

STAFF GUIDANCE NOTE 01/2018

THE AUDITOR'S PROVISION OF RESTRUCTURING SERVICES TO PUBLIC INTEREST ENTITY PARTICIPANTS IN BANK LENDING OR BOND FUNDED SYNDICATES

Introduction

1. This staff guidance note sets out the FRC's guidance in respect of "*restructuring services*" provided by auditors to bank lending or bond funded syndicates ("*lending syndicates*") in which one or more Public Interest Entities (PIEs) audited by the auditor participate ("*participating PIE*"). It sets out the FRC's consideration of the application in practice of the main, relevant requirements in the EU Audit Regulation and the FRC's Ethical Standard.
2. This is a complex area, and the FRC has developed this guidance after careful consideration. It is important that in applying this guidance, auditors keep in mind that the compliance and ethical assessments they need to make require the exercise of careful judgement. In making an assessment, the auditor draws on their own experience and understanding of the services to be provided and of the participating entities, but ultimately reflects on how an objective, reasonable and informed third party¹ would view matters. Auditors should ensure that they document clearly: the basis for the assessment they carry out; the factors that they considered; and the conclusions that they have drawn as a result.
3. The auditor needs to consider whether a (non-audit) service is provided to the PIE (paragraph 4); whether any service is prohibited (paragraphs 5-7); threats to auditor independence (paragraphs 8-11); approval of the services (paragraphs 12-15); and the application of the non-audit services fee cap (paragraphs 15-16).

To whom are the restructuring services provided?

4. Determining whether the restructuring services provided to a lending syndicate, are in fact provided to each of the participant PIEs requires the careful application of judgment to the specific facts and circumstances. The FRC is aware of a number of potential indicators which the auditor and the participating PIE audit committee use as a suitable proxy to assess to whom the restructuring services are provided. These indicators include whether an entity:
 - is party to an engagement;
 - has signed a letter of engagement;
 - is an addressee of the report produced by the auditor/ audit firm;
 - owns a significant amount of the total debt that will be the subject of the restructuring services;

¹ See paragraphs I14 and I15 of the introduction to the FRC Ethical Standard.

- exerts significant influence over the lending syndicate (e.g. by virtue of being a member of the steering committee, and/ or influencing appointment of the provider of services to the syndicate);
- pays for the restructuring services, although the payment of the fee by the borrower (as is often the case for such services) is not prima facie evidence that an entity is not receiving a service; and
- is owed a duty of care by the auditor providing the restructuring services, noting that this may apply even where that entity is not party to an engagement letter.

Are restructuring services prohibited?

5. In cases where it is judged that the PIE would be being provided with the restructuring services, the auditor ensures that the provision of services to the syndicate does not include any element of a prohibited service.

6. **Article 5.1** of the EU Audit Regulation (as set out in paragraphs **5.167R** and **5.168R** of the FRC Ethical Standard) states that:

“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 non-audit services.....”.

7. Based on our understanding of the market for such services, our conclusion is that there is no general prohibition, in principle, of the provision of such restructuring services to a participating PIE. However careful judgment is **always** required when considering the particular circumstances.

Threats to independence

8. The auditor carries out an assessment to determine whether providing restructuring services to the PIE would pose a risk to independence. **In doing so, the auditor needs to consider how the provision of such a service would be viewed by an objective, reasonable and informed third party. If such a third party would be likely to conclude that the actual or perceived independence of the auditor would be affected, then the auditor should not accept the engagement.**

9. To avoid certain potential threats to independence, appropriate engagement conditions that should exist and that the engagement letter issued by the auditor for each restructuring services engagement provided to a participating PIE should incorporate, include that:

- The auditor’s role is advisory only;
- The loan conditions are set by the lead lending institution;
- The restructuring services cannot be tailored for the specific participating PIE;
- The loan is managed by the syndicate which will also negotiate final terms and conditions with the debtor²; and
- The auditor has no authority to bind or transact for the lending institution.

² Noting that when acting for a syndicate the service provider may be used to communicate options for terms and conditions from participants, however, this cannot bind the participants.

10. Other factors that should be taken into account when assessing the impact of providing restructuring services on the perceived independence of the auditor include whether the participating PIE is in a position to exert significant influence over the appointment of the auditor to provide the restructuring services. This can happen where a participant PIE acts either as the agent or a member of the steering committee of a lending syndicate or is able to exert significant influence by virtue of its share of the debt held.³
11. We believe the consideration of risks to independence outlined above to be consistent with the approach taken by other international regulators in similar circumstances.

Approval of services

12. The auditor will also need to determine what approvals are necessary, and from whom, to be able to provide restructuring services to the participating PIE. Where the service being provided is trivial, it can be approved through a standing procedure established by the PIE's audit committee. Where the service provided is not trivial, specific pre-approval by the PIE's audit committee is required.
13. In making an assessment, on a case by case basis, of whether or not the restructuring services to be provided are trivial, the primary consideration will be whether the fee for the service provided is trivial in the context of the PIE's financial statements. Triviality will be a matter for the judgment of the auditor, and of the audit committee, in both quantitative and qualitative terms.⁴
14. There is no basis set out in law as to how to assess the quantum of fees for the restructuring services attributable to a participating PIE. Existing market practice suggests that where non-audit fee disclosures are given the bases used include:
 - the proportion of the total fee for the restructuring services provided to the lending syndicate as a whole is pro-rated to reflect the percentage of the syndicate's debt held by the participating PIE;
 - the actual payments made, or agreed to be made, for the restructuring services either by the lending syndicate as a whole or by the participating PIE.
15. Where the provision of the restructuring services is approved through a standing procedure, work may then be carried out up to the value of that standing approval (subject to the application of the non-audit services fee cap, as explained below). If subsequent changes to the cost and/or scope of restructuring services cause the fees to exceed this pre-approval threshold, the auditor needs to gain prior approval, from the audit committee, to allow the services to continue to be provided.

³ A rule of thumb that a holding of more than 20 per cent will be considered to give rise to significant influence may be helpfully adopted.

⁴ PIE audit committees have told us that they also consider a range of broader measures including their assessment of the auditor's approach to the provision of non-audit services; and the scale of the PIE's participation in the syndicate.

The non-audit services fee cap

16. The EU Audit Regulation and the FRC's Ethical Standard (see Appendix 1) set out a non-audit services fee cap applicable to PIEs.
17. Where the audit committee has determined that a service received is trivial, then the committee's standing procedures may suggest that a standard 'deemed' amount be used for the value of the service provided for the purposes of monitoring against the non-audit services fee cap. This deemed amount should be consistent with the audit committee's assessment of what is trivial for the purposes of being approved through a standing procedure.

Impact of syndicate changes

18. In reality, lending syndicates operate with a flexible membership and the share of debt held by each participant is subject to ongoing change. If such a change arises after the provision of the restructuring services has commenced, that results, for example, in a change in the nature or circumstances of the engagement, such that an objective, reasonable and informed third party would consider the changed circumstances poses a threat to independence, then the auditor should take necessary steps to respond appropriately, (having also satisfied themselves that any change to the nature and circumstances has not resulted in the inclusion of any additional services that are prohibited). Our expectation is that the auditor should review the basis of the assessment of the quantum of fees and also reconsider whether a service needs formal prior approval rather than standing approval at least:

- when there is a material change⁵ in the agreed scope of the engagement;
- when there is a material change⁵ in the agreed fee for the service;
- when the PIE changes its participation to the extent that it becomes able to exert significant influence over the syndicate;
- where work done under a standing authority will breach the fee level of that authority;
- where any other event or circumstance occurs, which has an impact on how an objective reasonable and informed third party would consider the independence of the auditor providing the services.

The impact of recusal

19. We have been asked to clarify what might happen where a participating PIE recuses itself from restructuring discussions that are subject to the engagement. This does not *automatically* lift the requirement for non-audit services to be approved and monitored as set out earlier in this note. Although a participating PIE that has exercised such recusal might consider that it no longer derives benefit from the engagement, the views of an objective, reasonable and informed third party need ultimately to be the basis for the auditor's assessment, as such a party might conclude that a participant continues to benefit from the work of the auditor that is provided in bringing the engagement to a conclusion.

⁵ In the context of that engagement and the fee for that engagement.

Knowledge to make an assessment of risks to independence

20. If a transaction is funded by way of bonds issued on the financial markets, the auditor may only know the identity of those bondholders they are engaged by, and not the full population of bondholders. In certain circumstances, an auditor may also not know the identity of all participants in a lending syndicate (and an objective, reasonable and informed third party might also conclude that an auditor might not be expected to have such information available to them). Where this is the case, there is still a requirement for the auditor to ensure that they are independent to undertake an engagement. The auditor makes their assessment of their independence and the effectiveness of any applicable safeguards in a way that reflects the actual knowledge the auditor has about the participants in a syndicate, and in a way that is proportionate to that syndicate and those able to control it (Paragraphs **1.61**, **1.64** and **1.67** of the FRC Ethical Standard refer). Actual knowledge will be informed by factors including the auditor's knowledge of the parties to the engagement, and any public statements made by large institutional investors and asset owners on investments they might have made in any such transaction.
21. **The FRC intends that this staff guidance note provides a basis for considering how requirements are interpreted for restructuring transactions funded through bank lending syndicates or a bond issue. This guidance note applies in respect of all syndicate related engagements commencing on or after 1 April 2018.**

Appendix 1

FRC Ethical Standard – Non-Audit Services Cap

4.34R When the ~~statutory auditor or the~~ audit firm, or a member of its network, provides to the ~~audited~~ a public interest entity that it audits, 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)⁴³ of ~~this~~ the EU Audit Regulation:

- (a) the total fees for such services provided to the audited entity and its controlled undertakings 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 ~~of its parent undertaking~~, of its controlled undertakings and of the consolidated financial statements of that group of undertakings; and
- (b) the total fees for such services provided by the audit firm shall be limited to no more than 70% of the average of the fees paid to the audit firm in the last three consecutive financial years⁴⁴ 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. [AR 4.2]

4.35R For the purposes of the limits specified in ~~the first subparagraph~~ paragraph 4.34R, non-audit services, other than those referred to in Article 5(1) of the EU Audit Regulation, required by Union or national legislation shall be excluded. [AR 4.2]

⁴³ See paragraph 5.167R of Section 5 of Part B of this Ethical Standard.

⁴⁴ This requirement does not apply retrospectively. The cap is based on the average audit fees for the three consecutive financial periods commencing on or after 17 June 2016. Following the appointment of a new auditor after that date the cap will apply from the fourth financial period of that engagement