

Public Interest Entities

Background

This agenda paper sets out the Task Force's views as to:

- whether additional auditor independence requirements currently applied to listed entities should also be applied to other public interest entities (PIEs); and
- what entities should properly be regarded as PIEs for the purposes of the auditor independence guidance.

Application of listed entity requirements to other PIEs

The rationale for applying differential requirements to listed entities is in terms of the perceived threats to independence, actual threats being addressed by the core requirements applicable to all audits. Listed entities have a much higher visibility and a wider range of stakeholders than privately owned entities, and it is more difficult to communicate on a direct basis to deal with perception concerns. The IFAC guidance has therefore required specific extra safeguards to be applied when auditing listed entities, to address the perception threats that would cause concern to a reasonable and informed third party.

The definition of PIEs varies (see below) but a wide range of stakeholders is a common feature (otherwise the entities would not be of public interest). A rationale can be constructed for a degree of differentiation on the grounds that the public is in practice most interested in listed companies because there is a very widespread direct or indirect ownership interest in listed entities, which is a factor not typically present with other PIEs.

Nevertheless, it follows that if additional requirements are needed to deal with perception issues for listed entities, there should be at least a rebuttable presumption that they should logically be necessary for other PIEs (those of significant public interest, as listed entities are) as well. Paragraph 290.28 alludes to this, suggesting that consideration be given to applying the requirements for listed entities to other entities of significant public interest. It does not, however, require the application of the requirements to other entities of significant public interest.

As noted below, and in more detail in Appendix A, a number of individual countries, and the EU Recommendation on auditor independence, do distinguish in their differential requirements, between PIEs and other entities. Many others restrict additional requirements to listed entities. This does not seem to be because of a disagreement with the theory of applying the requirements more widely, but more with practical issues. Sometimes this is because of regulatory scope restrictions, but common issues are:

- difficulty in defining PIEs;
- concerns over the cost benefit of applying listed entities requirements to other, potentially small entities, that happen to be of public interest.

Subject to practical issues (considered below), the Task Force is of the view that in principle, requirements applied to listed entities should be applied to other entities of significant public interest. The CAG suggested that consideration should be given to having presumptive inclusions – for example entities which would have a significant influence on financial stability. It considered that it is how the entity interacts with the community that determines whether or not it is a PIE.

Definition of PIEs

Appendix A shows the results of a survey of definitions of PIEs in a sample of countries (not selected by statistical means) and the EU. As noted above, many countries have chosen not to define PIEs for practical reasons. Of those that do, there seem to be two schools of thought:

- a precise definition either along the lines of ‘listed entities plus others with revenue/assets over x’ (e.g. Austria, Netherlands), or a detailed list of types of entity (e.g. Hong Kong, Japan, Denmark – the latter being a combination of the two);
- a less precise definition that presumes a need to consider on a case by case basis, indicating factors to consider when making the judgement (e.g. EU Recommendation on Auditor Independence, UK)

Where there is a list, the only type of entity universally included is listed entities. Other common types of entity referred to include:

- Entities with revenue/ assets, etc over x;
- Regulated financial entities and other credit institutions;
- Large not for profit entities
- Investment funds
- Some publicly owned entities (though sometimes these are not referred to at all, presumably because they are dealt with separately elsewhere).

The Code takes the case by case approach with paragraph 290.28 noting:

“Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities may include listed companies, credit institutions, insurance companies, and pension funds.”

This is quite similar to the EU Recommendation (the two documents were written at about the same time):

“Entities which are of significant public interest because of their business, their size, their number of employees or their corporate status is such that they have a

wide range of stakeholders. Examples of such entities might include credit institutions, insurance companies, investment firms, UCITS (Undertakings for Collective Investment in Transferable Securities), pension firms and listed companies.”

The recently revised EU 8th directive takes a hybrid approach:

“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 Article ..., credit institutions within the meaning of Article ... and insurance undertakings as defined in Article Member States may also designate other entities as public interest entities, for instance entities that are of significant public relevance because of the nature of their business, their size or the number of their employees;”

Issues with definitions

Cost benefit considerations

In considering the cost benefit of broader application it is useful to focus on the additional requirements for listed entities. The extant additional requirements address:

1. Extension of independence assessment to related entities of the client (§290.21)
2. Regular communication (orally and in writing at least annually) with the audit committee or equivalent (§290.29-30)
3. Compulsory rotation of the engagement and EQCR partners, unless there are insufficient partners (§290.154 & 157)
4. Prohibition of accounting assistance, except in emergencies (§290.171).

The Task Force recognizes that the existing requirements do provide some flexibility in situations where there are a limited number of partners, provided other safeguards are put in place to address the familiarity threat. The Task Force is concerned that extending the requirements to all public interest entities would not necessarily be in the public interest because it could result in unnecessary rotation.

Similarly the Task Force is concerned that a prohibition on the provision of accountancy services except in emergencies might not be in the public interest. Smaller entities often use their auditors to provide book keeping assistance rather than use a third party. Such assistance results in improved quality of financial reporting. In such circumstances, auditors are required to apply safeguards to reduce threats to independence.

On balance, the Task Force is of the view that, in any definition, there should be a pragmatic size cut-off given that the cost-benefit of applying the extra requirements would be disproportionate for small organisations.

This does seem to be recognised by the EU and existing IFAC ‘definitions’, which refer to entities being of ‘significant public interest’. They would therefore seem to have been written with a national context in mind.

Variability of national regulatory framework and legal requirements

Where specific lists have been prepared in individual countries, though there are common themes (see above) the detail varies. For example, where specific size has been referred to, Austria uses a revenue level of €146m, Denmark DK5bn (approx. €670m) and the Netherlands €1400m.

In addition, the regulatory framework varies in terms of what types of entities are subject to, for example, financial services regulation, and whether publicly controlled entities are dealt with elsewhere or not.

It is notable that the EC 8th directive definition, though having a partial list (see above) considers it sensible not to come up with a precise list that will work across boundaries.

The Task Force is of the view that the extant position in Section 290 is insufficient to address requirements in countries which apply differential requirements to a wider set of PIEs. Based on the examples in Appendix A, these latter seem principally to have such requirements set in law, and thus tend towards precise definitions. The EU Recommendation applies differential requirements to a wider set of PIEs and uses a definition similar to IFAC. A number of EU countries are using this as the basis of their independence codes. The 8th Directive specifically requires the partner rotation requirements to be applied to PIE audits but adopts a slightly different definition (requiring certain types of entity to be included regardless of local consideration).

The Task Force is of the view that it would be impossible for the IESBA to produce a precise detailed list of entities that would be regarded as a workable global definition of PIEs. The preliminary views of the CAG were in agreement with this, though urging that the Code should do as much as possible to give people guidance to know where to draw the line.

Alternatives

Options are:

1. To retain the current position where additional requirements are applied only to listed entities, but encourage auditors to consider applying the requirements to other PIEs. This has the advantage of pragmatism, but it is below the levels required in many countries and does not provide much guidance for the practitioner.
2. Extend the differential requirements to all significant PIEs and precisely define such entities. As noted above, this is not considered practicable.

3. Extend the differential requirements to all significant PIEs, but require member bodies implementing the IFAC code to define what a PIE is, providing that as a minimum, listed entities are included.
4. Retain the current requirements for listed entities but have a rebuttable presumption that they should be applied to other significant PIEs as well, leaving member bodies to define PIEs.

A number of firms do apply IFAC directly and it is possible that they would encounter some locations where the code had not been implemented (and there was thus no definition available). It would accordingly be necessary to give an indication of the type of entities that ought to be taken into consideration (some member bodies may indeed wish to use this as the definition.) This would allow maximum compatibility with local requirements.

Taking into account the preliminary comments of the CAG, the Task Force is of the view that option 4 is the preferred course of action. That is, to retain the current requirements for listed entities but have a rebuttable presumption that they should be applied to other significant PIEs as well, leaving member bodies to define PIEs

Illustrative wording

Under this alternative the term “Listed entities” would be replaced by, for example: “listed entities and in general, other entities of significant public interest” throughout section 290. The relevant paragraphs could thus be rewritten along the following lines:

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| 290.26 | Certain examples in this section indicate how the framework is to be applied to a financial statements audit engagement for a listed entity <u>and any other entity of significant public interest. There may be circumstances where, taking into account the stakeholders and the impact of the additional requirements, it is inappropriate to apply the additional requirements to entities of significant public interest (other than listed entities, where the requirements should always be applied). In such circumstances, the auditor should document the rationale for not applying the additional requirements.</u> |
| 290.28 | The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest. Certain entities may be of significant public interest because, as a result of their business, their size, <u>their number of employees</u> or their corporate status they have a wide range of stakeholders. <u>Examples of such entities may include listed companies, credit institutions, insurance companies, and pension funds.</u> Because of the strong public interest in the financial |

statements of listed-such entities, certain paragraphs in this section deal with additional matters that are relevant to the financial statement audit of listed entities and in general, any other entity of significant public interest. In the absence of an overriding national definition, the types of entity that should be considered to be of significant public interest are included in the definitions section. †The additional requirements wouldshould always be applied‡ to listed entities. -Consideration should be given to the application of the framework in relation to the financial statement audit of listed entities to other financial statement audit clients that may be of significant public interest.”

Definitions:

“Entity of significant public interest– An entity which is of significant public interest because of the nature of its business, or because its size, its number of employees or its corporate status is such that it has a wide range of stakeholders. -Examples of entities meeting such criteria isare likely to include [regulated] financial and other credit institutions, insurance companies, large not for profit entities such as charities and pension funds, and may include large publicly owned entities and other entities where there is a potentially significant effect on financial stability of the relevant economy.”

Action requested

Members are asked to consider the recommendation of the Task Force and the illustrative wording.

Appendix A

Scope of PIEs in individual countries	
Comment	Definition
<i>Australia</i>	
No definition used. Considered at one point but difficulty with defining. Would have encompassed (as well as listed entities):	large charities, local governments, APRA (financial services regulated) funds, etc.
<i>Austria*</i>	
Company law includes a definition of PIE:	- listed entities and - entities with either total assets > €36,5M. or revenues > €146 M.
<i>Canada</i>	
No definition used. Considered at one point but non-listed element of code considered robust enough. A draft definition, not used, was:	... that may be of significant public interest, such as credit institutions, insurance companies, pension funds, public sector entities, large not-for-profit entities and private corporations with significant external financing
<i>Denmark*</i>	
Company law includes a definition of PIE:	listed companies, investments funds, state-owned companies, financial institutions under the supervision of the Danish Financial Supervisory Authority and other large companies which two years in a row exceed two or more of the following criteria: a net turnover of DKK 5 b, 2,500 employees, and/or total assets of DKK 5 b.

Scope of PIEs in individual countries	
<i>European Union</i>	
The EU Recommendation on Auditor Independence of 2002 includes the following definition of PIEs:	Entities which are of significant public interest because of their business, their size, their number of employees or their corporate status is such that they have a wide range of stakeholders. Examples of such entities might include credit institutions, insurance companies, investment firms, UCITS (Undertakings for Collective Investment in Transferable Securities), pension firms and listed companies.
The revised 8 th directive includes the following definition, which envisages members states adding on items themselves, to a basic core	... 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 Article ..., credit institutions within the meaning of Article ... and insurance undertakings as defined in Article Member States may also designate other entities as public interest entities, for instance entities that are of significant public relevance because of the nature of their business, their size or the number of their employees;
<i>France</i>	
There is no directly applicable definition but rotation requirements apply to a relatively broadly defined sector which includes:	listed entities, UCITS, and a significant part of non for profit sector.
<i>Germany</i>	
German commercial code effectively defines a PIE as being a listed entity.	

Scope of PIEs in individual countries	
<i>Hong Kong</i>	
Not defined in ethical standards. Applies IFAC differential to listed entities. Definition opposite is from SME reporting framework.	<p>An entity has public accountability ... if:</p> <ul style="list-style-type: none"> (a) at any time during the current or preceding reporting period, the entity (whether in the public or private sector) is an issuer of securities, that is, its equity or debt securities are publicly traded or it is in the process of issuing publicly traded equity or debt securities; (b) the entity is an institution authorised under the Banking Ordinance; (c) the entity is an insurer authorised under the Insurance Companies Ordinance; or (d) the entity is a corporation which is granted a licence under the Securities and Futures Ordinance to carry on business in a regulated activity ...
<i>Hungary*</i>	
Currently there is no such definition in the law. The concept of “public interest” is defined only by the Quality Assurance Rules of the Chamber:	<p>It includes, beside the listed companies, banks, insurance companies, investment funds, broker firms, pension funds, etc.</p> <p>During the codification work currently carried out it is expected that this definition will be regulated and it is possible that the term will be enlarged with some state-owned companies.</p>

Scope of PIEs in individual countries	
<i>Japan</i>	
There is no direct definition of PIEs but CPA law imposes different independence requirements on audits of certain types of entity:	<p>1 Large companies that are subject to statutory audits under the Audit Special Law ...: Companies whose capitals are 500 million yen or larger or that have total liabilities of 20 billion yen or larger</p> <p>2 Companies subject to statutory audits under the Securities and Exchange Law: listed companies, and companies whose securities are publicly offered even though they are not listed at stock exchanges.</p> <p>3-5 banks, long-term credit banks, and insurance companies</p> <p>6 Other categories of companies that are defined by the Cabinet Orders: -the Japan federation of credit banks -the Japan federation of labor banks -the Japan federation of credit unions and cooperatives -Norin Chuo Bank -Japan Post -Pension Fund Management Foundation -Independent administrative entities that are subject to statutory audits -National universities and entities that universities jointly use -Provincial independent administrative entities that are subject to statutory audits.</p>
<i>Netherlands*</i>	
A PIE is defined as:	<ul style="list-style-type: none"> - all quoted companies and institutions for which a legal audit is mandatory - all companies and institutions for which a legal audit is mandatory and for which debt papers are quoted - all other companies and institutions for which a legal audit is mandatory provided that these companies and institutions meet two of the following three criteria: <ul style="list-style-type: none"> • consolidated revenues exceed €1,4 billion • consolidated balance sheet total exceeds €700 million • consolidated number of employees exceeds 12.500.
<i>Spain*</i>	
There is no specific definition but rotation rules are applied to:	for entities under public supervision, listed companies and companies with a turnover higher than €30m.

Scope of PIEs in individual countries	
<i>United Kingdom & Republic of Ireland</i>	
The three Chartered Accountant Institutes had the following discussion in their now-superseded independence guidance.	...those unlisted companies and organisations in both the public and private sectors, which are ‘in the public eye’ because of their size or product or service they provide. Examples of such companies and organisations would be large charitable organisations and trusts, major monopolies, duopolies, building societies, industrial and provident societies or credit unions, deposit taking organisations, and those holding investment business clients money.
The Auditing Practices Board only applies additional requirements to listed entities but advises policies for considering them in other circumstances:	...These policies will take into consideration the nature of the entity’s business, its size, the number of its employees and the range of its stakeholders.
<i>United States</i>	
No definition used	

* Derived from draft FEE Survey on independence implementation, 10/05