



Governance *in brief*

Changes to auditor independence rules

Headlines

- A timely reminder that audit committees need to take action now, if they haven't done so already, to review their policy on non-audit services provided by the auditor. For 31 December 2016 year ends, any revisions to the policy need to have been put in place by that date, and any newly prohibited services ceased by 1 January 2017.
- The FRC's changes relating to auditor independence include new prohibitions and restrictions on non-audit services. In addition, UK public interest entities (PIEs – for definition see below) and UK groups which contain an EEA PIE will be required to apply a 70% cap on non-audit services fees for the first financial period commencing on or after 17 June 2019 based on the three preceding years of audit fees.
- The non-audit services changes introduce a number of significant changes for UK PIEs and UK groups which contain an EEA PIE, which audit committees will need to reflect in their non-audit services policies:
 - There is a “cooling in” period required in respect of designing or implementing internal control over financial information or systems, and in respect of designing and implementing financial information technology systems. This applies for twelve months prior to the start of the financial year in which the auditor will provide its first audit and will require careful planning of tender processes.
 - Certain tax and most valuation services are no longer permitted. Where tax and valuation services are permitted, they may only be provided by the auditor if the service has “no direct or, in the view of an objective, reasonable and informed third party, would have an inconsequential effect, separately or in the aggregate on the audited financial statements.”
- There may be a challenge for groups containing multiple EEA PIEs operating in different member states in applying non-audit services restrictions, given a range of member state options. This is likely to affect banking and insurance in particular.

Background to the changes

This *Governance in brief* focuses on the changes to auditor independence rules in the new Ethical Standard. Part One, focusing on updates to the UK Corporate Governance Code and the Guidance on Audit Committees, is available at <http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-governance-in-brief-code-and-guidance-on-audit-committees-gib.pdf>.

In the UK, transitional arrangements relating to the required 10 year competitive audit tender and the 20 year audit rotation requirements were confirmed by BIS in 2015, explained in [Governance in brief: BIS clarifies timelines for the new mandatory rotation requirements](#). The Statutory Auditors and Third Country Auditors Regulations 2016, which formalise these arrangements for Companies Act companies and building societies, took effect from 17 June 2016. Legislation for entities other than companies will be finalised by the end of 2016.

The FRC has also confirmed that the new 70% cap on fees for non-audit services compared to the average statutory audit fee over the previous three years will apply from the fourth financial period commencing on or after 17 June 2019 – so for a calendar year end company, this will first apply throughout the year ending 31 December 2020 (see below for details). In the event of a change in auditor or an entity newly becoming a PIE, the mechanism of the cap is such that it will apply from the fourth financial year in which the new auditor acts or the entity is a PIE respectively.

The changes in EU law have been directly implemented in the UK by amendments to the Companies Act, which in turn gives legal force to the Revised Ethical Standard 2016. Accordingly, they will continue to apply even after the UK's exit from the EU.

Although this is a principles-based standard, there are still a lot of detailed rules.

Outcome of the consultation process

For those who are familiar with the content of the FRC consultation [Enhancing confidence in audit](#), the key changes relating to the Ethical Standard are included in the following table and examined in more detail below.

Ethical Standard for Auditors

- The Standard now applies to all audits, reporting accountant engagements and CASS reporting on client assets for financial services.
 - The methodology for calculating compliance with the 70% cap on non-audit fees has changed and a second test has also been introduced – more information is provided later in this *Governance in brief*.
 - Contingent fee tax engagements are banned outright for PIEs, larger listed entities and their significant affiliates.
 - Clarification of the restrictions on tax advocacy.
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FRC Ethical Standard for Auditors

There is now one FRC Ethical Standard for Auditors which now also covers the ethical standards for reporting accountants (previously ESRA) and CASS reporting on client assets for financial services. This is a principles-based standard, which nevertheless contains a lot of detailed rules. Auditors are required to consider the broad principles even if they think they have complied with all of the rules. In addition to changes relating to non-audit services detailed below, there are also changes for auditors relating to personal independence.

The changes described below apply to UK PIEs and to UK groups that contain an EEA PIE. A "PIE" is a public interest entity, defined in EU law as being an entity governed by Member State law with securities (debt or equity) admitted to trading on an EEA regulated market (including LSE Premium or Standard Listing, not AIM), a credit institution (bank or building society in UK terms) or insurance undertaking.

Companies incorporated outside the EU but listed on the main market of the London Stock Exchange will not, as a matter of law, be required to apply the EU PIE restrictions, but will need to consider investor attitudes to any decision to apply a different set of restrictions to non-audit services.

Audit committees should note that, although the position in the UK is becoming clearer, both regarding auditor rotation and non-audit services, this is not the case across all member states. The availability of member state options means that there are differences between legislation passed which could affect PIEs in the same group. Some member states have also retained minimum terms for auditor appointment from their existing legislation. This could cause particular problems for auditor rotation where groups with multiple PIEs aim to have the same audit network providing the audit service across the group.

There is also some uncertainty around which member state's legislation should be considered when determining whether non-audit services are permitted. The UK is applying its Ethical Standard to all UK PIEs and all UK groups containing EEA PIEs, however EEA subsidiaries and parents will also need to consider the local restrictions in their own member state and assess provision of non-audit services under both sets of regulations. Care will be needed in applying the Ethical Standard to multi-jurisdictional group situations.

Certain tax and most valuation services are no longer permitted.

Prohibited services

The FRC has adopted the EU "blacklist" of banned non-audit services which cannot be provided to EEA PIEs by their auditors. Incorporated in the final FRC restrictions are pre-existing prohibitions under UK standards, reinforcing the UK's desire to be seen as having leading standards of independence but allowing Audit Committees a degree of flexibility within certain regulatory constraints. There are no changes to the table provided in the Appendix to our 2015 [Governance in brief: FRC consultation: Implementation of EU Audit Regulation and Directive, CMA Order and other changes relevant to audit committees](#), which is reproduced in an Appendix to this publication and expanded to indicate the effect of the restrictions on SME listed entities and on private companies. Where audit firms need to comply with IESBA restrictions as part of their obligations as a member of a global audit network, exemptions available for SME listed entities may be of limited use in practice.

Certain tax and most valuation services are no longer permitted. Where tax and valuation services are permitted, they may only be provided by the auditor if they have "no direct or, in the view of an objective, reasonable and informed third party, would have an inconsequential effect, separately or in the aggregate on the audited financial statements," and, for the purposes of the statutory audit of the financial statements, the audit firm would not place significant reliance on the work.

There are some aspects of non-regulatory Reporting Accountant work for listed entities engaged in material acquisitions which need to be looked at carefully as they will count towards the 70% cap.

The bans on providing non-audit services commence at the start of the financial period being audited and last until the audit report is issued. There is a "cooling-in" required in respect of designing or implementing internal control or risk management procedures relating to the preparation and/or control of financial information or designing and implementing financial information technology systems. This applies for twelve months prior to the start of the financial year in which the auditor will provide its first audit – in practice, this means that such services would need to have ceased before the start of January 2016 for a calendar year end PIE.

The bans on providing non-audit services go beyond the end of the financial period until the audit report is issued.

For PIEs, larger listed entities and their significant affiliates (all listed entities with market capitalisation over €200 million), contingent fee tax engagements have been banned outright. This is an extension from the previous ban on those dependent on uncertain legal positions. There is a transition provision allowing those contingent tax fee engagements contracted for and in progress at 17 June 2016 to be completed.

Services provided to multiple parties or to syndicates

There are potentially complex independence issues where services are provided to multiple parties or to syndicates such as lending syndicates. There could end up being circumstances where no major professional services firm can be engaged.

Areas for interpretation

There is no explanation provided for certain terms in the new Ethical Standard. This means that it is possible that different audit networks or different audit committees could currently come to differing conclusions on what services can or cannot be provided and in which circumstances. These include 'clearly inconsequential', 'playing any part in management', 'indirectly providing a service'. Again, we expect a common interpretation and practice to emerge on these matters fairly quickly as audit committees and auditors form their views. The FRC has also recently released [Staff Guidance Note 02/2016](#) to support practitioners in reaching conclusions on the meaning of "playing any part in management or decision making".

Audit committees should consider which services are being provided by which audit firms in advance of planning a tender.

Key considerations – prohibited services

- Audit committees should consider which services are being provided by which audit firms in advance of planning a tender for non-audit services. The prohibitions and the 12-month "cooling-in" period for certain non-audit services could otherwise lead to restrictions of choice or potential delay in changing external auditor.
- Most of the restrictions are limited to EEA PIEs, or the EEA parent or subsidiary of an EEA PIE. Three of the restrictions (services that involve playing a part in the management or decision making of the audited entity, 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) apply to subsidiaries worldwide. When updating their non-audit services policy, audit committees should also consider how their policy will apply to subsidiaries outside Europe.
- The FRC has provided some clarification by rewording the restrictions around provision of restricted non-audit services such as valuations or certain tax services, which may now be permitted if they would have "no direct or, in the view of an objective, reasonable and informed third party, would have an inconsequential effect, separately or in the aggregate on the audited financial statements." We expect that a common interpretation will emerge in practice in due course, although the FRC has stated that, if there is doubt around whether a service is inconsequential, it is not inconsequential.
- In circumstances where services relating to a particular year could be provided after the audit in question has been completed, such as tax returns, it is unclear whether those would be considered to have no direct impact, and whether there is a difference in whether they could be provided if there is a planned audit firm rotation before the following audit.
- In this final version of the Ethical Standards, the FRC has clarified that it is not 'gold plating' the restrictions relating to tax advocacy and these do not prohibit an auditor from acting as an advisor for an entity in its dealings with HMRC, assisting with the provision of information and explanation of the technical basis for positions taken.

The “70% cap” on non-audit services

The EU audit regulation contains a 70% cap on non-audit fees for services provided to EEA PIEs, which applies for all non-audit services, including audit-related services, other than those services required by EU or national law. For example, an interim review is not normally required by law, although audit-related, and is therefore subject to the cap, whereas regulatory reporting to the PRA and FCA is required by law and therefore outside the scope of the cap.

The cap is based on comparing the average of three consecutive years of statutory audit fees to the non-audit fees for services in the fourth year. The three years of statutory audit fees for the initial calculation start with the year commencing on or after 17 June 2016 and the first calculation will be for the year commencing on or after 17 June 2019, unless boards and audit committees choose to implement the cap earlier.

The Ethical Standard includes two separate calculations that need to be performed, one an individual audit firm calculation, the other the audit firm network calculation.

Individual audit firm

The average of three consecutive years of audit fees paid to the individual audit firm for its audit of the EEA PIE and, where applicable, its parent and its subsidiaries, compared to fees for non-audit services paid to the individual audit firm in respect of the EEA PIE, its parent and its subsidiaries in the fourth year.

Audit firm network

The average of three consecutive years of audit fees paid to the audit firm and its entire network for audits of the EEA PIE and its subsidiaries, compared to fees for non-audit services paid to the audit firm and its entire network for non-audit services provided to the EEA PIE and its subsidiaries in the fourth year.

The EU audit regulation contains a 70% cap on non-audit fees for services provided to EEA PIEs, which applies for all non-audit services, including audit-related services, other than those services required by EU or national law.

Key considerations – 70% cap

- It is not always clear which services fall within the exemption for services required by EU or national law. It is worth bearing in mind that simply because work may be advised or required by an industry regulator does not mean it is pursuant to legislation – it will depend whether the industry regulator has statutory rights to require the work. Early discussion with the auditor is recommended for such services in order to avoid potential problems.
- For Reporting Accountants’ engagements (for listed entities making material acquisitions for example), the company’s preferred option is in many cases the statutory auditor, however, the cap may mean that PIEs are not able to use their auditors for certain aspects of Reporting Accountants’ work that are not pursuant to regulation, such as “long form” due diligence reports, report and comfort letters in respect of working capital and financial position and prospects and SAS 72 comfort letters to underwriters.

Further information

The FRC's 2016 UK Corporate Governance Code, Guidance on Audit Committees, Ethical Standard and International Standards on Auditing (UK), together with supporting material, are available at:

UK Corporate Governance Code 2016 - <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-April-2016.pdf>

Guidance on Audit Committees 2016 - [https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-\(2\).pdf](https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-(2).pdf)

Revised Auditing Standards 2016 - <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/2016-Auditing-Standards.aspx>

Revised Ethical Standard 2016 - <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/2016-Ethical-Standard.aspx>

The FRC has also put on its website a table of issues raised with the FRC, following discussion of the issues at the FRC's Audit Technical Advisory Group, and the first two of a series of guidance notes. These materials can be found at <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Staff-Guidance-Notes.aspx>

Deloitte View

- We welcome the finalisation of the 2016 UK Corporate Governance Code, the Ethical Standard and the International Standards on Auditing applicable in the UK in advance of the implementation date. We recognise this has been a challenging exercise and that not all member states have met the timetable.
- However, there is still work to be done on matters of interpretation and continued engagement between the FRC, companies and auditors will continue to be required to resolve these matters.
- There is an issue across Europe of lack of consistency in application, arising largely from member state options.
- It is particularly important that audit committees should engage early and thoroughly with these changes where there is an upcoming tender, as they may find that restrictions regarding "cooling in" periods for certain non-audit services could limit their choice of external auditor.

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Appendix – Additional detail on provision of non-audit services

Prohibited services

The list of prohibited services for UK PIEs or UK groups including an EEA PIE is set out in the following table. We also present the approach the FRC has taken to group situations, including where the subsidiary or parent of the PIE is based outside the European Economic Area (non-EEA). The table does not attempt to cover all pre-existing bans or restrictions and focuses on the changes under EU audit reform.

As confirmed in the FRC's [Staff Guidance Note 01/2016](#), provision of all of these services to non-EEA parents has not been changed and will still be considered on the basis of an assessment of the threat and whether appropriate safeguards can be implemented. This is a practical approach – companies tend to be able to tell their subsidiaries what to do (and hence who to buy services from), but cannot necessarily influence their parents. However, the services provided will still need to take into account the global 70% cap on non-audit services, once that comes into effect.

The FRC will allow those services in *italics* below (some, but not all, tax services plus valuations) if they have no direct effect, separately or in the aggregate on the audited financial statements or, in the view of an objective, reasonable and informed third party, would have an inconsequential effect on the audited financial statements. In order to take advantage of this derogation, the auditor must document the estimated effect of the service, explain this to the audit committee justifying how the principles of independence have been applied, and the auditor must not place significant reliance on these services as part of their audit.

The table also includes the position for SME listed entities and for private (unlisted) companies. Within the “threats and safeguards” approach for these entities, it is important to note that services such as valuations, which affect the figures reported in the financial statements, cannot be provided if they would both involve a significant degree of subjective judgement and have a material effect on the financial statements either separately or in aggregate.

Key:

No	Prohibited
Restricted	Prohibited unless no direct effect or an inconsequential effect in the view of an objective, reasonable and informed third party
T & S	"Threats and safeguards" approach

		Can be provided to:				
		EEA PIE, EEA parent of an EEA PIE, EEA subsidiary of an EEA PIE, listed entity that is not SME listed *	Non-EEA subsidiary of an EEA PIE	Non-EEA parent of an EEA PIE	SME listed entities *	Private (unlisted) companies **
A	Tax services – note that contingent fees for any tax services will also be prohibited				Note: Contingent fees not prohibited for SME listed entities	Note: Contingent fees not prohibited for private companies
	<i>preparation of tax forms</i>	Restricted	T & S	T & S	T & S	T & S
	payroll tax	No	T & S	T & S	No	T & S
	customs duties	No	T & S	T & S	No	T & S
	<i>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</i>	Restricted	T & S	T & S	Restricted	T & S
	<i>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</i>	Restricted	T & S	T & S	Restricted	T & S
	<i>calculation of direct and indirect tax and deferred tax</i>	Restricted	T & S	T & S	T & S	T & S
	<i>provision of tax advice</i>	Restricted	T & S	T & S	Restricted	T & S
B	services that involve playing any part in the management or decision-making of the audited entity	No	No	T & S	No	No
C	bookkeeping and preparing accounting records and financial statements	No	No	T & S	T & S	T & S
D	payroll services	No	T & S	T & S	No	T & S
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	No	No	T & S	No	T & S
F	valuation services , including valuations performed in connection with actuarial services or litigation support services	Restricted	T & S	T & S	T & S	T & S

Key:	No	Prohibited
	Restricted	Prohibited unless no direct effect or an inconsequential effect in the view of an objective, reasonable and informed third party
	T & S	"Threats and safeguards" approach

		Can be provided to:				
		EEA PIE, EEA parent of an EEA PIE, EEA subsidiary of an EEA PIE, listed entity that is not SME listed *	Non-EEA subsidiary of an EEA PIE	Non-EEA parent of an EEA PIE	SME listed entities *	Private (unlisted) companies **
G	legal services , with respect to					
	the provision of general counsel	No	T & S	T & S	No	No
	negotiating on behalf of the audited entity	No	T & S	T & S	T & S	T & S
	acting in an advocacy role in the resolution of litigation	No	T & S	T & S	T & S	T & S
H	services related to the audited entity's internal audit function	No	T & S	T & S	T & S	T & S
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	No	T & S	T & S	T & S There are further bans for certain restructuring services for distressed entities	T & S
J	promoting, dealing in, or underwriting shares in the audited entity	No	T & S	T & S	No	T & S
K	human resources services , with respect to					
	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 positions; or undertaking reference checks of candidates for such positions	No	T & S	T & S	T & S	T & S
	structuring the organisation design	No	T & S	T & S	No	T & S
	cost control	No	T & S	T & S	No	T & S

* The definition of SME listed entities can be found in the Ethical Standard (5.47). It includes entities with an average market capitalisation of less than €200 million, on the basis of year end quotes for the previous three calendar years, or entities with exclusively non-equity financial instruments where the nominal amount of those financial instruments issued and outstanding does not exceed €200 million and which also meet certain other size criteria. The market capitalisation criterion should allow many AIM companies to make use of the reliefs available. ***

** Companies with only a "technical listing" on an unregulated market - where the quoted or listed securities are in substance not freely transferable or cannot be freely traded - are treated as unlisted.

*** Many audit firms in the UK follow the IESBA standards which may require more stringent application of various restrictions and mean that reliefs available for SME listed entities may be of less use in practice.

Notes

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