

EU Audit reform imminent



The European Parliament has now voted to approve a Regulation and a Directive intended to reform the audit market in the EU. It remains now for the Council of Ministers to ratify the measures thereby paving the way for the legislation to enter into force in the EU in the second half of 2014. There is a two year transition period which means that the legislation will become applicable in the 28 Member States of the EU in 2016.

The key requirements of the new legislation are summarised below.

Scope

The regulation will impact EU entities that fall within the definition of a public interest entity (PIE). The PIE definition captures all EU entities, irrespective of size, that (i) have securities listed on a regulated market, are (ii) credit institutions or (iii) insurance undertakings. Member States may also expand the PIE definition to include other entities.

The reforms will impact thousands of entities throughout Europe and have an extraterritorial dimension for groups. Subsidiaries that meet the definition of a PIE would be affected by the regulation irrespective of whether they have an EU or non-EU parent.

Auditor rotation and appointment

All PIEs would be required to change their auditor after a maximum term of 10 years. Member States may allow shorter rotation periods or the extension of the maximum auditor tenure where a public tender has taken place or in the case of a joint audit by a further 10 or 14 years (ie to a maximum of 20 or 24 years) respectively.

Multinational groups with PIE subsidiaries will be faced with the choice of either applying the shortest rotation period to the entire group or having to appoint different

audit firms in different countries, with the difficulties that this can imply for group audits.

Transitional rules

Transitional rules stagger the introduction of MFR and depend on the length of auditor tenure at the date the legislation is finalised ('Entry into Force' or EIF, which is currently expected sometime between July and October 2014). Where the auditor tenure at the date of EIF has been:

- 20 years or longer – an audit engagement cannot be entered into or renewed any later than 6 years after the date of EIF.
- 11 to 20 years - an audit engagement cannot be entered into or renewed any later than 9 years after the date of EIF.
- 11 years or less – the company has at least 12 years before it must rotate its auditor. In this case, if a Member State has opted to permit a further extension of 10 years, then the company would need to conduct a public tender by July 2026, and may then extend its audit relationship until 2036 (or 2040 if there is a joint audit).

Audit committees will be responsible for submitting a recommendation to the administrative or supervisory body of the audited entity for the appointment of the auditor or audit firms. The recommendation of the audit committee should include at least two possible choices for the audit engagement and a duly justified preference for one of them, so that a real choice can be made. In order to provide a fair and proper justification in its recommendation, the audit committee should use the results of a mandatory selection procedure organised by the audited entity, under the responsibility of the audit committee.

In such selection procedure, the audited entity should not restrict statutory auditors or audit firms with a low market share from presenting proposals for the audit engagement. Tender documents should contain transparent and non-discriminatory selection criteria to be used for the evaluation of proposals.

The audited entity shall prepare a report on the conclusions of the selection procedure, which shall be validated by the audit committee; and, be able to demonstrate, upon request, to the competent authorities that the selection procedure was conducted in a fair manner.

Non-Audit Services (NASs)

The Regulation contains a list of services which the statutory auditor of a PIE and all members of the statutory auditor's network are prohibited from providing to the PIE itself or to that PIE's EU controlled undertakings or its EU parent undertaking.

The NASs' prohibitions are extensive and many advisory and tax services would not be allowed. The prohibited list includes tax compliance, tax advice, services that 'involve playing any part in the management or decision making of the audited entity', and 'services linked to the financing, capital structure and allocation, and investment strategy of the audit client, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity'.

These rules effectively prohibit many non-audit services that are permitted under other internationally recognised frameworks such as the IESBA Code of Ethics or the SEC's independence rules in the US. This inconsistency with rules outside of the EU will again increase the cost and complexity of doing business in Europe.

The statutory auditor is prohibited from providing NASs not only up to the date of the issuing of the audit report but, also, services in relation to 'designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information technology systems' in the financial year immediately preceding the period subject to audit. This will affect entities in the 12 months prior to the appointment of a new auditor (eliminating the incumbent and the nominee as possible service providers).

Fees for permissible NASs provided to the group must not exceed 70% of the average of the last three years' group audit fees.

Member States may add to the list of prohibited NASs, establish stricter rules under which permissible NASs may be provided, or apply a stricter NAS fee cap. They may also allow the provision of certain tax and valuation services in limited circumstances. This will lead to a patchwork of independence rules throughout Europe.

For services other than those on the prohibited list, audit committee approval is required after having assessed the threats to independence and the safeguards applied.

The audit committee may also issue guidelines in relation to the tax and valuation services which member states may opt to permit.

Reporting to the audit committee

The proposed reforms require that the auditor must explain the results of the statutory audit in an additional report to the audit committee.

Whilst many of the requirements do not constitute a significant departure from current practice there are some new requirements, more specificity and some that require further clarification, for example inter alia:

- a description of the nature, frequency and extent of communication with the audit committee including the dates of the meetings with those bodies;
- a description which balance sheet categories have been directly verified and which have been based on system and compliance testing;
- a report and assessment of the valuation methods applied to the various items in the financial statements including the impact of any changes in such methods;
- any significant deficiencies in the entity's or, in case of consolidated financial statements, the parent undertaking's internal financial control system and/or in the accounting system. For each such significant deficiency, the additional report must state whether or not the deficiency in question has been resolved by the management; and
- the significant difficulties, if any, encountered during the audit.

The regulation also allows Member States to set additional requirements in relation to the content of the additional report to the audit committee.

Furthermore, upon request the statutory auditor(s) or the audit firm(s) is (are) required to make available without delay the additional report to the competent authorities.

Effective date and transition arrangements

The regulation comes into effect ("the date of entry into force") 20 days after publication in the Official Journal (expected sometime between July-October 2014). EU Member States are required to apply the legislation no later than two years thereafter – i.e. 2016.

Contact us

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