

IMPLEMENTATION GUIDANCE

1. Transitional Provisions

The Ethical Standard has an effective date of 15 March 2020, with transitional provisions for engagements relating to the audit of earlier financial periods, and for non-audit or audit-related services, for which an engagement letter has been agreed and for which work is already underway prior to the effective date, to be completed in accordance with the terms of the original engagement letter.

We have been asked to clarify the status of non-audit or audit-related services which have not been engaged for or started prior to 15 March 2020, but which relate to a financial period which commences prior to 15 March 2020. In those circumstances, our view is that an objective reasonable and informed third party is likely to conclude that it is probable the auditor's independence would be compromised as a result of the provision of services not included in the list of permitted services, and thus it would be inappropriate to enter into an engagement for such services.

2. Other Entities of Public Interest

An Other Entity of Public Interest (OEPI) is defined in the Glossary of Terms. Large private companies in sub-paragraph (d) refers to those covered by the criteria in Part 8, paragraph 23(3) of The Companies (Miscellaneous Reporting) Regulations 2018 (SI/2018/860). The definition excludes fund management entities¹ contained within a private equity or venture capital limited partnership structure.

The auditor of a portfolio company held by a private equity or venture capital fund that meets the definition of an OEPI, may only provide non-audit or audit-related services to that entity which are included on the list of permitted services in paragraph 5.40 of the Ethical Standard.

The same requirement applies to any controlled undertakings held by that entity and to its UK parent. Given the exclusion of fund management entities from the definition, the requirement in respect of providing services to the UK parent applies to services in respect of, or relevant to the OEPI itself, or its subject matter. Other services provided to the UK parent by the OEPI auditor can only be provided after the audit firm has undertaken an assessment of threats to independence and applied any necessary safeguards to address this.

¹ The advisor, the general partner, the fund manager and the fund itself.

3. Entities that are subject to the governance requirements of The Companies (Miscellaneous Reporting) Regulations 2018 (SI/2018/860) by reference to the most recent set of audited financial statements

The governance requirements of The Companies (Miscellaneous Reporting) Regulations 2018 (SI/2018/860) ('The Regulations') do not apply to certain types of entity, for example LLPs, or to companies which are subject to the Small Companies and Groups (Accounts and Director's Report) Regulations 2008 (SI 2008/409). These entities therefore do not meet the criteria to be classified as OEPIs, nor do those entities which choose to voluntarily comply with the governance requirements of The Regulations. In the context of a group, the criteria to determine whether an entity is an OEPI are to be applied at the level of each individual statutory entity, rather than with reference to consolidated group accounts.

The Regulations also include a 'two year rule' (except in an entity's first financial year), which requires the entity to meet the thresholds for number of employees and/or turnover and size of balance sheet for two consecutive financial periods before being subject to the relevant governance requirements. The sole criteria relevant to the assessment of whether a relevant entity is an OEPI is with reference to the most recent set of audited financial statements. The 'two-year rule' is therefore not relevant to this determination.

When an entity ceases to meet the relevant criteria to be classified as an OEPI, again with reference to the most recent set of audited financial statements, then the requirements of paragraph 5.40 of the Ethical Standard are no longer applicable for the audit of the next financial year commencing after the date of the publication of those financial statements and the auditor's report.

4. Government owned OEPIs

The ultimate parent undertakings of some OEPIs are central government bodies. Central government bodies in the UK are generally not included within the definition of either Public Interest Entities (PIEs) or OEPIs. Therefore, in the same way as the requirements apply to fund management entities contained within a private equity or venture capital limited partnership structure, the requirement in respect of providing services to the UK parent applies to services in respect of, or relevant to the OEPI itself, or its subject matter.

Other services provided to the UK parent by the OEPI auditor can only be provided after the audit firm has undertaken an assessment of threats to independence and applied any necessary safeguards to address this.

5. AIM listed entities

AIM listed entities are only classified as OEPIs where they exceed the threshold to be an SME listed entity as calculated using the definition in the FRC's *Glossary of Terms (Auditing and Ethics)* (2019):

SME listed entity—

(a) An entity whose equity financial instruments had an average market capitalisation of less than €200m on the basis of year end quotes for the previous three calendar years; or

(b) An entity that issues exclusively non-equity financial instruments if:

- (i) The total nominal amount of the non-equity financial instruments issued and outstanding does not exceed €200m; or*
- (ii) According to the last annual or consolidated accounts, meets at least two of the following criteria:*
 - An average number of employee during the financial year of less than 250;*
 - A total balance sheet not exceeding €43m;*
 - An annual net turnover not exceeding €50m.*

An entity whose equity financial instruments have been admitted to trading for less than three years shall be deemed an SME if its market capitalisation is below €200m based on:

(a) The closing share price of the first day of trading, if its shares have been admitted to trading for less than one year;

(b) The last closing share price of the first year of trading, if its financial instruments have been admitted to trading for more than one year but less than two years; or

(c) The average of the last closing share prices of each of the first two years of trading, if its financial instruments have been admitted to trading for more than two years but less than three years

In the same way as audited entities can move in and out of the definition for an SME listed entity, they can move in and out of the OEPI definition on the basis of the criteria set out above.

6. Private Sector Pension Schemes

We have been asked to clarify the meaning of certain terms used in the OEPI criteria as they relate to Private Sector Pension Schemes:

Members:

All members should be considered as part of the relevant criteria, except for dependents, until such time as those dependents are in receipt of benefits from the scheme on the death of a member.

Assets:

The term 'assets' refers to 'total net assets' available to members (as so defined under paragraph 3.9.2 of the 2018 Pensions SORP). This would be in the aggregate for all DB/Defined Contribution (DC) sections in a hybrid arrangement.

Paragraph 5.40 of the Ethical Standard sets out the non-audit services that audit firms (and firms in their networks) are permitted to provide when carrying out statutory audits of OEPIs. This list of permitted services extends to those provided to the audited entity, its UK parent undertaking or its worldwide controlled undertakings. In the case of Private Sector Pension schemes, we do not consider sponsoring employers to fall within the intended definition of 'parent undertaking'. Similarly, Pension Schemes are not considered to be 'controlled undertakings' of sponsoring employers which fall within the definition of an OEPI.

The auditor of an OEPI pension scheme is nevertheless not permitted to provide non-audit services to the sponsoring employer where they relate to the management of pension scheme assets, liabilities or funding, or to the subject matter of the pension scheme where they involve judgements about asset or liability valuations. This is on the basis that an objective, reasonable and informed third party would consider such services to compromise independence, as set out in para 115.

7. Lloyds Syndicates

Where capital is being provided by corporate members, audit firms will need to exercise judgement when assessing whether a Lloyds Syndicate has a 'parent undertaking' for the purpose of applying the OEPI non audit service rules.² This assessment will be informed by factors such as the degree of alignment between a corporate member and the Syndicate – for example where one corporate member is providing 100% of the capital for a Syndicate.

8. OEPI – Transitional Arrangements

The new requirements for OEPIs come into effect for the audit of financial periods beginning on or after 15 December 2020. Engagements for the provision of non-audit services, where a letter of engagement has been entered into, and where work has commenced prior to that date may be completed in accordance with the original terms.

² Managing agents would not be considered a 'parent undertaking' of a Lloyd's Syndicate.

Except for the circumstances set out below, firms should not enter into new non-audit services engagements which would not be permitted under the OEPI requirements after that date, even where that service would be provided in the period between 15 December 2020 and the start of the entity's next financial period. Consistent with our overall approach to the implementation of the revised Ethical Standards, our view is that an objective reasonable and informed third party might conclude that it is probable that the auditor's independence would be compromised as a result of the provision of such non-permissible services.

Where an audit firm has given or received a binding notification or clear written communication from those charged with governance that it will not conduct the statutory audit of the next financial reporting period starting on or after 15 December 2020, then the extended prohibitions described above do not apply.

9. Tendering and Rotation

OEPIs are not required to tender and rotate their auditors. As part of the transitional arrangements audit firms and OEPIs are reminded that they should avoid creating the need for companies to tender for the provision of audit services during the current Covid-19 pandemic.

Entities and their auditors are reminded that the OEPI requirements are limited to the list of permitted non-audit services. The 70% fee cap and prior approval of such services by those charged with governance does not apply.

Financial Reporting Council

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Appendix 1: Example Implementation for a large private company

Financial Year Ending	OEPI criteria met	Audited Financial Statements Published	Relevant financial reporting period OEPI non-audit service rules apply ³	Relevant financial reporting period from which OEPI non-audit service rules no longer apply
31 st December 2019	Y	June 2020	1 January – 31 December 2021	
31 st December 2020	N	June 2021		1 January 2022 - 31 st December 2022
31 st December 2021	Y	June 2022	1 January 2023 – 31 st December 2023	
31 st December 2022	Y	June 2023	1 January 2024 – 31 st December 2024	

³ Note section 7 above for transitional arrangements for in the first year these new provisions become effective.

Appendix 2: Example where publication of accounts is delayed

Financial Year Ending	OEPI criteria met per financial statements	Other Events	Audited Financial Statements Published	Relevant financial reporting period OEPI non-audit service rules apply ⁴	Relevant financial reporting period from which OEPI non-audit service rules no longer apply
31 st December 2019	Y	July 2020 redundancy programme reduces employees to below the 2000 threshold	September 2020 (ie for FY ending 31/12/19, when OEPI criteria were still met) ⁵	1 January – 31 December 2021	
31 st December 2020	N		January 2022 (delayed)	The entity continues to be classified as an OEPI for the period 1 January – 31 st December 2022 based on the most recent published financial statements for the year ended 31 st December 2019.	
31 st December 2021	N		June 2022		1 January - 31 st December 2023

⁴ Note section 7 above for transitional arrangements for in the first year these new provisions become effective.

⁵ In this example the relevant basis for assessing whether OEPI criteria are met remains the most recent published set of audited financial statements.