WHITE PAPER

Global independence checks

Regulatory necessity or growth opportunity?

Executive summary

Every global accounting network must comply with well-established policies and procedures to ensure their auditors' independence. These regulatory and ethical requirements command a substantial level of financial and operational resources from all global networks. There is no way around this. Independence: Regulators demand it. Clients need it. Public expects it.

Independence regulations and procedures should not be viewed solely as cost centers. They also create significant revenue opportunities.

Nimble, entrepreneurial firms have a once-in-a-generation opportunity to take advantage of the coming shake-up in audit and non-audit services as accounting networks and their clients absorb the full consequences of the legislative changes.

Such firms will maneuver the highly regulated landscape by strategizing which clients to approach and what services to offer, and in the process, will increase their market share.

In short, properly managed independence processes are essential to the accounting network member firms' ability to attract and retain clients. When coordinated according to stated firm strategy, they will have a significant impact on network-wide revenue growth, profitability, and strategic pipeline development.

This paper will examine both the complexity and costs of the new regulatory landscape as well as the opportunities presented.

The new landscape

The new regulatory landscape presents complex challenges. Several recent regulatory regimes require member firms of global accounting networks to fully demonstrate independence not only in their own engagements, but also from the engagements of their fellow member firms throughout the world. The U.S. Securities and Exchange Commission's rules on network firms, for example, there are specific requirements on the extent and nature of audit work they can take on when the specific firm is part of a network. Other countries are in the process of considering independence requirements for global networks' member firms operating both within and outside of their borders.

An EU example:

The European Union's latest regulations are illustrative of the tremendous challenges global network accounting firms face. Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 creates complex issues for statutory auditors who must keep track of the fees received from and services rendered to their clients as well as their clients' global networks of subsidiaries.

The EU begins by classifying a new category of client for accounting firms: Public Interest Entities (PIEs.) These are:

(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 Council, 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/EEC; 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.

There are approximately 30,000 such entities in the EU, each of which requires the services of a statutory auditor. Auditors must now abide by regulations that include a "no-fly zone" of prohibited non-auditing services (NAS)--services that cannot be provided to a PIE by a firm also acting as its auditor. In addition, there are caps on fees that a statutory auditor or audit firm can earn from the audit of a single PIE client and caps on non-auditing service fees.

There are of course "permissible" non-audit services, such as those that can be rendered by a firm to a PIE while also auditing that PIE. However, the regulations recognize that "fee pressures" can be brought to bear by unscrupulous firms on auditors wishing to earn their business. In order to lessen this threat, statutory auditor or audit firms are disallowed from receiving fees for permissible non-auditing services that exceed 70% of the average audit fees paid in the last three consecutive financial years.

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, non-audit services 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% 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 instance, if statutory audit fees in Years 1, 2, and 3 are 100E, 200E, and 300E respectively, then fees for permissible non-auditing service in Year 4 are capped at 140E (70% of the average of those three years).

In addition, the regulations recognize that statutory audit firms or auditors can feel undue pressure to produce a favorable outcome for a client whose fees represent an overly large portion of their total fees from all clients. That is, if a firm receives 50% of its gross revenue from a single company, it bears to reason there could exist a temptation to create an unwarrantedly favorable audit. Regulations therefore call for statutory audit firms or auditors who receive in excess of 15% of their total fees over a three-year period from a single PIE to disclose that fact to the PIE's audit committee for review.

When the total fees received from a public-interest entity in each of the last three consecutive financial years are more than 15 percent of the total fees received by the statutory auditor or the audit firm or, where applicable, by the group auditor carrying out the statutory audit, in each of those financial years, such a statutory auditor or audit firm or, as the case may be, group auditor, shall disclose that fact to the audit committee and discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats. The audit committee shall consider whether the audit engagement should be subject to an engagement quality control review by another statutory auditor or audit firm prior to the issuance of the audit report.

Where the fees received from such a public-interest entity continue to exceed 15 percent of the total fees received by such a statutory auditor or audit firm or, as the case may be, by a group auditor carrying out the statutory audit, the audit committee shall decide on the basis of objective grounds whether the statutory auditor or the audit firm or the group auditor, of such an entity or group of entities may continue to carry out the statutory audit for an additional period which shall not, in any case, exceed two years.

The regulations apply to PIEs and their statutory auditors or audit firms within the 28 EU member states as well as Liechtenstein, Iceland, and Norway which are members of the European Economic Area.

These new EU regulations and in-the-works member state additions create a complex web that puts enormous logistical pressures to remain not just practically but legally independent.

Take ExampleCo, a Public Interest Entity. It is incorporated in France and audited by Firm X. It has three subsidiaries in different countries.

Example 1

Firm X is the legal auditor of the European PIE Example Company and its network and therefore:

- Cannot provide prohibited NAS to Example Company and Subsidiary A, located in the EU.
- Might be able to provide NAS to subsidiaries B and C as entities outside EU. Must comply with national laws and provide an assessment of whether their independence is compromised before providing non-audit services to B and C.
- Firm X (SP), auditor of Example Company, must report to the Audit Committee of Example Company on any threats to its independence.

Chain of command	Country of incorporation	Statutory auditor	Can firm X perform prohibited NAS
Example Company – Parent Undertaking (PIE)	Spain	Firm X (SP)	No
Subsidiary A (PIE/non-PIE)	France	Firm X (FR)	No
Subsidiary B, (PIE/non-PIE)	USA	Firm X (US)	Possible
Subsidiary C (PIE/non-PIE)	China	Firm X (CH)	Possible

Example 2

Example Company is registered in China and not audited by Firm X. It is the Parent Undertaking of A1 and B1. A1 controls A2 which controls A3. B1 controls B2 which controls B3 and therefore:

- Firm X cannot perform prohibited NAS to subsidiaries A1 and A2 as they are EU countries and Firm X is auditing A2, a PIE.
- Firm X may be able to perform prohibited NAS to B1 as it is not a PIE.
- Firm X may be able to perform prohibited NAS to B2 as its parent, B1, is not a PIE.
- In addition, prohibited NAS are possible to B1 and B2 because while A2 is a PIE, B1, B2, and B3 are only sister companies and not controlled by A2.
- Prohibited NAS are possible to A3, and B3 as non-EU companies, subject to national law.

Chain of command	Country of incorporation	Statutory auditor	Can firm X perform prohibited NAS?
Example Company – Parent Undertaking (PIE/non-PIE)	China	Not firm X	Yes
Subsidiary A1 (PIE/non-PIE)	Spain	Not firm X	No
Subsidiary A2 (PIE)	Italy	Firm X	No
Subsidiary A3 (PIE/non-PIE)	Mexico	Firm X (MX)	Possible
Subsidiary B1 (not a PIE)	Portugal	Firm X (PO)	Possible
Subsidiary B2 (PIE/non-PIE)	Greece	Not firm X	Possible
Subsidiary B3 (PIE/non-PIE)	China	Firm X (CH)	Possible

These are simple examples. In the real world, multinational corporations can have thousands of subsidiaries spread across the globe, creating tens of thousands of opportunities to lose business. Preparing the taxes for a small subsidiary in Reykjavik can make it impossible to accept a major audit client in Munich. It would be easy for these independence rules to nullify all the market power of a global brand by not coordinating the business development and business acceptance activities of member firms in the network.

Navigating the new landscape

Exacerbating the difficulties posed by the expanded EU regulations and other nations, many statutory auditors and audit firms still rely on "carrier-pigeon solutions." Independence management is often Excel-based and administered by hand.

Phone calls are made and emails are sent back and forth to partners whose billable hours are far better spent generating new business than answering questions on independence.

Further, these old-fashioned solutions are highly susceptible to input error, user error, and simple greed. Inadvertently passing along information that causes the loss of a potential client is a very real risk inherent to these manual processes.

While EU regulations do not specify the nuts and bolts of safeguarding independence, they are firm in their call to create a robust system to do so.

Statutory auditors and audit firms should establish appropriate internal policies and procedures in relation to employees and other persons involved in the statutory audit activity within their organisations, in order to ensure compliance with their statutory obligations. Those policies and procedures should in particular seek to prevent and address any threats to independence and should ensure the quality, integrity and thoroughness of the statutory audit. Those policies and procedures should be proportionate, in the view of the scale and complexity of the business of the statutory auditor or the audit firm.

The solution: Centralized clearance checking

The future of conflict management and independence is a single, searchable set of data and supporting workflows—a global independence solution that contains the firm's network of relationships and constantly crosschecks them against an ever-growing matrix of regulations, client data, corporate tree providers, private equity data, sanction lists, business development targets, and financial information.

External data is added automatically, aggregating content from providers such as Dun & Bradstreet, Pitchbook, World Check, Audit Analytics, DNBi as well as from EU and individual member state directives.

All members of a statutory audit firm's network and its subsidiaries provide data pertinent to independence checks that is automatically aggregated into a global independence solution. This includes data generated by Salesforce, Microsoft Dynamics, and on legacy platform such as Excel. In return, all members of the network have access to a common set of data and tracked workflows—both desktop and mobile versions—and thus instant information to guide them in expanding clientele.

Not just a cost center: Global independence can be optimized for revenue maximization

The ability to automatically update data and utilize consistent, enforceable workflows will significantly lessen the prospect of costly errors. A single regulatory fine can cost millions of dollars; a pattern of fines will cause customers to choose a competitor.

In addition, extending and maintaining a bespoke software system can be extremely costly and unpredictable. Turnover of principal engineering staff and project owners can lead to loss of knowledge and greatly extend time for fixes and needed features. An automated global independence solution will reduce these internal costs by ensuring that the system is "future-proof." As the firm grows and regulatory requirements evolve, it will provide the ability to quickly modify processes without the need for custom programming and management of IT infrastructure.

By far the most important benefit of an automated global independence solution to audit independence issues is that it takes advantage of the opportunities presented by what could be seen as onerous new regulations.

Small tax or payroll work for a PIE's subsidiary by an audit firm can cost its sister firm millions by making it ineligible for audit work for the PIE parent company. By effectively managing restricted entities and strategic business targets, the firm can avoid situations in which business conflicts result in lost business opportunities.

In the example on the previous page:

“Preparing the taxes for a small subsidiary in Reykjavik can make it impossible to accept a major audit client in Munich.”

A global independence solution system would more readily enable a situation in which the Munich firm could “horse trade” with the Rejkjavik firm, cutting them in on the larger Munich deal in return for them not pursuing their local client.

A firm’s network-wide revenue can be grown by proactively choosing which clients/subsidiaries/parent corporations will produce the optimal mix of revenue and growth opportunities. A successfully implemented and consistent independence checking system will give a firm greater insight into deal and project pipelines so that revenue maximizing choices can be made in a deliberate and coordinated manner.

Whitelist

Definition:
Always allow these types of clients, specific companies, or types of engagements.

Example:
A firm emphasizing its competitive advantage and knowledge in a particular industry segment could choose to always allow any member firm to accept audit work for that specific industry, while disallowing prohibited, non-audit work in order to proactively build revenue and expertise in the segment.

Blacklist

Definition:
Never allow a certain company in identified types of service lines.

Example:
A partner has confirmed that a large public interest entity client will be putting its audit up for bid in two years Therefore, all member firms will be prevented from taking payroll, tax, or other non-audit work during the EU mandated two-year “cooling off” period so that the firm will be eligible to bid on the audit work.

Greylist

Definition:
Business development and client onboarding held for human moderation and committee discussion/approval.

Example:
A medium-sized member firm wants to perform the tax work for a large public interest entity or U.S. Fortune 500 company. However, a larger member firm believes such an engagement will jeopardize their ability to win large-scale audit work with the same PIE/Fortune 500 company. A dispute resolution process is kicked off via the software independence checking program. Early pipeline visibility and advance warning give all member firms involved adequate runway to present their best business cases.

Finally, the new regulations will be a boon to mid-size statutory audit firms and auditors who will find additional growth opportunities to secure the audit and non-audit services of European public interest entities. By creating blacklists and restricted lists within the global independence system, firms will be able to strategically target these sectors by ensuring no member firm takes on clients or services that might prevent the securing of strategic accounts.

The last decades have seen a worldwide explosion of data. It is exhilarating, empowering, and progressively more difficult to handle. Accompanying this information overload, though, have been aggressive advances in client management such as a global independence system.

Firms with data at their core need to be nimble to survive and prosper. Those who aren’t will find themselves mired in tar like the dinosaurs and slowly disappear.