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How will the EU Auditor Independence Reform impact the European tax services market?

Jakob Bundgaard (CORIT advisory) · Tuesday, July 21st, 2015

The 2010 Green Paper from the EU Commission led to significant amendments to the EU Auditor regulation (see 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 and repealing Commission Decision 2005/909/EC). One such amendment is a ban against provision of tax services from the auditor firm to the firms being audited.

We are approaching the effective date of the amended Regulation, which is 17 June 2016. For good reasons, the full effect of the amendments remains yet to be seen. EU Member States shall make some crucial decisions on the actual scope of the Regulation within their domestic legislation (even if the Regulation as such does not need implementation). This post addresses some of the possible effects on the European tax services market of the EU auditor reform.

The purpose of the amendment is stated in the relevant sections of the preamble, where the following is said:

(8) The provision of certain services other than statutory audit (non-audit services) to audited entities by statutory auditors, audit firms or members of their networks may compromise their independence. Therefore, it is appropriate to prohibit the provision of certain non-audit services such as specific tax, consultancy and advisory services to the audited entity, to its parent undertaking and to its controlled undertakings within the Union. 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. 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.

Let’s have a look at the ban on non-audit services found in article 5 of the amended Regulation. According to this provision a statutory auditor or an audit firm carrying out the statutory audit of a public-interest entity (PIE), 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 non-audit services.

For the purposes of this Article, prohibited non-audit services 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;

In addition Member States may prohibit services other than those listed above where they consider that those services represent a threat to independence.

Based on the wording the ban seems rather broad and in particular with respect to no. (vii) regarding provision of tax advice. Viewed on a stand-alone basis the ban would likely have a significant impact on the services which the auditor of the firm is able to provide to the company being audited.

But the amendments were not as ambitious as originally intended. Consequently, on the other hand, Member States may according to the provision allow the services referred to above provided that certain requirements are complied with.

The reasoning is explained in the Preamble:

(9) It should be possible for Member States to decide to allow the statutory auditors and the audit firms to provide certain tax and valuation services when such services are immaterial or have no direct effect, separately or in the aggregate, on the audited financial statements. Where such services involve aggressive tax planning, they should not be considered as immaterial. Accordingly, a statutory auditor or an audit firm should not provide such services to the audited entity. A statutory auditor or an audit firm should be able to provide non-audit services which are not prohibited under this Regulation, if the provision of those services has been approved in advance by the audit committee and if the statutory auditor or the audit firm has satisfied itself that provision of those services does not pose a threat to the independence of the statutory auditor or the audit firm that cannot be reduced to an acceptable level by the application of safeguards.

The requirements according to the provision are the following:

(a) they have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements;

(b) the estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee referred to in Article 11; and

(c) the principles of independence laid down in Directive 2006/43/EC are complied with by the statutory auditor or the audit firm.

An audit firm carrying out statutory audits of PIEs, may provide to the audited entity non-audit services other than the prohibited non-audit services referred to above subject to the approval of the audit committee after it has properly assessed threats to independence and the safeguards applied in accordance with Article 22b of Directive 2006/43/EC. The audit committee shall, where applicable, issue guidelines with regard to the services referred to.

Against this background certain issues needs clarification to assess the full impact of the EU Auditor reform.

As it is seen immaterial effect cannot exist in situations involving aggressive tax planning. i.e. the auditor cannot assist in matters concerning aggressive tax planning. As a consequence it is crucial to understand how aggressive tax planning is defined in this respect. Aggressive tax planning is not a legal term and is not specifically defined in any legal text. However, the EU Commission has defined aggressive tax planning in its 2012 Action plan on the topic (Communication from the Commission to the European Parliament and the Council: An Action Plan to strengthen the fight against tax fraud and tax evasion, COM(2012) 722 final). The following definition is used:

“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. 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)”.

It is expected that this definition will also be used in the context of the EU Auditor Regulation. Aggressive tax planning according to this definition may include tax structuring, which would not normally be considered aggressive within the industry, e.g. traditional debt push down structures and hybrid mismatch arrangements. Moreover, it is expected that the term should be interpreted in light of the ECJ case law on abusive practices.

The full impact of the EU auditor reform on the European tax services market rely on the outcomes of the Member State options which are included on the Regulation:

- The threshold for being a PIE, i.e. the number of companies included?
- Whether services are added to the list of banned services?
- Whether specified tax services are excluded from the list of banned services (subject to the above requirements)?

Ceteris paribus the reform should affect the tax services market place within the EU. In total it is still early to make any conclusions on the actual effect on the European market on tax

services. The magnitude obviously depends on the actions taken by EU member states to determine PIE and to determine the actual tax services covered by the ban.

In my practical experience several MNEs are already preparing themselves for the changes, even before the full scope is known. This is seen by an increasing number of tenders being called for. Consequently, the likelihood of a diminished dependency on the auditor may in fact increase. MNEs seem to have been using several service providers for some time already, depending on the competencies of the service provider on a case-by-case or topic-by-topic approach. The EU Auditor reform may further increase this tendency.

As a final note the EU auditor reform may also have a bearing on another parallel tendency in international business. It appears to be a well known fact that taxes are becoming increasingly important from a governance and risk management perspective. With a popular expression taxes have “moved into the board rooms” and have now obtained the attention of top management. It is a likely consequence of the EU auditor reform that this tendency is even further strengthened, also in light of the increased responsibility of the audit committees.

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