



European Union Audit Legislation

Frequently asked questions
For discussion purposes

September 2020

The EU Directive and Regulation contains a series of requirements governing every statutory audit of a PIE in the EU and amends the existing Statutory Audit Directive of 2006.

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Welcome

Welcome to the September 2020 edition of the ECG FAQs.

All changes of substance compared to the October 2019 edition have been marked up in the question with either "New" or "Updated" as relevant.

NOTE — The European Contact Group (ECG), which is an informal regulatory and policy working group of six large audit networks in the EU (BDO, Deloitte, EY, Grant Thornton, KPMG and PwC), has produced this FAQ document on the EU Audit Legislation. Although the Legislation is final, the language is unclear in many places. Consequently, the opinions expressed in these Frequently Asked Questions (FAQs) may also evolve as Member States implement the Legislation. These FAQs represent the most frequent questions received by the networks from their audit professionals and from clients/Audit Committee Chairs and are designed to help understand and apply the EU audit legislation in a consistent manner, drawing on the EC's Q&As. The content is provisional and will be updated on a regular basis, as needed. It has been prepared to provide general guidance on matters of interest only, and does not constitute professional advice. There may be local nuances which require specific consideration. You should not act upon the information contained herein without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this document and, to the extent permitted by law, neither ECG nor any of its members accepts or assumes any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this document or for any decision based on it. Public interest entities will need to consider the expectations of their shareholders and regulators while also complying with the Legislation.

Abbreviations, definitions, and references:

Directive	Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts
EC	European Commission
Second additional EC Q&A	European Commission Frequently Asked Questions issued on 31 May 2016
Additional EC Q&A	European Commission Frequently Asked Questions issued on 1 February 2016
EC Q&A	European Commission Frequently Asked Questions issued on 3 September 2014
CEAOB	Guidance on the duration of the audit engagement issued on 28 November 2019
CEAOB	Guidance on monitoring the fee cap of non/audit services issued on 21 September 2018
EU	European Union
IESBA	The International Ethics Standards Board for Accountants
Legislation	Both Directive 2014/56/EU and the Regulation (EU) No 537/2014
MFR	Mandatory firm rotation
NAS	Non-audit services
Regulation	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

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General – legislative process

01

1.1 **What is the form of the Legislation?**

The Legislation is in the form of a Directive and a Regulation.

The Directive contains a series of requirements governing every statutory audit in the EU and amends the existing Statutory Audit Directive of 2006.

The Regulation contains a series of additional requirements that relate only to the statutory audits of Public Interest Entities (PIE). The provisions on mandatory firm rotation (MFR), tendering, and the list of prohibited non-audit services (NAS) are contained in the Regulation and only apply to PIEs and their statutory auditors (and their networks as far as NAS are concerned).

1.2 **What is the background of the EU Legislation?**

The European Commission initiated new legislation on audit as a part of its response to the global financial crisis. The legislative proposals were issued in 2011, following a public consultation, and were finally adopted by the Council and Parliament and published in May 2014.

1.3 **When did the Legislation come into effect?**

Regulation — There is a 2 year delay in the application of most provisions from the date it entered into force (16 June 2014) which pushed the effective date for practical purposes to the first financial year starting on or after 17 June 2016. Note - There are separate transitional provisions for MFR (see [Section 4](#)).

Note also that there are several Member State options which will only come into effect once/ if a Member State decides to apply them. There is no deadline for this (see [Section 13](#)).

Directive — Unlike the Regulation, the Directive will need to be transposed by the respective Member States into their national laws in order to become effective law. Member States have a 2 year period in which to do so, such that by 17 June 2016 Member States shall adopt and publish the measures necessary to comply with this Directive (see [Question 1.6](#) below).

1.4 **What is the difference between a Directive and a Regulation?**

A Directive is an EU legislative instrument that has to be transposed by each of the 28 EU Member States and incorporated into their respective national laws. Once adopted at EU level, Member States would normally have 2 years to bring their national laws in line with the Directive. Many Directives including the Statutory Audit Directive, adopt the 'minimum harmonization' approach which means that it sets a minimum threshold that national legislation must meet.

A Regulation is an EU legislative instrument that has direct effect following a transitional period which is normally 2 years. In that regard, Regulations are directly applicable and enforceable in the EU Member States. Regulations always have supremacy over national law, and so may require Member States to amend their national law to ensure it is consistent with the Regulation.

Both the Statutory Audit Directive and Audit Regulation contain certain Member State Options which allow Member States to nominate a local exception to specific requirements in the Directive or Regulation. These Member State Options allow, in relation to these specific requirements, Member States a degree of flexibility in meeting the EU's requirements.

General — legislative process

1.5 Where will the new audit Legislation apply?

This new Legislation will apply in the 28 EU Member States and also in Iceland, Liechtenstein, and Norway as these countries are bound by this Legislation as members of the European Economic Area. Iceland, Liechtenstein and Norway are not third countries for the purposes of this Legislation. The formal agreement of the EEA Joint Committee on the date of application of the Regulation and the transposition date of the Directive is still pending. See [Section 12](#) for implications of the Legislation outside the EU.

1.6 To whom does the Legislation apply?

The precise scope of the Legislation, the entities to which they apply and how they apply, is a complex issue and is covered in more detail in this FAQs document. However, the starting point is that the rules in the Regulation apply to entities which are, or to groups that contain, a PIE as defined for these purposes. Where a group contains a PIE, the rules have an impact on its statutory auditor (and, in relation to the provision of NAS, on its network (see [Section 7](#) for further details)). See [Section 2](#) for further details on PIEs.

1.7 How certain is the application/interpretation of the wording?

The Legislation is imprecise in many places and the detail as to how this applies in practice requires ongoing analysis and interpretation. Guidance and examples are provided in this FAQ document based on the current interpretation of the Legislation.

1.8 Will there be any guidance issued to assist with interpretation?

The interpretation of EU legislation is ultimately up to the European Court of Justice, and is based on an interpretative methodology that examines the plain language, overall scheme and purpose of the measure in question.

The EC has issued some frequently asked questions¹ to facilitate the implementation of the new EU regulatory framework on statutory audit and contribute to a consistent application of the new framework across the Union. The EC Q&A is described as a 'work in progress' and may be updated.

A new oversight body is to be established, a Committee of European Audit Oversight Bodies (CEAOB) replacing the existing EGAOB — see [Section 11](#) for further details. The CEOAB will comprise the national authorities responsible for auditor oversight and part of its remit, under Article 30(7), will be to:

- a) Facilitate the exchange of information, expertise and best practices for the implementation of this Regulation and Directive 2006/43/EC.
- b) Provide expert advice to the Commission as well as to the Competent authorities, at their request, on issues related to the implementation of this Regulation and Directive 2006/43/EC;

Article 30(9) states - For the purposes of carrying out its tasks, the CEOAB may adopt non-binding guidelines or opinions. The EC shall publish the guidelines and opinions adopted by the CEOAB. The responsible Regulator in each country may also issue guidance.

1.9 What are the enforcement arrangements to ensure that audit firms comply with these requirements?

In addition to the public oversight regime supervising the quality assurance system that

¹ https://ec.europa.eu/info/law/audit-directive-2006-43-ec/implementation/guidance-implementation-and-interpretation-law_en

applies to auditors, there are various measures to ensure that auditors comply with their obligations under the Directive and Regulation.

Article 30(a) of the amended Directive provides that Member States shall provide for competent authorities to have the power to apply a range of sanctions on auditors including, amongst other sanctions, fines and temporary prohibitions on a statutory auditor, an audit firm or a key audit partner from carrying out statutory audits and/or signing audit reports for up to 3 years.

Article 10 of the Regulation requires that the audit report includes a declaration that prohibited NAS were not provided and that the statutory auditor or the audit firm remained independent of the audited entity.

Article 39(6) of the Directive imposes a duty on the audit committee to review and monitor the independence of the statutory auditor or the audit firm and in particular the appropriateness of the provision of NAS to the audited entity.

Both the audit firm and the audited entity have duties to report to regulators, including, for example, the reasons for an audit firm being dismissed or resigning.

1.10 Will there be any review of the impact of this Legislation?

Yes — two reports from the EC to the European Parliament and to the Council are mentioned in Article 40 of the Regulation:

- A review and report on the operation and effectiveness of the system of cooperation between competent authorities within the framework of the CEAOB — by 17 June 2019, if necessary accompanied by a legislative proposal
- A report on the application of the Regulation by 17 June 2028 (report to the European Parliament and to the Council).

In addition, Article 27 of the Regulation requires each Member State's competent authority (usually this will be either the audit regulator or the stock market regulator or, possibly, both) as well as the European Competition Network (ECN), to draw up a report on developments in the market for providing statutory audit services to PIEs, notably focusing on concentration, audit quality and the effectiveness of audit committees. The report must be submitted to the CEOAB, ESMA, EBA, EIOPA and the EC. The first report was published in September 2017 on https://ec.europa.eu/info/publications/170907-statutory-audit-services-report_en, and will be followed by reporting at least every three years. To the extent that there are issues with audit quality, the preparers of the report may suggest possible legislative remedies.

The EC will use the submitted reports to draw up a joint report on developments at the EU level. The joint report will then be submitted to the Council, the ECB and the European Systemic Risk Board, as well as, where appropriate, to the European Parliament.

Finally, in the context of a [call for evidence](#) on the EU financial services regulatory framework launched by Commissioner Hill in autumn 2015, the subsequent [EC Communication](#) issued in November 2016 mentions that the EC will review the national options in the Regulation, focusing on the cross-border impact of mandatory rotation and prohibited services, and consult on the impact of diverging national options.



Public interest entities (PIEs) and scope of the legislation

02

Overview

2.1 Is the PIE concept a new one?

No. The 2006 Statutory Audit Directive (the 8th Directive) included the same definition. However, a previous Member State option contained in Article 39 of the old 8th Directive has now been deleted (see [Question 2.7](#)). The key difference with this Legislation is that the practical impact of being a PIE compared to a non-PIE is now much increased (see [Question 2.2](#)).

2.2 What is the implication of being defined as a PIE?

The Regulation introduces additional obligations (i.e. MFR, NAS prohibitions and NAS fee cap) only on the statutory auditors of PIEs (and on members of the network of the statutory audit regarding NAS prohibitions — see [Section 7](#)) and on PIEs themselves.

The new EU Legislation also requires that an engagement quality control review be performed (Article 8 in the Regulation) for the statutory audits of PIEs.

Finally, an auditor of a PIE must prepare an annual Transparency Report that meets the requirements of Article 13 of the Regulation.

As such, an understanding of the PIE definition is important (see [Question 2.6](#)).

Note that Member State legislation may apply all or part of the Regulation to non-PIEs, as long as this does not infringe the provisions of the Directive.

2.3 What is the impact of having a PIE in a group?

The Regulation applies to individual entities. If an individual entity qualifies as a PIE, the Regulation will apply to that PIE irrespective of whether its parent company is a PIE or not and irrespective of whether its parent is outside the EU or not.

However, the NAS prohibitions (see [Section 7](#)), the NAS fee cap (see [Section 8](#)) and the requirement for Audit Committee approval (see [Section 9](#)) will also impact parent undertakings and controlled undertakings of the PIE, with some territorial limitations.

2.4 Is there any exemption to the impact of being a PIE?

The only potential exemption in the Legislation to the impact of being a PIE is in relation to co-operatives and savings banks. This largely relates to the German and Austrian markets and is expected to have limited application elsewhere.

The definition of a co-operative referred to in the Regulation² is as follows:

'cooperative' means a European Cooperative Society as defined in Article 1 of Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE) (1), or any other cooperative for which a statutory audit is required under Community law, such as credit institutions as defined in point 1 of Article 1 of Directive 2000/12/EC and insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC.'

² Article 2(3) of Regulation 537/2014 of 16 April 2014

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The exemption is only intended to apply where the statutory audit of co-operatives (defined above) is characterised by a system that does not allow them to choose their statutory auditor or audit firm freely and the **auditors act on a non-profit making** basis. As such, independence is deemed not to be an issue. If the audited entity engages a 'regular' audit firm to do the audit then there is no possibility for derogation from being in the scope of the Regulation.

2.5 Does the exemption for cooperative and savings banks extend to their subsidiaries?

Given that a subsidiary of a cooperative or of a savings bank might fall within the definition of a PIE in their local markets, it is conceivable that these subsidiaries might be subject to the exemption option given in Article 2(3) of the Directive even if they are not cooperatives or savings banks in their own right.

The Directive grants individual Member States the possibility to exempt subsidiaries of co-operatives and savings banks. However, it is not clearly stated in the Directive whether these subsidiaries also need to be savings banks or cooperatives.

PIE Definition

2.6 How is a PIE defined in the new Legislation?

The Regulation will impact EU entities that fall within the definition of a public interest entity (PIE).

The PIE definition is contained in the new statutory audit Directive (as amended on 16 April 2014) and is as follows:

- a) entities governed by the law of a Member State whose **transferable securities** are admitted to trading on a **regulated market** of any Member State within the meaning of point 14 of Article 4.1 of Directive 2004/39/EC;
- b) **credit institutions** as defined in point 1 of Article 3(1) of Directive 2013/36/EU of the European Parliament and of the Council³, other than those referred to in Article 2 of that Directive;
- c) **insurance undertakings** within the meaning of Article 2(1) of Directive 91/674/EEC⁴ or;
- d) **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.

³ Point 1 of Article 3 (1) of Directive 2013/36/EU refers to point 1 Article 4(1) of Regulation (EU) No 573/2013 = an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF>).

⁴ Article 2(1) of Directive 91/674/EEC refers to 2 directives: Directive 73/239/EEC which has been several times amended (last modification with Directive 2002/13/EC) and directive 79/267/EEC which has been repealed by Directive 2002/83/EC (life insurance); also note that these 2 directives will be repealed as from 1 January 2016, date of application of the new Solvency II Directive (directive 2009/138/EC).

2.7 Has the amended Directive changed the PIE definition from the old 8th Directive definition?

The definition of a PIE itself is unchanged. However, a previous Member State option contained in Article 39 of the old 8th Directive has now been deleted. That option permitted a Member State to exempt unlisted PIEs from the requirements of Chapter 10 of the old 8th Directive. These entities will, from now on, have to comply the same obligations as a listed PIE.

2.8 How does the Regulation affect multi-national corporations where the ultimate parent company is incorporated outside the EU?

Unless the group contains a PIE (see [Question 2.3](#)), they will not be affected. Where the group does contain a PIE, see [Section 12](#).

2.9 What is meant by 'governed by the law of a Member State'?

References to companies that are 'governed by the law of an EU Member State' are generally understood to mean companies that are incorporated in that Member State. So, companies incorporated outside the EU that are listed on a regulated market within the EU would not generally qualify as an EU-governed company.

However, some Member States have domestic provisions which cause their corporate law to apply to companies which have their operational headquarters in that country, even though that company is incorporated elsewhere. Any company caught by such a provision would also be regarded as governed by the laws of that Member State.

In addition, being a tax resident and subject to a Member State's tax law **does not** make a company 'governed by the law of an EU Member State' — the concept of being 'governed by' relates only to the **company law** that applies to a company.

2.10 Does the Regulation apply to branch offices?

We understand the position to be as follows:

- Where a credit institution or insurance undertaking in the EU has a branch also in the EU, as the EU based branch forms part of an EU entity which is itself a PIE, then the Regulation also applies to the EU based branch — to the extent that provisions of the Regulation are relevant. For example, the NAS prohibitions that apply to the PIE also apply to the branch as part of the PIE. In addition, where the EU branch is required by law to have a statutory audit then the statutory auditor will also be subject to MFR. We understand that the MFR rules of the 'parent' of the branch will apply. For example, a UK bank with a branch in Ireland and the Irish branch is required to have a statutory audit: the statutory auditor must rotate in line with the UK MFR rules.
- Non-EU branches of an PIE would be caught in that the NAS prohibitions (see [Question 7.33](#)) would apply equally to the branch inside/outside the EU as to the rest of the legal entity inside the EU.
- EU branches of non-EU based credit institutions or insurance undertakings do not fall within the PIE definition.

The issue of branches, is also set out in the EC Q&A.

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2.11 Are funds captured by the PIE definition?

Funds in general (e.g. UCITS or AIFs) are not PIEs unless so designated by a Member State under the existing Member State option. See [Question 2.6](#).

However funds which are governed by the law of a Member State and have their prices listed on an EU regulated market⁵ are caught by the PIE definition.

Note that a fund listed on an EU regulated market but registered outside of the EU, and assuming it does not meet one of the other PIE definitions (credit institution, insurance undertakings or entities designated as PIEs by Member States), would not be classed as a PIE as it is not 'governed by the law of an EU Member State' (see [Question 2.9](#)).

2.12 Are smaller/medium sized listed entities caught by the PIE definition or is there a size criterion?

The categories of PIE prescribed by the EU capture all PIEs irrespective of size, such that small and medium-sized entities that have shares or debt admitted to trading on a regulated market⁶ as well as credit institutions and insurance undertakings will be caught. There are many entities within these categories which are either quite small and/or have relatively restricted operations. The additional category of entities designated by Member States as PIEs may contain size criteria in some cases.

There is however, a specific derogation for co-operative bodies, savings banks or similar (or their subsidiaries) — see [Question 2.4](#).

2.13 Is a subsidiary which is 100% owned by a PIE parent undertaking also considered a PIE?

Unless a subsidiary of a PIE meets the criteria set out in Article 2(13) of the Directive in its own right, it should not be considered to be a PIE. A subsidiary, whether wholly-owned or not, will never be designated as a PIE simply by virtue of its parent company's status as a PIE. However, some of the requirements of the Regulation will apply to a non-PIE subsidiary by virtue of its relationship with a PIE, notably the restrictions on the provision of certain non-audit services by the statutory auditor of the PIE or network members of that statutory auditor.

⁵ https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_mifid_rma

⁶ https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_mifid_rma

Transferable securities

2.14 What are transferable securities?

Transferable securities are defined in Article 4, paragraph 1 (18) of the 2004 Markets in Financial Instruments Directive (MiFID) and under Article 4, paragraph 1 (44) of the 2014 Markets in Financial Instruments Directive (MiFID 2), as follows:

'Transferable securities' means those classes of securities which are negotiable on the capital market (with the exception of instruments of payment) such as:

- a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;
- b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
- c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;

2.15 Does a company with listed debt fall within the PIE definition?

As noted in [Question 2.14](#), the definition of transferable securities includes debt. Whether the company is a PIE will depend on whether the company in question is an EU incorporated undertaking (i.e., a company governed by the laws of a Member State) whose debt is admitted to trading on an EU regulated market. The specific markets that are defined as regulated markets are published by the European Securities and Markets Authority (ESMA).

However, not all markets in the EU fall within this definition for this purpose. For example, neither the Luxembourg Euro MTF nor the Irish GEM markets are currently defined as 'regulated'. As such, companies with debt listed on such markets will not be PIEs for this reason alone (although they could be if they fall within one of the other PIE categories: credit institutions, insurance undertakings, or designated by the relevant Member State as PIEs).

2.16 Is commercial paper considered to be listed debt under the definition of a PIE?

No, we do not believe that commercial paper qualifies as listed debt. MiFID 2⁷ Article 4 is where the definition of transferable securities comes from, and commercial paper seems to be classified as a 'money-market instrument':

(17) 'money-market instruments' means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment.

Under MiFID 2, Annex 1, Section C, listing financial instruments, money market instruments are listed as a separate item from transferable securities which suggests that commercial papers are not transferable securities.

⁷ For more information on MiFID (2004/39/EC) and MiFID 2 (2014/65/EU), please go to <http://www.esma.europa.eu/page/Markets-Financial-Instruments-Directive-MiFID-II>

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Regulated markets

2.17 What are regulated markets?

Regulated markets are defined in Article 4, paragraph 1 (14) of MiFID⁸ and under Article 4, paragraph 1 (21) of MiFID 2, as follows:

“Regulated market” means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments — in the system and in accordance with its non-discretionary rules — in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III;’

Not all markets in the EU fall within this definition. For example, the London AIM market is not covered. The European Securities and Markets Authority (ESMA) maintain a list of EU regulated markets⁹. The additional category of entities designated by Member States as PIEs could include entities listed on unregulated markets.

2.18 What Member State law applies to an entity governed by the law of one Member State but with securities admitted to trading solely on an EU regulated market in another Member State?

Although it is through its listing in the second Member State ‘host’ that the entity qualifies as a PIE, it is generally understood that the Member State law that governs the entity will be that of its ‘home’ Member State as this is the law that governs the company itself. For example, a company incorporated and head quartered in Luxembourg that is listed on a regulated market in Ireland would have to apply the mandatory audit firm rotation and NAS prohibitions of Luxembourg, not Ireland.

2.19 What happens if an EU entity is listed on an EU regulated market but has no securities actually traded on that market?

An entity (governed by the law of an EU Member State) does not need to be actively traded on an EU regulated market to qualify as a PIE; it is enough that it is listed on a regulated market. This position is based on the definition of a PIE which mentions ‘entities governed by the law of a Member State’ whose transferable securities are admitted to trading on a regulated market of any Member State. This entity would only cease to be a PIE if it were to be delisted from the EU regulated market.

⁸ See footnote 7

⁹ https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_mifid_rma

Credit institutions

2.20 Are there any exemptions to the credit institutions definition in Article 2(13)(b) of the Directive?

Yes — certain specific institutions listed in Article 2 of [The Capital Requirements Directive IV \(2013/36/EU\) \(CRD 4\)](#) are excluded from the EU PIE scope. They are as follows:

- central banks
- post office giro institutions
- in Belgium, the Institut de Réescapte et de Garantie/Herdiscontering-en Waarborginstituut
- in Denmark, the Eksport Kredit Fonden, the Eksport Kredit Fonden A/S, the Danmarks Skibskredit A/S and the KommuneKredit;
- in Germany, the Kreditanstalt für Wiederaufbau, undertakings which are recognised under the Wohnungsgemeinnützigkeitsgesetz as bodies of State housing policy and are not mainly engaged in banking transactions, and undertakings recognised under that law as non-profit housing undertakings
- in Estonia, the hoiu-laenuühistud, as cooperative undertakings that are recognised under the hoiu-laenuühistu seadus;
- in Ireland, credit unions and the friendly societies;
- in Greece, the Ταμείο αρακαταθηκών και ανείων (Tamio Parakatathikon kai Danion);
- in Spain, the Instituto de Crédito Oficial;
- in France, the Caisse des dépôts et consignations;
- in Italy, the Cassa depositi e prestiti;
- in Latvia, the krājaizdevu sabiedrības, undertakings that are recognised under the krājaizdevu sabiedrību likums as cooperative undertakings rendering financial services solely to their members;
- in Lithuania, the kredito unijos other than the Centrinė kredito unija;
- in Hungary, the MFB Magyar Fejlesztési Bank Zártkörűen Működő Részvénytársaság and the Magyar Export-Import Bank Zártkörűen Működő Részvénytársaság;
- in the Netherlands, the Nederlandse Investeringsbank voor Ontwikkelingslanden NV, the NV Noordelijke Ontwikkelingsmaatschappij, the NV Industriebank Limburgs Instituut voor Ontwikkeling en Financiering and the Overijsselse Ontwikkelingsmaatschappij NV;
- in Austria, undertakings recognised as housing associations in the public interest and the Österreichische Kontrollbank AG;
- in Poland, the Spółdzielcze Kasy Oszczędnościowo — Kredytowe and the Bank Gospodarstwa Krajowego;
- in Portugal, the Caixas Económicas existing on 1 January 1986 with the exception of those incorporated as limited companies and of the Caixa Económica Montepio Geral;

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- in Slovenia, the SID-Slovenska izvozna in razvojna banka, d.d. Ljubljana;
- in Finland, the Teollisen yhteistyön rahasto Oy/Fonden för industriellt samarbete AB, and the Finnvera Oyj/Finnvera Abp;
- in Sweden, the Svenska Skeppshypotekskassan; and
- in the United Kingdom, the National Savings Bank, the Commonwealth Development Finance Company Ltd, the Agricultural Mortgage Corporation Ltd, the Scottish Agricultural Securities Corporation Ltd, the Crown Agents for overseas governments and administrations, credit unions and municipal banks.

Note — an entity that is not licensed to take deposits is not a credit institution and, by extension, not a PIE.

2.21 Is an entity that grants credit but does not take deposits a credit institution?

No — an entity that is not licensed to take deposits is not a credit institution¹⁰ and, by extension, not a PIE.

2.22 In certain Member States there are regulated entities that are not banks (e.g. broker dealers or securities trading companies). Would broker dealers and other such non-bank regulated entities be PIEs per the EU definition?

Where such entities are neither credit institutions (i.e. meaning an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account) nor are they regulated by one of the specified regulated markets, then they would not be classed as a PIE.

For example, UK broker dealers or securities traders regulated by the FCA/PRA that are not banks would be unlikely to fit the PIE definition as FCA/PRA is not one of the specified markets. However, it is possible that a Member State could decide to include such entities within the PIE definition as is permitted by Article 2(13)(d) of the Amended Directive.

Insurance undertaking

2.23 What is an 'insurance undertaking' for the purpose of the EU Audit Legislation?

The definition of an Insurance undertaking is defined in Directive 91/674/EEC on the annual and consolidated accounts of insurance undertakings, with some specific exclusions covered in Directive 79/267/EEC and Directive 73/239/EEC.

An 'insurance undertaking' is any undertaking that carries out or is authorised to carry out a regulated insurance activity which:

- includes direct insurers, life assurance, general insurance, reinsurance and permanent health insurance; and
- excludes mutual insurers.

Insurance broking does not as such fall within the definition but a group 'captive' insurer would be if it was established in the EU.

¹⁰ See [EBA report](#) (p.12) stating that the definition of a credit institution requires meeting both of the following criteria: accepting deposits/repayable funds and granting credit.

2.24

An entity received its banking/insurance license in Year X, and then the country subsequently became a Member State of the EU. When should the entity be considered a PIE from? **UPDATED**

An entity should be considered as a PIE from the moment that the entity commenced the activities that qualify it as a PIE. However, if the Member State in which the entity received its licence was not an EU Member State then PIE status only applies from the moment that the country does become an EU Member State.

In calculating audit tenure, the date an entity first became a PIE is accordingly key. Consistent with the CEAOB's 28 November 2019 [Guidance on Duration](#), the calculation of the duration of the audit engagement for a PIE should start in the financial year in which the entity became a PIE.

The ECG accepts the CEAOB's 28 November 2019 position, above, and shall give precedence to it over the EC's earlier position stated in the [Second Additional EC Q&A](#) of 31 May 2016 which takes the view that if 'an entity qualifies as a PIE during the course of an audit engagement, the calculation of the duration should start from the first financial year after the entity qualifies as a PIE' (Q1).

2.25

An entity was listed on a stock exchange (during Year X) when that exchange was not recognised as a regulated market because its country was not a member state of the EU. The country then subsequently became a member of the EU (during Year Y), with the exchange being recognised as a regulated market immediately from that date. Should the entity be considered a PIE from Year X or Y? **UPDATED**

The entity should be considered as a PIE from the moment that the country became an EU member state and the market on which the PIE is listed became a regulated market. Consistent with the CEAOB's 28 November 2019 [Guidance on Duration](#), the calculation of the duration of the audit engagement for a PIE should then start in the financial year in which the entity became a PIE — ie. in this case, Year Y.

We also note the EC's earlier stated position in the [Second Additional EC Q&A](#) of 31 May 2016 which takes the view that if "an entity qualifies as a PIE during the course of an audit engagement, the calculation of the duration should start from the first financial year after the entity qualifies as a PIE" (Q1) — ie. in this case, Year Y+1.

See also [ECG FAQ 2.24](#), above.

2.26

An entity was listed on an EU stock exchange at a certain date (during Year X) when that exchange was not recognised as a regulated market because it did not meet certain criteria. The exchange subsequently took steps to qualify as a regulated market and was recognised accordingly at a later date (during Year Y). Should the entity be considered a PIE from Year X or Y? **UPDATED**

The entity should be considered as a PIE from the moment that the exchange became recognised as a regulated exchange. Consistent with the CEAOB's 28 November 2019 [Guidance on Duration](#), the calculation of the duration of tenure should be calculated as starting from the first financial in which the entity became a PIE — ie. in this case, Year Y.

We note the EC's earlier position stated in the [Second Additional EC Q&A](#) of 31 May 2016 which takes the view that if 'an entity qualifies as a PIE during the course of an audit engagement, the calculation of the duration should start from the first financial year after the entity qualifies as a PIE' (Q1) — ie. in this case, Year Y+1.

See also [ECG FAQ 2.24](#) and [2.25](#), above.

Mandatory firm rotation (MFR)

03

3.1

What are the requirements for mandatory audit firm rotation?

The initial engagement period of a statutory auditor or audit firm must not be for less than 1 year and must not exceed 10 years. In many Member States the statutory auditor is appointed on an annual basis. In such cases the first annual appointment can be renewed a further 9 times so as to reach the initial maximum duration period of 10 years.

However, in some Member States the statutory auditor is appointed for an engagement period other than 1 year (e.g., a 3-year mandate is currently required in Belgium, a 6-year mandate in France and a 9-year mandate in Italy). Member States have the option to nominate an initial maximum duration period that is shorter than the 10 years (see [Section 13](#)). For example, with a current 3-year mandate, the initial maximum duration period for a Belgian statutory auditor would be 9 years (i.e., 3 mandates of 3 years) whilst Italy will be able to maintain their existing maximum duration period and rotation requirement of 9 years.

Member States may also opt to extend the initial maximum duration period — see [Question 3.2](#).

3.2

Can the initial maximum duration period be extended? **UPDATED**

Yes — but only if the Member State applies one of two available derogations permitting extension in the event of either a tender or a joint audit arrangement (see also [Section 13](#)).

- 1. Extension due to a tender process** — The initial 10-year maximum duration period may be extended by a Member State up to a total period of **20-years** irrespective of the initial maximum duration of the audit engagement, but only if a tender is conducted in accordance with the process specified in Article 16 of the Regulation and takes effect after the expiry of the initial maximum duration period. Note: Article 17 mentions a *public* tender process however there are no obligations in Article 16 to *publish* a call for tenders.
- 2. Extension due to a joint audit arrangement** — The initial 10-year maximum duration period (or a shorter period if elected by a Member State) may be extended by a Member State up to a total of **24 years** for companies that choose to have two auditors (i.e. a joint audit) after the initial maximum duration period (see [Section 6](#)). Note that in this case:
 - A tender at the end of the initial maximum duration period is not required, and
 - The extension for joint audit appears to apply irrespective of whether or not a joint audit has been in place during that initial maximum duration period (see [Section 6](#)).

There are specific transitional rules for a staggered introduction of MFR (see [Section 4](#)).

Mandatory firm rotation (MFR)

3.3 How do I calculate the duration of audit tenure? **UPDATED**

The principle to be applied in working out the duration of audit tenure for rotation requirements is set out in Article 17(8) of the Regulation as follows:

‘the duration of the audit engagement shall be calculated as from the first financial year covered in the audit engagement letter in which the statutory auditor or audit firm has been appointed for the first time for the carrying out of consecutive statutory audits for the same PIE’.

Tenure is therefore counted from the start of the first accounting period audited. For the avoidance of doubt, it does not start to count from the actual date of the appointment or the date of the engagement letter or the date of the AGM at which the appointment is ratified.

For example, if a new statutory auditor is appointed to perform the audit of a PIE for the year ended 31 December 2011, then this will count as year 1 of the auditor relationship.

As a general rule, if an ongoing engagement is interrupted the calculation of duration will reset and not continue after the auditor/audit firm is reappointed or after the entity qualifies again as a PIE, except — as applicable — where there is a merger/acquisition (on this latter point; see [ECG FAQ 3.4](#) and [ECG FAQ 3.7](#), below). That said, when specifically calculating the duration of the audit engagement for the purpose of implementing the rotation requirements, the CEAOB has recommended that if an auditor stops providing audit services to the PIE for a period shorter than 4 years (ie. the “cooling-off period”) and is appointed again to provide audit services to the same PIE after that interruption, the calculation of the maximum duration would not restart (see [CEAOB Guidance](#), Duration of the Audit Engagement, 28 November 2019, page 2).

3.4 What is the impact of mergers of audit firms on the calculation of audit tenure? **UPDATED**

The Regulation provides that for the purposes of the provisions on audit firm rotation, the audit firm is to include other firms that it has acquired or with which it has merged.

As per the [CEAOB guidance](#) - Duration of the Audit Engagement, 28 November 2019, page 5 - the duration of the engagement in case of mergers and acquisitions of audit firms should count from the original audit engagement carried out by one of the merged audit firms, that is, regardless the effect of the merger or as if the merger has not taken place.

If there is uncertainty as to the date at which the audit firm started carrying out a statutory audit of a PIE, such as due to firm mergers, acquisitions, or changes in ownership structure, the audit firm must inform the relevant Member State’s competent authority which will determine the relevant date for the purposes of the rotation requirement.

The exact facts and circumstances of each relevant transaction or situation would in any event need to be examined carefully.

3.5 When does the maximum duration expire if the PIE changed its accounting reference date or for some other reason the duration of the audit tenure started at a non-standard date? **UPDATED**

The duration is a maximum duration therefore we consider that the PIE will need to tender/rotate its audit to ensure that the maximum duration is not exceeded.

So, for example, a PIE appointed its auditor for the year ended 30 June 2008 (i.e. for the financial year starting on 1 July 2007) and subsequently changed its accounting reference date to 31 December. The 10 year maximum duration expires at 1 July 2017, mid accounting period. So the PIE would need to tender/rotate its auditor for the accounting period ending 31 December 2017, so that the maximum 10-year duration is not exceeded. Note however that certain Member State legislation may calculate audit tenure by reference to financial years only, in which case audit firm tenure would be for a maximum of ten financial years, regardless of the duration in actual years.

Using the words of the CEAOB, in “exceptional and duly justified” cases, the PIE may request the national competent authority to grant only one extension, that may be up to 2 years, to reappoint the statutory auditor (see [CEAOB Guidance](#), Duration of the Audit Engagement, 28 November 2019, page 3). In the event of doubt, the ECG would recommend that what is “exceptional and duly justified” should be interpreted in consultation with the relevant national competent authority.

3.6 Which country’s rules governing audit firm rotation should be followed in a cross-border merger situation? **UPDATED**

Consider the following example. Company X1 (with a 31 December year-end) is incorporated in Germany and has been audited by Auditor A since 2011. In 2014, the company merges with Company X2 and a new legal entity is created, Company X3. Company X3 is incorporated in Spain and its shares are admitted to trading on a regulated market in Spain. It is therefore a PIE. It is now audited by a Spanish audit firm, Auditor B, which is a member of the same network as Auditor A. However, the company’s headquarters continue to be physically located in Germany where many of the company’s employees continue to reside and much of the audit work is performed.

As with all such transactions, in order to determine the correct application of the EU audit Legislation, the precise terms of the merger will need to be carefully considered (see [ECG FAQ 3.7](#)). In this example, the new entity Company X3 clearly qualifies as a Spanish PIE (despite its physical base in Germany). Accordingly it will be Spanish law that dictates when Auditor B will need to rotate off the audit.

To determine the relevant effects of the transitional provisions on mandatory firm rotation according to Article 41 (3) of the Regulation, two issues will need to be further considered. Firstly, under Spanish law, what is the maximum permitted audit engagement period? Secondly, under Spanish law, can that engagement period be extended or not following a tender? Under the new Spanish legislation, the answer is 10 years with no extension, and the first audit is for the year ending 31 December 2014, then Auditor B will need to rotate off the engagement after performing the 31 December 2023 audit. The previous relationship of Auditor A with Company X1 should have no impact on this calculation because Company X3 is a new legal entity, though this may need to be

Mandatory firm rotation (MFR)

confirmed under relevant Member State law — in this case, the law of Spain, with any uncertainty checked with the national competent authority (see also [ECG FAQ 3.7](#)).

If there remains any doubt as to the appropriate time to rotate, Article 17 (8) of the Regulation provides that the audit firm shall immediately contact the local competent authority which shall decide.

3.7 What is the impact of mergers, acquisitions or changes in structure of PIEs on the calculation of the audit tenure? **UPDATED**

In such cases, legal advice may be required to assess the detailed terms of the merger which could impact the way in which audit tenure is calculated. In addition, if there is uncertainty as to the date at which the audit firm started carrying out a statutory audit of a PIE, the view of the competent authority may be sought.

As a general principle, the ECG's view is that if two entities merge to create a new legal entity then tenure for MFR transition purposes would be calculated from the date of the creation of the new legal entity to the extent that it is a PIE. Depending on the individual facts of the case, this may need to be checked under the relevant Member State law.

By way of example, in cases of major acquisitions, management buy-outs or other significant corporate events a reasonable interpretation would be that if they do not result in the formation of a new legal entity and the existing auditor does not change as a result of the transaction, then this is not treated as a 'new' start to the audit relationship — although, again, legal advice should be sought. Clearly a PIE with such a situation will also consider the corporate governance and market perspective and may wish to consult with the relevant national competent authority.

For its view, above, the ECG relies directly on the text of the Audit Regulation and Jonathan Faull's letter of 2 September 2014, both of which refer to "the same public interest entity" in the context of Article 17(8) of the Regulation as the basis for the calculation of duration of the audit engagement.

Alternatively, the CEAOB's [Guidelines on Duration](#), 28 November 2019, page 5 point 8, also expresses the view that: "if the auditor of the absorbent entity or the new entity created after the merger was the auditor of any of the PIEs involved in the merger, the duration of the engagement should count from the original audit engagement of the PIEs involved in the merger. The same criteria will be applicable to acquisitions, demergers and other changes in ownership structure." The CEAOB explains that "[t]his rationale is also consistent with the approach of substance over form, according to which the economic substance and its concrete effects precedes the formal legal design (of previous mergers/acquisitions)."

Like the ECG, the CEAOB confirms that, in the event of uncertainties in the context of restructurings, consultation should be had by the auditor with the national competent authority.

3.8 For the purpose of understanding duration of tenure for mandatory firm rotation requirements, does the period before the entity became a PIE count towards total audit tenure? **UPDATED**

In calculating audit tenure for the purpose of MFR rules the date an entity first became a PIE is key.

The ECG acknowledges the position articulated by the CEAOB on this point in point 5, page 4, of the CEAOB [Guidance on Duration](#), 28 November 2019. The CEAOB states that in the case of an entity that "qualifies as a PIE during the course of a financial year, for example, due to the admission of its securities on a regulated market, the calculation of the maximum duration of the audit engagement should start the first year the audited entity was a PIE at the time of the reporting date, that is the closing date of the financial statements".

For example, Audit Firm X have been auditors since 2005 but the entity only listed during financial year 2010 — in this scenario the audit duration will be counted from the closing date of the first set of financial statements in financial year 2010 that the entity reports as a listed entity.

The ECG also notes the EC's earlier position stated in the [Second Additional EC Q&A](#) of 31 May 2016 which had taken the view that if "an entity qualifies as a PIE during the course of an audit engagement, the calculation of the duration should start from the first financial year after the entity qualifies as a PIE" (Q1).

3.9 When must a tender be performed?

The audited entity may perform a tender and change its auditor at any time provided the maximum duration is observed. However see [Question 3.11](#) below if the Member State has exercised the option to permit reappointment of the existing auditor and the audited entity wishes to consider such reappointment. See also [Section 5](#).

Note —there is also no restriction preventing the current statutory auditor from participating in a tender for NAS work due to commence upon expiry of the statutory audit relationship. See [Section 7](#).

3.10 When must a tender be performed in order to extend the maximum duration period?

Where the Member State has elected to permit the extension of the initial maximum duration period and the audited entity wishes to consider reappointing the existing auditor, companies may carry out the tender at an earlier point in time, but the appointment resulting from the tender 'takes effect after the expiry of the initial maximum duration period' (i.e. at the end of the initial maximum duration period of up to 10-years).

3.11 Do the new audit firm rotation requirements replace the need to rotate audit partners? **UPDATED**

No. There is still a requirement for 'key audit partners' to rotate after a maximum of 7 years, followed by a 3-year cooling-off period (see [ECG FAQ 3.12](#)). Member States may not impose a shorter cooling-off period. These requirements are broadly in line with the IESBA Code — although the Code has been amended with the effect that for financial statement periods commencing on or after 15 December 2018 the cooling

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off period for the lead audit engagement partner will be five years, with a transitional period for the EU, i.e. where a competent authority has established a cooling-off period for a lead audit engagement partner of less than five consecutive years, the higher of that period or three years may be substituted for the cooling-off period of five consecutive years provided that the applicable time-on period does not exceed seven years. Member States have the option to elect shorter partner rotation periods (see [Section 13](#)). A number of Member States currently have shorter partner rotation periods of 6 or 5 years (see [ECG FAQ 10.4](#) on engagement quality control review requirements).

3.12 What are the arrangements for rotation of key audit partners? **UPDATED**

Article 17(7) states that:

'the key audit partners responsible for carrying out a statutory audit shall cease their participation in the statutory audit of the audited entity no later than 7 years from the date of their appointment'

So for example, a key audit partner first appointed auditor to a PIE with a December 2013 year-end would be able to remain key audit partner for 7 years until the 31 December 2019 year-end audit - after which they would need to rotate.

If the audited entity only becomes a PIE during the key audit partner's tenure, based on the principles set out in the EC's guidance (issued in the [Second Additional EC Q&A](#)), the length of time the individual has served as the key audit partner shall be counted from the beginning of the financial year following that in which the entity becomes a PIE. However, note that the IESBA requirements are stricter and will also need to be respected.

Note that it is a Member State option to reduce the key audit partner rotation requirements from 7 years.

Article 17(7) also includes a cooling-off period: "They shall not participate again in the statutory audit of the audited entity before three years have elapsed following that cessation."

The meaning of the phrase "years from the date of their appointment" is undefined in the Regulation and Directive. Does it refer to calendar years or financial years? We believe that the better view is that the phrase is a reference to financial years. This is consistent with paragraph R540.5 of the IESBA Code which also refers to "years" and which is interpreted as a reference to financial years not calendar years.

On the basis of the above, it is recommended that key audit partners cease their participation in the statutory audit after having audited seven financial years (or any lower amount provided under relevant Member State law) and do not participate again before three financial years have elapsed following that cessation.

It is also highly recommended by the CEAOB as a good practice, that the key audit partner is not appointed as engagement quality control reviewer during the cooling-off period, as it could impair the objectivity to perform the responsibilities laid out in Article 8 of the Regulation due to a high familiarity threat (see 28 November 2019 [Guidance on the Duration](#) of the Audit Engagement; page 5).

Article 17(7) also states that the statutory auditor/audit firm shall establish an appropriate gradual rotation mechanism (see [ECG FAQ 3.22](#), below, for more on this mechanism) with regard to the most senior personnel involved in the statutory audit, including at least the persons who are registered as statutory auditors. The CEAOB has confirmed that "most senior personnel" includes "at least those who — not being key audit partners and engagement quality control reviewers — participate, with the audit team, in the direction, review or supervision of the audit engagement and the members of the audit team who are registered as statutory auditors" (see 28 November 2019, [Guidance on the Duration](#) of the Audit Engagement; page 5).

If the financial year in question for the particular audit is a shortened financial year then the application of the Article 17(7) cooling-off period will need to be assessed by reference to the facts of that case, as appropriate.

3.13 As per EU legislation, are the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries subject to the same rotation requirements as the lead audit partner on the audited PIE (i.e. maximum 7-year time-on and 3-year cooling-off)? **NEW**

Yes — this derives from the fact that Article 17 of the EU Regulation 537/2014 and Article 2.16 of Directive 2014/56 defines "key audit partner(s)" broadly, as follows:

- Article 17 of the EU Regulation 537/2014 states:

"The key audit partners responsible for carrying out a statutory audit shall cease their participation in the statutory audit of the audited entity not later than seven years from the date of their appointment. They shall not participate again in the statutory audit of the audited entity before three years have elapsed following that cessation."

- Article 2.16 of the Directive 2014/56/EU defines key audit partner(s) as:

"(a) The statutory auditor(s) designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on behalf of the audit firm; or

(b) In the case of a group audit, at least the statutory audit at the level of the group and the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries; or

(c) The statutory auditor(s) who sign(s) the audit report."

Accordingly, any key audit partner who falls within (a), (b) or (c) above is considered as a "key audit partners responsible for carrying out a statutory audit" and therefore would be subject to a 7-year time-on and 3-year cooling-off.

3.14 When does the new three year (replacing the current two year) cooling-off period for key audit partners start applying? **UPDATED**

Article 17 (7) of the Regulation introduces a three-year cooling-off period for key audit partners who have been responsible for carrying out a statutory audit of a PIE for seven years (or less than seven years, if a Member State opts for a shorter period). This replaces the existing two-year cooling-off period required by the 2006 Statutory Audit Directive.

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As a general principle, any cooling-off period should be measured by reference to the financial year of the audit engagement from which a key audit partner has had to rotate (see also [ECG FAQ 3.12](#)). This is in line with Article 17(8) of the Regulation.

The new three-year requirement for cooling-off periods would apply to cooling-off periods starting on or after 17 June 2016 (i.e. where a cooling-off period straddles 17 June 2016, the two-year cooling-off period for key audit partners will still apply), according to the [Second Additional Q&A](#) (Q1).

3.15 **Is there any cooling-off requirement for the incumbent auditor once the audit firm rotates off the audited entity?**

Yes — there is a 4 year cooling-off period. Article 17(3) of the Regulation states that neither the statutory auditor (nor, where applicable any members of their networks within the Union) can perform the statutory audit for that same PIE for a period of 4 years. Member States may not impose a shorter or longer cooling-off period.

3.16 **Will all entities within an EU corporate group be required to rotate at the same time?**

There are two scenarios that must be considered:

PIE parent with non-PIE subsidiaries

The PIE parent company auditor will rotate in line with the national law of the Member State where the PIE parent is incorporated. Although the subsidiaries are not PIEs in their own right and therefore not subject to mandatory rotation, the parent company may well want to appoint one auditor for the entire group. So the non-PIE subsidiary auditors may in practice rotate at the same time.

PIE parent with a PIE subsidiary

The PIE subsidiary auditor will have to rotate in line with the national law of the EU Member State where that PIE subsidiary is incorporated. This may in some cases be a different period than that applying to the PIE parent. If the subsidiary period is longer than the parent period, then from a practical standpoint the parent period may dictate when the audit is rotated. This would have to be the case if the parent company preferred to have just one auditor for the entire group. However, if the subsidiary's national rotation period is shorter than the parent's national rotation period; the subsidiary will have to rotate even if the parent retains its existing auditor.

3.17 **Are there any exceptions regarding extension of maximum tenure in exceptional circumstances?**

Paragraph 6 of Article 17 of the Regulation allows a PIE to apply to the competent authorities (i.e., the auditor oversight body), on an exceptional basis, for an extension of its audit relationship by not more than 2 years.

'Exceptional circumstances' have not been further defined however the EC clarified in a stakeholder meeting that this could relate to mergers or to the situation where a tender process had been unsuccessful. It is expected that Member States will provide additional guidance on their interpretation of this requirement.

The PIE may only apply for this 2-year extension if they either conduct a tender (as referred to in Article 17.4(a)) or appoint more than one auditor. The extension can only be applied at the very end of the auditor relationship. For example, if a Member State

has introduced a standard '10 years plus 10 years' regime (i.e., an initial duration period of the 10 year maximum and a 10 year maximum extension following a tender) the PIE will not be able to apply for a 2-year extension after the end of the first 10-year period.

However, PIEs can apply **to the competent authorities** for such an extension irrespective of whether or not their respective Member States have activated the Member State options provided for in Article 17.4, providing that they conduct a tender or appoint more than one auditor. We consider that PIEs may also apply for such extension in the context of the different transitional measures outlined in Article 41 (1), (2) and (3), providing of course that they conduct a tender or appoint more than one auditor.

3.18 **Will the EU Member States that already have mandatory firm rotation requirements be able to keep their current regimes?**

Yes, to the extent that these requirements are compatible with the Regulation. For example, Italy will be able to maintain their existing maximum period and rotation requirement of 9 years.

3.19 **Which countries will exercise their option to extend to 20 years (tender)/24 years (joint audit) and may choose periods shorter than 10 years? UPDATED**

Member State implementation of the options has resulted in a patchwork effect across the EU in terms of the initial maximum duration period and allowing for the extension of up to 20 years (tender)/24 years (joint audit). See [Section 13](#). See the [ECG Dashboard](#).

3.20 **What are the implications for group auditors and the application of ISA 600? UPDATED**

The implications for a group auditor will need to be assessed on a case by case basis. Issues are likely to arise where a group has multiple PIEs in the EU and has PIE subsidiaries which will be required to rotate their auditors over a shorter period than the period applying to the parent company auditor. Similarly there will be issues for inbound groups with PIEs, where the parent and other parts of the group have no rotation requirement or a different rotation requirement. See [ECG FAQ 3.12](#)

3.21 **Upon expiry of the statutory audit mandate of a PIE carried out by network member audit firm A in country A, may a member of the same audit network but in a different country be appointed as the new statutory auditor for the same PIE?**

In Article 17(3) there is a specific reference to the implications on the network as follows:

'After the expiry of the maximum durations of engagements ... or after the expiry of the durations of engagements... neither the statutory auditor or the audit firm nor, where applicable, any members of their networks within the Union shall undertake the statutory audit of the same public-interest entity within the following four-year period.'

Therefore in the above example no member of the audit network within the EU to which Audit Firm A belongs may undertake the statutory audit of the PIE until a period of 4 years has elapsed.

Mandatory firm rotation (MFR)

3.22 What is meant by a 'gradual rotation mechanism'? **UPDATED**

Article 17(7) of the Regulation states:

*The statutory auditor or the audit firm shall establish an appropriate gradual rotation mechanism with regard to **the most senior personnel involved** in the statutory audit, including at least the persons who are registered as statutory auditors.*

The Regulation provides some guidance as to what is understood by a 'gradual rotation mechanism' of the most senior personnel involved in the statutory audit. The gradual rotation mechanism shall be:

- applied in phases on the basis of individuals rather than of the entire engagement team;
- proportionate in view of the scale and the complexity of the activity of the statutory auditor or the audit firm and
- the statutory auditor or audit firm shall be able to demonstrate to the competent authority that such mechanism is effectively applied and adapted to the scale and the complexity of the activity of the statutory auditor or the audit firm.

The CEAOB has confirmed that "most senior personnel" includes "at least those who — not being key audit partners and engagement quality control reviewers — participate, with the audit team, in the direction, review or supervision of the audit engagement and the members of the audit team who are registered as statutory auditors" (see 28 November 2019, [Guidance on the Duration of the Audit Engagement](#); page 5). See also [ECG FAQ 3.12](#), above.

Transitional arrangements for MFR

04

4.1

What are the transitional provisions for MFR? **UPDATED**

There are specific transitional provisions in the Regulation (Article 41) that govern the application of the MFR requirements and apply in a uniform manner across the EU as clarified/confirmed in the CEAOB's 28 November 2019 [Guidance on the Duration of the Audit Engagement](#) (Q9) and [Second Additional EC Q&A](#) (Q7). These transitional provisions are based on the length of the existing auditor/client relationship at the date of entry into force (16 June 2014) as follows:

- a) Where the auditor/client relationship is 20 years or more when the Regulation entered into legal force on 16 June 2014, (i.e. audit relationships started in the financial year ending 31 May 1995 or earlier) the company cannot enter into or renew an audit engagement with its incumbent auditor as from 17 June 2020.
- b) Where the auditor/client relationship is between 11 and 20 years when the Regulation entered into force on 16 June 2014, (i.e. audit relationships started in the financial year ending from 30 June 1995 up until and including 31 May 2004) the company cannot enter into or renew an audit engagement with its incumbent auditor as from 17 June 2023.
- c) Where the auditor/client relationship is less than 11 years on 16 June 2014, (i.e. audit relationships started in the financial year ending 30 June 2004 onwards) then the period before 17 June 2016 should be taken into account in calculating the duration of the audit tenure, according to the EC. So the rotation requirements (per Article 17 — see [Section 3](#)) for this tranche of engagements would begin to apply to the first financial year starting on or after 17 June 2016, if the maximum tenure has been reached. See [ECG FAQ 4.4](#).

In all cases the tenure of the engagement will be calculated on the date of entry into force (16 June 2014) to determine which transitional rules apply.

4.2

How do I calculate the tenure of an audit engagement for the purposes of the transitional regime? **UPDATED**

As described in [ECG FAQ 3.3](#) the calculation of tenure should be from the start of the first accounting period audited — in other words treat the first accounting period audited as 'year 1'. It is not explicitly stated in the Legislation that the calculation of tenure should be on the same basis for the transitional regime as for normal rotation, but this is logical and was supported by the [EC's letter](#) of 2 September 2014 to Member States on the transitional arrangements and by the [Second Additional EC Q&A](#) (Q1).

As described in [ECG FAQ 3.8](#), if an entity qualifies as a PIE during the course of an audit engagement, the calculation of tenure should be from the first financial year covered in the audit engagement letter in which the statutory auditor/audit firm has been appointed for the first time to carry out consecutive statutory audits of the same PIE. This is also confirmed by the CEAOB in its 28 November 2019 [Guidance on Duration of the Audit Engagement](#), pages 2 and 4.

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In the particular case of an entity that qualifies as a PIE during the course of a financial year, for example, due to the admission of its securities on a regulated market, the ECG agrees with the view of the CEAOB that the calculation of the maximum duration of the audit engagement should start the first year the audited entity was a PIE at the time of the reporting date, that is the closing date of the first set of financial statements that the entity reports as a listed entity (CEAOB [Guidelines on the Duration of the audit engagement](#), page 4).

The ECG also notes the EC's earlier stated position in the [Second Additional EC Q&A](#) of 31 May 2016, which had taken the view that if 'an entity qualifies as a PIE during the course of an audit engagement, the calculation of the duration should start from the first financial year after the entity qualifies as a PIE' (Q1).

4.3 In calculating the length of audit firm tenure for the purpose of determining which transitional rule applies, how do we take account of previous relationships within the same audit firm network in other Member States?

On completing the statutory audit of the 31 December 2013 financial statements, an audit firm in country A has now performed the statutory audit of a PIE for 15 years. In 2014 the audit engagement for the PIE moves to another member of the same audit firm's network but from country B. The question is whether the 15 years tenure of audit firm A needs to be taken into account in determining the length of audit relationship with audit firm B as of 16 June 2014 (i.e., the date of entry into force)?

For the purpose of establishing which of the transitional arrangements within Article 41 apply, the audit firm rotation rule only applies to the statutory auditor or audit firm and does not apply to networks. The fact that a member of the network, in this case in Country A, has been providing audit services to the PIE in the past is not relevant for the purposes of the calculation of the duration of the audit engagement for the network firm in Country B. Local regulators may however form an alternative view.

Note — in all cases the maximum permitted tenure of the relevant Member State should not be exceeded.

4.4 How do the rules apply to a year-end that straddles the application date of 17 June 2016? Can an audit firm complete the year end 31 December 2016 audit where the audit relationship is in the less than 11 years category and already exceeds 10 years?

Yes, an audit firm may complete the year end 31 December 2016 audit where the audit relationship already exceeds 10 years, based upon the [September 2015 written reply from Commissioner Jonathan Hill](#) to a written question from MEP Kay Swinburne. For example, a relevant PIE with a 31 December 2016 year end would have to change auditor for the FY 2017 statutory audit.

As a general principle, the EC Q&A confirmed that 'the new requirements will apply to the first financial year starting after the date of application of 17 June 2016'. On this basis, an audit for a financial year beginning on 1 January 2016 would **not** be affected by the Legislation.

However, if the Member State has chosen to take up the option to allow for an extension of the mandatory rotation period the incumbent auditor could then participate in the tender process for the 2017 audit. If the incumbent audit firm is re-appointed based on the outcome of the tender process, the maximum tenure period of 20 years would in any

event have to be respected. If the first financial year audited by the audit firm is calendar year 2004 and, following a tender, the audit firm is reappointed for financial year 2017, the last financial year that the audit firm may audit would be 2023 (except if the PIE, on an exceptional basis, applies to the competent authority for an extension to renew the audit firm for a further period of 2 years as allowed by Article 17 (6) of the Regulation).

As always, law and guidance applicable in the relevant Member State should be reviewed.

A. Auditor/client relationship of 11 years or more at 16 June 2014 (i.e. Article 41(1) and 41(2))

4.5 Where the statutory auditor has been in place for more than 20 years as at 16 June 2014, can the auditor perform the statutory audit for the year beginning 1 January 2020? **UPDATED**

The CEAOB has confirmed in its 28 November 2019 guidelines concerning the Duration of the Audit Engagement that Article 41(1) applies to transition where auditors at the date of entry into force of the regulation (16 June 2014) have been providing uninterrupted audit services for the PIE for 20 or more consecutive years.

This means for the CEAOB that when the start of the first financial year covered in the audit engagement is prior to, or on, 16 June 1994, the audited entity will not be allowed to renew or enter into an audit engagement with the given audit firm or statutory auditor for periods that start on or later than 17 June 2020.

Based on the above, our interpretation is that a renewal that takes place in 2020 for the audit of a company's financial statements for the year ending 31 December 2020 would be permitted. This applies equally to single or multi-year engagements - e.g. in France a 6-year engagement may be renewed prior to 17 June 2020 for a further 6 years, 3 years in Belgium etc.

Conversely, a renewal in 2020 for the audit of a company's financial statements for the year ending 30 June 2021, would not be permitted.

B. Auditor/client relationship is less than 11 years at 16 June 2014 (i.e. Article 41(3))

4.6 How do I interpret the transitional provisions where my auditor/client relationship is less than 11 years?

For this category, the EC initially indicated in a [letter](#) dated 2 September 2014 addressed to the EU audit oversight bodies and posted on the EC website that the period before 17 June 2016 should be taken into account in calculating the duration of the audit tenure. The rotation requirements (per Article 17) for this tranche of engagements would thus according to this letter appear to **apply immediately** as from 17 June 2016, if the initial maximum rotation period of 10 years (or less if Member States opt for a shorter initial tenure period — see [Question 3.1](#)) has been reached.

The [September 2015 written reply from Commissioner Jonathan Hill](#) to a written question from MEP Kay Swinburne has further clarified that such PIEs would need to change auditors in the financial year **starting on or after 17 June 2016**. For example, a relevant PIE with a 31 December 2016 year end would have to change auditor for the

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FY 2017 statutory audit.

For this tranche of audit/client relationships, the engagement cannot be renewed for the financial year starting on or after 17 June 2016 unless the relevant Member State has taken up the option to allow for an extension (see [Question 3.2](#) and [Section 13](#)).

Where an auditor/client relationship was first entered into for accounting periods **beginning** between **17 June 2006 and 17 June 2016** (assuming a 10 year initial maximum duration period), a tender will be required (where the relevant Member State has taken up the option to allow for an extension) to take effect upon expiry of the initial maximum duration period (subject to Member State options the relationship may be extended). So in these scenarios the usual initial maximum duration applies but will see a staggered introduction (see [Questions 3.1](#) and [3.2](#)).

4.7 **Where the first accounting period of the auditor/client relationship is for the year ended 30 June 2004, can we still do the audit in FY 2016?**

In the case of an audit relationship where the first auditor/client relationship related to the accounting period beginning 1 July 2003 for an accounting period ended 30 June 2004, then the audit relationship would be classed as being less than 11 years at the date of entry into force (16 June 2014). As such the PIE in this example, would need to (depending on the Member State options implemented in their country) rotate or tender to extend (see [Question 4.8](#)) its audit for the accounting period ending 30 June 2017. It is our understanding that the 30 June 2016 audit may be completed before either rotation or tendering is required (See [Question 4.4](#)).

4.8 **When the audit engagement has reached the initial maximum duration period by 17 June 2016 or thereafter, can the engagement be extended?**

The engagement can be extended if the relevant Member State adopts the option to allow for an extension and the PIE complies with the derogation provisions e.g. tender. See [Questions 3.1](#) and [3.2](#) for further details.

In addition paragraph 6 of Article 17 of the Regulation allows a PIE to apply to the competent authorities (i.e., the auditor oversight body), on an exceptional basis, for an extension of its audit relationship by not more than 2 years.

4.9 **Where a PIE needs to tender/rotate its audit for the first accounting period starting after 16 June 2017, when does the tender need to take place?**

There are no specific provisions in the Legislation and we would expect the general principles in [Questions 3.9](#) and [3.10](#) to apply.

4.10 **My Member State is opting for an initial maximum duration period of say 8 years, — i.e. less than the maximum 10 years. How am I impacted?**

The auditor/client relationships first entered into for accounting periods starting between **17 June 2003 and 16 June 2008** will be immediately impacted. The reason is that by the time such engagements reach the date of application of the Legislation of 17 June 2016 they will have already reached the maximum permitted tenure as specified by their Member State of **8 years** — therefore the provisions of Article 17 (see [Section 3](#)) will immediately apply to any auditor reappointments for financial years starting on or after 17 June 2016.

4.11 **If a PIE has held a recent tender for its audit before the entry into force of the Regulation (i.e. before 16 June 2014) and decided to retain the incumbent, will this tender be taken into account in establishing when a company needs to rotate its auditor?**

The transitional provisions take account of the length of the auditor/client relationship as at the date of entry into force of the Regulation, being 16 June 2014. The fact that a tender has just been carried out and the existing auditor has been reappointed has no impact on the cumulative relationship with the company being audited in these circumstances. This would suggest that a second tender might be required within a few years of the original tender. However, this is still subject to confirmation. See [Question 4.1](#) for the transition rules.

If a new auditor is appointed as a result of a tender performed pre-17 June 2016 for an accounting period commencing on or after 17 June 2016 then Article 17 will immediately apply and tenure for the new auditor would be counted from the start of the first full accounting period audited commencing as from 17 June 2016 (see [Question 3.3](#)).

4.12 **For the mandatory firm rotation transitional measures, when is the starting point of audit firm tenure in case of a break followed by a re-appointment?**

The transitional measures under Article 41 of the Regulation provide ultimate end dates for audit firm renewal based on the number of consecutive years, at the date of entry into force of the Regulation (16 June 2014), during which the audit firm has been providing audit services to a given PIE. As the number of consecutive years is taken into account, if there has been a break in audit firm tenure for at least one financial year, audit firm tenure for the purposes of these transitional measures should be counted from the beginning of the most recent set of consecutive years' audits. As an example, if a PIE appoints an audit firm as its auditor for consecutive financial years from 1989 to 2010, appoints another audit firm for financial year 2011 and then re-appoints the first audit firm for 2012, tenure for the purposes of the transitional measures should be calculated from 2012.

4.13 **For the mandatory firm rotation measures, what is the impact on calculation of tenure of a de-listing of a PIE on a regulated market followed by a re-listing on a regulated market? UPDATED**

The transitional measures under Article 41 of the Regulation provide ultimate end dates for audit firm renewal based on the number of consecutive years, at the date of entry into force of the Regulation (16 June 2014), during which the audit firm has been providing audit services to a given PIE.

As the number of consecutive years is taken into account and as the Regulation applies to statutory audits of PIEs, if the audited entity has ceased to be a PIE for at least one financial year, audit firm tenure for the purposes of these transitional measures should be counted from the beginning of the first accounting period audited — in other words treat the first accounting period audited as 'year 1'. It is not explicitly stated in the Legislation that the calculation of tenure should be on the same basis for the transitional regime as for normal rotation, but this is logical and was supported by the EC's letter of 2 September 2014 to Member States on the transitional arrangements and by the [Second Additional EC Q&A \(Q1\)](#).

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If an entity qualifies as a PIE during the course of an audit engagement, the calculation of tenure should be from the first financial year covered in the audit engagement letter in which the statutory auditor/audit firm has been appointed for the first time to carry out consecutive statutory audits of the same PIE. This is also confirmed by the CEAOB in its 28 November 2019 [Guidelines on the Duration](#) of the Audit Engagement, page 2.

In the particular case of an entity that qualifies as a PIE during the course of a financial year, for example, due to the admission of its securities on a regulated market, the ECG agrees with the view of the CEAOB that the calculation of the maximum duration of the audit engagement should start the first year the audited entity was a PIE at the time of the reporting date, that is the closing date of the first set of financial statements that the entity reports as a listed entity (CEAOB [Guidelines on the Duration](#) of the audit engagement, page 4). See also [ECG FAQ 3.8](#).

The ECG accepts the CEAOB's 28 November 2019 position, above, and shall give precedence to it over the EC's earlier position stated in the [Second Additional EC Q&A](#) of 31 May 2016 which had taken the view that if 'an entity qualifies as a PIE during the course of an audit engagement, the calculation of the duration should start from the first financial year after the entity qualifies as a PIE' (Q1).

4.14 How will the transitional arrangements for MFR work in the non-EU EEA Member States?

Before any piece of EU legislation "with EEA relevance" takes effect in the three non-EU EEA countries (Iceland, Liechtenstein and Norway), it needs first to be the subject of a Decision of the EEA Joint Committee. As of the date of these FAQs, that Decision has not yet been taken (see Question 1.5).

When the EEA Joint Committee Decision is taken, that Decision will establish the date of entry into force of the underlying legislation as well as its date of application. In order to avoid this legislation having a retrospective impact in the EEA countries, it is likely that specific dates in the EU audit legislation will be adjusted. On this basis, the specific dates of 17 June 2020 and 17 June 2023 referred to in Articles 41(1) and 41(2) of the Regulation may be deferred for Iceland, Liechtenstein and Norway.

Tendering

05

5.1 **Is there a tendering requirement introduced by the Regulation?**

Article 16 of the Regulation introduces tendering for all auditor appointments of PIEs **other than auditor renewals**. PIEs will be obliged to have a tender process with the close involvement of the audit committee when considering either the selection of a new auditor, or the re-appointment of an existing auditor at the end of the initial maximum duration period of 10 years (where permitted by their Member State).

5.2 **Is there a difference in the requirements that need to be followed where there is the appointment of a new auditor, as opposed to where there is the simple reappointment of an existing auditor?**

Yes. The tender requirements in Article 16(3) of the Regulation need not be followed where there is the renewal of an existing auditor. Otherwise a tender must be carried out in accordance with the obligations set out in Article 16(3).

5.3 **Is there an exemption available to the tendering requirement?**

No, all PIEs have to tender when required — See [Question 5.1](#). However Article 16(4) says that Public-interest entities which meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC (copied below) shall not be required to apply the criteria described in Article 16(3) when conducting their selection procedure.

(f) *'small and medium-sized enterprises'* means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria:

- an average number of employees during the financial year of less than 250,
- a total balance sheet not exceeding EUR 43 000 000, and
- an annual net turnover not exceeding EUR 50 000 000.

(t) *'company with reduced market capitalisation'* means a company listed on a regulated market that had an average market capitalisation of less than EUR 100 000 000 on the basis of end-year quotes for the previous three calendar years.

5.4 **Are there any requirements regarding which audit firms are to be invited to tender?**

Not explicitly. Article 16(6) says that contractual clauses between a PIE and a third party restricting the shareholders' choice of auditor in general meeting shall be null and void, which implies that invitations to tender should similarly not be restricted. A PIE is free to invite any audit firms to submit proposals but the organisation of the tender process must not preclude the participation of smaller audit firms (defined in Article 16(3) (a) as those who received less than '15% of the total audit fees from public-interest entities in the Member State concerned in the previous calendar year'). It is not clear how this requirement to 'not preclude' the participation of smaller audit firms is to be interpreted. Audit committees are responsible for submitting a recommendation to the supervisory body of the audited entity for the appointment of the auditors. The recommendations should include at least two possible choices for the audit engagement and a justified preference for one of them.

Tendering

5.5 How should a company demonstrate compliance with Article 16(3)(a)?

Article 16(3)(a) requires a company to ensure that when conducting a tender they should not exclude smaller audit firms. The Regulation defines these as firms “which received less than 15% of the total audit fees from PIEs in the Member State concerned in the previous calendar year”.

The purpose of this requirement is to ensure that smaller audit firms are not routinely excluded from the tender process just because they are not as big as a Big 4 firm.

To assist companies, the competent authorities are required to maintain and make public a list of all PIE auditors which have received less than 15% of the total audit fees from PIEs in the previous calendar year, including those which have received no audit fees from PIEs, to be updated annually. This will help companies to identify those audit firms that meet the requirements of Article 16(3)(a).

In terms of how a company demonstrates that they have not excluded such firms from the tender process, the audit committee should formally document the various criteria they considered (e.g., geographical coverage, industry expertise or audit inspection results) in deciding which firms to invite to tender. Some companies are also considering publishing a formal Request for Proposal.

5.6 If a PIE would voluntarily choose to rotate its auditors before the end of the transition period, would the provisions of Article 16(3) apply for selecting a new auditor?

No, Article 41(4) of the Regulation on MFR transition stipulates that the provisions for auditor selection mentioned in Article 16(3) of the Regulation need only apply to tendering for audit engagements that commence after expiry of the maximum duration period (of 10 years). As such they do not appear to apply to voluntary changes of auditors before the end of the first transition period.

5.7 Does the end of the tender process itself represent the end of the engagement of the incumbent auditor?

No. This will depend on the relevant Member State law but typically a new auditor will need to be appointed and the incumbent auditor’s appointment will formally cease at the General Assembly/Meeting adopting the audited financial statements which will occur after the end of the tender process. The incumbent auditor is in place until such time.

5.8 Article 17(4)(a) of the Regulation makes reference to a “public” tendering process – does the inclusion of the term ‘public’ create any additional requirements on a tender process?

Article 17(4)(a) requires a tender to be “conducted in accordance with paragraphs 2 to 5 of Article 16”. This suggests that the term ‘public’ does not add any further requirements to the tendering process over and above those stated in Article 16(2)-(5). It remains to be seen whether national legislators or regulators intend to create additional requirements.

5.9 Is tendering required to appoint a new, second auditor in cases of joint audit?

Yes, where a Member State opts to extend the maximum duration of the audit engagement through joint audit, a PIE from that Member State will be required to conduct a tender to select the new, second auditor, according to the Second Additional EC Q&A (Q5).

A tender is not however required in these circumstances to renew the appointment of the first auditor. The EC Q&A (p.6) in effect specifies that there is no obligation to organise a public tender under the requirements set out in the Regulation in order for a PIE to maintain its auditor for an additional period of 14 years.

5.10 The audit committee’s recommendation for the appointment of an auditor must be free from influence by a third party under Article 16(2) of the Regulation – what is meant by “third party” in this context?

In the context of the requirement under Article 16(2) for an audit committee’s recommendation for the appointment of an auditor to be free from influence by a third party, we understand “third party” to mean any party other than either the audit firm(s) which are being considered for the (re)appointment or the audit committee (or the body performing equivalent functions) which is making the recommendation to the board or supervisory body.

Joint audit

06

- 6.1 Are joint audits going to become mandatory?**
No, this is not a requirement in either the Regulation or the Directive.
- 6.2 To qualify for the 14 year extension, is a joint audit required throughout the initial 10 year period?**
No, a company **does not** need to have a joint audit throughout the first 10-year duration period in order to qualify for an extension of that engagement for up to 24 years (i.e. 10-year initial maximum duration period plus maximum 14-year extension for joint audit).
However, firstly, a Member State must explicitly allow the extension in cases where a company decides to have a joint audit. Secondly, the company would then be required to have a joint audit **for the entire extended period**.
- 6.3 Is a joint audit required throughout the second (extended) period?**
Yes. The extension is allowed, providing *'the statutory audit shall result in the presentation of a joint audit report.'*
- 6.4 MFR and joint audit: What happens when audit firm tenure is different for each of two joint auditors?**
If we take a simple example, let's assume that firm A had been auditing a PIE since 2006 for 8 consecutive years as sole auditor. Before 2006, firm B had been auditing the same PIE for a period of 5 years in a joint audit alongside firm A. The question is whether the five years that firms A and B audited the PIE in a joint audit apply when determining how many years firm A audited the PIE as at 16 June 2014.
We believe that the 5 years whilst both A and B were joint auditors will have to be considered in determining tenure because in a joint audit each of the auditors needs to form their own opinion on the financial statements of the PIE.
Adoption of joint audit for part of the audit engagement does not have an influence on the length of tenure. In the example above, the start of the engagement period for the purpose of calculating tenure of firm A is 2001.
- 6.5 In a joint audit scenario where the initial appointment dates for the two audit firms differ, when would a tender be required to extend tenure?**
Let's consider the following example. X and Y are joint auditors of a PIE — X was first appointed joint auditor for the financial year ended 31 December 2011 and Y appointed joint auditor for the financial year ended 31 December 2014. The initial maximum duration period in this scenario is 10 years and the maximum duration period is 24 years.
After the end of the respective initial 10 year periods (i.e., after the 2020 audit for X and after the 2023 audit for Y) both joint auditors may continue **without tendering** until the end of their respective maximum duration periods of 24 years. This view is based on the EC Q&A which states that there is no obligation to organise a tender in order to benefit from the extension of audit tenure up to 24 years.

Joint audit

On this basis, the first time when a tender may be required by law is after conclusion of the audit for the year ending 31 December 2034. At this stage, auditor X will have been in place for the maximum permitted duration of 24 years. The company has two options:

- a) Appoint a new joint auditor Z following a tender. This will enable the existing joint auditor Y to continue in office up until the conclusion of the 31 December 2037 audit.
- b) Appoint a new sole auditor Z following a tender. In this case, both joint auditors X and Y would rotate and be replaced by auditor Z.

The company cannot allow auditor Y to continue as a sole auditor because the maximum permitted duration of 24 years is only allowed when there are joint auditors and auditor Y has already been in place for considerably more than the initial 10 year engagement period.

In relation to the second auditor (Y in this example) we understand the EC's view to be that a tender would not be required (see [Question 5.1](#)).

Note — A Member State may permit the duration of the initial engagement period to be extended in the event of a joint audit, for a period shorter than the 14-year maximum. For example a Member State might only permit an extra 4 year extension as opposed to 14 years. In this case, the total maximum permitted tenure would be 14 years as opposed to 24 years.

6.6

If an auditor is appointed for the first time as joint auditor for an extended period of 14 years, for how long may this auditor then be appointed as sole auditor after completing 14 years as joint auditor?

The Regulation does not address the situation where, pursuant to the joint audit extension option provided for in Article 17(4)(b) of the Regulation, an additional auditor is appointed following the expiry of the maximum duration period of the first auditor and where the PIE, after the expiry of the 14-year extension, wishes to appoint the additional auditor as its sole auditor.

Where a Member State has opted to allow an extension of auditor tenure of up to 24-years in the case of a joint audit, and of up to 20 years in the case of a tender, it appears reasonable for the additional auditor to be allowed to be reappointed (as sole auditor) for a period of 6 years, providing a tender has taken place. As a result, the additional auditor will have audited the audit client for a total period of 20 years, of which 14 years as a joint auditor.

Non audit services (NAS) — prohibited list of services

07

A. Overview of the NAS prohibitions

7.1

How do the provisions on prohibited services work?

The Regulation contains a list of services that cannot be provided ('prohibited services') by a statutory auditor and its network to an entity that is a PIE, to the PIE's EU parent undertaking or to the PIE's EU controlled undertakings.

For services provided by the network to controlled undertakings **outside the EU**, a 'threats and safeguards' approach is required although a limited number of absolute prohibitions still apply (see [Section 12](#)).

The interpretation of the Regulation as regards the list of prohibited NAS may be dealt with as part of Member State implementation of Legislation. Member States may issue, or may have issued, guidance. This FAQ considers the following:

- Understanding the nature of the NAS that are prohibited (see [Questions 7.7 to 7.28](#)); and
- Determining to whom the prohibitions apply and timing implications (see [Questions 7.29 to 7.56](#)).

7.2

What NAS can be provided?

Services that are not on the list of prohibited services are permitted, subject to the general principles of independence and audit committee approval.

All permitted NAS provided in the EU by the audit firm or a member of the network to the PIE, its parent undertaking or its controlled undertakings require audit committee approval (see [Question 9.3](#)).

In addition, a cap on the fees from such permitted services may also apply to the statutory audit firm (see [Section 8](#)).

7.3

Who will ultimately be responsible for determining if a service is permissible?

Clearly the lead audit partner will have to be satisfied but ultimately the approval of permissible NAS will be a decision for the audit committee of the affected PIE. Decisions by the audit committee could be subject to future regulatory scrutiny.

Non audit services (NAS) — prohibited list of services

7.4 Is there any flexibility regarding prohibited NAS such as Member State options?

Member States may add to the list of prohibitions and may adopt legislation further restricting NAS.

With one important exception, Member States may not set a lower threshold in relation to NAS prohibitions — the prohibited list is therefore a minimum baseline. However the exception to this is a Member State option relating to certain tax and valuation services.

Although the Regulation prohibits valuation services and almost all tax services, Member States have an option to allow valuation and certain tax services (preparation of tax forms, identification of public subsidies and tax incentives, support for tax inspections, calculation of direct and indirect tax and deferred tax, and tax advice), provided that these services have no direct effect, or have an immaterial effect, either separately or in the aggregate, on the audited financial statements, the estimation of the effect on the audited financial statements is comprehensively documented and explained in a report to the audit committee and the principles of independence are complied with. (See [Questions 7.7 to 7.13](#)).

7.5 What are the implications of inadvertently providing a prohibited service to a PIE audit client group?

The implications are potentially quite severe.

Article 10(2)(f) requires an audit firm to make a declaration in their audit report on the financial statements of a PIE that the prohibited non-audit services (NAS) referred to in Article 5(1) were not provided and that the audit firm remained independent of the audited entity in conducting the audit.

In terms of the provision of prohibited NAS, the Regulation is completely silent on the question of the significance of breaches. In the case of a serious breach where the audit firm did not remain independent, it is clearly correct that the audit firm would be unable to complete the audit. However the question of a trivial and inadvertent breach is more difficult.

As it stands today, the provision of any prohibited NAS by an audit firm would result in that audit firm not being able to make the relevant declaration required by Article 10(2)(f).

In appropriate factual circumstances, an audit firm and audit committee might believe that even if a prohibited NAS has been inadvertently provided to a PIE audit client, the nature and significance of such NAS are such that the objectivity of the audit firm in question is not impaired. As such, it could be argued that it would be reasonable for the audit firm to make the second part of the declaration required by Article 10(2)(f) in that the audit firm has, in substance, remained independent of the audited entity in conducting the audit. Discussion with the relevant supervisory authority may be appropriate in particular as regards the impact on the declaration.

The IESBA Code of Ethics contains provisions addressing breaches of the Code which are consistent with existing practice in many jurisdictions. The principle underlying these provisions is that termination of the audit engagement is not always the necessary outcome of a breach. Rather an evaluation should be made by the auditor of the significance of a breach and whether actions can be taken to satisfactorily address its consequences. In making this determination, the auditor shall take into account whether a reasonable and informed third party, weighing the significance of the breach,

the action to be taken and all the specific facts and circumstances available to the auditor at that time, would be likely to conclude that the firm's objectivity would be compromised and therefore the auditor is unable to issue an audit report. The auditor is required to discuss the matter with the audit committee.

It is possible that guidance will emerge from provisions enacted by individual Member States. Absent that guidance and post application of the Regulation (for the first financial year starting on or after 17 June 2016 — see [Question 7.40](#)), if an audit firm becomes aware that it has inadvertently provided a prohibited NAS to a PIE audit client, they should discuss this with the Audit Committee and consider an approach to the appropriate competent authority without delay. It is also possible that individual Member States will adopt their own approach to this issue.

7.6 What are the key areas of difference with the IESBA Code of Ethics?

In some cases, the prohibitions simply codify what is already prohibited by the IESBA Code of Ethics. However, in other cases, the key prohibitions are different; they expand upon the IESBA Code by incorporating additional concepts, well established IESBA concepts are not included or concepts similar to IESBA are used, but use different wording, so it is not clear whether the meaning is the same. One key difference from the IESBA Code is that (except where Member States exercise an option to allow tax and valuation services as discussed below — see [Questions 7.7 — 7.13](#)) there is no exception to permit services which are 'immaterial' to the financial statements. There are also cases where the wording of key definitions is similar to IESBA but the wording differs leading to possible confusion and inconsistent interpretation.

In addition, the Regulation appears to be stricter than the IESBA (and SEC) rules, as it does not appear to include the "not subject to audit" principle that is included in the Code (and indeed the US SEC auditor independence rules) which permits, subject to certain conditions, the provision of services to the parent undertaking that would otherwise be prohibited by Article 5.1.

B. What are the NAS prohibitions?

In this section we will consider the NAS prohibitions as follows:

- Tax and valuation services — including the Member State option
- Other Non-Audit Services

See also [Appendix 7](#) which provides a flowchart explaining the NAS prohibitions.

Non audit services (NAS) — prohibited list of services

Tax and valuation services — including the Member State option

7.7

What tax services are prohibited?

The services listed in sub-paragraph A of Article 5(1) cover a wide range of tax services including tax compliance, the calculation of taxes and tax advisory. See Appendix 1.

However, the tax services at (a) (i), (iv), (v), (vi) and (vii) may still be provided in certain cases, i.e. where the Member State applies the derogation (see [Question 7.4](#)) provided:

- they have no direct or have immaterial effect, separately or in the aggregate, on the audited financial statements,
- the estimation of the effect on the audited financial statements is comprehensively documented and explained in an additional report to the audit committee, and
- the principles of independence are complied with).

Such services would also need to be:

- approved by the audit committee (see [Question 9.3](#))
- within the fee cap if it is applicable (see [Section 8](#))
- not prohibited by any other applicable prohibition in the Regulation (see Article 5).
not otherwise prohibited under Member State law (see [Section 13](#))

These principles also apply to Valuation services.

7.8

What does 'have no direct or have immaterial effect' on the audited financial statements mean?

A. How is the phrase "have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements" interpreted?

The use of the conjunction 'or' would indicate the clear intent to establish an alternative. That is, 'no direct effect or such direct effect is immaterial' or 'no direct effect or any effect is immaterial'. This view is supported by the Accountancy Europe interpretation (formerly known as FEE), as laid down in the Accountancy Europe briefing paper 'Provision of Non-Audit-Services to Public Interest Entity statutory audit clients: A Need for Clarification and Consistency' issued in June 2014. This view is also supported by Recital (9), where the wording differs slightly but significantly, stating that statutory auditors may be allowed to provide certain services 'when such services are immaterial or have no direct effect'.

Existing German legislation, which uses similar wording to the Regulation in this regard and which we understand was the original source of the Regulation, also establishes that a service must have no direct effect unless any such direct effect is immaterial, either separately or in the aggregate, on the financial statements.

With respect to the meaning of indirect effect the Regulation is silent. However, the IESBA Code requires auditors to consider whether the outcome of tax and valuation services will have a material effect on the financial statements, irrespective of whether that effect is direct or indirect. At the stakeholder meeting of 11 April 2014, the EC staff referred to International Standards on Auditing (i.e., ISA 320 'Audit

Materiality') for guidance on what is meant by 'material' and such standard does not distinguish between direct effects and indirect effects.

In addition, our view is that the reference to 'audited financial statements' is to those of the EU PIE legal entity (i.e. single or consolidated financial statements of that company) and not the financial statements of the legal entity to whom the tax services are provided — which may be different.

In summary, the phrase "have no direct effect or immaterial effect" means "have no direct effect or any such direct effect is immaterial" to the financial statements (stand-alone and consolidated) of the PIE legal entity being audited.

B. When might a tax or valuation service be considered to have a "direct" effect on the financial statements?

Under German law (see above) and based on our current understanding, the German Legislator considers that as the mere provision of options still requires management to make a decision, simply providing options including advice should not be regarded as having a direct effect on financial statements.

Subject to Member State guidance, several services will typically not have a direct impact; the following are meant as examples:

- Tax compliance:
In general, tax compliance services are based on historical information and principally involve analysis and presentation of such historical information under existing law, including precedents and established practise. Furthermore, the preparation of tax returns generally occur after the preparation of the financial statements.
- Tax incentives:
The availability of a tax incentive is usually dependent on the taxpayer meeting conditions that have been designed to achieve the government's objectives relating to investment, employment and/or sustainability. The client's management will decide whether it wishes to satisfy these conditions in order to benefit from the tax incentive. If the tax planning advice results in action being taken by the client, and a reduction in the tax payable or paid by the client, the advice will have an indirect effect on the client's financial statements.
- Tax inspection support services:
Such services do not have a direct effect on the audit client's financial statements, as the service relates to a filed return and therefore does not involve giving directions or assistance to the client regarding the accounting for or reporting in its financial statements of tax. To the extent that the tax inspection results in a reassessment, the amount of the amended tax is determined by the tax authority.
- Tax planning and other tax advisory services:
Tax planning for future transactions and on the other hand tax advice on historic transactions do not normally have a direct effect on the client's financial statements (see [Question 7.10](#)), if provided in accordance with the IESBA Code of Ethics. In cases of tax planning for future transactions, client management will decide whether it wishes to apply the advice. To the extent that the auditor's tax planning advice results in action being taken by the client, and a reduction in the tax payable or paid by the client, the advice will have an

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indirect effect on the client's financial statements.

It is noted, in this context, that Recital 9 to the Regulation provides that services which involve aggressive tax planning should not be considered as immaterial. The EC Q&A referred to the EC recommendation on aggressive tax planning of 6 December 2012 for further guidance on how this term is to be interpreted. This states that 'aggressive tax planning consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability. Aggressive tax planning can take a multitude of forms and is not defined. Its consequences include double deductions (e.g. the same loss is deducted both in the state of source and residence) and double non-taxation (e.g. income which is not taxed in the source state is exempt in the state of residence).

7.9

When is an effect 'immaterial'?

At the stakeholder meeting of 11 April 2014, the EC staff referred to International Standards on Auditing (i.e., ISA 320 'Audit Materiality') for guidance on what is meant by 'material'. The ISA includes the following:

"Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered."

It goes on to say that "The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements." The ISA provides implementation guidance.

Whilst the lead audit engagement partner needs to be satisfied that any NAS to be provided to the audited entity are legally permissible, the ultimate responsibility rests with the audit committee. Article 5.4 of the Regulation provides that the audit committee may decide to issue guidelines as to what tax or valuation services are, or are not, considered material.

7.10

What services would likely be permitted if the Member State adopts the derogation?

Following the rationale set out in [Question 7.8](#) the following examples would likely be permitted services if the derogation under Article 5.3 is applied by a Member State:

Preparation of tax returns and other forms;

- The preparation of 'tax forms' is permitted by the Regulation if a Member State implements the derogation of Article 5.3. Article 5.3 references 'tax forms' which is a broad term that would encompass all formal tax documentation submitted to the tax authorities including tax applications and registrations. However, it should be noted that some official translations of the Regulation use more restrictive

terms such as tax declarations and tax returns. In any case, such services are generally based on historical information and involve analysis and presentation of such information under existing tax law, including precedents and established practice. Since management takes full responsibility for information submitted, including judgments made, providing such services does not generally create a threat to independence.

Tax advice, assuming management takes all responsibilities and makes related decisions (see also [Question 7.15](#))

- Our rationale that such services are permitted is that the effect on the financial statements of the EU PIE, if any, only results from management's decision to take our advice and enter into a transaction, not from the advice itself.
- The parliamentary papers in Germany¹¹ highlight the importance of differentiating between different types of tax advice and provide a useful indicator about the types of advice that would be permitted and what would likely be prohibited. These papers differentiate between tax advice in which the accounting firm offers structuring options, which would be permitted where the member state has taken up the derogation, and tax advisory services where auditors assume a more active structuring role supplying clients with 'products' that result in significant modifications to the presentation of their net assets, financial position and earning position, which would be prohibited unless the impact is immaterial (which is consistent with the IESBA Code, Section 290.190). In addition, the parliamentary papers also highlight how permitted tax advice would include providing reference to an existing tax position or actions to be taken by the client in order to protect or maintain advantages or benefits. For example, it would be a permitted service for an auditor to point out that the sale of certain assets is tax-free or enjoys tax benefits only up to a particular date, and the client follows such advice even though such decision has effects, which may be material, on financial accounting and annual financial statements due to the required de-recognition of the related assets and the recognition of the consideration received.

Transfer pricing studies and certain advisory studies (including assistance to clients in planning its transfer pricing approach and meeting its associated documentation requirements);

A transfer pricing engagement may consist of various service elements. For independence purposes, the following service elements should be taken into account:

- a) assisting an audit client with preparation of transfer pricing documentation related to compliance matters;
- b) preparing a TP benchmarking study (be it for goods, services, royalties or financial transactions), assisting with TP dispute prevention and resolution initiatives taken by the client (e.g. audit defense), including the drafting of inter-company contracts, such as Advanced Pricing Agreements (APA);
- c) advising an audit client on how to plan and manage its intra-group transfer pricing to comply with the relevant local and international rules, reduce tax inefficiency and mitigate potential exposures.

¹¹ Bundestags-Drucksache 15/3419, p. 41f.

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If no derogation is taken, an auditor must not provide the transfer pricing advisory services described in paragraphs (b) and (c) above. Services outlined in (a) will often be related to one of the services referenced in the blacklist, namely tax advice, tax compliance or assistance with tax audits. In those cases, the services would not be permissible unless the derogation is taken.

If the derogation is taken, an auditor must not provide the described in paragraph (b) or (c) above if the service will have a direct and material effect on the PIE audit client's financial statements.

Tax-only valuations (where the financial statements are only affected through accounting entries related to tax)

Such services are generally permitted since the valuation will not have a direct effect on the financial statements. However, consistent with the IESBA Code (290.191), those services are generally not permitted if the indirect effects are material.

7.11

What about advice and assistance completing personal tax forms for individuals who are employees of the PIE?

The restrictions on NAS are relevant where services are provided to the PIE, to the PIE's EU parent undertaking (s) or to the PIE's EU controlled undertakings (Employer assistance). If the employer does not receive any part of the services, but merely pays for the services provided to its employee for example as a benefit (Employee assistance), we believe that the services will be permitted regardless of any Member State approach to the derogation. We further believe it would be permissible for the company and the auditor to agree a standard engagement structure and price which could be used when contracting with individuals.

However, if any of these entities receives any part of the services, the restrictions on NAS will need to be applied. In this case the tax return services would be prohibited unless the Member State allows such services as part of the Article 5.3 derogation.

If the services to the individual and to the PIE, to the PIE's EU parent undertaking (s) or to the PIE's EU controlled undertakings are 'bundled' and cannot be separated, then the services would be prohibited unless the Member States for all entities who receive the services, either directly or indirectly, allow such services as part of the Article 5.3 derogation.

7.12

What is the scope of the prohibition on "tax services relating to...payroll tax?"

Article 5 prohibits the statutory auditor from providing payroll services (Article 5.1(d)). The scope of the prohibition on payroll services is consistent with existing independence requirements under the IESBA Code and other regimes. Such prohibited payroll services would include the processing of gross pay calculations and deductions, preparation of accounting entries, preparation of payroll tax returns and making payments to employees and government agencies.

Article 5.1 (a) (ii) prohibits services related to "payroll taxes," without the possibility of a derogation. However, the meaning of "tax services relating...to payroll tax" remains uncertain as to which elements of tax services remain prohibited when a Member State applies the derogation, for instance with respect to the "provision of tax advice" and "preparation of tax forms".

There is no universally recognized form of taxation called "payroll tax." However,

there is commonality insofar as many countries require employers to administer the following:

- the collection of their employees' income tax by means of a mandatory or voluntary deduction from their employees' wages.
- the deduction of social security contributions from their employees' wages.

Each of these deductions and payments needs calculation by reference to the employee's gross salary, subject to defined allowances and limits, and would typically be processed and administered through the employer's payroll system. In addition, the payment of the employer's own social security contributions will be processed through the payroll system.

We therefore consider that the prohibition of 'tax services relating to ... payroll tax' covers the kind of deductions of an employee wage that would normally be processed and administered through the employer's payroll system. Therefore, the term "payroll tax" can be read as "taxes calculated through the payroll system".

Note - the reference to social security above is only valid where such payments are classified as a "tax" in the jurisdiction.

The following would be examples of prohibited services, which would have to be categorized as "calculated through the payroll system":

- manual collection of salary items and information and review of the tax treatment of salary items and preparing a report indicating what figures need to be processed by the client within its payroll,
- preparing employer tax returns summarizing the tax collected through payroll deductions, and
- advising on or assisting with the design or implementation of payroll software including, for example, the update of standing data to reflect changes in tax rates or thresholds.

On the other hand, expressing a conclusion on a client-prepared payroll or payroll tax document designed to enhance the degree of confidence of the tax authority or other intended user against criteria established for that purpose may be viewed as an assurance engagement as opposed to a "payroll tax" service if there are suitable criteria against which to make an assessment and if the assurance service does not in effect result in the performance of an otherwise prohibited service. As such, the service would have to be carefully evaluated as described in [Question 7.24](#). NOTE: Member States may take different views on the permissibility of such a service.

There has been a debate as to whether "shadow payroll" or "net to gross" calculations are permissible tax advice or impermissible payroll tax service.

We understand that "shadow payroll" service involves a regular (monthly) payroll tax calculation which includes the preparation of withholding tax returns, payment instructions for the employer etc., whereas the calculations could be based on net- or gross-salary and the net-salary is paid through a different payroll. We therefore believe that these services have to be classified as a "payroll service" according to Art. 5 .1 (d) and therefore are not permissible.

With regard to "net to gross", we believe that where these calculations are to be used by the employer to calculate the actual payroll taxes to be withheld from an employee's salary either in the host or home country on a regular basis (e.g. bi-weekly or monthly), the service will be an impermissible payroll tax service. However, calculations relating to the overall assignment costs (so-called assignment cost projection) would be permissible as general tax advice if the derogation is taken.

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See [Question 7.11](#) for guidance on the preparation of employee's personal income tax returns.

7.13 **Article 5.1 prohibits tax services relating to: (iv) identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law. What is the scope of this prohibition? Does it extend to services that are not "tax" services?**

A public subsidy is a form of financial aid or support extended by a government to an economic sector, institution, business, or individual, generally with the aim of promoting economic and social policy.

A tax incentive may be defined as a deduction, exclusion, or exemption from a tax liability, offered by a government as an enticement for tax payers to engage in a specified activity for a certain period.

Any data gathering, analysis and/or documentation of information and facts to support a tax service related to public subsidies or tax incentives would seem to be providing a tax service "related" to the identification of subsidies and incentives as such work would support the ultimate tax service/position.

Where non-tax professionals, such as surveyors or engineers, contribute to the identification of tax incentives, their work will apply the tax criteria and cannot be separated from "tax services relating to: (iv) identification oftax incentives." Hence we consider that such services are prohibited.

However, where the audit firm provide services relating to the identification of public subsidies which are not tax related (e.g. grants), there is no tax element, so such services are not "tax services relating to: (iv) identification of public subsidies." Hence such services may be permitted, subject to consideration of other independence requirements.

Given the considerations above, it would appear that tax planning and tax advice relating to the identification of public subsidies and tax incentives by the audit firm would generally be prohibited for a PIE audit client, as well as its parent undertaking and controlled undertakings in the EU. However, this is subject to derogation and may be a permissible tax service if a Member State chooses to allow it.

7.14 **Are all valuation services prohibited?**

Yes — including valuations performed in connection with actuarial services or litigation support services. However, Member States have the option to allow these services subject to exactly the same conditions as apply for tax services i.e. not having a 'direct effect' or 'have immaterial effect'.

Other Non-Audit Services

7.15 **'Services that involve playing any part in the management or decision-making of the audited entity' are prohibited. What does this mean?**

A. To what extent can the statutory auditor or firm provide "advice and recommendations" to management of the audited entity?

Advising is the act of providing guidance and recommendations (based on the expertise or knowledge of the advisor) to a person or entity for him/her to consider and evaluate in making decisions or determining action, if any, about something.

When the auditor assists an audited entity in analysis or provides options from which management may choose, or provides advice and recommendations upon which management may or may not act, accept or approve, then such services do not result in the auditor 'playing a part in the management or decision making of the audited entity'. Rather in such situations the auditor is offering his/her professional expertise and opinion to the audited entity's management, and it is management's sole responsibility to choose to accept or decline that advice. The auditor should refrain from making any decisions on behalf of management during the course of the audit engagement period.

Consistent with the principles set out in the IESBA Code, to avoid the risk that the auditor may, or may be seen to be, involved in decision making the engagement partner responsible for the service (in conjunction with the audit engagement partner, where appropriate) must always be satisfied the client's management makes all judgments and decisions that are the responsibility of management. This includes ensuring that the client's management:

- designates an individual who possesses suitable skill, knowledge and experience to be responsible at all times for the client's decisions and to oversee the services,
- provides oversight of the services and evaluates the adequacy of the results of the services performed for the client's purpose, and
- accepts responsibility for the actions, if any, to be taken arising from the results of the services.

The audit firm should ensure that it is clear that this is the basis for its services. For example, the management of the audited entity may expressly acknowledge their responsibilities as described above (for example in the engagement contract) and the audit firm may expressly state that its advice and recommendations are matters for consideration and decision by the management of the audited entity.

We consider that it remains appropriate for a firm to provide advice and recommendations to client management provided that such advice is not clearly prohibited by one of the specific prohibitions in Article 5.1 and subject to the above.

B. What are the implications for services in relation to those areas mentioned in Recital 8?

Recital (8), which is not a formal part of the Regulation, states that "The services that involve playing any part in the management or decision-making of the audited entity might include working capital management, providing financial information, business process optimisation, cash management, transfer pricing, creating supply chain efficiency and the like". It is acknowledged that these areas of business activity would involve management in making decisions about "how it runs the business" and should be approached with particular care when considering application of Article 5 (1). However, we consider that providing advice and recommendations, in an appropriate manner as set out above, to an audited entity in relation to matters for which management makes decisions and accepts responsibility is an acceptable way of delivering advice to management in connection with services areas mentioned in Recital 8.

C. Is the provision of "assistance" to management permissible?

When providing professional advice to a client (see above) as it carries out a particular project, clients sometimes request assistance (i.e. hands-on support)

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during the project. Examples include the provision of initial generic templates and subsequent assistance to the client as it tailors the document for client specific use. Assistance may also consist of reporting on the status of a project to a clearly designated client's project lead and consolidating status information on a pre-defined schedule, providing draft language for internal communications about project-related issues. Documentation assistance, e.g. on the outcome of project meetings, is also permissible so long as the documentation is merely of an administrative nature. We consider that such limited services are permissible provided that the subject matter of the project does not relate to a prohibited non-audit service (e.g. design or implementation of a financial system), a significant amount in the financial statements and professional judgement is not required, and the firm is demonstrably not so intimately involved in a project that it is viewed as inseparable from the client and in essence becomes one with the designer, implementer and/or management of the system/process implementation project. In assessing the extent to which services can be provided the firms will need to consider whether:

- the degree of the firm's involvement is such that it is essentially holding the client's hands throughout the process and project, and whether
- the firm's team can be separated from the client's project team? Or would the firm, in fact or appearance, be core to the project from the perspective of the client or a knowledgeable third party?

D. Are secondments of staff to the audited entity permitted?

There is a risk that secondment of the firm's staff to an audited entity would result in the firm playing a part in management of the entity or making decisions on behalf of the client, or at least being seen to do so. Furthermore, there is a risk that such a secondment would give rise to a self-review or self-interest threat to independence. This risk is clearly higher when those involved are senior staff of the firm who are seconded to positions of seniority within a client's management structure. Although there is nothing explicit in the Regulation to prohibit such secondments we consider that it is inappropriate for the audit firm to second senior staff to fulfil senior positions at an audited entity, in particular those where they would (a) have influence over the accounting records or financial statements or (b) fulfil other "management roles" such as acting as lead project manager on a client project. We consider, however, consistent with the principles set out in the IESBA Code, that secondments of junior staff are permissible, but only for a short period of time and on the clear basis that the audit client must be responsible for directing and supervising the activities of the individual and the firm's personnel must not be involved in taking decisions that are the proper responsibility of management and that the individual is not involved in providing NAS that would not be permitted under the Regulation if provided by the firm itself.

7.16

Which services fall within the prohibition of Article 5(1)(c) of the Regulation "bookkeeping and preparing accounting records and financial statements"?

Accounting records is a broad term which includes the documents and records that are relevant for the purposes of preparing the accounts and the financial statements of an entity. The relevant services related to this could include, but are not limited to; recording of transactions in the general ledger or in other ledgers, recording of any accounting entry in the accounting system, any work preparation on ledgers to produce financial reporting and/or financial statements and preparing the financial statements.

7.17

What does 'financial information' mean in the context of Article 5.1(e)?

We believe we should look to the IESBA Code too consider what is meant by 'financial information'. The Code defines 'Financial Statements' as, "A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term can relate to a complete set of financial statements, but it can also refer to a single financial statement, for example, a balance sheet, or a statement of revenues and expenses, and related explanatory notes." Historical financial information is defined as, "Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting systems, about economic events occurring in the past time periods or about economic conditions or circumstances at points in time in the past."

Furthermore, the Directive paragraph 5 states that: "**Whilst the primary responsibility for delivering financial information should rest with the management of the audited entities, statutory auditors and audit firms play a role by actively challenging the management from a user's perspective.** In order to improve audit quality, it is therefore important that the professional scepticism exercised by statutory auditors and audit firms vis-a-vis the audited entity be reinforced. Statutory auditors and audit firms should recognise the possibility that a material misstatement due to fraud or error could exist, notwithstanding the auditor's past experience of the honesty and integrity of the audited entity's management."

Both of these definitions point to information deriving from the audited entity's accounting systems and ending up in the financial statements and/or the explanatory notes. On this basis, it is reasonable to apply the restrictions in article 5.1(e) to information, process, and procedures relating to financial statement reporting.

7.18

Are recommendations regarding internal control considered a prohibited service under Article 5(1)(e) 'designing and implementing internal control service'... and hence prohibited in the financial year immediately preceding the financial year audited ('clean period')?

Providing internal control recommendations does not involve the act of design and implementation of the controls themselves, and merely provides feedback to Management for them to act upon, or not, as they see fit. Recommendations on internal controls could be made, for example, as part of the statutory audit function. Accordingly, an audit firm would not be prohibited from providing recommendations regarding internal controls in the clean period.

Where the service involves the act of 'design and implementation' regarding the operation of internal controls then it would fall into Article 5(1)(e).

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7.19 **Article 5.19(e) refers to “risk management procedures”. How is this to be interpreted?**

According to “ISO 31000 (2009) Risk Management Dictionary in Plain English” Risk management refers to “a coordinated set of activities and methods that is used to direct an organization and to control the many risks that can affect its ability to achieve objectives”

According to the *Introduction to ISO 31000 2009*, the term *risk management* also refers to the architecture that is used to manage risk. This architecture includes risk management principles, a risk management framework and a risk management process.

In principle then, risk management procedures are typically broad and incorporate controls and procedures that would permeate an entire organization. However, 5.1(e) concerns the risk management procedures related to the preparation and/or control of financial information. That is the activities, methods and architecture that the audited entity uses to control the risks associated with the preparation of information to be reported in their financial statements. We consider systems and processes related to the preparation and/or control of financial information should be taken into account when determining if a service is or is not permissible under 5.1(e).

Therefore, we consider that if the risk management procedures are related to controlling the accuracy of financial reporting, the design and implementation of such procedures would not be permissible.

However, the distinction between internal controls over financial information and risk management procedures is not clear but we believe the following types of services are examples of risk management procedures which would be impermissible:

- Treasury functions where the risk management procedures relate to information which will feed into or form the basis of the financial information such as front to back office account reconciliation (for example, reconciling the revenues received from front office operations with revenue reported into the financial systems by the back office).
- Information Technology risk management procedures which control access to the financial information, such as Identity Access Management for the Finance function of an EU PIE audited entity.
- Regulatory controls and/or reporting where the output of those procedures will form the basis of information contained in the financial statements such as risk management procedures related to the calculation of leverage ratios where the output will be subject to audit procedures.

However, we consider that design and implementation of operational risk management procedures that are not related to financial information (as defined) are not restricted under Article 5.1(e).

In all cases the prohibition relates to designing and implementing and therefore we believe that providing advice and recommendations, as well as performing benchmarking exercises when measured against legislative or COSO type requirements, will remain permissible under 5.1(e) as long as the advice and

recommendations do not extend as far as to be considered “designing and implementing”. The services would also need to be assessed against the other provisions of Article 5.1.

7.20 **Are there restrictions on legal services?**

Yes. The Regulation prohibits legal services, with respect to:

- (g)(i) The provision of general counsel,
- (g)(ii) Negotiating on behalf of the audited entity, or
- (g)(iii) Acting in an advocacy role in the resolution of litigation.

7.21 **What is meant by the term ‘general counsel’?**

Legal services are defined in the IESBA Code “as any services for which the person providing the services must either be admitted to practice law before the courts of the jurisdiction in which such services are to be provided or have the required legal training to practice law”.

Our interpretation is that the prohibition regarding acting as general counsel applies to the following service elements of “legal services”:

- The appointment of a partner or employee of an audit firm to serve as an audit client’s General Counsel - this is supported by the IESBA Code which states that this service would create self-review and advocacy threats that are so significant that no safeguards could reduce the threats to an acceptable level.

In addition the following would apply:

- Providing legal services that involve the audit firm and the network playing a part in the management or decision-making of the audited entity as reinforced by Article 5(1) (b).
- For any other legal services, the audit firm should look to the principles of independence laid down in the Directive (analysis of threats) and the requirements and guidance of the IESBA Code of Ethics to identify threats and develop appropriate safeguards. For example, when providing a legal opinion regarding a transaction, the threats would depend on factors such as the nature of the service and the materiality of the transaction in relation to the financial statements, among others.

This position outlined above is aligned with international standards but would need to be tailored to guidance and interpretations issued by individual Member States.

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7.22 Are immigration services prohibited?

Immigration services (assisting individuals with the administrative formalities required for them to become residents in another country) are not regarded as legal services in most if not all countries in the EU, in which case they would fall outside the scope of the legal services prohibition in the Regulation. Accordingly, the current understanding is that such services are not prohibited. However, one has to be aware that many services provided nowadays are hybrid in character and may not fall exclusively into one or another category.

7.23 How are Corporate Finance type services impacted by the Legislation?

Article 5.1(i) prohibits the following:

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.

In addition, recital 8 stipulates that:

Services linked to the financing, capital structure and allocation, and investment strategy of the audited entity should be prohibited except the provision of services such as due diligence services, issuing comfort letters in connection with prospectuses issued by the audited entity and other assurance services.

A. How broadly should the phrase “services linked to” be interpreted?

Although it is not clear what is meant by the term “linked to”, we believe that the prohibition should be interpreted broadly to cover a breadth of services related to the financing, capital structure and allocation, and investment strategy of the audited entity, subject to the discussion below. For example, we believe it should cover not only the hands-on support and assistance, but also the wide range of advisory services associated with financing, capital structure and allocation and investment strategy.

B. What is the scope of this prohibition?

The wording of Article 5(1) (i) is not specific as to what type of services are prohibited. The terms seem in general to point to corporate finance activities in a broad sense and indeed this is thought to be the origin of the prohibition. Having regard to standard dictionary definitions the terms might be described as follows:

- **Financing** — the provision of funds for business activities, including purchasing or investing
- **Capital Structure** — the method by which a company finances its overall operations and growth through the use of different sources of funds
- **Capital Allocation** — the process by which businesses allocate their various capital resources to different functions in order to maximise value
- **Investment strategy** — the capital decisions taken by a company to protect or promote its competitive advantage such as market strategy and/or capital transaction strategy.

Accounting literature might provide a helpful way to categorise the types of services that are likely included in this prohibition. IAS 7, for example, provides requirements as to how companies should present different types of activities in their financial statements. Key principles specified by IAS 7 for the preparation of a statement of cash flows are as follows:

- **operating activities** are the main revenue-producing activities of the entity that are not investing or financing activities, so operating cash flows include cash received from customers and cash paid to suppliers and employees [IAS 7.14]
- **investing activities** are the acquisition and disposal of long-term assets and other investments that are not considered to be cash equivalents [IAS 7.6]
- **financing activities** are activities that alter the equity capital and borrowing structure of the entity [IAS 7.6]

In light of the above, we consider that services related to a client’s **investing** activities and **financing** activities are in general covered by the prohibition whereas services related to a client’s **operating** activities are not covered by the prohibition as these do not relate to investing or financing activities.

As far as concerns independence literature, the IESBA Code, for example, contains provisions on corporate finance services which describe such services in language that clearly has a significant overlap with the services covered by Article 5.1:

- assisting an audited entity in developing corporate strategies;
- identifying possible targets for the audited entity to acquire;
- advising on disposal transactions;
- assisting finance raising transactions, and
- providing structuring advice.

Further, we believe that Article 5.1(i) should be taken together with Article 5.1(j) which prohibits promoting, dealing in, or underwriting shares in the audited entity. Exactly the same provision is included in the corporate finance provisions in the IESBA Code.

The following discusses our understanding of the intended scope of the Regulation more specifically with regard to certain service types.

Corporate finance-type services

Corporate Finance services in particular need to be evaluated to determine whether they are linked to the capital structure, capital allocation or investment strategy. As an example, playing a lead advisory role in respect of a client corporate transaction should be considered as being “linked to” the capital allocation even after the client has made the decision to acquire a particular entity. This is because work associated with the lead advisory role could impact the price of the acquisition and therefore could impact the capital allocation. If, however, the service involves advice about how to get the best value once the transaction has happened, we consider that such a service is permissible, provided not “linked to” the capital allocation. Similarly, we consider that Article 5.1(i) itself does not extend to the provision of services such as transaction integration services which take place after the company has completed a transaction.

Non audit services (NAS) — prohibited list of services

Debt Advisory and Restructuring Services

The types of services which we consider are likely impermissible would include those related to debt as well as equity. However, other services which are more akin to due diligence, such as independent business reviews, are we believe permissible. In addition, formal insolvency appointments should be permissible if, upon appointment, the affiliation/control relationship between the audit client and the entity in administration ceases.

Strategy Consulting Services

In the light of the above, we consider that providing strategy consulting advice to a client with respect to its decision as to whether or not to enter a new market or whether to have operations in a different territory would likely be covered by services linked to an audit entity's "investment strategy". Conversely, strategy and other consulting services not linked to the audit client's financing, capital structure and allocation and investment strategy are permissible. For example, it is reasonable to assume that providing strategy consulting advice to a client as it is considering how to structure pricing to maximise the profit from different customer segments would not be covered by this prohibition as this would not relate to its investing or financing activities.

Applying the above, we consider that the following services are prohibited under the Regulation (categorised here according to the service types mentioned in the IESBA Code):

- Assisting an audit client in developing corporate strategies related to financing, capital structure and allocation and investment strategy
 - Financial strategy related services — which can include assisting the company with re-evaluating their capital allocation and deployment, capital transaction strategy, and/or market strategy
 - Business modelling — where it supports a company with defining or reorganising its corporate structure
- Identifying possible targets for the audit client to acquire
 - M&A lead advisory acquisition services which can include research into potential targets, assistance with negotiations as well as execution
- Advising on disposal transactions
 - M&A lead advisory disposal services which can include sell-side assistance which involves assisting the client to "package" a part of their business for sale as well as helping to identify potential buyers
- Assisting finance raising transactions
 - Capital and debt advisory services relating to financing, capital structure and allocation or re-allocation of assets of the audit client
 - Promoting, dealing in, or underwriting shares in the audited entity (separately covered under 5.1(j))
 - Providing structuring advice unless specifically covered in one of the other sections.

¹² Tax structuring advice would however be treated as a tax service and its permissibility subject to whether it is specifically derogated by the relevant member state

- Transaction structuring, including financial modelling services¹²
- Legal entity reorganisation and other restructuring services which are designed to change an entity's equity or debt financing structure (note that this differs from tax or legal advice. Legal advisors would only translate the decisions taken by the client into legal language and Tax advisors would only look at the restructuring from a tax perspective.)
- Investment advisory services (e.g. providing investment business financial advice)

C. What types of assurance and due diligence services are permitted?

The exclusion for assurance services should be interpreted broadly as it seems clear that services typically provided by an auditor in connection with capital markets regulation and corporate transactions (buy and sell-side) should continue to be permitted (subject to the fee cap and other controls).

Prospectus-related assurance work and due diligence services

There is a specific exclusion from the prohibition of Article 5.1(i) for prospectus-related assurance work. In practice, it is customary in many member states, including under the Prospectus Directive, for audit firms to provide reports in connection with their audit client's prospectuses, which are not limited to assurance work. There are comfort letters, for example, which are more in the nature of agreed upon procedures reports than assurance reports. It is also customary in some member states (e.g. the UK) for the audit firm to provide a private due diligence report (a "long form report") which is not normally considered to be an assurance report. We believe this exclusion should not be applied narrowly only to the types of reports that are assurance reports within the meaning of the IAASB Assurance Framework. In particular, due diligence reporting is excluded from the scope of the "corporate finance" prohibition following the statement in Recital 8 in the Regulation.

Given the fact that Recital 8 is not limited to financial due diligence, it is appropriate to consider due diligence generally being permissible on the basis that these involve investigation-type procedures intended to better inform management's due diligence process, but not to form part of their decision making itself. However, where the subject matter is covered by other categories of prohibition (e.g. tax¹³ and legal¹⁴ due diligence), the interaction with those restrictions needs to be considered.

In summary, we consider that the following services remain **permissible under the Regulation**¹⁵:

- Due diligence (financial, market, integrity, commercial, tax, and legal), both buy-side and sell-side
- Reports typically provided by an auditor in connection with capital markets regulation and corporate transactions
- Independent business reviews for banks

¹³ The treatment of the services will depend on whether the respective due diligence is linked to a tax advice, in which case the ability to provide the service will be dependent on a Member State electing to derogate tax services under Article 5.3 and the services having no direct or having an immaterial effect, separately or in aggregate on the audited financial statements.

¹⁴ The determination will depend on whether the due diligence includes or is linked to a legal advice, in which case the ability to provide the service will be subject to the Member State interpretation of legal services).

¹⁵ Subject to not falling within any of the other prohibitions, including that they do not involve "playing any part in management or decision-making".

Non audit services (NAS) — prohibited list of services

- Accounting consultations and audits in connection with acquisitions
- Agreed upon procedures, for example with respect to the client's loan covenants
- Model assurance or audit services
- Corporate strategic advice not linked to financing, capital structure and allocation, and investment strategy

7.24 Do the NAS prohibitions also apply to assurance services?

The exclusion for assurance services from the prohibited list should be interpreted broadly as it seems that assurance services typically provided by an auditor in connection with capital markets' regulation and corporate transactions (buy and sell-side), including due diligence services, continue to be permitted (subject to the NAS fee cap and other controls).

If the assurance service falls within the prohibition on Corporate Finance type services (per Article 5(1)(i)) (see [Question 7.23](#)), then they are permissible if they relate to the provision of assurance in relation to the financial statements, including the provision of comfort letters prepared in connection with a prospectus.

However, to the extent that an assurance service falls by exception within any of the prohibited services (e.g. 'playing any part in the management...' (see [Question 7.12](#)), internal audit work) then, yes, the prohibitions will apply to assurance services.

7.25 Are there any corporate finance services which we believe permissible?

Services which are traditionally performed by the auditors and which are likely to be permissible include:

- Due diligence (financial, market, integrity, commercial, tax, and legal);
- Prospectus/working capital reporting, including comfort letters;
- Accounting consultations and audits in connection with acquisitions;
- Valuations (where specifically allowed by a Member State — see [Question 7.12](#));
- Tax structuring advice (where specifically allowed by a Member State — see [Question 7.10](#)).

Services which should remain permissible (on the basis that there is no playing any part in the management or decision — making of the audited entity — see [Question 7.15](#)):

- Independent business reviews for banks where the subject matter of the review is not an audit client or a parent or controlled undertaking;
- General discussions with the company about options they may have with regard to financing strategy and structuring;
- Model assurance or audit services;
- Transaction integration services;
- Sell-side due diligence;
- Voluntary liquidation services where the company is solvent and the auditor is assisting in the formalities of having the entity closed down; and
- Involuntary liquidation services where 'control' of the entity in liquidation by the former parent entity is broken and a Court or similar legal body oversees the winding up of the entity.

In all cases compliance with any local insolvency ethical codes is required.

7.26 Are there restrictions on the provision of Human Resource Services?

Yes. In addition to a restriction on services relating to, in broad terms, the recruitment of senior people for the client's finance function with which auditors are familiar, the Regulation also prohibits human resource services with respect to 'structuring the organisation design' and 'cost control'.

7.27 What HR services are prohibited with respect to "structuring the organisation design"?

Organisation design means looking at the relationship between tasks, workflow, responsibility and authority and making sure these all support the objectives of the business. It may involve the integration of people with core business processes, technology and systems.

Determining an appropriate structure for the organisation is a key element of organisational design, whether along functional, geographic, product line, customer orientated, hierarchical, matrix or other.

Given the broad nature of the prohibition we do not believe that this prohibition can be limited to services affecting the structure of the finance and accounting functions.

In broad terms the following services would likely be prohibited:

Design or implementation services relating to the structuring of the organisational design concerning any of the following matters:

- human resource elements of enterprise-wide, company or departmental (re) organisation, from strategy through to implementation, including governance models;
- human resource elements of organisational charts;
- human resource elements of reporting hierarchies;
- roles and responsibilities within an organisation or organisational sub-unit
- grade structures;
- work force planning supporting current and future staffing of an organisation; and
- skills and capability models/frameworks which describe what skills or behaviours are required for different levels within a company.

However, services where any structuring elements of organisational design are only insignificant or are an ancillary by-product of the broader primary objective of the service should remain permissible if all of the following apply:

1. Structuring/restructuring the human resource element of the organisational design is not the clearly articulated primary driver and/or goal of the client
2. Client management or third parties have led the development of any proposed structure and/or the organisational design, and
3. No other relevant prohibition applies to the service (including any Member State interpretation) and the service is subject to an analysis of threats and safeguards.

Non audit services (NAS) — prohibited list of services

7.28 What is meant by 'cost control' in relation to HR services?

Article 5.1(k) (iii) prohibits 'human resources services, with respect to cost control'. It is not clear what the Regulation means by 'cost control' at 5.1(k)(iii), but many compensation, incentives and benefits consulting services are not primarily designed to control or reduce the client's costs. Cost-effectiveness is typically one factor among many that the client will want to evaluate when designing a new compensation, incentive or benefit arrangement. We do not believe that the intention is so broad as to prohibit any consulting in which cost control is an underlying relevant consideration.

However, there are programmes or initiatives where the entity's primary goal is the reduction or management of people related costs to a business. Where this is the case and the service is clearly related to human resources, we consider that the following types of services would be prohibited:

Performing gap analyses, recommendations, providing advice, assistance, design and implementation service for the client with respect to:

- Staff costs linked to closing client activities/sites, redundancy plans, mergers of units or functions
- Staff costs linked to re-engineering of processes
- Staff cost analysis, bench-marking and costs forecasting
- (Re-)design of compensation policies and programmes to optimise or reduce costs

In contrast, services where human resource cost reductions are ancillary or a by-product of the primary objective of the service or advice should remain permissible.

Finally we believe that tax advisory services in relation to HR costs remain permissible provided the derogation is in place and the service itself is permissible.

Note: we do not believe that this would prohibit a benchmarking survey sponsored by a trade organization for the benefit of its members who contribute their information to the process and which may include a PIE audit client of the firm.

7.29 What "internal audit" related services are prohibited?

Article 5.1(h) of the Regulation prohibits the auditor from providing services "related to the audited entity's internal audit function". Given how broadly the wording of the restriction seems to be, the definition is intended to be widely drawn and it is understood to include both recurring and ad hoc services.

In assessing what services are prohibited it is important to have regard to the role of internal audit in an organisation and the activities and functions that are played by internal audit, which generally focus on the management of risk. The Institute of Internal Auditors describes the role of the function as follows:

"Evaluating an organisation's management of risk. This involves assessing the quality of risk management processes, systems of internal control and corporate governance processes across an organisation and reporting directly to senior management. It acts as a catalyst for improvement in an organisation's practices."

According to the IESBA Code of Ethics internal audit activities may include:

- a) Monitoring of internal control — reviewing controls, monitoring their operation and recommending improvements thereto;

- b) Examination of financial and operating information — reviewing the means used to identify, measure, classify, and report financial and operating information, and specify inquiry into individual items including detailed testing of transactions, balances and procedures;
- c) Review of the economy, efficiency and effectiveness of operating activities including non-financial activities of an entity; and
- d) Review of compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

While the text of the Regulation refers to "services" related to the "function" itself, which could arguably drive a narrow interpretation focused only on services (e.g. advice) to the function, we believe that the intent of the legislation is also to prohibit services or activities that would typically be performed by such a function (whether or not the entity has an internal audit function).

Given that the responsibilities of an internal audit function are not limited to matters that touch financial information and reporting, and there is no clear limitation in the Regulation, we do not believe that the prohibition is limited to those services that relate to internal controls over financial reporting or financial accounting systems.

The general principle to be followed in evaluating the prohibition is whether the proposed service would either (a) be regarded as the outsourcing of the function or (b) relates to the function itself (whether by way of advice to the function or playing a part in management of the function).

The evaluation of whether a service is prohibited or not will necessarily have regard to the facts and circumstances.

Examples of services that would be prohibited include

- playing a part in management of the function
- internal audit outsourcing and co-sourcing, including monitoring of internal controls;
- regulatory support services that are ordinarily performed by internal audit and involve participating in management's testing requirements;
- operational internal audit services (including those unrelated to the internal accounting controls, financial systems or financial statements);
- advising on and assessing a client's specific internal audit activities (other than as permitted below);
- training members of the function, for example, relating to the objectives, responsibilities and activities of an internal audit function unless the training is generic; and
- assurance services (opinions) related to the adequacy and effectiveness of the internal audit function other than as permitted below.

Non audit services (NAS) – prohibited list of services

Permitted services

Activities that form part of, and are performed within, the scope of the financial statement audit are permissible. Doing so is a part of the accountant's responsibilities under GAAS. This includes:

- The assessment of the internal audit department's effectiveness in assessing the risks of the internal control system or other assessments of the internal audit function, including providing advice and recommendations for improvements to the structure or activities of the internal audit department.
- The evaluation, in accordance with generally accepted auditing standards ("GAAS"), of the company's internal controls and which may involve the audit firm in making recommendations for improvements to those internal controls.

The permissibility of other services should be evaluated following the general principle outlined above and as contemplated in FAQs 7.18 and 7.55.

Relevant factors when considering whether a service would be regarded as the outsourcing of the internal audit department include:

- 1) The role of an internal audit function and its activities and responsibilities
- 2) The scope of the internal audit plan
- 3) The knowledge and expertise of the function and whether an activity would typically be performed by the function (see below)
- 4) The nature of any report and the addressee of the report. For example, if an assurance report is addressed to a third party this is indicative that this would not represent the outsourcing of an internal audit activity.

For example, although the internal audit department may undertake some general investigative activities they are not typically responsible for forensic investigation and dispute services where specialist help is often required. Those services are usually assigned to external third parties which have technical processes and knowledge not generally available to the internal audit department and hence such services are not prohibited by Article 5.1(h) as long as they do not extend to monitoring engagements. Note - An evaluation of whether forensic or dispute services would be permissible would necessarily require a consideration of other prohibitions in Article 5 that might be applicable, based on the facts and circumstances and the proposed scope of the engagement.

Application of the NAS prohibitions - to whom do they apply and when?

Application:

- 7.30 How do the NAS prohibitions apply to the Statutory Auditor's network?**
The NAS prohibitions apply to the statutory auditor of the PIE and any member of the statutory auditor's network. Note that the definition of a 'network' remains in place from the definition under Directive 2006/43/EC.
- 7.31 How is the network to which the audit firm belongs defined?**
The term "network" is defined in Article 2(7) of the Directive 2006/43/EC (and has not changed under the reform):

'Network' means the larger structure:

- which is aimed at cooperation and to which a statutory auditor or an audit firm belongs, and
- which is clearly aimed at profit- or cost-sharing or shares common ownership, control or management, common quality-control policies and procedures, a common business strategy, the use of a common brand-name or a significant part of professional resources.

7.32 Are partners and other staff who were previously engaged on an audit client free to provide NAS to that same former statutory audit client after the audit firm has rotated?

Yes. Following the signing of the last audit report or, if later, the end of the audit engagement period, the former audit firm can start providing NAS to the PIE because that audit firm is no longer performing the statutory audit of the PIE in question.

7.33 Where a Key Audit Partner rotates off an audit (effectively becoming a 'cooling off partner') but the entity remains audited by the audit firm, may the cooling off partner continue to provide NAS to that audited entity?

Yes they can, subject to compliance with the IESBA provision, set out below.

The current IESBA position is that the cooling off partner cannot participate in the audit of the entity, provide quality control for the engagement, consult with the engagement team or the client regarding technical or industry specific issues, transactions or events or otherwise directly influence the outcome of the engagement.

7.34 What is meant by 'indirectly provide' when talking about prohibited non-audit services?

As an initial question, what constitutes the provision of a service? Within the EU firms that provide professional services, such as those contained in Article 5(1) of the Regulation, are governed by the EU Services Directive 2006 (Services Directive). The Services Directive defines "service" as meaning "any self-employed economic activity normally provided for remuneration, not in the course of employment".

The IESBA Code provides a definition of Professional Services as "professional activities performed for clients". We can infer that the use of the word "clients" means that to provide a professional service, there needs to be a practitioner/client relationship.

From these definitions, we can identify a service as being provided typically when:

- An individual or firm is engaged by a third party, who is not their employer;
- The individual or firm undertakes work which is provided specifically for a client's use or the use of a specified third party and that work is tailored to the needs of the client/specified third party;
- The individual or firm accrues a right to an economic benefit, e.g. fee, in exchange for undertaking the work; and
- The recipient has legal rights under a contract or otherwise.

Non audit services (NAS) — prohibited list of services

A. What constitutes the direct provision of a service?

Services are typically provided directly when a party:

- has engaged the audit firm (i.e. is party to the contractual terms);
- is provided with the service; and
- pays for the service or causes another to pay on their behalf.

B. What constitutes the “indirect” provision of a service?

Article 5(1) of the Regulation states that neither an audit firm, nor any member of the network to which the audit firm belongs, shall provide, directly or indirectly, any prohibited non-audit services to a member of the EU PIE Group. The Regulation is silent on what is meant by the indirect provision of a service. In substance, we consider what the EC is saying is that it does not matter if the PIE Group receives a service directly or indirectly, if it receives a service, it is caught by the prohibition. It is not intended to widen the scope of who may be deemed to have been provided a service.

The IESBA Code does not explicitly address the direct or indirect provision of a non-audit service. The focus of the Code on non-audit services is whether the service creates a threat to independence, in particular through the direct effect of the non-audit service on the financial statements of the audited entity. There are references in the Code to the direct or indirect application of a general principle (e.g. contingent fees charged indirectly through an intermediary or the holding of an indirect financial interest) which imply that some form of intermediary relationship is a condition of the application of indirect.

There may be instances where the recipient has not engaged the audit firm directly but nevertheless is an intended recipient of the service and that service has been tailored to their needs. For example:

- Where the statutory auditor or audit firm is to provide a service to an audited entity in conjunction with another entity, which is not part of the Network, for example in a prime/subcontractor relationship where that other party has a direct contractual relationship with the PIE, then the services by the audit firm in connection with that contractual relationship would be regarded as being provided “indirectly” to the audited entity by the audit firm.
- Where the service is provided to another entity, such as a parent entity located outside the EU, and where the PIE audit client is also intended to be a recipient of the service. Examples include:
 - A network firm is requested to provide a design and implementation service of financial information systems to the non-EU parent (which is not an audit client of the network firm) and the intention is that the system is also to be implemented and used for the benefit of the PIE audited entity (a controlled undertaking) then the service could in effect be an indirect service to the PIE audited entity and therefore be subject to the Regulation. This will depend on the nature of the service and the purpose of the financial information system.
 - A network firm is requested to provide an internal audit service to the non-EU parent and its group companies (including those in the EU) and the service

involves providing services that are other than incidentally related to the internal audit function of the PIE. Again, this will depend on the nature of the service.

From this analysis we consider that it is reasonable to interpret “indirect”, in respect of Article 5(1), as meaning “The provision of a service to an entity within the PIE Group, via an intermediary” be that another group entity or third party. We consider the mere passing on by an entity of a report or output of a service to a third party is not sufficient to mean that entity is acting as an intermediary.

7.35

To what extent do the NAS prohibitions apply to related entities of the PIE?

The statutory auditor of the PIE and any member of its network cannot provide prohibited services to:

- the PIE audit client itself; and
- its EU formed parent undertaking(s); and
- its EU formed controlled undertakings.

The restrictions apply irrespective of whether the parent or controlled undertaking is an audit client of the Network.

There are limited restrictions applicable to controlled undertakings outside the EU (see [Section 12](#)).

For the definition of ‘parent undertaking’ see [Question 7.37](#).

For the definition of a ‘controlled undertaking’ see [Question 7.38](#).

The prohibitions do not apply to services provided to equity affiliates either of the PIE or any of its parent(s) or controlled undertakings in the EU.

The prohibitions do not apply to services provided to sister companies of the PIE.

For services provided by the statutory auditor’s network to controlled undertakings of the PIE outside of the EU, a ‘threats and safeguards’ approach is required giving some scope to provide services by the network — although a limited number of absolute prohibitions still apply (see [Question 12.4](#)).

7.36

Article 5(1) stipulates that non-PIE parent and controlled undertakings of an audited PIE entity would be caught by NAS restrictions. Would this provision also apply if the PIE in the chain is ‘designated by the Member State’ but is not designated as a PIE in the country of the parent or subsidiary undertaking?

Yes. If an entity qualifies as a PIE in a Member State by virtue of that Member State having applied the option in Article 2(13)(d) of the Directive, then the prohibitions on non-audit services will apply to that entity (because it is a PIE) as well as any parents or controlled undertakings in the EU, even if they are not PIEs.

7.37

What is a ‘parent undertaking’?

Neither the Regulation nor the Directive contains a definition of a ‘parent undertaking’.

However, the EC point to the definition in the Accounting Directive 2013/43/EU (Article 2(9)), defining a ‘parent undertaking’ as an entity that owns or controls another entity either directly or indirectly (and thus includes more than just the PIE’s immediate parent).

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It follows from Article 2(9) of the Accounting Directive that the element of control is what defines a parent undertaking/controlled undertaking relationship. Neither the Accounting Directive nor any other relevant EU legislative act defines the concept of 'control'. However, the Accounting Directive does contain a number of relevant Recitals and Articles as regards the concept of 'control':

Recital 31 to the Accounting Directive provides:

'Consolidated financial statements should present the activities of a parent undertaking and its subsidiaries as a single economic entity (a group). Undertakings controlled by the parent undertaking should be considered as subsidiary undertakings. Control should be based on holding a majority of voting rights, but control may also exist where there are agreements with fellow shareholders or members. In certain circumstances control may be effectively exercised where the parent holds a minority or none of the shares in the subsidiary. [...]

Article 22(1) of the Accounting Directive provides:

1. 'A Member State shall require any undertaking governed by its national law to draw up consolidated financial statements and a consolidated management report if that undertaking (a parent undertaking):
 - a) has a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking);
 - b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking;
 - c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for such contracts or clauses shall not be required to apply this provision; or
 - d) is a shareholder in or member of an undertaking, and
 - i) a majority of the members of the administrative, management or supervisory bodies of that undertaking (a subsidiary undertaking) who have held office during the financial year, during the preceding financial year and up to the time when the consolidated financial statements are drawn up, have been appointed solely as a result of the exercise of its voting rights; or
 - ii) controls alone, pursuant to an agreement with other shareholders in or members of that undertaking (a subsidiary undertaking), a majority of shareholders' or members' voting rights in that undertaking. The Member States may introduce more detailed provisions concerning the form and contents of such agreements. [...]

Article 22(2) of the Accounting Directive provides:

2. In addition to the cases mentioned in paragraph 1, Member States may require

any undertaking governed by their national law to draw up consolidated financial statements and a consolidated management report if:

- a) that undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking); or
- b) that undertaking (a parent undertaking) and another undertaking (the subsidiary undertaking) are managed on a unified basis by the parent undertaking.'

Our reading of Article 22 of the Accounting Directive is that an undertaking controls another undertaking if one of the conditions listed in Article 22(1) is met (in which case the Accounting Directive requires consolidated accounts) but that there may be other cases of control in addition to those listed in Article 22(1). Indeed, Article 22(2) gives Member States the option to require consolidated accounts where an 'undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking).'

A combined reading of Articles 22(1) and 22(2) leads us to three conclusions:

- First, the list of cases of control in Article 22(1) is not exhaustive;
- Second, there may be cases where there is control but nevertheless not a requirement to consolidate accounts (Article 22(2) provides that Member States 'may' require consolidated accounts); and
- Third, the fact that the Accounting Directive does not define the concept of 'control' and the fact that Article 22(2) essentially defers to the Member States' discretion suggest to us that the question as to whether there is 'control' may well be a question of national law.

There is also a current debate as to whether the IFRS definition of control might apply rather than the accounting directive definition and this is of particular relevance in the private equity context.

7.38

What is a 'controlled undertaking'?

The concept of control is addressed in the EC Q&As.

'The term 'parent undertaking' is defined in point (9) of Article 2 of the Accounting Directive 2013/43/EU as an undertaking which controls one or more subsidiary undertakings. See [Question 7.37](#).

The term 'controlled undertaking' is defined in point (f) of Article 2(1) of the Transparency Directive 2004/109/EC as meaning any undertaking:

- i) in which a natural person or legal entity has a majority of the voting rights; or
- ii) of which a natural person or legal entity has the right to appoint or remove a majority of the members of the administrative, management or supervisory body and is at the same time a shareholder in, or member of, the undertaking in question; or
- iii) of which a natural person or legal entity is a shareholder or member and alone controls a majority of the shareholders' or members' voting rights, respectively, pursuant to an agreement entered into with other shareholders or members of the undertaking in question; or
- iv) over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control;

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In most cases the position will be obvious but in cases where doubt exists, specialist advice should be sought.

Whether a pension fund is a 'controlled undertaking' will depend on its facts. Each case will have to be considered individually. However, in some Member States, pension funds are defined as PIEs in their own right — in such cases, the Regulation will fully apply.

7.39 **Are joint ventures deemed to be controlled undertakings? For example, a 50%/50% JV between a listed PIE (UK) and a listed PIE (Germany)?**

Whether a joint venture entity is a 'controlled undertaking' of a PIE will depend on the exact facts and circumstances — see [Questions 7.37 — 7.38](#) for the criteria to be taken into consideration.

Typically a 50%/50% joint venture entity would not be considered to be a 'controlled undertaking' of either of the PIEs that own the joint venture entity as neither PIE would fulfil the 'control' criteria (for example, each would have half of the voting rights, not the majority, and be entitled to appoint half of the members of the administrative, management or supervisory body, not the majority).

Taking the example of a 50%/50% joint venture between a listed PIE (UK) and a listed PIE (Germany), the statutory auditor of either PIE would therefore not be subject to the specific prohibitions of Article 5 of the Regulation when providing NAS to the joint venture although the general principles of independence under Member State law and the IESBA Code would of course apply.

If however a PIE would have a majority of the voting rights, say 51%, in the joint venture entity or have the right to appoint the majority of its directors or other indicators of control such as golden share or veto rights over major operating decisions, the joint venture entity would qualify as a controlled entity of that PIE and its auditor would not be allowed to provide the NAS prohibited under Article 5 of the Regulation to that joint venture entity.

7.40 **Is the determination of control strictly based on the accounting definition or is there a scenario when legal control should be referenced?**

For instance, when a Private Equity upstream entity utilises the IFRS 10 investment exemption and does not consolidate entities over which it has a measure of control, is the lack of consolidation sufficient to conclude that private equity entity is not a 'parent undertaking'?

No — in our view a lack of consolidation is not sufficient per se to conclude that an entity does not qualify as a 'parent entity'. The EC Q&A refers to the Accounting Directive for a definition of a 'parent company' as an undertaking which controls one or more subsidiary undertakings and to the Transparency Directive for the term 'controlled undertaking' (as set out in [Question 7.38](#) above), and both Directives refer to control through owning a majority of voting rights (legal control) but also to cases of de facto control.

7.41 **Do the NAS prohibitions apply to groups with government ownership?**

The NAS restrictions apply to the 'parent undertaking' of a PIE (see [Question 7.37 for this definition](#)). The relevant government ownership structure would have to be

[examined in detail \(type of entity, control mechanisms etc.\) to see whether it would qualify as a 'parent undertaking'](#).

7.42 **How do the NAS prohibitions apply to cross border groups?**

Article 5(1) of the Regulation stipulates that an audit firm, or any of its network firms (in the world), cannot provide any prohibited non-audit services to the audited entity, its parent and its controlled undertakings in the EU.

Article 5 does not distinguish in the case of parent or controlled undertakings of the audited entity between PIEs and non-PIEs.

The question is how the principles set out in Article 5(1) should be applied to audited entities with PIE parents and/or PIE subsidiaries in various EU Member States which have:

1. enacted the Member State option to allow tax and valuation services;
2. prohibited additional services; and/or
3. not made use of the options above.

Based on initial views in the EC September 2014 Q&A, it is our understanding that if the audited entity has subsidiaries in other EU Member States, such subsidiaries would have to comply with the law of the Member State in which they were established (principle of local law), i.e. the local version of the Article 5 (1) prohibitions, which would apply regardless of whether the subsidiary is itself a PIE or not or whether the subsidiary is audited by a network member of the auditor or not. However, branches of a PIE located in another EU Member State are required to follow the local requirements of the PIE as they form part of the PIE and are not separate legal entities. As an example, if a German PIE has a controlled entity that is a PIE in France and a non-PIE controlled entity in Spain, the respective national Article 5 non-audit prohibitions would apply to each controlled entity in each respective jurisdiction.

For example, if the local law of the non-PIE subsidiary is more restrictive than the EU Regulation (or the derogation for certain tax and valuation services has not been taken up), the auditor cannot provide to non-PIE subsidiaries those additional services.

7.43 **Can Member States use the option under Article 5(2) to add on to the list of prohibited NAS but only apply those additional prohibitions to the local auditor, excluding its network?**

Yes. If a Member State decides to use the option to add to the list of prohibited NAS, this prohibition should in our view only apply to audited PIEs (and their parent companies and subsidiaries) within its jurisdiction (and to the auditor and any of its network firms in that jurisdiction) to avoid any cross-border reach of the Member State option. This is an example of the principle of application of local law outlined in the EC Q&A (see [Question 7.42](#)). However, we understand that this is an area where some Member States may be taking a different approach.

7.44 **How do the NAS prohibitions apply to branches?**

The answer will depend on whether the branch is a branch of a PIE or of a non-EU entity and where it is located. Our understanding is as follows:

- If it is an EU based branch of a **non-EU entity** then the EU branch will not fall

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within the scope of the PIE definition. As such, the NAS prohibitions would not apply. This applies even if the branch is a credit institution or insurance undertaking in the EU (see [Question 2.10](#)).

- If it is an EU based branch of an **EU entity**, then the application of the NAS prohibitions will depend upon whether that EU entity is a PIE. For an EU PIE which has a branch inside/outside the EU, the NAS prohibitions would apply equally to the branch inside/outside the EU as to the rest of the legal entity inside the EU.

7.45 **How do the NAS prohibitions apply for the statutory audit of a PIE when the same auditor does *not* also audit the EU parent or controlled entity?**

There is no **'not subject to audit'** exception as there is under, say, the SEC rules. Thus where a member firm of a network audits the PIE, no member of the network can provide prohibited services to that PIE's EU parent undertaking whether the network audits that parent or not. This may be of particular relevance to the Funds and Private Equity industries (where those organisations have parent undertakings in the EU).

Similarly, where a member firm of a network audits the PIE, no member of the network can provide prohibited services to that PIE's EU controlled undertaking whether the network audits that controlled undertaking or not. The NAS restrictions of Article 5 of the Regulation will apply, as implemented by the Member State in which the controlled undertaking is based (following the principle of local law, see [Question 7.42](#)).

7.46 **What happens if client acquisition activity results in services that the firm is providing becoming prohibited?**

For example, a PIE entity X acquires another non-PIE entity Y to which X's auditor is providing services which are now prohibited.

There is a provision in the Directive relating to general independence requirements which includes a reference to NAS if during the period covered by the financial statements, an audited entity is acquired by, merges with, or acquires another entity (Article 22.6). We believe that Article 22(6) can be applied, in such situations where the statutory auditor or firm has been providing NAS to the acquired entity prior to the acquisition in accordance with the non-PIE rules. Consistent with Article 22(6), such services should be terminated as soon as possible and no later than 3 months after the acquisition. In addition, the statutory auditor or audit firm would have to assess the threat to independence that those non audit services may create and consider whether safeguards may be put in place to address the threats or whether, in extreme cases, the auditor should withdraw from the statutory audit of the PIE. This may be subject to Member State interpretational/implementation guidance.

7.47 **How does the legislation apply where a PIE acquires a new subsidiary and a member of their statutory auditor's network has already provided a prohibited NAS to this new subsidiary?**

Article 5 prohibits the statutory auditor from providing certain services to the audited entity, its parent and controlled undertakings during the period covered by the financial statements and until the issuance of the auditor's report. On acquisition

of an undertaking by the audited entity, the statutory auditor and members of the network are not permitted to provide prohibited services to the acquired undertaking. Ongoing service provisions should be terminated as soon as possible, where required, to avoid a breach of the provisions of Article 5. Termination requires coordination and communication with management of the audited entity and its audit committee. Generally, termination should be achieved of any relevant services prior the effective date of the acquisition (the completion date). In all cases, termination must take place within three months of the acquisition (see Art 22 VI of the Directive).

Where appropriate, the auditor should consider approaching the relevant national competent authority (or other relevant body) to seek guidance (or agreement to a proposed solution) in the event that compliance with Article 5 cannot be secured as from the effective date of the acquisition (or within three months if permitted by local Law). Any such recourse involving discussion with the competent authority should be had as early in the process as practicable. If the competent authority is not in a position to provide guidance, consideration to next steps should be given on a case-by-case basis. In doubt the auditor should obtain legal advice.

Services previously provided in the financial statement period to the acquired undertaking before acquisition (whilst not a breach of Article 5) may create threats to independence (e.g. self-review threats may arise when the statutory auditor or its network has provided bookkeeping services or has designed internal accounting controls). The statutory auditor should analyse the impact of such services on its independence and implement effective safeguards to reduce independence threats to an acceptable level. Such threats and safeguards should be communicated to the audit committee of the audited entity. Where effective safeguards are not available, appropriate steps should be taken.

7.48 **How should the NAS prohibitions for PIEs be applied when an entity whose financial statements are audited first becomes a PIE?**

Considering the wording of Article 5.1, the NAS prohibitions would only apply from the date that the entity becomes a PIE. Appropriate steps at the time an existing audited entity becomes a PIE would include:

- Evaluating any services in process for permissibility and if impermissible terminating them prior to the date the entity becomes a PIE.
- Evaluating all services provided during the financial statement period, including during the time before the entity becomes a PIE, to identify threats to independence and apply safeguards where appropriate. Ideally, before the audited entity assumes PIE status, the audit committee of the audited entity should be looking ahead to when the audited entity will assume PIE status and be working with the statutory auditor to ensure that there are no Article 5 breaches when the audited entity's status changes.
- Communicating all such services and the auditor's evaluation and conclusion of the impact on independence to the Audit Committee in accordance with Article 6 of the Regulation and obtaining Audit Committee approval, prior to the date the entity becomes a PIE, to continue any services in process that are permissible.

Despite efforts to plan ahead in recognition of the change in status, where the Article 5 requirements cannot be met upon the audited entity assuming PIE status, the Competent Authority (or other relevant body) should ordinarily be approached for guidance and to report the breach, where appropriate.

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Ideally this recourse discussion should be had in advance of the change in status occurring. Factors that may be relevant for presentation to the competent authority might include that the change in status of the audited entity was necessarily sudden (for example, for commercial or other regulatory reasons) and that the non-compliance with Article 5 was unavoidable in this context. It is expected that a Competent Authority, provided with credible reasons as to why the Article 5 breach was unavoidable, will seek to make a limited, pragmatic exemption that would enable the statutory auditor to complete the financial year audit and sign the statutory audit. It is envisaged that prior consultation with the audit committee will be required and that generally this recourse discussion should be a joint approach involving the client and the statutory auditor.

If the competent authority is not in a position to provide guidance, consideration to next steps should be given on a case-by-case basis. This may involve obtaining legal advice.

We do not believe that the cooling-in provision in Article 5.1 applies to services provided to the entity before it becomes a PIE. However, the statutory auditor should evaluate any threats created by the provision of any such services and, when necessary, implement safeguards to the threat.

Timing considerations

7.49 For what period do the NAS rules apply?

The NAS rules apply to the period between the beginning of the period (i.e. financial year) audited and the issuing of the audit report for the relevant PIE according to Article 5(1)(a).

In addition, Article 22 of the Directive 'Independence and objectivity' contains a provision relating to general independence: 'Independence shall be required at least during both the period covered by the financial statements to be audited and the period during which the statutory audit is carried out.'

7.50 When do the new NAS rules start to apply? For example, what about a December 2016 year-end?

The NAS prohibitions will only apply after the Regulation becomes applicable and there is no retrospective application of this provision.

The EC Q&A stated that 'the new requirements will apply to the first financial year starting after the date of application of the new Legislation' (i.e. 17 June 2016). This view is also supported by Accountancy Europe.

Therefore following this principle the restrictions on NAS would apply to the first accounting period **beginning on or after 17 June 2016**. This would mean that for a PIE with a 31 December 2016 year end, the new restrictions on NAS would apply from 1 January 2017 (i.e. for the 31 December 2017 year-end). If the auditor/PIE relationship ends with completion of the audit of the financial year ending on 31 December 2016, the new restrictions on NAS for the incoming auditor would apply from 1 January 2017 until the issuing of the audit report (see [Question 7.47](#)).

7.51 Over the transition, when does the 'clean period' start to apply in relation to services that fall within the definition of Article 5(1)(e)?

There are no specific provisions to define how the additional clean period for Article 5.1(e) services (see [Appendix 1](#)) should apply when the Regulation first comes into effect, apart from the general principle that the new regime should not apply retrospectively.

Based on the [1 October written reply from Commissioner Jonathan Hill](#) to a written question from MEP Kay Swinburne, we understand that the new regime applies to the first financial year starting on or after 17 June 2016, which will be when the requirements including the cooling-in for the previous financial year, will be assessed. For example, where the first audit within the new regime is the year ending 31 December 2017 then the auditor should have ceased to provide the Article 5.1 (e) services by 1 January 2016.

7.52 Does the "cooling-in" requirement apply to services to controlled entities outside the EU?

Article 5 (1) prohibits certain services in the financial year immediately preceding the period subject to audit. Article 5 applies in principle to EU entities only, with Article 5 (5) addressing services to subsidiaries of PIEs in third countries. Where an audit firm audits a PIE, its network firms can only provide NAS to that PIE's subsidiaries outside of the EEA to the extent that compliance with Article 5(5) of the Regulation is ensured. Article 5(5) requires the audit firm to assess whether its independence would be compromised by its network firm's provision of NAS to the third-country subsidiary of the PIE. If that is the case, the audit firm has to apply safeguards to mitigate the threats. Article 5 (5) (a), however, provides that the provision of those services referred to in Article 5(1)(e) shall be deemed to affect the audit firm's independence in all cases and to be incapable of mitigation by any safeguards. As a result, the absolute prohibition of the provision of these three types of services is equally applicable to PIEs and third-country subsidiaries of PIEs.

Our reading is that Article 5(5) merely refers to the list of NAS in Article 5(1), second subparagraph, and provides for a special regime for when the audit firm provides any of these NAS. As a result, the temporal provisions in Article 5(1), first subparagraph (including Article 5(1) (a) and Article 5(1) (b) of that subparagraph), which include the "cooling-in" provisions, would not apply outside the EU (and in due course the EEA). On this reading, the governing temporal provision would be the word "provides" in Article 5(5) — so that its restrictions on NAS provided to third-country subsidiaries of a PIE would only apply at the same time that statutory audit services are being provided to the PIE, but not with a "cooling-in" period.

7.53 What is the impact of the Regulation and Directive applying later in the non-EU European Economic Area countries?

The three non-EU countries in the EEA (i.e. Iceland, Liechtenstein and Norway) are required to adopt national legislation to incorporate the Legislation because it is of "EEA relevance". However, the Legislation needs first to be the subject of a formal Decision by the EEA Joint Committee (see [Question 1.5](#)). That Decision will clarify the date of application and entry into effect of the EU Audit legislation in the EEA countries.

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Until that Decision is adopted and the Legislation applies, the three EEA countries should be treated like any other non-EU country. On that basis, the statutory auditor of a PIE (or a member of its network) could provide prohibited non-audit services to a controlled undertaking in an EEA country, subject to the specific requirements of Article 5(5) of the Regulation, or to a parent undertaking in an EEA country.

7.54 **How will these provisions affect risk assurance type services?**

The prohibitions aimed at risk assurance type services are similar to existing regulatory restrictions with which practitioners are familiar with in practice, but consideration will need to be given to the relevant prohibitions in article 5.1 Provided the provisions relating to 'services playing any part in the management or decision-making of the audited entity' are suitably clarified (see [Question 7.15](#)), the most significant impact is likely to come from the cap on the overall level of fees for NAS. See [Section 8](#).

7.55 **Are there any other provisions specifically affecting Risk Assurance Services type work?**

Yes. There are two and both relate to the prohibition on services that involve 'designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems'. The first is that these are the only services for which the prohibition also applies in the year PRIOR to the start of the audit engagement (See [Question 7.49](#)).

The second is that these services are ones which are deemed always to threaten auditor independence in a way that cannot be dealt with by safeguards and so can never be provided by a member of the audit firm network to a controlled undertaking of a PIE audit client incorporated outside the EU.

7.56 **Is the provision of 'review and recommend' services around internal controls, risk management and related systems prohibited?**

It is not thought to be so. This is consistent with interpretation of similar SEC provisions, these services do not appear to constitute 'design and implement' services and so do not fall within the prohibition.

7.57 **If an audit client entity ceases to be a PIE during the financial statement period subject to audit, when do the NAS prohibitions cease to apply?**

The NAS prohibitions established in Article 5.1 of the Regulation apply when an "A statutory auditor or an audit firm [is] carrying out the statutory audit of a public-interest entity". Accordingly, if an entity ceases to be a PIE during "the period between the beginning of the period audited and the issuing of the audit report" then the prohibitions cease to apply from that date. To illustrate, the statutory auditor is contracted to audit the financial statements for the calendar year 2018. On 30 June 2018, the company de-lists from the relevant EU Stock Exchange and is no longer a PIE. The Statutory auditor and its network may provide services included in Article 5.1, subject to compliance with relevant independence requirements that apply to the non PIE audit.

This answer is based on the following:

- Article 5.1 only applies to a PIE.
- Once the company is no longer a PIE, there is no deemed "public interest".
- The Company may have disbanded its audit committee by the time of the proposal for new services, so there would be no such body to approve NAS.
- There will be no requirement to make the NAS declaration in the audit report.

And, consistent with the above:

- The audit report (if any) will be based on the requirements for a non-PIE.
- The requirement to appoint an EQCR partner will no longer apply.

The principle is consistent with the (reverse) principle that if an entity becomes a PIE during the engagement period (above) that the NAS prohibitions apply from that date (see [Question 2.24](#)).

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08

Calculation considerations

8.1 **How is the 70% NAS fee cap calculated (i.e. which statutory audit fees need to be taken into account)?** UPDATED

Article 4 of the Regulation states that, for the purpose of calculating the fee cap, statutory audit fees include those generated by the **statutory auditor/audit firm** 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 applicable'.

The EC and CEAOB have [provided](#) clarification on what is meant by 'where applicable' - in order to determine the amount of 'statutory audit fees'. These will include the statutory audit fees paid by the audited EU PIE aggregated with the statutory audit fees of any parent undertaking(s) and/or controlled undertakings, either inside or outside of the EU, audited by the [EU Member State statutory auditor/audit firm](#). The cap therefore applies solely at the level of the statutory auditor/audit firm and not to the whole network.

The average of these statutory audit fees is then computed over the preceding 3 consecutive years. This then forms the denominator of the cap calculation.

In Article 4(2), permitted NAS provided by the EU Member State statutory auditor/audit firm of a PIE references its controlled undertakings, and also its "parent undertaking". Should the reference to "parent undertaking" be interpreted in the singular or the plural?

The preferred ECG interpretation is that the reference in Article 4(2) to "parent undertaking" refers to the quality of being a parent, and not as being an individual parent. The former can comprise one or more undertakings, extending up the chain of control within the EU to the ultimate parent undertaking that controls the group to which the PIE belongs. This can include parent, grandparent, great-grandparent entities etc., and also joint parents where, for example, an undertaking is jointly controlled by two parents. The main reason for this position comes from the definitions of "parent" and "subsidiary" undertaking in the Accounting Directive. Article 2.9 defines "parent undertaking" as "an undertaking which controls one or more subsidiary undertakings". Article 2.10 defines "subsidiary undertaking" as "an undertaking controlled by a parent undertaking, including any subsidiary undertaking of an ultimate parent undertaking". See also ECG FAQ 7.36. An entity accordingly qualifies as a subsidiary undertaking where it has an undertaking which controls it, including any subsidiary undertaking of an ultimate parent undertaking. The key element is the notion of "control", whether direct (e.g., the immediate parent undertaking) or indirect (e.g., the parent undertakings further up the chain to the ultimate parent undertaking).

Read in this way, where a PIE is a subsidiary with a parent undertaking that is itself a subsidiary, one continues up the chain to the ultimate controlling entity. This is consistent with the reading by the ECG of "parent undertaking" in Article 5, read as applying to all parent undertakings in a chain. This is also consistent with the statement by the European Commission in their 17 June 2016 FAQs that calculations for the fee cap need to be at group level: "All calculations for the cap need to be done at group

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level — i.e. they need to take into account not only the audited entity but also, where applicable, its parent undertaking, its controlled undertakings and the consolidated financial statements of that group of undertakings". One can accordingly read the references to "parent undertaking" in the Commission 17 June 2016 FAQ, as well as the reference to "parent undertaking" in the CEAOB Monitoring the Fee Cap of Non-Audit Services paper adopted on 21 September 2018, where they state the fee cap as defined by reference to the audited PIE but also, where applicable, "its parent undertaking" and its controlled undertakings in this context.

The ECG notes an alternative reading of Article 4(2), which limits "parent undertaking" to the immediate parent undertaking, going no further up the chain of control. This reading relies on the fact that "parent undertaking" is written in the singular. It interprets this literally to mean that only one parent and not the chain of parents should be taken into account in calculating the fee cap in Article 4(2). One can read the references to "parent undertaking" in the CEAOB Monitoring the Fee Cap of Non-Audit Services paper adopted on 21 September 2018 in this context, with the fee cap then as applicable to the "parent undertaking". The underlying principle here is that the fee cap calculation for any particular PIE should be independent and separate from other PIEs in the chain.

A consistent interpretation of the Regulation within an EU Member State - which is expressly supported by all stakeholders, in particular by the national competent authority — is important, in the public interest.

Where there are multiple EU PIEs in a group, each will need a separate fee cap.

To the extent that the relevant audit service is provided, we understand that for the purpose of the calculation, fees (both audit and non-audit fees) from non-PIE controlled undertakings and/or non-PIE parent(s) are also included in the cap calculation to the extent that the service is provided by the PIE's EU Member State statutory auditor/audit firm. If the statutory audit service for the parent undertaking(s) and/or controlled undertakings are provided by another auditor/audit firm, even within the same network, then these fees are not included in the calculation, even if the relevant audit service is provided for the purpose of the consolidated financial statements of the PIE.

The numerator of the cap applies to permissible NAS provided by the statutory auditor or audit firm to the audited entity and its parent undertaking(s) and controlled undertakings, whether in the EU or outside of the EU. Member States have the option to impose more stringent requirements.

Non-audit services that have been directly provided by a statutory auditor/audit firm to a PIE but have been billed by a firm of the same network to that PIE should be included in the calculation of the cap. Fees generated by those working on behalf of the audit firm should also be included.

In the case of a joint audit, each auditor calculates the 70% fee cap based on the statutory audit fees it charges to the PIE it audits, not based on the total audit fees including those charged by the other joint auditor.

8.2

Is the cap calculation based on fees paid, billed or on an accrual basis?

The EU regulation states that "the total fees for such services shall be limited to no more than 70% of the average of the fees paid in the last three consecutive financial years for the statutory audit(s)". It is our understanding, based on guidance from the CEAOB, that the calculation of average audit fees would be based on fees for the audit of the financial statements paid on average during the three financial years of reference of the PIE, but calculation of (permitted) non-audit services would be based on amounts "realised" during the financial year".

Statutory audit services

8.3

Which services should be considered as statutory audit services?

The interpretation of what is to be included as statutory audit services and what is to be considered as non-audit services may diverge across the EU Member States.

Statutory audit fees are the fees for the core audit, fees for any procedures or reports the statutory auditor is obliged under local law to provide as and in the context of the statutory audit (legal add-ons) and fees for services which provide audit evidence for the statutory audit and which is used by the statutory auditor to perform his audit work and to provide his audit opinion. Eg the audit of the bookkeeping system or the audit of the directors' report.

In addition, local regulation often requires that the statutory auditor performs certain procedures and/or issue specific reports or confirmations as part of its statutory audit mandate. Inclusion of services related to such work may, or may not, be considered as statutory audit services based on facts and circumstances and on the national law, eg prudential obligations for bank auditors to provide assurance on banks' risk management systems. However, if not considered statutory audit services, then these should be considered NAS, but would be excluded from the fee cap because they are required by local legislation (see also [Question 8.7](#)).

8.4

Are fees from interim reviews included in the denominator for the calculation of the cap?

For the purpose of calculating the cap, the denominator is required to include "fees paid in the last 3 consecutive financial years for the **statutory audit**". The term statutory audit is defined in the Directive 2006/43, article 2.1 as follows:

'Statutory audit means an audit of annual financial statement or consolidated financial statements in so far as required by Union law; required by national law as regards small undertakings...'

A reasonable assumption would therefore be that interim reviews by nature are not annual and in many cases are not 'required' by national law — the denominator would therefore appear not to include fees from interim reviews. If interim reviews are not required by member state law then the fees for these services should be included in NAS.

However, the Regulation is not explicit on this point and it remains possible that some Member States or regulators may take the alternative view, for example if review procedures are used by the statutory auditor to contribute to audit evidence then they may be categorised as audit services.

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8.5 Are fees related to the audit of reporting packages to be included in the denominator for the purpose of calculation of the cap?

As per the CEAOB guidance on the fee cap, if the reporting packages reviewed/audited by the statutory auditor or the audit firm of the PIE are either due to the audit of the consolidated financial statements of an audited parent undertaking(s) located in the EU, and/or are also used in the context of the statutory audit of the single financial statements (PIE) entity, fees should be regarded as statutory audit fees.

For example, if an audit firm audits or reviews a reporting package of an EU-PIE for the purpose of the audit of the consolidated financial statement of a US parent, the fees should be considered as audit fees for the financial statement audit of the EU-PIE if the audit procedures are also used for the purpose of the statutory audit of the EU PIE.

Non-audit services

8.6 Are any NAS excluded from the cap?

Yes, Article 4 explicitly excludes NAS, other than prohibited NAS under Article 5.1 of the Regulation, that are required by EU law or the law of a Member State:

‘For the purposes of the limits specified in the first subparagraph, non-audit services, other than those referred to in Article 5(1), required by Union or national legislation shall be excluded’.

So such services will not be restricted in any way. For example a Contribution-in-Kind report in Belgium or the Certification of a Corporate Tax Return in Greece would not be caught by the cap because both services are required by national law.

In exceptional circumstances, the competent authority can grant a 2-year dispensation in relation to the application of the cap (see Question 8.13). However, member state law can set a more strict dispensation.

8.7 Are fees for non-audit assurance work by the PIE’s auditor that is required by the EU or national legislation excluded from both the numerator and the denominator in calculation of the cap?

Yes — they would be excluded from both. The Regulation defines all services other than statutory audit as non-audit services. Although the Directive allows member states to set specific requirements that may be considered an integral part of the statutory audit (see Article 26(4) of the Directive), as per CEAOB guidance, fees for assurance work required by national legislation will not be included in the denominator, unless such services are included in the national definition of a statutory audit as per Article 26(4) of the Directive (under the ISAs, these are considered "Other Legal and Regulatory Requirements).

8.8 How are NAS handled which are required by third country authorities?

According to the [CEAOB guidance](#), permitted NAS required by a third country authority are not required by Union or national law so should be included as NAS in the calculation of the cap. However, ‘integrated audit’ procedures, for example PCAOB standards (SOX 404), cannot be separated from audit procedures performed for the statutory audit

By way of example, do the fees related to SOX 404 opinions (or an integrated audit) form part of the numerator ("NAS") or denominator ("statutory audit services") of the Article 4(2) Cap Calculation?

For US purposes, SoX 404 procedures form an integrated - and mandatory - part of an audit opinion and, for example, any 20- F filing.

The US auditing standards (AS5) expressly confirm that a SoX 404 audit of internal controls over financial reporting forms an integrated part of an audit of the financial statements. See: <https://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx>

Article 4(2) expressly states that permitted NAS should not exceed 70% of the average of the fees paid in the last three consecutive years for the statutory audit AND the "consolidated financial statement of that group of undertakings". So, in this context, where SoX procedures form an integrated part of the audit of the consolidated group financial statements they enter into the calculation, but in the denominator together with the statutory audit work (See Question 8.15).

By way of example, if an EU-based Foreign Private Issuer (FPI) issues consolidated financial statements for filing in the United States, as it is required to do, then it is also a legal requirement to include an audit of internal controls over financial reporting as part of an integrated audit of the financial statements (see [PCAOB guidance](#)).

Scope of the cap

8.9 Does the cap apply to members of the audit firm’s network?

No. The cap does not apply to permitted non-audit services provided by firms which belong to the statutory audit firm’s network. The cap only applies to the PIE’s ‘statutory auditor or audit firm’ (defined as an auditor or audit firm licensed in the EU to carry out statutory audits) who provides the permitted non-audit services to the audited PIE, its parent undertaking(s) or its controlled undertakings (see [Question 8.1](#)).

For example, if ABC Denmark (DK) audits a DK PIE, the cap will only apply to permitted non-audit services provided by ABC DK, as statutory auditor to any of the entities referred to above. As members of the ABC network, ABC France and ABC Germany can provide permitted NAS to the DK PIE, the parent company or controlled undertakings of the DK PIE without fee limit (providing that these subsidiaries are not EU PIEs in their own right that are respectively audited by ABC France or ABC Germany), because neither ABC France nor ABC Germany are the statutory auditors of the DK PIE.

However, if ABC DK (noted above) were to also provide permitted NAS to a parent undertaking(s) or a subsidiary of the DK PIE incorporated in France or Germany, those services would be subject to the cap.

Member States may apply more stringent requirements. See also [Question 8.13](#).

8.10 Does the cap have an extra-territorial effect?

We understand that the cap applies to permitted NAS provided by the statutory auditor or audit firm to the PIE and its parent and controlled undertakings (see [Question 8.1](#)). The geographical location of these entities, that are part of the group, is irrelevant.

As discussed in [Question 8.1](#) above, the 70% cap itself only applies to the statutory auditor or audit firm of the PIE and not to the members of that statutory auditor's or audit firm's network (see [Question 8.7](#)). Note that Member States may adopt stricter legislation.

Timing Considerations

8.11 What is the first financial year for the purpose of calculating the 70% cap?

According to the CEAOB guidance, this provision in the Regulation is not applied retrospectively and only starts to apply as from the first financial year starting on or after 17 June 2016. This can be understood as an uninterrupted period of three years where both audit services and NAS must have been provided by the same statutory auditor or audit firm. If this condition is not met, the cap provision will not be applicable.

For example; where a PIE has a 31 December year end, then the first financial year to count towards the cap calculation would be the year ending 2017. Assuming 3 consecutive years of service this would mean the cap would first apply to the financial year commencing 1 January 2020. If in years 1, 2 and 3, total statutory audit fees paid are €100, €120 and €170 respectively, then permitted NAS in year 4 are capped at 70% of the average audit fees of €130 (i.e. €91).

For new audit engagements, the period first to be taken into consideration for the calculation is the fourth year after the initial appointment of the statutory auditor. For example, if the auditor is appointed for the first time for the audit of the financial year 2020, the three-year period for calculation of the cap would be financial years 2020, 2021 and 2022 and the cap would first apply in 2023.

8.12 When does the fee cap start to apply to a new PIE? **UPDATED**

As per the CEAOB [guidance](#) on the fee cap, if an entity qualifies as a PIE during the course of an audit engagement, the calculation of the fee cap should start from the financial year in which an entity becomes a PIE. For example, if an audited entity first has its securities admitted to trading on a regulated market in the EU in financial year 2018, the three-year period for calculation of the cap would be financial years 2018, 2019 and 2020 and the cap would first apply in 2021. This logic is consistent with the CEAOB's views generally on the calculation of audit tenure - see the [CEAOB's guidance on Duration](#) dated 28 November 2019 and [ECG FAQ 3.8](#).

Member State options

8.13 Can Member States opt for a stricter cap?

Yes - Member States may establish stricter rules for setting the cap.

8.14 If a Member State has implemented a NAS permitted list ('white list'), does the 70% cap calculation include the fees for white list services performed?

The only permitted exclusion from the fee cap calculation in Article 4 is where non-audit services from the PIE's auditor or audit firm are 'required by Union or national legislation'. Our understanding is that a service being permitted by a Member State by inclusion on a white list does not also mean it is 'required by law' and as such it follows that such a service would be subject to the fee cap. For example, reporting accounting work may be a permitted service but as it is not 'required by law' it would be subject to the cap.

However, Member States may require certain NAS to be performed by the statutory auditor. See also [Question 8.6](#) and [8.7](#).

8.15 With some services (e.g. capital markets work), the fee for NAS in 1 year could easily exceed the average audit fee for the last 3 years. Where such services are not required to be provided by the statutory auditor under local law, is there any flexibility in the Regulation to allow for exceeding the 70% cap?

Yes. Member States have an option which, if exercised, would allow the relevant competent authority in the Member State, upon a request by the statutory auditor, to exempt that auditor from the cap in relation to an entity for a maximum period of 2 years.

8.16 How does the cap apply to EU branches of a bank or insurance company?

Firstly, an EU branch of a non-EU bank or insurance company does not fall within the scope of the EU definition of a Public Interest Entity according to the EC Q&A, unless a particular Member State has designated such an entity as an EU PIE in its Member State. As such, the cap on permissible NAS does not apply. However, where a bank or insurance company is incorporated in the EU, because such an entity falls within the scope of the PIE definition, all of their branches, whether in the EU or outside of the EU, will also be subject to the requirements of the Regulation. When looking at the cap, permissible services that may be subject to the cap will include those provided to the whole legal entity including its branches. The relevant statutory audit fee to which the cap is applied will be the statutory audit fee (paid to the statutory auditor or audit firm of the PIE) of the whole legal entity including its branches. To the extent that there are other entities in the group (e.g. parent and controlled undertakings of the audited entity) to which the statutory auditor/audit firm provides NAS, the statutory audit fees of those additional entities shall, as stated in Article 4(2) of the Regulation, also be aggregated with those of the PIE including its branches when calculating the average of fees paid. There may be an exception in national law, for example if the branch qualifies as a PIE under national law; in this case the calculation also needs to be done at the branch level.

8.17 What is the effect of acquisitions and disposals of subsidiaries by the EU PIE on the cap calculation?

The Regulation does not address this but our view is that, where the EU PIE either acquires or disposes of entities during the year, both the audit and non-audit fees earned from those entities need to be considered when calculating the fee cap. For example, if the EU PIE disposes of a portion of its group during the year, the statutory auditor would need to exclude from the fee cap calculation both the statutory audit fees and the non-audit fees related to those entities earned from the date the entities are disposed of. However, in the case of acquired entities, the statutory auditor should include both the statutory audit fees and the non-audit fees earned after the closing of the acquisition in the fee cap.

Information requirements

8.18 What is the primary source of information to calculate the cap?

As per the CEAOB guidance on the fee cap, the financial records of the audit firm should be used as basis for calculation of the cap as the monitoring of the fee cap remains in the first instance with the audit firm and because this monitoring does not only encompass the audited entity. If the PIE and audit firm have different closing dates, the financial year to consider shall be the one of the audited PIE.

It is recommended that the audit firm provides the relevant fee and the outcome of the fee cap calculation information to the audit committee for the purpose of reviewing and monitoring the independence of the auditor. The audit committee has responsibilities for monitoring the fee cap, as part of their responsibilities to monitor independence. As such it would be best practice in the third year of being auditor of the PIE, to indicate during the planning phase of the audit engagement the anticipated level of the cap as part of the communications with those charged with governance, and this could be updated at regular intervals.

Audit committees

09

9.1

Are there any changes to the role of the audit committee?

In reality, most of the requirements for audit committees set out in the Directive and Regulation are already being performed today and represent 'best practice'. So the main change of substance is the fact that these requirements are now being enshrined in law meaning those companies that have previously applied some but not all areas that are now covered by the law will need to take steps to comply. There is also a requirement under Article 30a of the Directive for Member States to provide for competent authorities to have the power to impose administrative measures for breaches of the Directive or the Regulation, including the imposing of administrative pecuniary sanctions on natural persons, which may impact audit committee members. In addition, there is now a requirement for a majority of the members of an audit committee to be independent from the entity. Under the old Directive only one member needed to be independent.

One area where the Regulation is quite prescriptive relates to the appointment (or re-appointment) of the statutory auditor. Whilst in most cases the audit committee related requirements are accepted practice, there is clear encouragement to audit committees to consider smaller audit firms as part of the tender process. In addition, all contractual clauses entered into between a PIE and a third party (e.g. a bank) that restrict the choice of that company's shareholders to only appoint certain categories or lists of statutory auditors or audit firms to carry out the statutory audit of that entity 'shall be null and void'. This refers to so-called 'Big 4 only' clauses.

The new report from the statutory auditor to the audit committee represents an important change. Whilst much of the content of this report would have already been discussed by the auditor as a matter of best practice, it now has the underpinning of EU Legislation.

Finally, the Regulation brings in a new requirement for Member State competent authorities to assess the performance of audit committees, as part of these authorities' audit market quality and competition monitoring tasks under Article 27 of the Regulation (see [Question 1.10](#)). The Regulation does not set the scope of this assessment of the audit committee but reference may be made to the duties of the audit committee set out in Article 39 (6) of the Directive, which include the auditor selection process, monitoring the statutory audit and reviewing and monitoring the independence of the statutory auditor or audit firm. Member States will need to ensure that the competent authorities have the necessary powers to carry out this assessment.

9.2

Is there a requirement for audit committees to have a policy on tendering for non-audit services?

No. This was a proposal from the European Parliament which was deleted as part of the informal trilogue negotiations.

Audit Committees

9.3 Is audit committee approval needed for any non-audit services?

Yes. The Regulation requires the audit committee (or the body performing equivalent functions) of a PIE to approve the provision of all permissible NAS by the auditor or by a member of the auditor's network to the PIE itself and to its EU controlled undertakings. It seems the approval of the audit committee of the PIE must also be obtained in the case of the provision of services to its EU parent undertakings.

We understand that approval of permissible NAS is only required from audit committees of entities that are located within the EU and in relation to services that will be provided within the EU.

9.4 Can audit committees of multiple PIEs in a group defer to the Audit Committee of the EU parent PIE?

The audit committee of the ultimate PIE parent undertaking in the EU should approve non-audit services to be provided to its PIE **and** non-PIE controlled undertakings in the EU. If the controlled undertaking is itself a PIE and is a direct recipient of these non-audit services (i.e. the service is being provided directly to the subsidiary) (see [Question 7.34](#)), those services should also be approved by the audit committee of the controlled undertaking (to the extent that an audit committee is required by local law¹⁶). If the controlled undertaking is itself a PIE but is not a direct recipient of these non-audit services, we understand that the approval of the controlled undertaking's audit committee would not be required. Member States may however take a different view.

9.5 Can audit committees of multiple PIEs in a group defer to the Group Audit Committee outside the EU to make NAS approvals?

No. The Group Audit Committee to approve the provision of NAS must be based in the EU. Approval by an EU-based Audit Committee (or equivalent) is required for all NAS provided to EU PIE subsidiaries. An Audit Committee based outside the EU (e.g. the Audit Committee of an ultimate US parent) cannot give this approval.

9.6 Can the audit committee pre-approve a list of permissible non-audit services which an audit firm can provide to an audited entity?

There does not seem to be anything preventing audit committees giving approval for certain types of services in advance. Of course, parent entities of groups may decide that the audit committees at each level in the group need to assess the threats to independence and safeguards on a case-by-case basis.

9.7 Who can be on the audit committee? Are there any limits?

Provisions covering the composition of the audit committee now sit in the Directive (Article 39). The audit committee should be composed of a majority of independent non-executive members of either the administrative body (i.e., Board of Directors) or the supervisory body (i.e., as exists in, for example, the German two-tier system). Audit committee members can also be directly appointed at the Annual General Meeting.

At least one member of the audit committee must have competence in accounting and/or auditing. The committee members as a whole should have competence relevant to the sector in which the company has its business.

¹⁶ Note that there is a Member State option to exempt a PIE that is a subsidiary of another PIE from the requirement to have an audit committee, under Article 39 of the Directive.

9.8 What guidelines is the audit committee required to issue regarding the provision of tax and valuation services if a Member State exercises its option to permit them (see [Question 7.4](#))?

There does not appear to be any provision in the Legislation requiring or preventing audit committees from giving approvals in advance for certain categories of permitted services.

9.9 What are the requirements for auditor reporting to audit committees?

Statutory auditors of PIEs will be required to provide a specific written report to the audit committee (Article 11 of the Regulation). This is already the case in some Member States but this requirement will now apply throughout the EU. This report will provide more detailed information on the results of the audit, together with explanatory text. Auditors will be required to disclose, in particular,

'the quantitative level of materiality applied to perform the statutory audit for the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions, account balances or disclosures, and disclose the qualitative factors which were considered when setting the level of materiality.'

Auditors will also be required to:

'report and explain judgments about events or conditions identified in the course of the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty; and provide a summary of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been taken into account when making a going concern assessment.'

9.10 Is an internal controls audit for a PIE required?

Article 11.2 (j) states that the additional report to the audit committee shall explain the results of the statutory audit carried out and shall at least....:

'report on any significant deficiencies in the entity's or, in the case of consolidated financial statements, the parent undertaking's internal financial control system, and/or in the accounting system. For each such significant deficiency, the additional report shall state whether or not the deficiency in question has been resolved by the management.'

9.11 When a Member State designates additional entities as a PIE are these PIEs still required to have an audit committee?

If a Member State opts to designate other entities as PIEs, those PIEs will also be subject to the requirements included in the Legislation and therefore the requirement to have an audit committee applies. However this is subject to the relevant Member State implementation of Article 39 of the Directive, which contains a number of potential exemptions (see [Question 9.12](#))

Audit Committees

9.12 Are there any exemptions from the requirement for a PIE to have an audit committee?

The Member State option to not require an audit committee under Article 39(3) of the Directive applies only with regard to the specific types of entities listed below:

- any PIE which is a subsidiary undertaking within the meaning of Article 2(10) of Directive 2013/34/EU if that entity fulfils the requirements set out in Article 39(1),(2),and (5) of the Directive, Article 11(1), Article 11(2) and Article 16(5) of Regulation (EU) No 537/2014 at group level (see **explanation** below);
- any PIE which is an UCITS¹⁷ or an alternative investment fund (AIF)¹⁸;
- any PIE where the sole business is to act as an issuer of asset backed securities¹⁹; and
- any credit institution within the meaning of point 1 of Article 3(1) of Directive 2013/36/EU whose shares are not admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and which has, in a continuous or repeated manner, issued only debt securities admitted to trading in a regulated market, provided that the total nominal amount of all such debt securities remains below EUR 100 000 000 and that it has not published a prospectus under Directive 2003/71/EC.

Explanation: An undertaking controlled by a parent undertaking, including any subsidiary undertaking of an ultimate parent undertaking, fits the requirements listed in the above first bullet point provided that, at group level, the following conditions are fulfilled:

- The group, presumably the (ultimate) parent, has an audit committee;
- In cases where the Member State has decided to assign the functions of the audit committee to the administrative or supervisory body as a whole, the chairman, if he is an executive member, does not act as a chairman of the body when it is performing the functions of the audit committee;
- The audit committee independence requirements are respected, unless member states have exempted the audit committee from those requirements where all members of the audit committee are members of the administrative or supervisory body of the audited entity;
- The auditor carrying out the statutory audit submits an additional report to the audit committee explaining the results of the statutory audit; this report must include the elements listed in Article 11(2) of Regulation 537/2014; and
- The proposal to the shareholders for the appointment of the statutory auditor includes the recommendations and preference made by the audit committee.

If a PIE does not have an audit committee, the duties of the audit committee should be carried out by the audit committee of its EU parent company, where applicable, or by the administrative or supervisory body to which the Member State has chosen to assign the functions of the audit committee, where applicable.

¹⁷ as defined in Article 1(2) of Directive 2009/65/EC of the European Parliament and of the Council (1)

¹⁸ as defined in Article 4(1)(a) of Directive 2011/61/EU of the European Parliament and of the Council (2)

¹⁹ as defined in point 5 of Article 2 of Commission Regulation (EC) No 809/2004 (3)

9.13 Audit Committee approval is required for permissible services – however must the Audit Committee also approve such services as allowed by the Article 5(3) derogation?

The audit committee is required to approve all permissible non-audit services. This will include any tax or valuation services that become permissible by virtue of a Member State adopting the specific derogation provided by Article 5(3). As a matter of good practice, audit committees might consider issuing guidelines to define those tax or valuation services that they conclude are permissible.

9.14 When do the new requirements for audit committees first apply?

The new requirements regarding the composition and competences of the audit committee will first apply for financial years starting on or after 17 June 2016, according to the Second Additional EC Q&A (Q8).

9.15 Does the audit committee of a PIE need to approve non-audit services by the audit firm that are ongoing and will not be completed before the beginning of the first financial year after 16 June 2016?

Yes. The requirement for approval of non-audit services is applicable for the first financial year starting after the application of the legislation (i.e. on or after 17 June 2016). If an audit firm is currently providing services and those services are expected not to be completed before the beginning of the first financial year subject to the new prohibitions, the services should be evaluated for compliance with the new rules and audit committee approval should be sought for continuation of the service before the start of the financial year subject to the Regulation. At a minimum there should be documentation of the approval process (i.e. there is a requirement for the audit firm to assess and document whether it complies with the non-audit services restrictions, among others, and to discuss this with the audit committee, in application of Article 6 of the Regulation). Given that the audit client is a PIE, approval will apply to all non-audit services provided to the audited entity, its parent undertaking in the EU or its controlled entities in the EU.

9.16 Does the audit committee play a role in determining whether a service is a prohibited NAS?

Yes, the audit committee should be the first point of call for discussion with the auditor. In addition, where there is doubt, consideration should be given to the need for consultation with the relevant competent authority.

Auditor reporting

10

10.1 What is the impact of the Legislation on the auditor report?

The Legislation relating to auditor reporting includes a series of requirements that should enhance investors' understanding of the audit process including critical judgements made during the audit.

Both the Regulation and the Directive contain detailed provisions affecting statutory audits and the way they are conducted. These include such things as the content and nature of the audit report, audit working papers, the role of audit committees, audit tender processes and many others.

The audit report for **all statutory audits** in the EU (i.e., not just statutory audits of PIEs) will need to *'provide a statement on any material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern'* (Article 28(2)(f) of the Directive).

For **PIEs only**, the audit report will need to *'provide, in support of the audit opinion, the following: (i) a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, (ii) a summary of the auditor's response to those risks, and (iii) where relevant, key observations arising with respect to those risks'* (Regulation Article 10(2)(c)).

For additional reporting requirements to the audit committee see [Section 9](#).

10.2 For which year-end will an auditor first be required to produce an audit report under the terms of the new Legislation?

The EC Q&A states that *'the new requirements will apply to the first financial year starting after the date of application'* of 17 June 2016. Applying that principle the first audit report to be produced under the new Legislation would be for the year ending 30 June 2017 and beyond.

10.3 Does the statutory auditor who signs the audit report need to be registered as a statutory auditor in the Member State where the opinion is issued?

It is generally understood that the signing partner must be a member of the local profession in the Member State where the opinion will be issued.

Article 14 of the Amended Directive on Statutory Audit (2014/56/EC) now includes a Member State option to allow a statutory auditor in one EU Member State to become a member of the profession in another Member State following up to a three-year adaptation period. But there is no guarantee that this option will be adopted consistently across the EU.

Furthermore, at the end of the adaptation period, the auditor has to undergo 'an assessment', probably in the local language of the other EU Member State. Although what that assessment should entail has not yet been defined, Member State responses as part of the legislative process did not show much support for the adaptation period concept. So the Member State option may have little impact on EU mobility of potential signing partners.

Auditor reporting

- 10.4 Does the Engagement Quality Control Reviewer need to be registered as a statutory auditor in the country where the audit opinion is issued?**
- An Engagement Quality Control Review is an existing requirement of international standards (i.e., ISA 220 and ISQC1). It is established practice for the EQC reviewer to be not only a statutory auditor but someone with experience that is relevant to the company for which the review is required. This is particularly the case in complex industries such as banking, insurance, energy or telecommunications and is an essential component of a quality audit.
- The EQC review is now incorporated into Article 8 of the Regulation and as such, has become a formal and legal obligation for the audit of every PIE as defined by the Member States. The Regulation requires the EQC reviewer to be a statutory auditor “who is not involved in the performance of the statutory audit to which the review relates” (i.e. has not taken part in the performance of the audit. ISQC1 requires the EQC reviewer to be independent of the audit engagement team.
- In addition the IESBA Code does not permit a key audit partner on a public interest entity who has rotated off the engagement after seven years to move into the EQC reviewer role within the two year cooling-off period under the Code (see [Question 3.11](#)). The EQC reviewer is in effect considered to be a key audit partner under the Code.
- The definition of a statutory auditor would, based on a literal reading of the Regulation, include any statutory auditor formally recognised in the EU in accordance with the Amended Directive. However, the 18 November 2015 [written reply](#) by Commissioner Hill to a parliamentary written question from MEP Kay Swinburne states that the EQC reviewer must be approved and registered as a statutory auditor in the Member State where the audit took place (i.e. the Member State requiring the statutory audit).
- 10.5 The IAASB has recently released new and revised auditor reporting standards. How do these align with the auditor reporting requirements included in Article 10 of the Regulation?**
- Much of the audit report will be consistent with the IAASB requirements, although there are still some additional unique EU disclosures (e.g., a declaration that no prohibited NAS as referred to in Article 5(1) have been provided to the audited entity and a separate indication of the length of the auditor/client relationship).
- In the area of risks of material misstatement including assessed risks of material misstatement due to fraud, the auditor has to provide a description of these risks, a summary response to those risks and, where relevant, key observations arising with respect to those risks. Accountancy Europe has produced a [helpful paper](#) setting out the recent developments in Auditor Communication including a comparison of EU and IAASB requirements. The new ISA auditing reporting standards provide guidance that can be useful when identifying the risks to discuss in the auditor’s report and what to include in the auditor’s description of the risks and the response.

- 10.6 What is the meaning of “including assessed risks due to fraud” in the audit report requirements?**
- The auditor is required to report on “the most significant assessed risks”. In accordance with ISA 240, an assessed risk of fraud is considered to be a significant risk. Therefore when identifying “the most significant assessed risks”, the auditor would take into account assessed risks due to fraud.
- 10.7 Will the report to the audit committee be a public document?**
- No. However, the statutory auditor must make the report available to the competent authorities if required by national law.
- 10.8 Handover files – what exactly do incumbent auditors need to handover and give access to?**
- Article 23(3) as amended by the Directive states that:
- ‘where a statutory auditor or an audit firm is replaced by another statutory auditor or audit firm, the former statutory auditor or audit firm shall provide the incoming statutory auditor or audit firm with access to all relevant information concerning the audited entity and the most recent audit of that entity’*
- The new Directive amends Article 23(3) in Directive 2006/43/EC by adding reference to access to all relevant information concerning the audited entity **‘and the most recent audit of that entity’**.
- It seems sensible to read the new requirement in conjunction with current practice. In particular, it is worth noting that the ISAs do not have extensive guidance on file handover, except for a reference in ISA 230 to *‘the review of matters of continuing significance’* by those responsible for carrying out subsequent audits. As a consequence, there is no widespread practice of full audit file handover.
- Our interpretation is that the amendment to previous requirements in Directive 2006/43/EC was not intended to change dramatically current practice for audit file handover, or indeed it would have been more explicit, but simply to include a requirement to provide relevant information (unspecified) from the most recent audit.
- In addition to the requirements in the Directive, incumbent auditors of PIEs are also required to grant the new auditors access to the additional reports to the audit committee (per Article 11 of the Regulation- see [Question 9.9](#)), as well as any information submitted to the competent authorities in relation to the audit of the PIE, for example: material breach of laws, a material threat to the continued functioning of the PIE or a refusal to issue an adverse/qualified opinion.

Auditor oversight/audit regulators

11

11.1

Who will be responsible for auditor oversight and what is their remit?

National oversight bodies still remain responsible for oversight at a Member State level. However, a new body is to be established, a Committee of European Audit Oversight Bodies (CEAOB), which will take over the existing role of the European Group of Auditor Oversight Bodies (EAOB). As the similarity of the acronyms suggests, there is not much of a change here other than the fact that the CEOB will be chaired by the Member States and not chaired by the EC.

The CEOB will comprise the national authorities responsible for auditor oversight (as does the existing EAOB) and part of its remit, under Article 30 of the Regulation includes to:

- facilitate the exchange of information, expertise and best practices for the implementation of this Regulation and Directive 2006/43/EC (Article 30(7)(a)).
- provide expert advice to the Commission as well as to the Competent authorities, at their request, on issues related to the implementation of this Regulation and of Directive 2006/43/EC (Article 30(7)(b));
- for the purposes of carrying out its tasks, the CEOB may adopt non-binding guidelines or opinions. The Commission shall publish the guidelines and opinions adopted by the CEOB (Article 30(9)).

11.2

What role does ESMA have to play?

ESMA has no role other than as a non-voting member of CEOB. The CEOB will establish a sub-group responsible for performing the ongoing technical assessments of the public oversight systems of third countries. That sub-group will be chaired by an ESMA representative.

11.3

Will the audit profession play any future role in the oversight function?

Yes. Whilst PIE audits will be supervised by competent authorities that are independent of the profession (as is the case today), they may delegate tasks to other bodies.

Oversight of non-PIE audits will continue to be largely performed by the professional bodies.

Auditor oversight/audit regulators

11.4 **Are there new requirements for dialogue between regulators and auditors?**

Yes. The competent authorities supervising credit institutions and insurance undertakings and the auditors of these entities shall establish an effective dialogue and share responsibility for doing so. In order to facilitate this dialogue, the European Banking Authority and the European Insurance and Occupational Pensions Authority shall issue guidelines. The disclosure in good faith to these authorities, by the auditor or network, of any information shall not constitute a breach of any contractual or legal restriction on disclosure of information.

At least once a year, the European Systemic Risk Board (ESRB) and Committee of European Auditing Oversight Bodies (CEAOB) shall organise a meeting with the auditors or networks carrying out statutory audits of all global systemically important (financial) institutions within the EU, as identified internationally, in order to inform the ESRB of sectoral or any significant developments in those systemically important financial institutions. The disclosure in good faith to the ESRB or CEAOB, by the auditor or network, of any information shall not constitute a breach of any contractual or legal restriction on disclosure of information.

11.5 **Does the new Legislation allow the competent authorities to exercise oversight over non-audit activities?**

Article 23 of the Regulation sets out the powers of the competent authority which includes power to:

- a) access data **related to the statutory audit** or other documents held by statutory auditors or audit firms in any form relevant to the carrying out of their tasks and to receive or take a copy thereof;
- b) obtain information **related to the statutory audit** from any person;

As the Legislation applies to the performance of statutory audits by statutory auditors, the powers of the competent authorities are limited to those activities. Article 26(6) of the Regulation further supports this view only referencing audit files when discussing quality assurance. However, the Legislation does not prevent a competent authority from expanding the scope of its activities. For example, when considering the issue of auditor independence, a competent authority may well want to review the nature and extent of other services provided by a statutory auditor.

In addition, Member States might require a competent authority to perform additional tasks beyond those mandated by the EU Legislation.

11.6 **When Member States take the option to require publication of findings and conclusions on individual inspections from the Oversight body, what will be the extent of disclosure of their findings?**

Member States have the discretion to determine how they would like to implement this requirement in their national law. Competent authorities may choose to publically disclose none, some or all individual inspection reports. The inspected firms might be named or anonymous.

11.7 **To whom does the sanctions regime under the directive apply?**

Article 30 of the Directive requires Member States to provide for effective, proportionate and dissuasive sanctions in respect of **statutory auditors** (individuals) and audit firms. However Article 30a (1) of the Directive also requires Member States to provide competent authorities with the power to impose administrative pecuniary sanctions on natural and legal persons for breaches of the Directive and Regulation, as well as temporary prohibitions on members of administrative or management bodies of a PIE banning them from exercising functions in PIEs. Part of the sanctions regime therefore also potentially applies to members of administrative or management bodies and potentially other third parties, in addition to statutory auditors and audit firms.

11.8 **How are any levies charged by auditor oversight authorities to audit firms for inspections calculated in different EU Member States?**

Where auditor oversight authorities charge a levy on the audit firms for inspections there appears to be a range of different funding models, including for example fixed fees per (PIE) audit carried out and actual inspection costs (see [IAASA consultation paper](#), appendix 2).

Impact outside of the EU

12

12.1 **Do the requirements apply to non-EU companies that are listed on a regulated market in the Union? For example, what about dual listing in both EU/Non-EU countries?**

The Regulation specifies that listed PIEs are companies that are 'governed by' the law of an EU Member State. This generally refers to companies that are incorporated in an EU Member State (however please note [Question 12.2](#) below). So non-EU companies that are listed on a [regulated market](#) in the EU would not, as such, fall within the PIE definition and would not be required to rotate their statutory auditors.

For example, a Jersey or Guernsey incorporated company with debt listed on a regulated market in the EU will not be a PIE as the Channel Islands (like the Isle of Man) are not a part of the EU.

12.2 **Is there any doubt that the part of the definition of PIEs relating to listed companies only catches companies that are EU incorporated?**

The provision actually refers to entities '*governed by the law of a Member State*' which is generally accepted as meaning 'incorporated' or 'formed' under EU law. However, some countries such as France or Belgium (but not, say, the UK) have domestic provisions which cause their corporate law to apply to companies which have their operational headquarters in that country even though that company is incorporated elsewhere. Any company caught by such a provision would also be regarded as governed by the laws of that Member State. Subject to this point, the provision should not catch a company that is tax resident but not incorporated in an EU Member State.

12.3 **How do the rotation rules apply to non-EU companies?**

If a non-EU parent has subsidiaries in the EU, and any of these subsidiaries are PIEs in their own right, then the PIE subsidiaries will have to rotate in line with the national law of the Member State where they are incorporated.

If a PIE parent company in the EU has non-EU subsidiaries, whilst these subsidiaries are never caught by the PIE definition (because they are outside the EU and therefore not '*governed by*' the law of an EU Member State), the EU parent may choose to rotate auditors of the entire group, including non-EU subsidiaries, in line with the law prevailing in the parent company's country of incorporation.

Impact outside the EU

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

Generally, the Regulation will not have effect outside the EU.

However, where a member of the network of the statutory auditor provides NAS to entities outside the EU that are subsidiaries of a PIE, the statutory auditor of the PIE must apply a 'threats and safeguards' approach when assessing the impact of those services on its own independence.

However, in such circumstances, the provision of the services outlined below is prohibited as they are deemed to affect the independence of the PIE auditor regardless of the nature of possible safeguards put in place. These are:

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

However the EU prohibitions on NAS **do not** apply:

- To non-EU parent companies/group companies upstream from the PIE; nor
- To sisters of the PIE regardless of whether formed in the EU if they are not in the direct ownership chain of the PIE.

12.5 To what extent do the three prohibitions of services provided outside of the EU differ from the IESBA Code of Ethics?

Each of the three absolute prohibitions differs from the IESBA equivalent as outlined below.

A. Bookkeeping

Section 290.172 of the IESBA Code prohibits an audit firm from providing accounting and bookkeeping services or preparing financial statements upon which the statutory auditor will express an opinion or preparing financial information which forms the basis of the financial statements.

In addition, Section 290.173 of the IESBA Code allows the provision of the above described services which are of a routine or mechanical nature and are provided to divisions or related entities of a PIE if the personnel providing the services are not members of the audit team and:

- The divisions or related entities for which the service is provided are collectively immaterial to the financial statements on which the firm will express an opinion; or
- The services relate to matters that are collectively immaterial to the financial statements of the division or related entity.

By contrast, the EU Regulation contains no 'immateriality' exception for such services. Accordingly, they are prohibited in all cases.

B. Information Technology

Section 290.206 of the IESBA Code prohibits the provision of services involving the design or implementation of IT systems that form a significant part of the internal control over financial reporting or generate information that is significant to the audited entity's accounting records or financial statements on which the firm will express an opinion.

The prohibition in the EU Regulation applies to all services that involve designing and implementing financial information technology systems without exception.

Playing part in management decision-taking See discussion in [Question 7.15](#).

12.6 How does the 'clean period' requirement of Article 5(1)(e) apply to entities outside of the EU controlled by the PIE?

'Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems' is the only prohibited NAS that may not be provided by the auditor in the financial year before the first period as statutory auditor ('1 year clean period'). This service also constitutes one of the 'prohibitions' (see [Questions 12.4](#) and [12.5](#)) that are deemed to have an effect if provided outside of the EU.

However, Article 5.1(a) is clear that the clean period only applies to services provided to the PIE, its parent undertaking and controlled undertakings within the EU by the statutory auditor and its network firms worldwide. Article 5.5 which describes the NAS rules that apply to entities outside of the EU that are controlled by the audited PIE does not specifically refer to the time period, just to the NAS themselves. In addition, the EC Q&A makes the point that in principle the Regulation prohibits the provision of certain NAS only within the EU and the Legislation should not have extra-territorial reach. In our view limitations to NAS provided to entities outside the EU should therefore be interpreted restrictively and as such the 'clean period' requirement would not apply to entities outside of the EU.

12.7 Can Audit Committees of multiple PIEs in a group defer to the Group Audit Committee outside the EU to make NAS approvals?

See discussion in [Question 9.4](#).

12.8 Does the cap have an extra-territorial effect?

We understand that the cap applies to permitted NAS provided by the **statutory auditor** to; the PIE and its parent(s) and controlled undertakings. The geographical location of these entities, that are part of the group, is irrelevant. See [Question 8.7](#).

Member State options

13

13.1 **How will the Member State optionality provided in the Regulation and Directive work and will its impact be significant?**

The Regulation and Directive contain over 50 Member State options in many of the key provisions. The key provisions impacted by the options include:

- Expanding the list of PIEs;
- Reducing the length of the initial maximum duration period to less than 10 years;
- Extending the initial maximum duration period by a further 10 or 14 years where a tender is carried out or a joint audit is introduced;
- Adding to the list of prohibited NAS, stricter rules around 'clean periods' or establishing stricter rules setting out the conditions under which permitted NAS may be provided; and
- Requiring stricter rules on a fee cap.

Member States will need to adopt specific national legislation to make use of these options, unless they already have such legislation in place. There is no time limit with regard to the options in the Regulation however those in the Directive must be in place by date of application — 17 June 2016.

13.2 **Which Member States are likely to adopt a more restrictive position in relation to any of the key areas of the Legislation — e.g. NAS, MFR etc.?**

Member States are at various stages in the process of working through their implementation and approach to the options.

13.3 **Which Member State options apply in a cross border situation?**

In general terms, a PIE company in Member State A will comply with the Legislation as enacted in Member State A. If this company has a parent undertaking in Member State B and a controlled undertaking in Member State C, the parent undertaking will comply with the Legislation as enacted in Member State B and the controlled undertaking will comply with the Legislation as enacted in Member State C.

In a group situation, it would not be unusual for the ultimate parent in the EU to impose its local laws on its controlled undertakings in other Member States to the extent that they are stricter than the laws applicable locally. However, this would be driven by the decision of the parent company and not the laws of the Member State in which the parent resides.

Specific issues affecting banking & insurance groups

14

- 14.1 Consider a non-EU bank or insurer with banking/insurance controlled undertakings in several EU countries. How do the rules apply?**
- Each EU banking/insurance controlled undertakings will be a PIE. Thus, no member of the audit firm's network may provide prohibited NAS to each PIE itself and any company in the direct ownership chain of that PIE (either upwards or downwards) if they are formed under EU law. The rules relating to controlled undertakings of the PIE outside the EU will apply (see [Question 12.4](#)).
- The prohibitions do NOT apply either to group companies above the PIE outside the EU OR to sisters of the PIE regardless of whether formed in the EU or not if they are not in the direct ownership chain of the PIE. The position of branches is dealt with at [Question 2.10](#).
- 14.2 A UK incorporated bank (with no controlled undertakings) is owned by an EU holding company which is not a PIE. The holding company has many EU formed controlled undertakings which are also not PIEs. Do the rules apply to the non-PIE controlled undertakings?**
- The prohibitions apply to services to the bank itself (the PIE) and its parent, the EU holding company. They do NOT apply to the other (non-PIE) controlled undertakings of the EU holding company.
- 14.3 How do the rules affect EU branches of non-EU banks or insurers?**
- See [Question 2.10](#).

Specific issues affecting asset management/funds groups

15

15.1 **Can prohibited services be provided to an Asset Management entity ('Man Co') by the statutory auditor of the listed funds?**

The position is complex as there are many factors that need to be considered. Accordingly, specialist advice should be sought.

Man Co, an EU entity, may of course be a PIE in its own right. If it is, then its statutory auditor may not provide prohibited non-audit services to Man Co. Similarly, if there are other PIEs in the Man Co group of companies, NAS restrictions would apply to the auditors of those PIEs.

Regarding the auditor of the funds, which may be different to the auditor of Man Co, the first question to consider is whether any of its listed funds qualify as PIEs (see [Questions 2.6](#) and following). If the fund does qualify as a PIE, the next step is to determine whether Man Co qualifies as a "parent undertaking" of the fund (see [Question 7.37](#)). This is relevant because the non-audit service prohibitions apply to an EU parent undertaking of a PIE as well as to the PIE's downstream controlled undertakings in the EU. If Man Co qualifies as a parent company of the PIE fund, Man Co and any other EU company in the ownership chain above Man Co will be 'parent undertakings' of the Fund and prohibited services cannot be provided to those entities by the auditor of the PIE fund.

By contrast, if Man Co is not a parent undertaking of the PIE fund, services to the Man Co for the benefit of the Man Co itself or for the benefit of any funds which do not qualify as PIEs should not be prohibited. However, the Regulation provides that prohibited NAS cannot be provided to affected entities 'either directly or indirectly'. Hence the auditor of a PIE fund cannot provide prohibited services to Man Co if these are for the benefit of the PIE fund.

15.2 **Consider a PIE funds audited entity, where the contract to provide audit services to each fund is actually with the management company. Does that make a difference?**

No. The auditor is still conducting a statutory audit of the fund and so the restrictions apply.

15.3 **In some countries, a fund is required to obtain a certificate from a suitably qualified person that the information given to unit holders regarding tax suffered on their distribution is correctly calculated. Are these services prohibited?**

It is not thought to be so. First it is unclear whether this would be regarded as a tax service within the provisions of Article 5 (since it is a form of non-audit assurance) but even if it is, it does not seem to be within any of the categories in the list of prohibited tax services.

15.4 **What about preparation of the information regarding tax that is sent to unit holders for a listed fund?**

The current view is that these services are possibly caught by the prohibited list. However, if the relevant Member State exercises its option to permit tax services as discussed in [Question 7.7](#), they could be permissible provided they meet the relevant conditions.

15.5 **Do investment funds need to carry out a tender per Article 16(3)? Is there an exemption available to them under Article 16(4)?**

Investment funds that qualify as PIEs can make use of the exemption from the selection procedure for statutory auditors foreseen in Article 16(3) if they meet the criteria of Article 16(4) — i.e. qualify as SMEs or as a 'company with reduced market capitalisation.' See [Question 5.3](#).

Specific issues affecting private equity (PE) groups or houses

16

16.1 **How do the rules affect private equity ('PE') groups?**

PE houses will only be impacted if they have a PIE in the group. If they have, then the NAS prohibitions apply ONLY to the PIE itself and to EU controlled undertakings in the direct ownership chain (up and down) but NOT to sister companies in the portfolio. Restrictions on services to controlled undertakings of the PIE outside the EU will apply.

16.2 **How would a private equity group come to have a PIE in its structure?**

If the group is headed by an EU formed and listed parent the rules apply as they do to any other group. Otherwise, the group might have a PIE for three reasons:

- A portfolio company with listed securities (either because shares were retained after an IPO or because less than 100 percent of the equity of a public company was acquired); or
- An EU incorporated finance company has listed debt on an EU regulated market; or
- The portfolio includes EU banking or insurance undertakings.

16.3 **How should Article 5(1) be applied to a Private Equity (PE) Structure**

Article 5(1) of the Regulation clearly applies to group entities, within the Union, that are in a parent or control relationship with a PIE. However, some PIE entities could be involved in a corporate relationship, where, unlike a traditional group structure where the exercise of control and shareholding are held by the same entity, an element of control may exist but the entity exercising control is not necessarily the same entity that is the shareholder or member of the PIE. Therefore, in a PE structure, the entity with a shareholding may not in fact be a parent undertaking, as they are not the entity that exercises control.

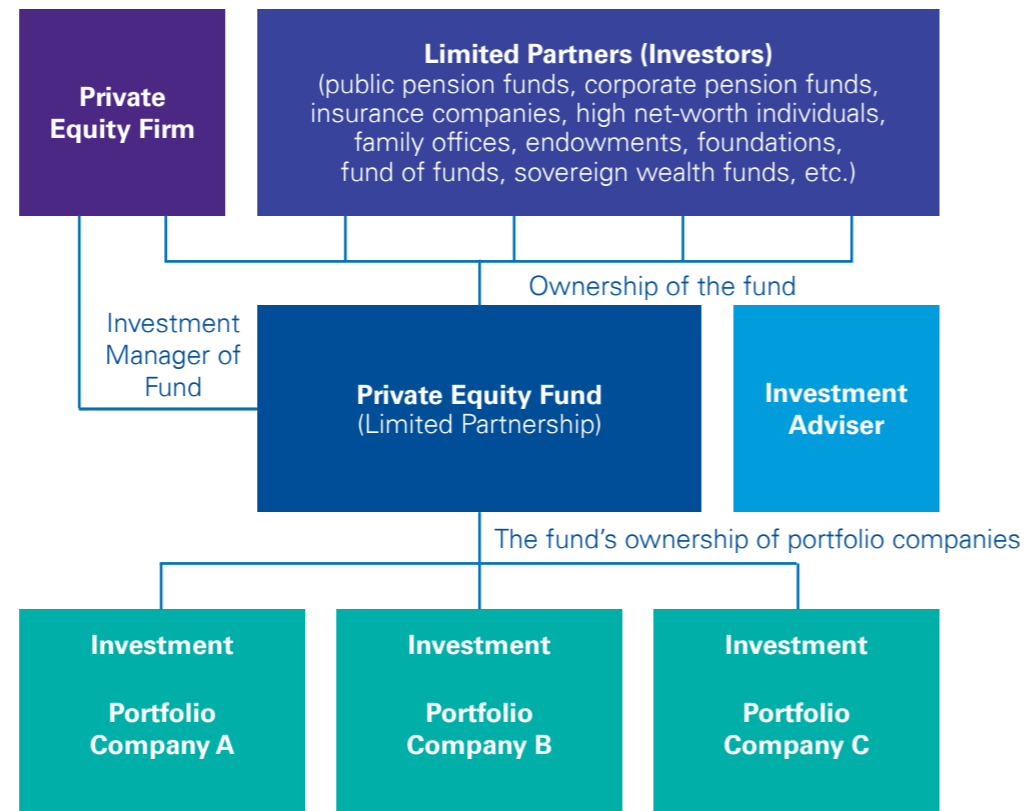
PE structures will undoubtedly vary both in terms of shareholding and the exercise of control. The analysis is both legally complex and highly fact-specific. This guidance is based on generic principles and is not intended to be a substitute for proper case specific analysis.

Structure of a PE House

To understand how private equity firms are structured, it is important to understand the entities/parties involved and their respective roles within the structure. Typically a PE Structure will have a "General Partner" (GP) who obtains capital commitments from (typically) institutional investors known as "Limited Partners" (LPs). These institutional investors include pension and endowment funds, retirement funds, insurance companies, and high net worth individuals. The capital commitments received are held in a Fund "Limited Partnership".

Private equity firms are structured as partnerships with one GP making the investments and several LPs investing capital. All institutional partners of the fund will agree on set terms laid out in a Limited Partnership Agreement (LPA). Some LPs may also ask for special terms outlined in a side letter.

Specific issues affecting private equity (PE) groups or houses



The General Partners, the Limited Partners and the Private Equity Fund would ordinarily be separate legal entities. The Fund will then invest in companies, known as Portfolio Companies, becoming the shareholder/member of that entity. As in the scenario above a fund could have investments in multiple Portfolio Companies and a successful Private Equity Firm (GP) will ordinarily have multiple funds.

If one or more of the Portfolio Companies is an EU PIE the question arises, would the statutory auditor of the PIE be prohibited from providing non-audit services to the fund, the GP, or the investment adviser?

In a situation where the Portfolio Company is the PIE it is necessary to assess whether an entity within the PE House is a 'parent undertaking' and therefore subject to the restriction on non-audit services.

Is the fund [limited partnership] a 'parent undertaking' for the purpose of Article 5(1)?

Investment Funds are exempt from producing consolidated financial statements but can nevertheless be a parent undertaking. Whether a fund is a 'parent undertaking' will be dependent on its shareholding in and/or influence over the Portfolio Company. Applying the conditions of Article 22(1) of the Accounting Directive:

- Where the fund owns more than 50% stake of the portfolio company the fund will typically be considered to be the 'parent undertaking' (Article 22(1)(a) Accounting Directive);
- Where the fund has a minority stake, i.e. $\leq 50\%$ in the portfolio company, it would not ordinarily be the parent undertaking unless it meets one of the other criteria under Article 22(1) e.g.:
 - The fund has the right to appoint or remove a majority of the board of directors of the portfolio company;
 - The fund controls the board sufficiently to be said to have dominant influence; or
 - The fund acts with the agreement of other members to exercise control.

Where one of the conditions above is met and the fund is considered to be the parent undertaking, the prohibition on the provision of non-audit services by the auditor of the Portfolio Company will also apply to the PE fund, where that fund is incorporated in an EU Member State.

Is the general partner of a PE fund a 'parent undertaking' for the purpose of Article 5(1)?

The application of Article 5(1) of the Regulations extends to all 'parent undertakings' incorporated in the EU. So the question arises as to whether the GP is a 'parent undertaking' of the PE Fund where the fund is subject to the restrictions for an audit firm as above?

Whether the general partner of a PE fund is deemed to be a "parent undertaking" again will depend on the exact facts and circumstances. In the scenario above the GP owns a portion of the fund in addition to the portion held by the Limited Partners. In this scenario the GP is a minority shareholder in the fund, whether it is a 'parent undertaking' will depend on the level of control operated by the GP over the fund. If the GP "controls" the PE fund, then the general partner would probably be considered to be the PE fund's parent undertaking and as such a parent undertaking of the Portfolio Company.

Various factors affect whether a GP has control over the fund, such as:

- The powers conveyed to the GP by Limited Partnership Agreement or conversely the constraints imposed; or
- The existence and exercise of the no fault divorce clause, contained in some LPAs, which enable the Limited Partners to replace the GP.

Where the powers conveyed to the GP are limited or the Limited Partners can exercise a no fault divorce clause and remove the GPs from the PE Structure and replace them, it is unlikely that the GP will be considered to have control over the fund and would therefore not be considered to be a 'parent undertaking'.

Specific issues affecting private equity (PE) groups or houses

However, there may be circumstances where the PE Fund has no staff of its own and is merely a cash shell and the control over the Portfolio Company is effectively exercised by the GP. In this scenario there is a separation of ownership and control between the two entities and potentially no 'parent undertaking' as the situation falls outside the scope of Article 22(1) of the Accounting Directive. Whether the GP is a 'parent undertaking' will depend on the exercise of individual member state options to include other circumstances giving rise to a need to produce consolidated accounts and as such an extension of the definition of 'parent undertaking'.

Accordingly, **the facts and circumstances of each situation are critical in determining whether control exists and therefore whether the NAS provisions would extend either up or down from the PIE** — whether the PIE is the Investment Fund, the portfolio company, or both.

Which elements of a PE fund can be the recipient of services?

Clearly the provision of a service to an entity in a PIE group, whether that is determined as being a Portfolio Company, PE Fund or GP will be a direct service and subject to non-audit services restrictions set out in Article 5(1) for the audit firm of the PIE audited entity.

The question arises where a GP or a fund is not a 'parent undertaking' of a Portfolio Company; can the GP or Fund engage the statutory auditor or audit firm of the PIE to provide non-audit services to them (in particular in circumstances where the subject matter of the service is the PIE or the output from the services is passed to the PIE)?

As in a group situation, this will depend on whether an entity outside the PIE Group is acting as an intermediary to procure services that are tailored for the needs of the PIE (an "indirect" provision of a service). This will depend on the facts and circumstances.

Investment Advisers

In addition to the GP, LP and fund many PE houses also have their own Investment Adviser associated with them. For any entity within the PE structure an assessment of whether the entity is in a control relationship with a PIE, will need to be carried out. This assessment will include the Investment Advisers.

In circumstances where the Investment Adviser is not in a control position and therefore not included in the PIE Group, the audit firm or statutory auditor will have to make an assessment whether the provision of a service to the Investment Adviser would constitute an indirect provision of a service to an entity within the PIE Group. This will be dependent on the scope of the service and the particular circumstances and will need to be assessed on a case by case basis.

Taking the example of an Investment Adviser who commissions a valuation of Portfolio Company B, at the request of the Fund, and upon receipt of the valuation passes it to the Fund, with no interpretation, further work or analysis added, the Investment Adviser is likely to be considered to be an intermediary and the service deemed to have been provided indirectly to the Fund. In these circumstances, the services would be subject to the non-audit service restrictions set out in Article 5(1).

However, where the Investment Adviser undertakes to provide a service to the Fund and engages one or more audit firms to provide tax restructuring advice, valuations etc in order to enable the Investment Adviser to provide its own advice to the Fund we consider that it is unlikely that the service will be considered to be an indirect service to the Fund by the statutory auditor or audit firm. In addition to the examples above regarding the substance requirement (active role of the Investment Adviser), we

consider an audit firm or statutory auditor would not be providing an indirect service to the Fund where typically:

- The contractual arrangement is with the Investment Adviser and not the Fund/GP and the statutory auditor;
- The Investment Adviser does not control the Fund/GP;
- The accounting firm's work product is not provided to the Fund/GP; and
- The fees for the service are not billed to the fund/GP.

In these circumstances, it may be reasonable to conclude that the service is provided to the Investment Adviser and is not being provided indirectly to the PIE, its parent or controlled undertakings, in which case the NAS prohibitions and fee cap would not apply.

16.4

Can the General Partner apply the IFRS 10 definition of a parent undertaking which can lead to a difference conclusion to the EU legislation? Which definition prevails when the two conflict?

We understand that the Accounting Directive would prevail, to the extent that there is any inconsistency.

Specific issues affecting consortia, syndicates or other collective ventures

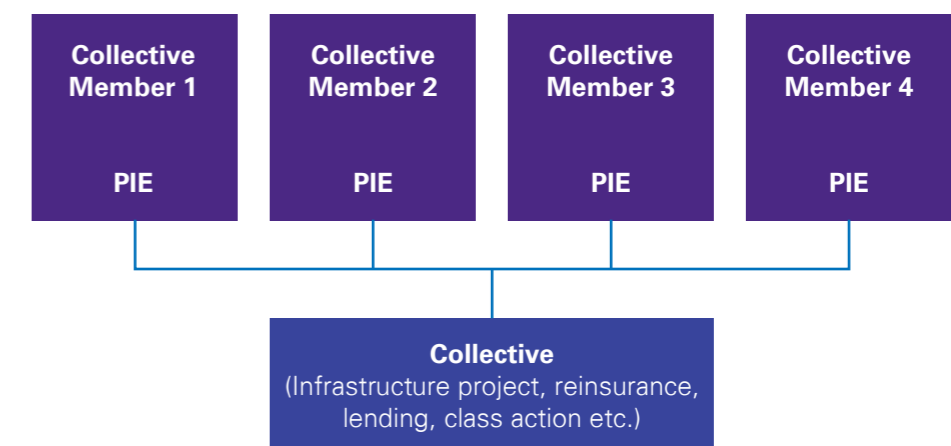
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17.1

How should Article 5(1) be applied to a collective, syndicate or consortium (Collective)?

There may be circumstances where a PIE enters into a commercial relationship with one or more entities, potentially other PIEs, for a given purpose or venture, a “Collective”.

Collectives may be either formal — for example, legal partnerships — or informal or loose associations, e.g. entities working together supported by a memorandum of understanding as opposed to the establishment of a separate legal entity. Collectives frequently occur between entities to widen the scope of business activities, bringing together companies with different expertise; spread the risk of lending; a group action etc.



In order to assess to whom the audit firm provides a service, consideration should be given to the following:

- When is a service provided directly to a collective as distinct from being provided to its individual members?
- Is the collective a controlled undertaking of a PIE member?
- Is the audit firm providing an indirect service to an individual member?

Specific issues affecting consortia, syndicates or other collective ventures

When is a service provided directly to a collective as distinct from being provided to its individual members?

Where a distinction can be made between a collective and its individual members it would be reasonable to consider a service is provided directly to the collective when:

- the audit firm is engaged by the “collective” (group, syndicate, consortium or similar) as a whole, for the purposes of its members’ common benefit, with services being provided to the collective as a whole for a common purpose and on common terms;
- the entities collectively comprise “the client”;
- the advice provided to the collective is not tailored or specific to the needs of any individual member; and
- no individual member of the collective has the ability to control the collective.

Provided the above conditions are met, we consider that services provided to the collective should not be viewed as being provided directly to the individual members.

Is the collective a controlled undertaking of the PIE?

Whether or not a collective could be classified as a ‘controlled undertaking’ will depend on the facts and circumstances and must be assessed on a case by case basis using the criteria set out in Article 2 (1) of the Transparency Directive 2004/109/EC. A controlled undertaking is one:

- i) in which a natural person or legal entity has a **majority of the voting rights**; or
- ii) of which a natural person or legal entity has the right to appoint or remove a majority of the members of the administrative, management or supervisory body and is at the same time **a shareholder in, or member of, the undertaking** in question; or
- iii) of which a natural person or legal entity is a shareholder or member and alone controls a majority of the shareholders’ or members’ voting rights, respectively, pursuant to an agreement entered into with other **shareholders or members** of the undertaking in question; or
- iv) over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control.

There may be one party within a collective that takes the lead in engaging advisers and day to day interactions, but it is not necessarily the case that any one party has control sufficient to constitute a parent/controlled relationship. In circumstances where there is a legal agreement, that agreement should be used to determine if any one party has control. Where there is no legal agreement alternative evidence would need to be obtained as to how the members are acting and whether any of them is in control of the collective.

In determining whether there is a control relationship between a PIE and a collective it may be necessary to understand who the parent undertakings of the individual members of the collective are. For example, if two or more members of a collective are controlled by the same parent undertaking their interests or influence in the collective would need to be added together to determine whether there is a control relationship that would constitute a ‘parent undertaking’ requiring the collective to be consolidated into the financial statements of the ultimate parent.

Is a service provided indirectly to an individual member of a collective?

As stated above, an indirect service is provided when it is provided via an intermediary. For the collective to have been an intermediary in the provision of a service to an individual member it is necessary for the service to have been provided in contemplation of the needs of the individual member rather than or in addition to the needs of the collective. It is not sufficient that the individual members are in receipt of the output of the service, it needs to have taken their specific requirements and circumstances into consideration.

For example, in a class action all parties sign an agreement in which they waive their rights to bring an action in their own right and to abide by the decision of the collective. In these circumstances we consider that it is reasonable to conclude that the service is provided to the collective only. Often the outcome of the service is not provided to the individual member and where they do obtain it they are not in a position to make use of it. We consider that the individual member has received neither a direct nor an indirect service.

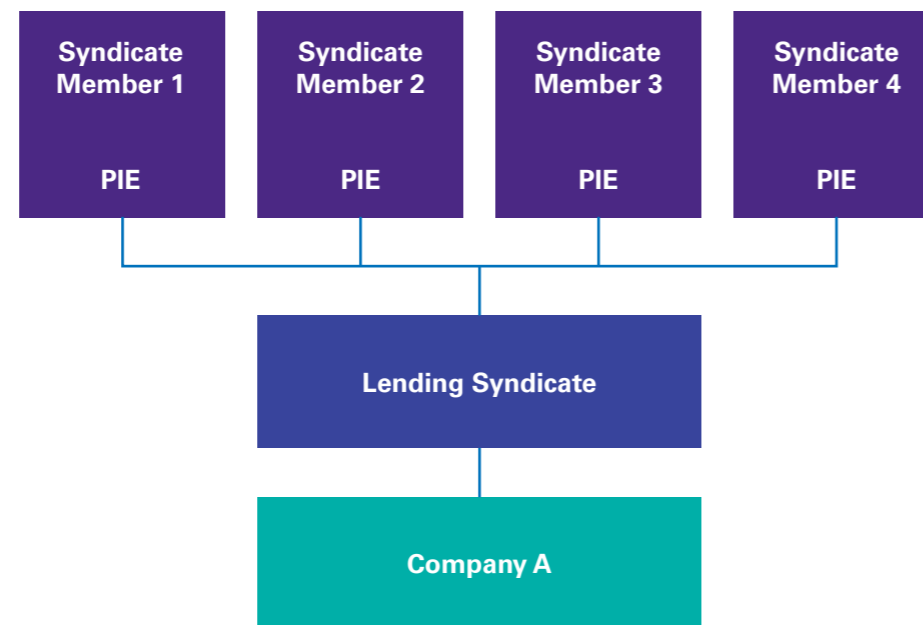
A further example could be a consortium for an infrastructure project where a number of specific parties come together to affect the project, each bringing with them particular skills. Professional advice is sought and provided to the consortium. In these circumstances the advice is only relevant to that specific set of members. No one member can take the advice (such as a feasibility study or business model) and use it in isolation from the other members. In these circumstances we consider that an individual member has not received a direct or indirect service, it is not tailored for their use and it is not capable of being used by them absent other members of the consortia.

A further example could be a lending syndicate. A formal legal agreement will exist between the members of the lending consortium which sets out (amongst other things) the majorities needed for consent, how syndicate members act and the process for engaging advisors. For example, a lending syndicate itself commissions or requires Company A, to whom it has lent monies, to commission a restructuring service. The syndicate receives a report on the outcome of the service and the future viability of the company. The engagement can be by way of:

- A tri-partite agreement between Company A, the syndicate and the audit firm; the syndicate will generally have an input into the scope of the engagement; or
- An agreement between the syndicate and the audit firm. The company itself is not a party to the agreement but signs a letter of acknowledgment.

In either case the service will be provided directly to the syndicate and not to the syndicate’s individual members.

Specific issues affecting consortia, syndicates or other collective ventures



The individual members have not received the service directly, the engagement is with the syndicate and the audit firm.

The individual member receives the output only in its capacity as a member of the syndicate and to inform its decisions as a member of that syndicate. The output is not tailored to the individual member's specific requirements and needs. The terms of conditions in the contract governing the provision of the service to the syndicate will include a specific disclaimer to make it clear that the audit firm is providing the output of the service, the restructuring report, to the syndicate and not to its individual members. Therefore, the service would not be an indirect service to the individual members of the syndicate.

[Can the collective be a recipient of a service prior to the construct of a formal agreement or separate legal entity?](#)

It may be the intention of a collective to establish a separate legal entity or form a legal agreement between parties, that will engage the service provider and be the sole recipient of those services. Prior to completing the legal structure the collective needs to engage an adviser to provide some preliminary services such as feasibility studies, business modeling or structuring advice. It is likely that the individual members, acting in concert, would engage a firm and be jointly and severally liable for the fees. Would the fact that each individual member of the collective is jointly and severally liable for the fees be sufficient to determine that they, the individual members, are the recipient of the service rather than the collective for whom the service is designed? On the same basis as described above, the individual members have not been provided a service directly or indirectly as the service provided is not capable of use by them, other than in respect of the collective.

Audit firm internal organisation and transparency report

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18.1 **Are there new obligations upon audit firms around their internal organisation?**

The Directive sets various standards relating to the internal organisation of statutory auditors and audit firms. These apply to all EU audit firms and not only to the auditors of PIEs (see [Question 1.3](#)). The Directive requires policies and procedures on several matters—for example to ensure that management do not intervene in the independence of the statutory auditor, so that professionals involved in statutory audits have appropriate knowledge and experience, so that there is an appropriate internal quality control system to ensure the quality of the statutory audit. Most of these requirements correspond to current best practice. However, there is one specific provision which involved some new obligations which will affect persons involved in, or able to influence the carrying out of the audit. This provision is that:

‘a statutory auditor or an audit firm shall have in place adequate remuneration policies, including profit-sharing policies, providing sufficient performance incentives to secure audit quality. In particular, the amount of revenue that the statutory auditor or the audit firm derives from providing NAS to the audited entity shall not form part of the performance evaluation and remuneration of any person involved in, or able to influence the carrying out of the audit’.

A similar prohibition on reflecting success in earning revenues from NAS applies to Key Audit Partners under IESBA.

IESBA code: ‘a key audit partner shall not be evaluated on or compensated based on that partner’s success in selling non-assurance services to the partner’s audit client.’

However, IESBA applies a threats and safeguards approach to other members of the audit team, whilst the Directive sets a rule applicable to any person involved in, or able to influence the carrying out of the audit. The prohibition may be of special relevance in practice to audit teams (including for example tax professionals who assist with the audit), on the audit of non-PIEs who may use their audit firm for a variety of NAS and which are not prohibited by the restrictions outlined in [Section 7](#).

Since this provision is contained in the Directive and has to be translated into national law, there may be differences in implementation.

18.2 **When will the new requirements for the auditor’s transparency report first apply?**

The first transparency report complying with the new rules will have to be published for financial years starting on or after 17 June 2016, according to the Additional EC Q&A. As such, for an audit firm with a 30 June financial year-end, the first financial year beginning after 17 June 2016 will be the financial year ending on 30 June 2017. It follows from this that the first Transparency Report under the new regime will be the Report for the year ended 30 June 2017. This would need to be made public within four months of the end of the year in question (i.e., by 31 October 2017).

Audit firm internal organisation and transparency report

18.3 What are the new requirements for the auditor's transparency report?

The new requirements for the auditor's transparency report under the Regulation, in addition to the requirements that already exist under the 2006 Directive, include the following:

- The transparency report is to be published on the audit firm's website at the latest four (instead of three) months after the end of the financial year;
- The transparency report, including any updates, must be maintained on the audit firm's website for at least five years;
- The audit firm must inform the competent authority when the transparency report or an update has been published;
- The name of each audit firm belonging to the network and the countries where each is qualified to carry out statutory audits or has its registered office or principal place of business must be included;
- The total turnover of audit firms that belong to the network from carrying out statutory audits of annual and consolidated financial statements must be published;
- Where not disclosed in its financial statements, the transparency report must include separate figures for the audit firm's revenues from (a) the statutory audit of annual and consolidated financial statements of entities belonging to a group of undertakings whose parent undertaking is a PIE, (b) the statutory audit of annual and consolidated financial statements of other entities, (c) non-audit services provided to entities the audit firm audits, (d) non-audit services to other entities;
- The transparency report must include a description of audit firm's policy concerning the rotation of key audit partners and staff.

The term "audit firm" is defined under the Legislation as an entity authorised by an EU Member State to carry out statutory audits, i.e. audits of annual financial statements or consolidated financial statements as required by EU law. The different turnover figures and names of audit firms that are member of the network to which the audit firm belongs that are required to be published in an audit firm's transparency report are therefore those of EU, or EEA, audit firms, and not those of network members located outside of the EU/EEA.

Specific issues affecting group audits

19

19.1

Are there any new provisions affecting how the group auditor and the competent authority may obtain access to third country component auditor's working papers?

The Directive further develops the 2006 Statutory Audit Directive requirements for the EU Member State auditor to review the audit work carried out by third country auditors for the purpose of the group audit.

Article 27 in the Directive addresses the statutory audits of consolidated financial statements (group audits) and includes a number of provisions regarding documentation and working papers of both the group and third country auditors of components. The various provisions deal with a number of different scenarios. Our interpretation of how the requirements can be met are set out below (see [Appendix 8](#) for further details).

Article 27 collectively defines a logical and pragmatic approach to documentation of third-country auditors'/audit firms' work in a group audit.

The documentation in the group audit file should focus on what is needed to demonstrate the group auditor's basis for the opinion on the group audit. As such it needs to provide a summary of the work performed by third-country auditors/audit firms and the group auditor's review and evaluation of that work. It is not necessary to have all of the detailed working papers of those auditors/audit firms. The Article recognises this.

Compliance with ISA 600 should achieve compliance with the documentation required in the Article.

The Article follows a pragmatic escalation process when additional access to third-country auditors'/audit firms' working papers is deemed necessary.

Seeking that access through the respective competent authorities in the first instance is appropriate as it is working through agreed legal means.

The Article implicitly acknowledges that the group auditor may not be able to obtain the necessary access for the competent authority when the competent authority is unable to obtain it directly, and addresses the documentation requirements in such circumstances.

Implications of the UK leaving the EU

20

20.1

What will the impact of the UK leaving the EU be on UK qualified auditors practicing in the EU and EU qualified auditors practicing in the UK?

Until such time as the UK formally exits the European Union, there is a requirement to continue to comply fully with all EU legislation so there would be no impact.

When the UK has formally exited the European Union, the Directive and Regulation will in principle no longer apply. Subject to the future agreements concluded between the EU and the UK and to future UK legislation:

- UK qualified auditors would in principle no longer automatically benefit from the possibility to practice in the EU after passing an aptitude test or completing an adaptation period;
- Similarly, EU qualified auditors would in principle no longer automatically benefit from the possibility to practice in the UK after passing an aptitude test or completing an adaptation period; and
- UK auditors of UK incorporated entities listed on a regulated market in the EU would have to register as third country auditors and be subject to the oversight, quality assurance and investigations and penalties regime of the EU Member State of the regulated market, except if the UK regime has been declared equivalent to the EU regime by a decision issued by the European Commission. Given that the UK's current regime complies with the Regulation and the Directive and assuming that there would be no significant relevant changes in the UK regime, we would expect that the UK regime would be considered to be equivalent and that, subject to reciprocity as may be required, UK auditors of UK incorporated entities listed on regulated markets in the EU may be exempted from registration and oversight, quality assurance and investigations and penalties regime of the EU Member State of the relevant regulated market.

Note that EU competent authorities shall be cooperating within the framework of the CEAOB on convergence in the EU of the requirements of the adaptation period and the aptitude test, according to Article 14(3) of the Directive.

List of non-audit service prohibitions (extract)

A1

Article 5 — prohibition of the provision of NAS (Extracts):

1. A statutory auditor or an audit firm carrying out the statutory audit of a public-interest entity, or any member of the network to which the statutory auditor or the audit firm belongs, shall not directly or indirectly provide to the audited entity, to its parent undertaking or to its controlled undertakings within the Union any prohibited NAS in:
 - a) the period between the beginning of the period audited and the issuing of the audit report; and
 - b) the financial year immediately preceding the period referred to in point (a) in relation to the services listed in point (e) of the second subparagraph.

For the purposes of this Article, prohibited NAS shall mean:

- a. Tax services relating to:
 - 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 the 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 the 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 any 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 information technology systems;
- f. Valuation services, including valuations performed in connection with actuarial services or litigation support services;
- g. Legal services, with respect to:
 - i) the provision of general counsel;
 - ii) negotiating on behalf of the audited entity; and
 - iii) acting in an advocacy role in the resolution of litigation;
- h. Services related to the audited 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;

Appendix 1: List of non-audit service prohibitions (extract)

- j. promoting, dealing in, or underwriting shares in the audited entity;
 - k. human resources services with respect to:
 - i. management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:
 - searching for or seeking out candidates for such position; or
 - undertaking reference checks of candidates for such positions;
 - ii. structuring the organisation design; and
 - iii. cost control.
2. By way of derogation from the second subparagraph of paragraph 1, Member States may allow the services referred to in points (a) (i), (a) (iv) — (vii) and (f) provided that they satisfy the following requirements:
- 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.

Report to the Audit Committee (extract)

A2

The Regulation states that the auditor must explain the results of the statutory audit in an additional report to the audit committee which shall at least:

- a) include the declaration of independence referred to in point (a) of Article 6.2;
- b) Where the statutory audit was carried out by an audit firm, the report shall identify each key audit partner who was involved in the audit;
 - where the statutory auditor or the audit firm has made arrangements for any of his, her or its activities to be conducted by another statutory auditor or audit firm that is not a member of the same network, or has used the work of external experts, the report shall indicate that fact and shall confirm that the statutory auditor or the audit firm received a confirmation from the other statutory auditor or audit firm and/or the external expert regarding their independence;
 - describe the nature, frequency and extent of communication with the audit committee or the body performing equivalent functions within the audited entity, the management body and the administrative or supervisory body of the audited entity, including the dates of the meetings with those bodies;
 - include a description of the scope and timing of the audit;
- c) where more than one statutory auditor or audit firm have been appointed, describe the distribution of tasks among the statutory auditors and/or the audit firms;
- d) describe the methodology used, including which categories of the balance sheet have been directly verified and which categories have been verified based on system and compliance testing, including an explanation of any substantial variation in the weighting of system and compliance testing when compared to the previous year, even if the previous year's statutory audit was carried out by other statutory auditor(s) or audit firm(s);
- e) disclose the quantitative level of materiality applied to perform the statutory audit for the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions account balances or disclosures, and disclose the qualitative factors which were considered when setting the level of materiality;
- f) report and explain judgements about events or conditions identified in the course of the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty, and provide a summary of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been taken into account when making a going concern assessment;
- g) report on any significant deficiencies in the audited entity's or, in the case of consolidated financial statements, the parent undertaking's internal financial control system, and/or in the accounting system. For each such significant deficiency, the additional report shall state whether or not the deficiency in question has been resolved by the management;
- h) report any significant matters involving actual or suspected non-compliance with laws and regulations or articles of association which were identified in the course of the audit, in so far as they are considered to be relevant in order to enable the audit committee to fulfil its tasks;

Appendix 2: Report to the Audit Committee (extract)

- i) report and assess the valuation methods applied to the various items in the annual or consolidated financial statements including any impact of changes of such methods;
- j) in the case of a statutory audit of consolidated financial statements explain the scope of consolidation and the exclusion criteria applied by the audited entity to the non-consolidated entities, if any, and whether those criteria applied are in accordance with the financial reporting framework;
- k) where applicable, identify any audit work performed by third-country auditor(s), statutory auditor(s), third-country audit entity(ies) or audit firm(s) in relation to a statutory audit of consolidated financial statements other than by members of the same network as to which the auditor of the consolidated financial statements belongs;
- l) indicate whether all requested explanations and documents were provided by the audited entity;
- m) report:
 - (i) any significant difficulties encountered in the course of the statutory audit;
 - (ii) any significant matters arising from the statutory audit that were discussed or were the subject of correspondence with management; and
 - (iii) any other matters arising from the statutory audit that in the auditor's professional judgement, are significant to the oversight of the financial reporting process.

Extract from Article 4 (the cap on fees for NAS)

A3

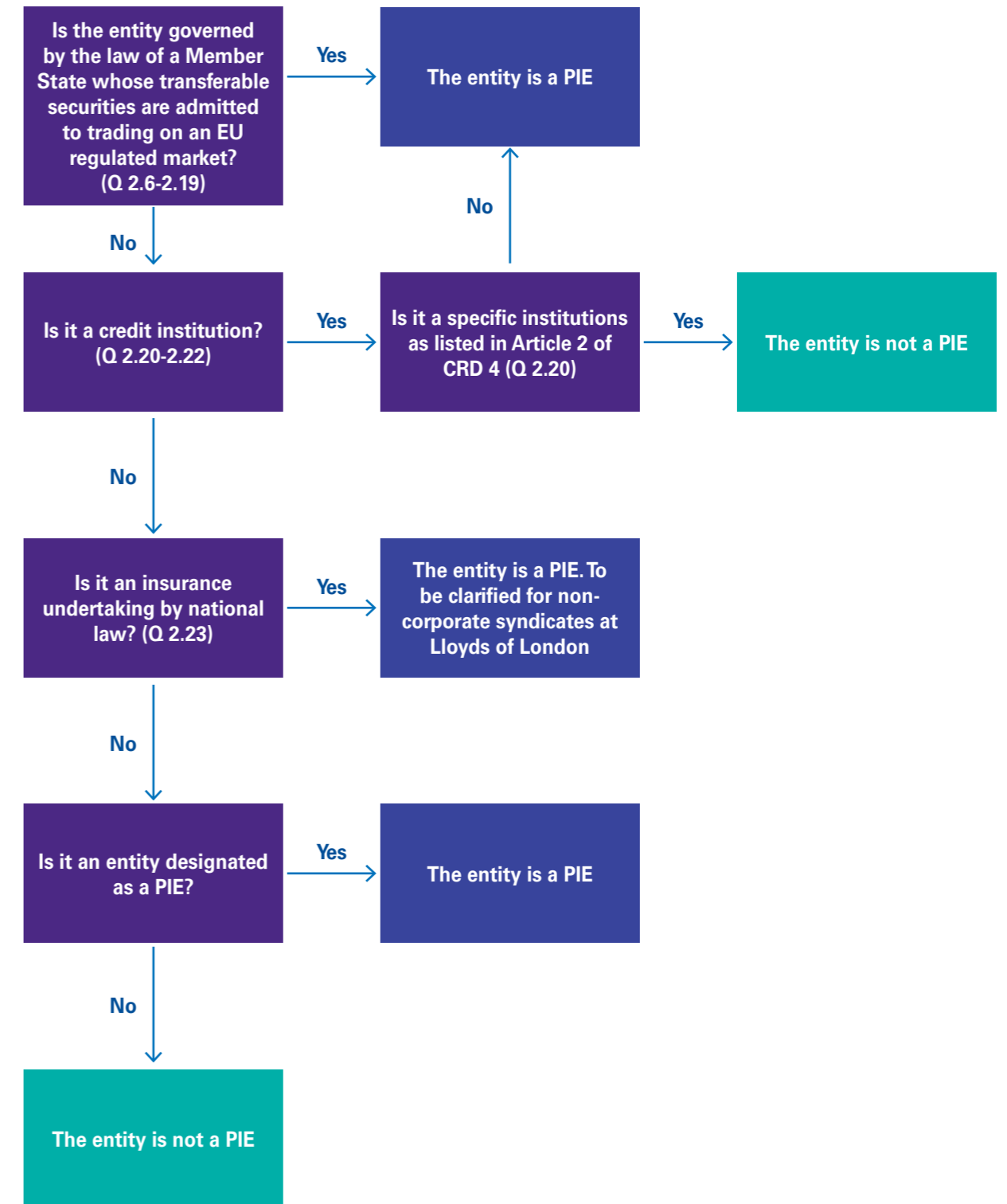
When the statutory auditor or the audit firm provides to the audited entity, its parent undertaking or its controlled undertakings, for a period of three or more consecutive financial years, NAS other than those referred to in Article 5(1) of this Regulation, the total fees for such services shall be limited to no more than 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, of its controlled undertakings and of the consolidated financial statements of that group of undertakings.

For the purposes of the limits specified in the first subparagraph, non-audit services, other than those referred to in Article 5(1), required by Union or national legislation shall be excluded.

Member States may provide that a competent authority may, upon a request by the statutory auditor or the audit firm, on an exceptional basis, allow that statutory auditor or audit firm to be exempt from the requirements in the first subparagraph in respect of an audited entity for a period not exceeding two financial years.

Illustration of the PIE definition

A4

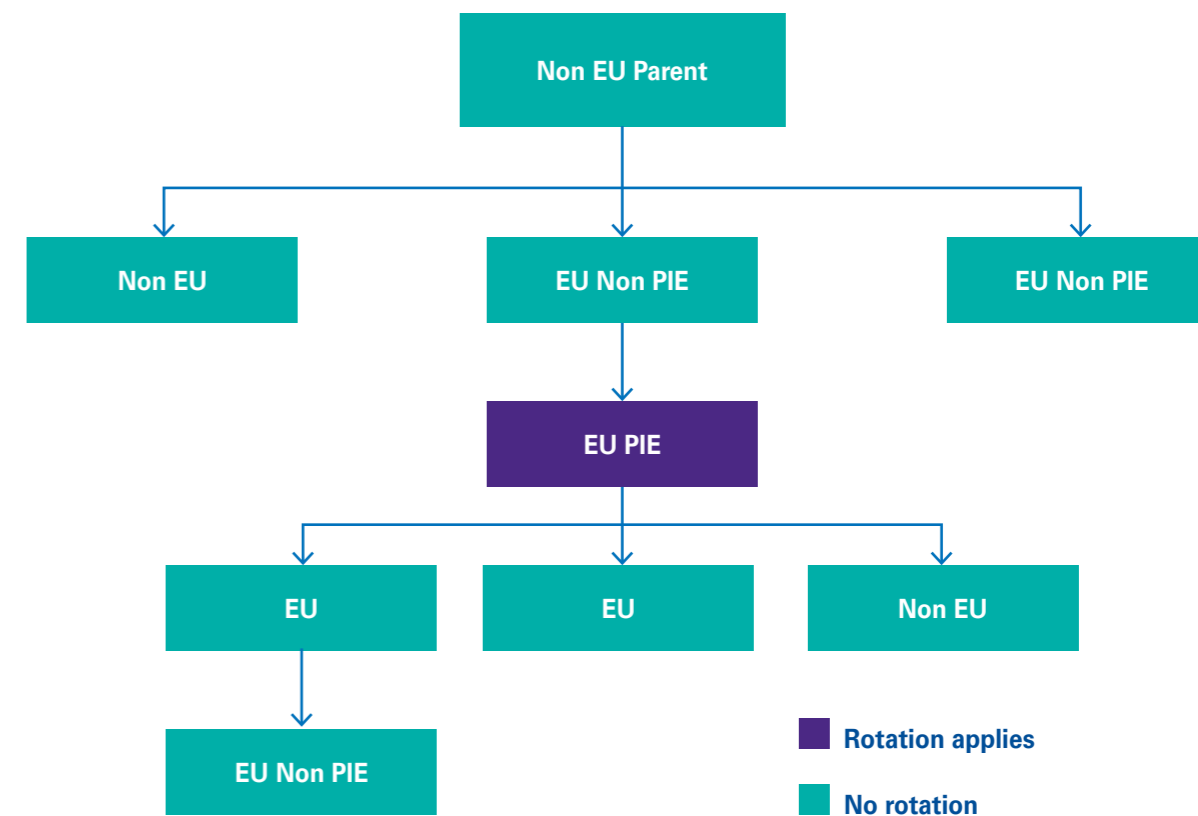


Illustrative examples of the impacts of having a PIE in the group

A5

Appendix 5.1 Illustrative example of the impacts of having a PIE in a group - mandatory audit firm rotation

MFR — Every entity that falls within the EU PIE definition must rotate their statutory auditors after a pre-defined period (see [Section 3](#)). The MFR requirements ONLY APPLY to the PIE itself and NOT to the parent or controlled undertakings. Nor does the MFR requirement apply to other members in the audit firm network.

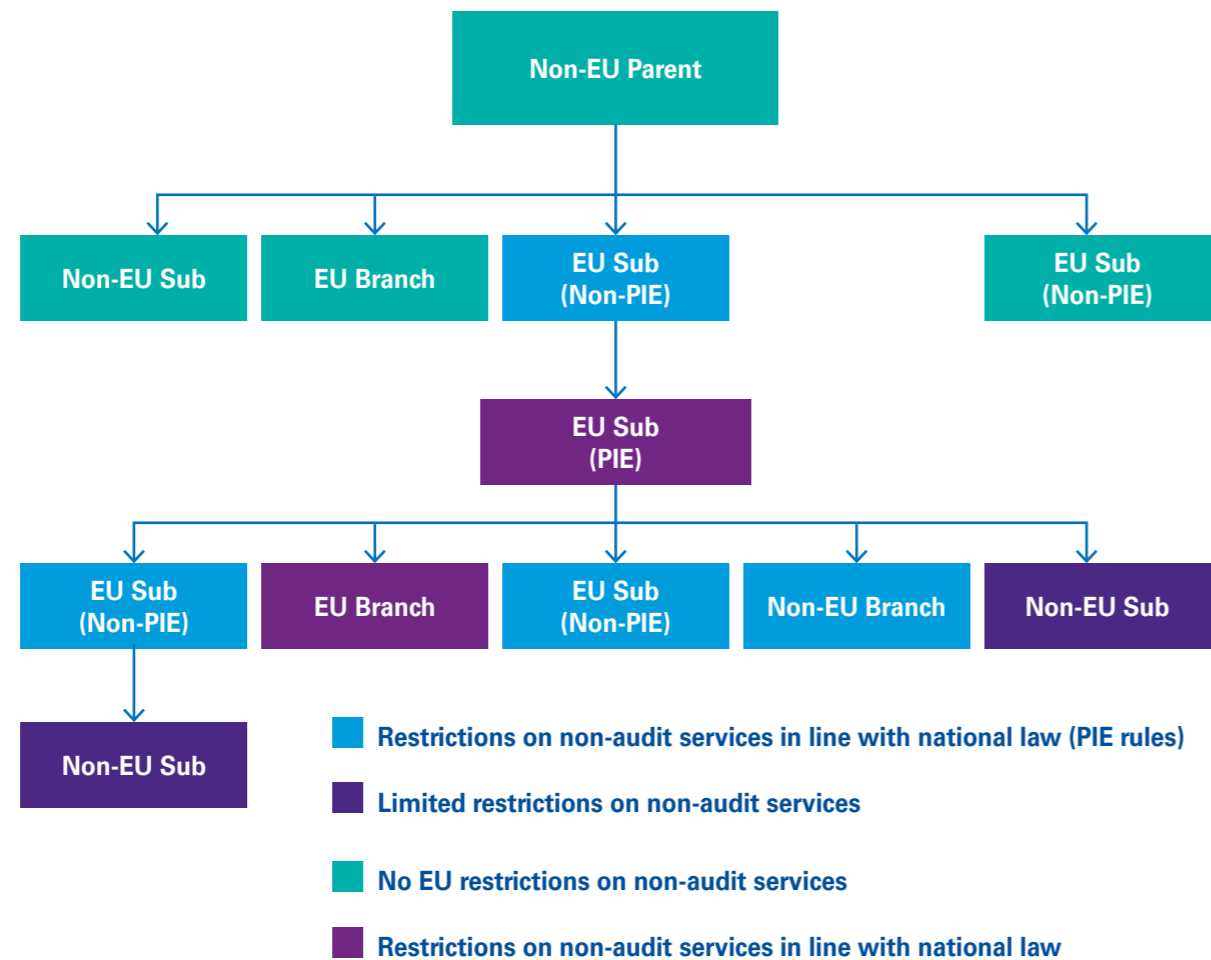


Appendix 5.2 Illustrative example of the impacts of having a PIE in a group - restrictions on non-audit services

NAS —The Regulation prohibits the statutory auditor of the PIE and all members of its network from providing many services to a PIE or to that PIE’s controlled undertakings or EU parent companies.

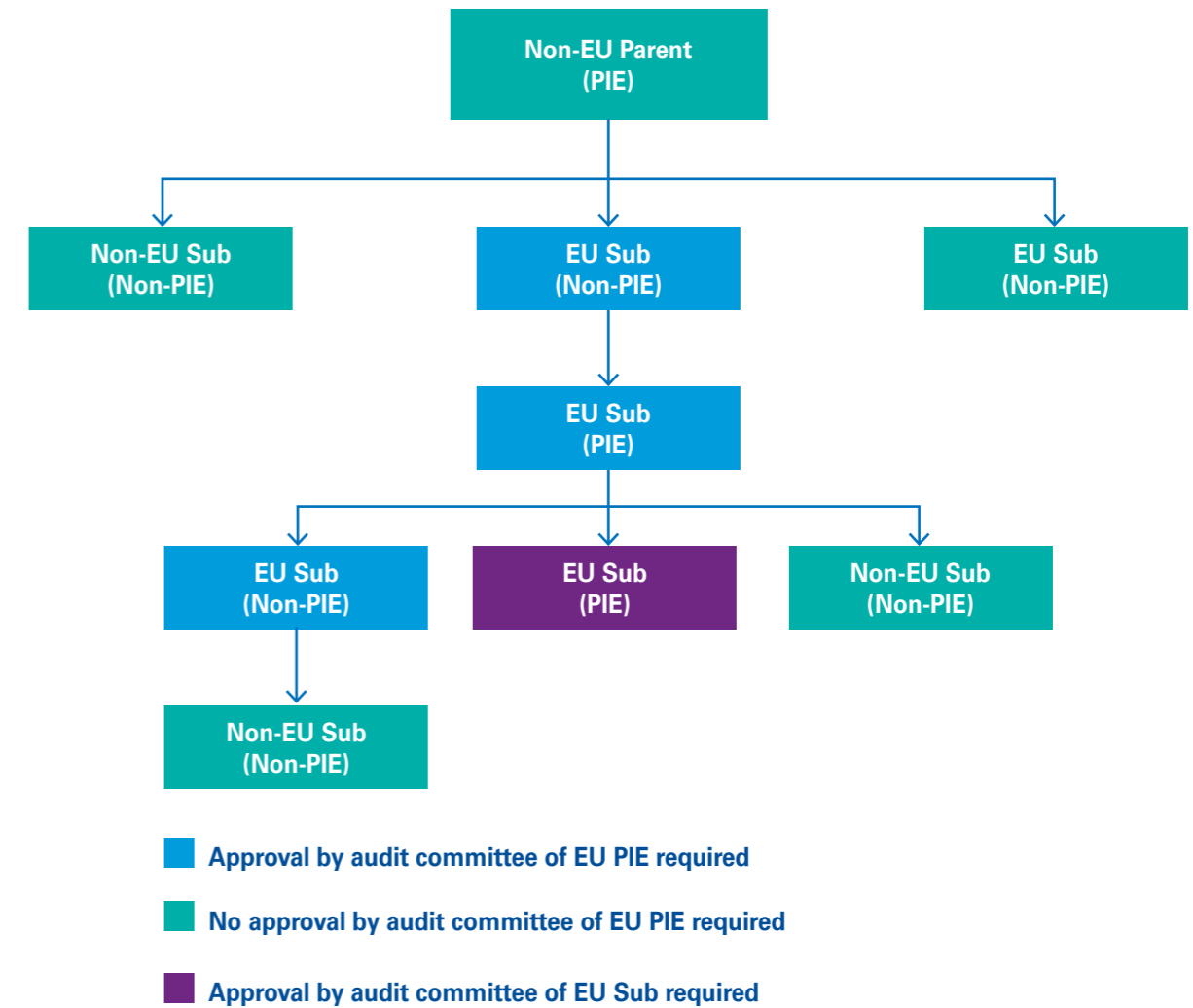
Although NAS provided to controlled undertakings of the PIE outside the EU by other members of the auditor’s network are generally permitted subject to a ‘threats and safeguards’ approach, some services are always prohibited irrespective of any available safeguards — referred to as ‘limited restrictions’ in the following example.

Note that the example only covers the EU Audit Legislation. MFR and NAS requirements that are part of other non-EU jurisdiction’s national laws must also be considered for non-EU members of the group.



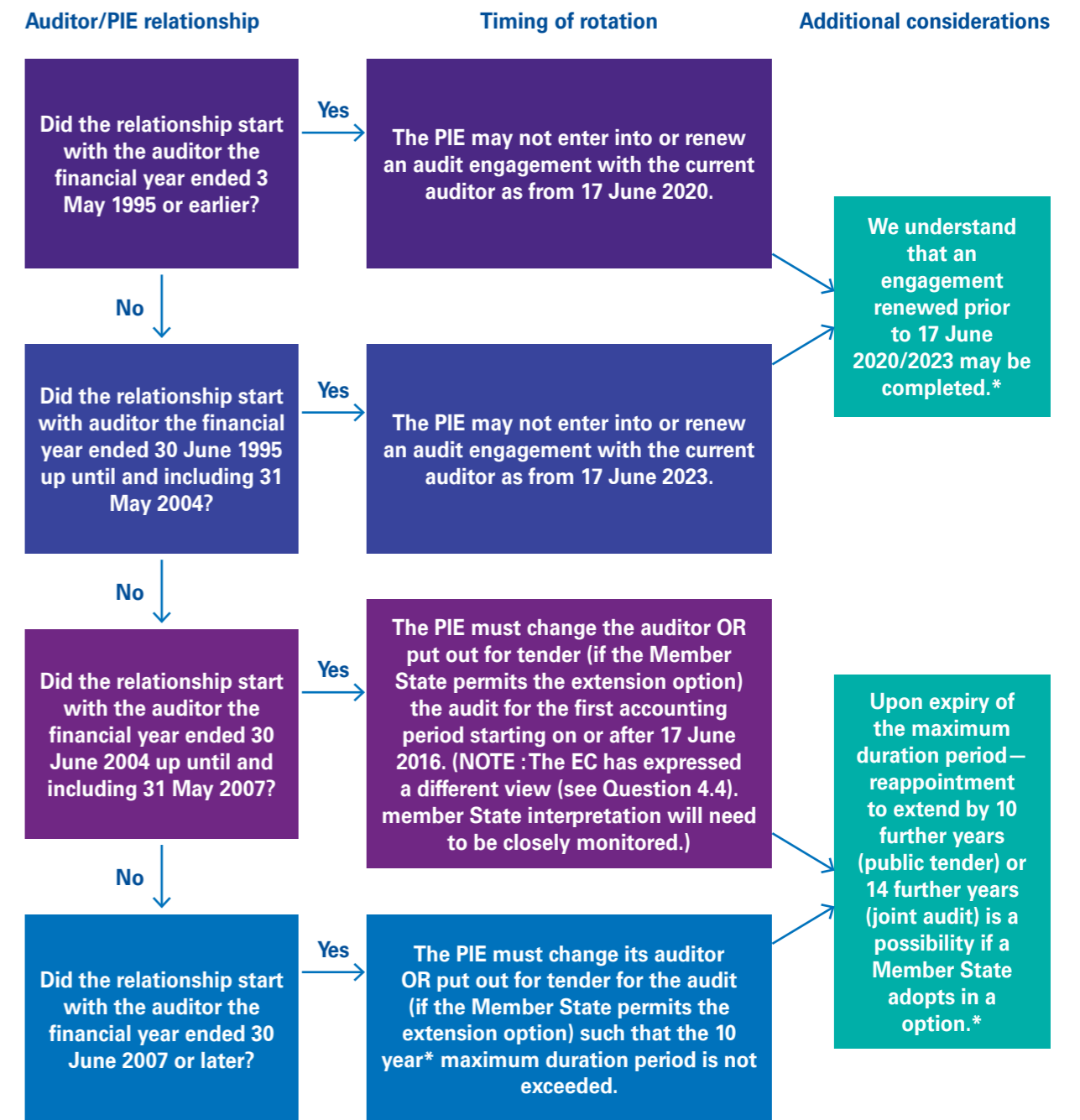
Appendix 5.3 Illustrative example of the impacts of having a PIE in a group - audit committee pre approval for the provision of NAS

Audit Committee approval -The Regulation requires the audit committee of the PIE to approve the provision of all permitted NAS— see [Question 9.3](#).



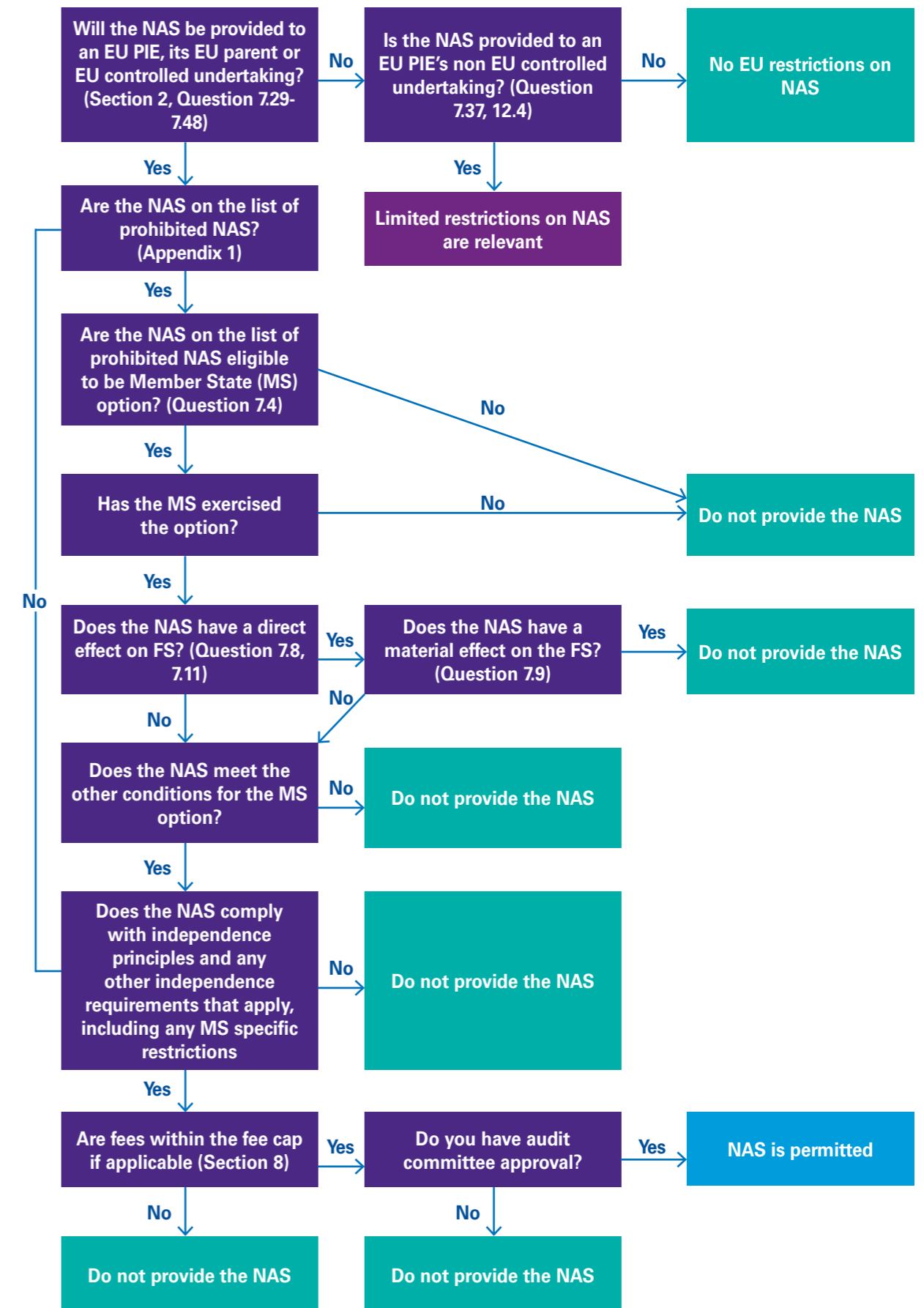
Mandatory Firm Rotation: Determining when a PIE must rotate under the transition rules

A6



* Subject to Member State interpretation.

NAS prohibitions



Group audits and access to working papers

A8

Reporting requirements in the Directive

Article 27 in the Directive addresses the statutory audits of consolidated financial statements (group audits) and includes a number of provisions regarding documentation and working papers of both the group and component auditors. The various provisions deal with a number of scenarios regarding how the group auditor and the competent authority may obtain access to the component auditor's working papers if and when considered necessary.

Our interpretation of how the requirements can be met are set out below.

- Article 27 collectively defines a logical and pragmatic approach to documentation of third-country auditors'/audit firms' work in a group audit.
- The documentation in the group audit file should focus on what is needed to demonstrate the group auditor's basis for the opinion on the group audit. As such it needs to provide a summary of the work performed by third-country auditors/audit firms and the group auditor's review and evaluation of that work. It is not necessary to have all of the detailed working papers of those auditors/audit firms. The Article recognises this.
- Compliance with ISA 600 should achieve compliance with the documentation required in the Article.
- The Article follows a pragmatic escalation process when additional access to third-country auditors'/audit firms' working papers is deemed necessary.
- Seeking that access through the respective competent authorities in the first instance is appropriate as it is working through agreed legal means.
- The Article implicitly acknowledges that the group auditor may not be able to obtain the necessary access for the competent authority when the competent authority is unable to obtain it directly, and addresses the documentation requirements in such circumstances.

Basis for the positions taken in the talking points

1.(a)

The group auditor is required to take full responsibility for the audit report and audit committee report.

This is consistent with ISA 600.

Appendix 8:

Group audits and access to working papers

	Summary of the Article 27 requirements	Interpretation and talking points			
1.(b)	<ul style="list-style-type: none"> The group auditor is required to evaluate the audit work of third-country auditors/audit firms for purposes of the group audit. The group auditor is required to document the nature, timing and extent of the work performed by those auditors, including the group auditor's review of relevant parts of those auditors' audit documentation. 	<ul style="list-style-type: none"> Compliance with the work effort and documentation requirements of ISA 600 are consistent with these requirements and provide an appropriate basis for compliance with them. Basis: ISA 600's documentation requirements are geared to ensuring that the group auditor's working papers include a sufficient description of the work performed by third-country auditors/audit firms to enable the relevant competent authority to understand the work of the group auditor and how the group auditor obtained sufficient appropriate audit evidence on which to base the group audit opinion. As later parts of Article 27 include provisions for seeking further access to the working papers of the third-country auditors/audit firms in particular circumstances, it is appropriate to conclude that this Article is seeking a description of the work performed rather than transfer of the underlying work papers. Therefore, compliance with the documentation requirements of ISA 600 should be sufficient to achieve compliance with the Article. 	1.(c)	<ul style="list-style-type: none"> The group auditor is required to review the audit work performed by third-country auditors/audit firms for the purpose of the group audit and document that review. For this purpose, the group auditor is required to request the agreement of the third-country auditors/audit firms to the transfer of "relevant documentation" during the conduct of the group audit, as a condition of reliance on their work. 	<ul style="list-style-type: none"> Compliance with ISA 600 should achieve compliance with this Article; the group auditor's instructions to third-country auditors/audit firms will need to include an explicit request regarding the transfer of "relevant documentation". Basis: The focus is on the group auditor's review of third-country auditors/audit firms "audit work". ISA 600 requires the group auditor to evaluate component auditor's communication, which is required to include confirmation that the component auditor has performed the work requested and the findings. The documentation requirements in ISA 600 include documentation of review of relevant parts of component auditor's documentation and conclusions. Therefore, compliance with ISA 600 should achieve compliance with this requirement. The group auditor will need to include an explicit request for third-country auditors/audit firms to agree to transfer "relevant documentation". ISA 600 requirements are designed to ensure the group audit working papers are sufficient to demonstrate the basis for the group audit opinion and, therefore, the communications required from component auditors should be considered "relevant documentation".

Appendix 8:

Group audits and access to working papers

2.

Where the group auditor is unable to comply with 27(1)(c):

- the group auditor takes appropriate measures, including carrying out additional audit work, either directly or by outsourcing the work, in the relevant subsidiary; and
- informs the relevant competent authority.

- **The proposed work effort is consistent with ISA 600**

- **Basis:** Under ISA 600 we are required to take appropriate measures to ensure that we are able to obtain sufficient appropriate evidence on which to base our opinion. We interpret this requirement to be consistent with ISA 600 where we will carry out additional work as need be.
- Although the wording is not entirely clear regarding when auditors would need to inform the relevant competent authority, we believe its intent is that the group auditor would communicate with the competent authority when the group is not able to obtain the necessary evidence through the additional measures. It would be unduly onerous, and unnecessary, for competent authorities to receive reports every time the group auditor decides it is necessary to perform further procedures.

3.

Where the group auditor is subject to a quality assurance review or an investigation concerning the group audit:

- Make available to the competent authority, when requested, the relevant documentation the group audit has regarding the audit work performed by the third-country auditors/audit firms for the purposes of the group audit, including any working papers relevant to the group audit.
- If the competent authority does not have a working arrangement with the third-country (and therefore cannot request the additional documentation needed from the relevant competent authority), the group auditor is required, when requested, to be responsible for ensuring proper delivery of the additional documentation of the audit work by the third party auditors or firms, including the working papers relevant to the group audit, by:
 - Retaining a copy of the documentation, or
 - Agreeing with the third-country auditors/audit firms that the group auditor is to be given unrestricted access to the documentation upon request, or
 - Take any other appropriate action.
- If the audit working papers cannot, for legal or other reasons, be passed from a third country to the group auditor, the group auditor's documentation needs to include evidence:
 - That the group auditor has undertaken appropriate procedures in order to gain access to the audit documentation and;
 - supporting the existence of the impediments if the impediments are other than legal ones (arising in legislation of the third-country).

- A group auditor will be able to transfer the relevant documentation they would have retained under ISA 600 to a competent authority.
- In instances where the competent authority requires additional documentation, the competent authority is required to first seek to obtain this information through working arrangements it has with the competent authority in the jurisdiction of the component auditor. This is an appropriate approach as the access is through legal means.
- In the event that such agreements do not exist, the obligation falls back to the group auditor. The requirements are practicable because they implicitly acknowledge that the group auditor may not be able to obtain them. Group auditors will need to document the steps taken and the legal impediment.
- We believe that on the basis that a competent authority will make a request, the potential need for access to working papers of a component auditor can be dealt with on a "upon request" basis to the component auditor firm.

Appendix 8:

Group audits and access to working papers

3. (contd.)

Based on the above requirements, component auditors will:

- Be asked to agree to transfer relevant documentation during the conduct of the group audit as a condition of reliance by the group
- Where the group auditor is subject to a quality assurance review or an investigation concerning the group audit, the component auditor needs - to be aware that:
 - The group auditor may be required to make available to the group auditor's competent authority any of the working papers or other documentation provided to the group auditor
 - The component auditor's competent authority may be asked to provide additional documentation on the component auditor's audit work to the group auditor's competent authority, as permitted under the Directive within Member States, or if the competent authorities have a working arrangement
 - Otherwise, the group auditor will be responsible for ensuring proper delivery of the additional documentation, either by:
 - Obtaining copies of the relevant documentation from the component auditor
 - Or, agreeing to give the group auditor unrestricted access to the working papers
 - If there are legal or other impediments to the group auditor's access, the group auditor will need evidence.

3. (contd.)

Where the group auditor is subject to a quality assurance review or an investigation concerning the group audit, the competent authority:

- May request additional documentation on the audit work performed from the relevant competent authorities, pursuant to Article 36 (Regulatory cooperation between Member States), or pursuant to working arrangements referred to in Article 47 (Cooperation with competent authorities from third countries).

- Additional requests will be subject to the same process as outlined above.

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