services is potentially

very broad. However, in this context it is qualified under the heading of 'human resources services' as being part of a line of exclusions that relate to recruitment, selection and job or organisation design. As such, it may be reasonable to assume that this exclusion relates specifically to advising on compensation and benefit costs – i.e. individual performance and reward services – which are part of the same 'family' of HR services. However, further clarification of the meaning of this prohibition is expected.

Is there a 'clean period' requirement in relation to NAS prohibitions?

The statutory auditor cannot provide prohibited NAS to a PIE audit client during the period of the audit up to the release of the audit report.

For internal control-related services (Article 5.1(E)), there is also a 'clean period' restriction on provisions during the financial year immediately preceding the start of the audit.

The prohibition applies not only to the incoming auditor of the PIE itself, but also to any member of the auditor's network that provides these specific services either to the audited entity itself, its parent undertaking(s), or its controlled undertakings within the EU.

How do the NAS prohibitions apply to controlled undertakings incorporated outside the EU?

In general, the Regulation should not have any effect outside the EU. Another member firm of the network (other than the auditor of the PIE itself), whether it is in the EU or not, can potentially provide services included on the list of prohibited services to such controlled undertakings, but only if the auditor of the EU PIE can justify that the independence of its audit is unaffected.

However, three types of services are always deemed to affect the independence of the statutory auditor of the EU PIE and can never be provided by members of the network to controlled undertakings incorporated outside

the EU, regardless of where these services are provided. These are:

- services that involve playing any part in the management or decision making of the audited entity (Article 5.1(B));
- bookkeeping and preparing accounting records and financial statements (Article 5.1(C)); and
- designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial IT systems (Article 5.1(E)).

See Fact Sheet – Impact of the EU Audit legislation outside of the EU for additional information.

POTENTIALLY PERMITTED SERVICES Article 5(3)

Are there any exceptions when the prohibited NAS may actually be permitted?

A number of tax services, as well as valuation services, **may still be provided** in certain cases*, subject to a Member State derogation that requires the audit committee to conclude that the services in question comply with the following:

- a. they have **no direct or have immaterial effect**, separately or in the aggregate, on the audited financial statements;
- b. the estimation of the effect on the audited financial statements is **comprehensively documented** and explained in the additional report to the audit committee referred to in Article 11; and
- c. the principles of **independence** laid down in Directive 2006/43/EC are complied with by the statutory auditor or the audit firm.

This derogation is another Member State option and therefore is unlikely to be applied consistently across the EU.

However, tax services relating to payroll tax and customs duties are not included in the Member State option and therefore are never permitted.

* See asterisks on prohibited table on page 1.



What are the permitted NAS?

An auditor and its network can provide any NAS that is not explicitly prohibited to the audited PIE, its parent undertaking or its controlled undertakings (subject of course to general principles of independence). Approval of the audit committee is needed following an assessment of the threats to independence and the safeguards in place to mitigate or eliminate those threats. For further guidance on the role of the audit committee, see the [KPMG Audit Committee Institute's handbook](#).²

Are there any restrictions in relation to permitted services?

Permitted services (other than those imposed by national or EU legislation) provided by the statutory auditor of the EU PIE are subject to a cap of 70 percent 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 and controlled undertakings and of the consolidated financial statements of that group of undertakings. The relevant details of the fee cap are summarised in the table below. However, further guidance is expected as Member States adopt the legislation.

How is the cap calculated?	<p>Article 4 states that statutory audit fees include those <u>generated by the EU PIE's statutory auditor</u> for the audit of the financial statements/consolidated financial statements of the EU PIE as well as those of its parent entity and controlled undertakings where appropriate. The cap does <u>not apply</u> to permitted services provided by members of the statutory audit firm's network.</p> <p>When calculating total 'statutory audit fees', assess these in a group context (i.e. the whole group statutory audit fees generated by the statutory auditor of the EU PIE in a given EU Member State irrespective of where the group' entities are located). The 70% cap is then computed on the average of these statutory audit fees over the preceding three years.</p>												
Example	Statutory audit fees	Cap on NAS*											
<p>* The cap only applies to permitted NAS provided by the statutory auditor of the EU PIE to the EU PIE, its controlled undertakings and its parent entities. The cap does not apply to the entire audit firm network.</p>	<table border="1"> <thead> <tr> <th>Year</th> <th>Statutory audit fees</th> </tr> </thead> <tbody> <tr> <td>Year 2017</td> <td>110</td> </tr> <tr> <td>Year 2018</td> <td>50</td> </tr> <tr> <td>Year 2019</td> <td>80</td> </tr> <tr> <td>Year 2020 (Cap on NAS)</td> <td>56</td> </tr> </tbody> </table>	Year	Statutory audit fees	Year 2017	110	Year 2018	50	Year 2019	80	Year 2020 (Cap on NAS)	56	Average 80K 70% = 56K	Year 2020
Year	Statutory audit fees												
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Can Member States opt for a stricter NAS fee cap than 70%?	Yes – Member States may establish stricter rules including stricter rules on a NAS fee cap.												
What are the transition arrangements for the NAS fee cap – do we need to count NAS fees before the legislation becomes law on 17 June 2016?	The NAS fee cap provision in the regulation is not retrospective and will not start to apply until 17 June 2016 onwards. Only then would the NAS fee cap 'clock' start to tick, at which point there would be three consecutive years before the cap would then apply in year four. NAS fees earned before the statutory auditor was appointed are not included in the calculation.												
What happens to the fee cap if our audit firm provides permitted services for only two years and there is then a break?	Any break in the consecutive nature of the permitted service would result in the clock effectively resetting itself back to zero.												
Are any services specifically excluded from the cap rule?	<p>Yes. Article 4 explicitly states that services required by national or EU legislation are exempted from the calculation of the cap.</p> <p>In addition, a Member State option exists whereby the national regulator or supervisor at the statutory auditor's request may exempt the auditor from the fee cap requirement for no more than two financial years.</p>												
Who is responsible for the operation of the cap?	The statutory auditor, with oversight by the audit committee.												
Does the cap have an extra-territorial effect?	The cap applies only to permitted NAS provided by the statutory auditor of the EU PIE to the EU PIE, its controlled undertakings and its parent entities. However, it appears that statutory audit fees of non-EU parent companies of the PIE and of its non-EU controlled undertakings would be included in the calculation of the total 'statutory audit fees' on which the EU cap would be based to the extent that the service is <u>provided by the EU PIE's statutory auditor</u> in a given EU Member State.												

² <https://www.kpmg.com/Ca/en/services/Audit/AuditCommittee/Documents/ACI-Audit-Committee-Handbook.pdf>

What are the practical considerations for selection and management of professional advisers in light of this regulatory change?

All EU PIEs will be affected by EU audit reform legislation. How and when they are affected will differ from company to company, depending on a number of variables and the views of investors. The chart below identifies a number of initial considerations in relation to NASs.

Immediacy and depth of the impact of the new rules



Ask yourself ...

Considerations

How many EU PIEs are in the group?	Few ? Many	The rules may affect more entities than first thought.
What is the extent of my global footprint?	Local (EU only) ? Global	The rules may affect undertakings located outside of the EU.
What is my current spend on non-audit services by the auditor of the EU PIE – both upstream and downstream?	Low ? High	Fees in excess of 70 percent of three-year average audit fees are prohibited.
What level of outsourcing activities or global contracts exist with audit firms? (other than current auditors)	Low ? High	The type of service may limit the number of audit firms available to tender for the statutory audit.
Do I have any large transformation projects currently underway with assistance provided by audit firms?	Few ? Many	May limit the ability of the audit firms engaged in these projects to tender for the audit.
What is my visibility over non-audit services provided by the current auditor in my entire group?	Low ? High	The full list of potential independence issues may not be complete. Understand the full extent of services provided by our auditors.
Does my business require consultants with specialised skills?	General ? Specialised	The expertise needed may limit the number of audit firms with the right skill set available to tender.

For further information please speak to your usual KPMG contact.

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