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EU Audit Reform Makes Global Waves

On April 3, 2014, members of the European Parliament voted in favour of EU audit reforms aimed at regulating the audit profession. After years of debate, this ruling will likely see final legislation come into effect by mid-2016. Given how these regulations have evolved, companies and their audit committees are looking for greater clarity regarding their impact.

The new rules apply to organizations that are public interest entities (PIEs) in Europe, primarily European organizations that are listed on EU-regulated markets and certain of their subsidiaries and affiliates. Canadian companies would not normally be in scope unless they have shares listed on an EU-regulated market or they are an EU-authorized credit institution or undertaking. Impacted organizations need to understand the requirements for mandatory firm rotation (MFR), which non-audit services (NAS) will be prohibited and how quickly they need to comply.

Multinationals, in particular, also remain concerned that divergent requirements may develop across Europe as each EU member state determines how they will implement the regulation and what restrictions will apply.

Although elements of the regulation will remain undetermined until each EU country passes it into law, this paper outlines some of the anticipated impact of the EU reforms on Canadian entities.

The Broad Strokes: Summarizing the EU's Reforms

Although the reforms are complex, in essence the regulation imposes mandatory firm rotation and non-audit service rules for all PIEs. They include EU entities listed on an EU-regulated market, credit institutions and insurance undertakings (including those with non-EU headquarters) and entities designated as PIEs by member states.

More significant, however, is the extra-territorial reach of the EU regulation. Specifically, Canadian subsidiaries of affected PIEs will be impacted by these rules if their parent companies are governed by the law of a member state that has listed securities in the EU. Similarly, if a Canadian company listed in the EU qualifies as a bank or insurance company authorized in the EU, it would also be considered a PIE.

Mandatory Firm Rotation

Under the new regulation, MFR is required for PIEs after a maximum period of 10 years, although member states may opt for a shorter time period. That said, member states have the option to allow PIEs to extend the duration of their audit engagements to a maximum of 20 years if they conduct a public tender process or to a maximum of 24 years if they enter a joint audit arrangement (defined below).

The introduction of MFR will be staggered based on the length of audit tenure at the time the law comes into force. For example:

- where the incumbent audit firm has tenure of 20 or more years, the PIE must adopt MFR within six years of the regulation coming into force;
- where the firm has tenure between 11 and 20 years, the PIE must adopt MFR within nine years of the regulation coming into force; and
- where the auditor/client relationship is less than 11 years when the regulation comes into force, the auditor has 12 years before it must rotate (or potentially longer if the member state permits an extension).

Non-Audit Services Prohibitions

For their part, the regulation's NAS prohibitions constitute severe restrictions on providing tax and advisory services to PIE audit clients. In essence, PIEs would be precluded from using their audit firm for many tax and advisory services that are currently permissible under the International Code of Ethics (IESBA). Member states may also add to the list of prohibited services.

While the NAS 'black list' may shift from one jurisdiction to the next, all jurisdictions will likely prohibit auditors from performing the following services:

- Tax services
- Services that play any part in the management or decision-making process of the audited entity
- Bookkeeping and preparing accounting records
- Valuation services
- Services related to the audited company's internal audit function
- Corporate finance type services, including those linked to the company's financing, capital structure and allocation, and investment strategy
- Legal and HR services.

In effect, these rules bar auditors from providing almost all tax and advisory services, and cap the proportion of audit fees that auditors can earn from offering any remaining permissible NAS, which the audit committee will be required to approve. In essence, this service fee cap limits the total fees a statutory auditor is allowed to charge for NAS to no more than 70% of the average of the fees paid in the last three consecutive years for the statutory audit of the audited entity and its group.

Impact Beyond the EU

Although these regulations apply within EU member states, some observers expect them to indirectly affect companies and their auditors in other jurisdictions as well.

That said, neither Canada nor the United States have embraced MFR—their response to audit reform has been to focus on enhancing audit quality.

In fact, the Chartered Professional Accountants of Canada, Canadian Public Accountability Board and the Institute of Corporate Directors recently expressed concern about mandatory firm rotation and further restrictions and caps on the provision of non-audit services by the auditor.

It is their view that annual and periodic comprehensive reviews of the auditor's performance—conducted by the audit committee—are more likely to improve audit quality as they focus on independence, objectivity and professional skepticism.

Canadian implications

Absent any change in Canadian regulations, the EU provisions may still affect Canadian entities. Consider these examples:

Example 1: Non-EU Subsidiaries of EU-Listed Parents

If a Canadian company is the subsidiary of an EU-listed parent, MFR will not apply (unless the EU-parent requires compliance) but certain NAS will be prohibited. Specifically, the company's auditors cannot provide the Canadian subsidiary with:

- Services that play any part in the entity's management or decision-making
- Bookkeeping or the preparation of accounting records and financial statements
- The design or implementation of internal controls or risk management procedures related to the preparation and/or control of financial information or financial information technology systems.

This is true even if the Canadian subsidiary is a private company, as are the majority of them.

Example 2: Non-EU Parent of EU-Listed Entities

If a Canadian parent company operates EU subsidiaries, it will need to understand which of those entities must comply with the new regulations. Specifically, any EU entities considered PIEs will need to comply with both MFR and NAS prohibitions. EU entities that are not PIEs will not be subject to MFR, but may still be prohibited from having their auditors provide certain NAS.

To further complicate matters, depending on the final laws implemented by each EU member state, a parent company's various EU entities may need to rotate auditors on different timeframes—while continuously ensuring that the audit firms of each entity do not provide NAS to any company within their direct chain of ownership.

Preparing for a New Age of Audit Regulation

While the majority of the EU reforms' impact will be confined to Europe, Canadian entities will not be unscathed. As a case in point, if an EU-parent company deems its Canadian subsidiary "sufficiently significant," it could require that subsidiary to comply with the EU legislation.

Canadian organizations that own, or are owned by, a European PIE, may be affected even if they are not deemed "sufficiently significant" by their parent.

Presuming the regulations come into force by mid-2016, as anticipated, affected companies must stop using their auditors for NAS by that date. Sometime between 2020 and 2028, companies will also be required to appoint new auditors (depending on the length of their audit relationship when the regulations come into force). In addition, a one-year "clean period" may be required before or after certain non-audit services.

Given the rapidly-approaching deadline for compliance with at least the NAS provisions of the EU reforms, Canadian parent corporations and subsidiaries of EU PIEs must begin to prepare for new types of auditor relationships, requirements and restrictions.

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