



# New Independent Financial Audit Act

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## What's new?

The new Independent Financial Audit Act, which transposes the provisions of Directive 2006/43/EC, amended by Directive 2014/56/EU, as well as Regulation (EU) No. 537/2014, was promulgated in the State Gazette on 29 November 2016. It introduces significant changes in relation to the obligations of the audit committees and in relation to the audit of public-interest entities (PIEs). The law introduces new major principles such as joint audit, mandatory rotation of registered auditors, prohibition of the provision of particular services and restrictions on the fees for non-audit services. Audit committees will be supervised by the Commission for Public Oversight of Registered Auditors. The changes are expected to influence significantly the PIEs.

## Effective date

The law becomes effective on 2nd December 2016.

The financial statement audits of PIEs for 2016 will be conducted according to the provisions of the old Independent Financial Audit Act.

# Public-interest entities: defined in the Accountancy Act (AA)

Quantitative criteria are introduced for the entities under e), f), g), i), j), k) to qualify as PIEs.

The public-interest entities are listed below:

- a. Entities whose transferrable securities are traded on the regulated market in a Member State of the EU;
- b. Credit institutions;
- c. Insurance and reinsurance companies;
- d. Pension insurance companies and the funds managed by them;
- e. Investment brokers which are large entities according to the AA;
- f. Collective investment schemes and management companies in accordance with the provisions of the Law on the Activities of Collective Investment Schemes and of Other Collective Investment Entities which are large entities in accordance with the AA;
- g. Financial institutions in accordance with the Law on Credit Institutions which are large entities in accordance with the AA;
- h. BDZ Holding EAD and its subsidiaries; National Company Railway Infrastructure;
- i. Commercial companies whose main activity is the production and/or the transportation, and/or selling of electrical energy and/or thermal energy and which are large entities;
- j. Commercial companies whose main activity is the import and/or transport and/or distribution, and/or transit or natural gas and are large entities in accordance with the AA;
- k. Water supply and sewerage operators under Article 2, para 1 of the Law on the Regulation of the Water Supply and Sewerage Services which are medium or large entities.

All PIEs must have audit committee in accordance with the Independence Financial Audit Act. If a PIE does not establish an audit committee or the shareholders do not approve its statute, the entity may be imposed a sanction from BGN 2,000 to 20,000, while the chairman of the Managing Board or the Board of Directors or the Managing Director may be subject to a sanction ranging from BGN 500 to 5,000.

# Audit committee: functions and obligations

Activities	Main requirements for the supervision carried out by the audit committee
<b>Supervision of the audit fees</b>	Supervise the fees received by the registered auditor of the PIE, including supervision over the cap of the permitted non-audit services (70% of the average of the audit fees paid in the last 3 consecutive financial years).
<b>Assessment of the compliance</b>	Supervise the process through which the registered auditor assesses the provision of permitted non-audit services, ensuring that particular requirements regarding the permitted services are met.
<b>Preliminary approval of the permitted non-audit services</b>	Assess the threats to independence and the safeguards applied to mitigate those threats before approval of non-audit services. All permitted services require preliminary approval by the audit committee. The Commission for Public Oversight of Registered Auditors is notified, so are the management and supervision bodies, for every approval, within 7 days from the date the decision was taken.
<b>Provision of guidelines and policies</b>	Provide guidelines and appropriate policies regarding the services which can be permitted.
<b>Appointment of statutory auditors</b>	Assess and recommend the appointment of registered auditors. The audit committee is responsible for the procedures and recommendations for the appointment of registered auditors.
<b>Prolongation of the tenor of the audit in relation to the mandatory rotation</b>	Recommend the prolongation of the audit engagement only if it is appropriate. The maximum initial period can be prolonged under certain conditions only if the audit committee recommends to the General Meeting of Shareholders that the engagement should be renewed and this proposal is accepted.
<b>Auditor independence monitoring</b>	The registered auditor must confirm its independence from the audited entity to the audit committee annually in writing and discuss every threat to its independence as well as the safeguards applied to mitigate those threats.
<b>Supervision of the process of financial reporting and internal control system and risk management</b>	Observe the process of financial reporting and provide recommendations and proposals to guarantee its effectiveness.  Observes the effectiveness of the internal control system, of the risk management system and the internal audit activity regarding the financial reporting in the audited entity.
<b>Reporting</b>	Report its activity before the appointment body. Prepare and present an annual report to the Commission for Public Oversight of Registered Auditors not later than 30 June.

The members of the audit committee are appointed by the General Meeting of the Shareholders or the Partners upon a proposal by the chairman of the Board of Directors or the Supervisory Board. Members can be chosen from among the members of the supervisory or management bodies of the entity who are not executive members of the management body. At least one of the members of the audit committee must possess at least 5 years of professional experience in the accountancy or audit sector. The majority of the members must be independent of the PIE; this is confirmed by means of a written declaration. The General Meeting of the Shareholders or the Partners approves the statute of the audit committee which determines its functions, rights and obligations regarding the financial audit, the internal control and the internal audit as well as its relationship with the management bodies.

# Joint audit

**The changes will affect the insurance, reinsurance, pension insurance companies and funds, and credit institutions.**

- Introduction of a requirement of a joint audit of two audit companies for the insurance, reinsurance, pension insurance companies and funds, and credit institutions.
- These companies appoint their auditors after preliminary coordination with the appropriate regulator – the Financial Supervision Commission or the Bulgarian National Bank.
- The criteria for coordination regarding the appointment of auditors are accepted by the appropriate regulator, the Financial Supervision Commission of the Bulgarian National Bank, in coordination with the Commission for Public Oversight of the Registered Auditors.

# Mandatory rotation of the registered auditors of PIEs

**The rotation mechanism will affect all PIEs.**

- A registered auditor carrying out a statutory audit of a PIE withdraws after 7 consecutive years and may not carry out audit engagements for a period of 4 years after the withdrawal.
- For an individual registered auditor assigned by the audit company as responsible for the audit, the restrictions encompass 4 consecutive years after which they may not perform the role for 3 years after their withdrawal.
- There is no possibility for extension of the maximum deadline through a tender procedure (unlike the possibilities set out in Regulation (EU) No 537/2014).
- Every PIE within the EU, which is a member of a group, will have to apply the rotation mechanism applied in the Member State where it is located. If the parent company within the EU has subsidiaries outside the EU, they do not fall within the scope of the audit rotation requirements.
- The initial date for calculation of the audit duration starts from the year when the first audit engagement for a statutory financial audit for the respective period is undertaken.
- In accordance with the Transitional and Final Provisions of the Independent Financial Audit Act, if the registered auditor carried out statutory financial audit services as at 16 June 2014 with a duration of:
  - 20 or more consecutive years, the entity shall not enter into or renew the audit engagement with this auditor as from 17 June 2020.
  - 11 or more years but not less than 20 consecutive years, the entity shall not enter into or renew the audit engagement with this auditor as from 17 June 2023
  - Less than 11 consecutive years, the entity may enter into or renew the audit engagement with this auditor until reaching the maximum duration – 7 consecutive years.

[Rotation of registered auditors of PIEs](#) graphic illustrates the transitional rotation rules.

# Prohibited non-audit services

**Certain services may not be provided by the auditor of the PIE.**

**The auditor may provide permitted non-audit services after the approval of the audit committee, for which the registered auditor notifies the Commission for Public Oversight of the Registered Auditors within 7 days from the approval date. The audit committee is also obligated to notify the Commission about the approval within 7 days from the decision date.**

A registered auditor carrying out a statutory audit of a PIE and the members of a network to which it belongs shall not directly or indirectly provide to the audited entity, the parent entity or the subsidiaries within the EU, the following:

- a. tax services, with the exception of tax consultations under the condition that they do not have effect or have immaterial effect separately or in aggregate on the audited financial statements; the estimation of the effect is documented thoroughly in the additional report for the audit committee; and the requirements for independence are fulfilled;
- b. services that involve playing any part in the management or decision-making of the audited entity;
- c. bookkeeping and preparing accounting records and financial statements;
- d. payroll services;
- e. designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems;
- f. valuation services, including valuations performed in connection with actuarial services or litigation support services;
- g. legal services, with respect to the provision of general counsel; negotiating on behalf of the audited entity; and acting in an advocacy role in the resolution of litigation;
- h. services related to the audited entity's internal audit function;
- i. services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, 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;
- j. promoting, dealing in, or underwriting shares in the audited entity;
- k. human resources services.

# Cap on fees for non-audit services

**Cap for permitted non-audit services – no more than 70% of the average audit fees for the last 3 years.**

**Additional requirements if the auditor receives more than 15% of their total fees from one PIE.**

- When the registered auditor provides to the audited entity, its parent company or its subsidiaries, for a period of three or more consecutive financial years, permitted non-audit services, the total fees for such services 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, where applicable, of its parent company, of its subsidiaries and of the consolidated financial statements of that group. The restriction shall not apply to non-audit services which are different from the prohibited ones and are required by law.
- When the total fees received from a public-interest entity in each of the last three consecutive financial years are more than 15% of the total fees received by the statutory auditor or the audit firm or, where applicable, by the group auditor carrying out the statutory audit, in each of those financial years, such a statutory auditor or audit firm or, as the case may be, group auditor notifies the audit committee and discusses the threats to their independence and the safeguards applied to mitigate those threats. In this case, the audit committee considers whether the audit engagement should be subject to an engagement quality control review by another statutory auditor or audit firm prior to the issuance of the audit report. When these circumstances continue, the audit committee decides whether the registered auditor may continue to carry out the statutory audit in an additional period which may not be longer than 2 years.



# Supervision over the audit committees

## **The Commission for Public Oversight of the Registered Auditors supervises the activities of the audit committees of PIEs.**

In the event of an inspection or investigation, the Commission for Public Oversight of the Registered Auditors is authorized to demand, in certain deadlines, from:

- Individuals and legal entities outside of the inspected or investigated registered auditor – the provision of certified copies of documents, information and statements related to the inspection or investigation;
- The audit committee – provision of certified copies of documents, statements and other information related to the powers of the Commission for Public Oversight of the Registered Auditors.

If negligence and violations are identified as a result of the inspection or investigation, the Commission may, in addition to imposing sanctions on the related registered auditor, propose to a body which supervises the activity of the PIE to impose a prohibition on a member of its executive body to perform their functions for a period up to 3 years, where the related supervisory body notifies the Commission for the measures undertaken in a suitable period.

# Other changes

## **The auditor must provide an additional report to the audit committee.**

- The audit report for the PIE is in a different form – in addition to other changes, from 1 January 2017 it must include a description of key audit matters.
- The registered auditor must prepare and present to the audit committee an additional report (in addition to the audit report). This applies to the auditor of the group as well – an additional report is presented to the audit committee of the parent company. If demanded by a competent body supervising the PIE, the registered auditor presents immediately this additional report.
- In the case of carrying out statutory audit of a PIE, the registered auditor must inform the management and the audit committee of the entity about all circumstances which could or are threatening their independence in the provision of audit services.
- The statutory auditor carrying out the statutory audit of a PIE shall have a duty to report promptly to the competent authorities supervising that PIE or, where so determined by the Member State concerned, to the competent authority responsible for the oversight of the statutory auditor, any information concerning that PIE of which it has become aware while carrying out that statutory audit and which may cause any of the following:
  - A material breach of legal provisions which determine the license terms or which specifically arrange the activities of the PIE;
  - A material threat or doubt concerning the continuous functioning of the public-interest entity;
  - A disclaimer of audit opinion, an adverse or qualified opinion.

# Changes that concern all entities

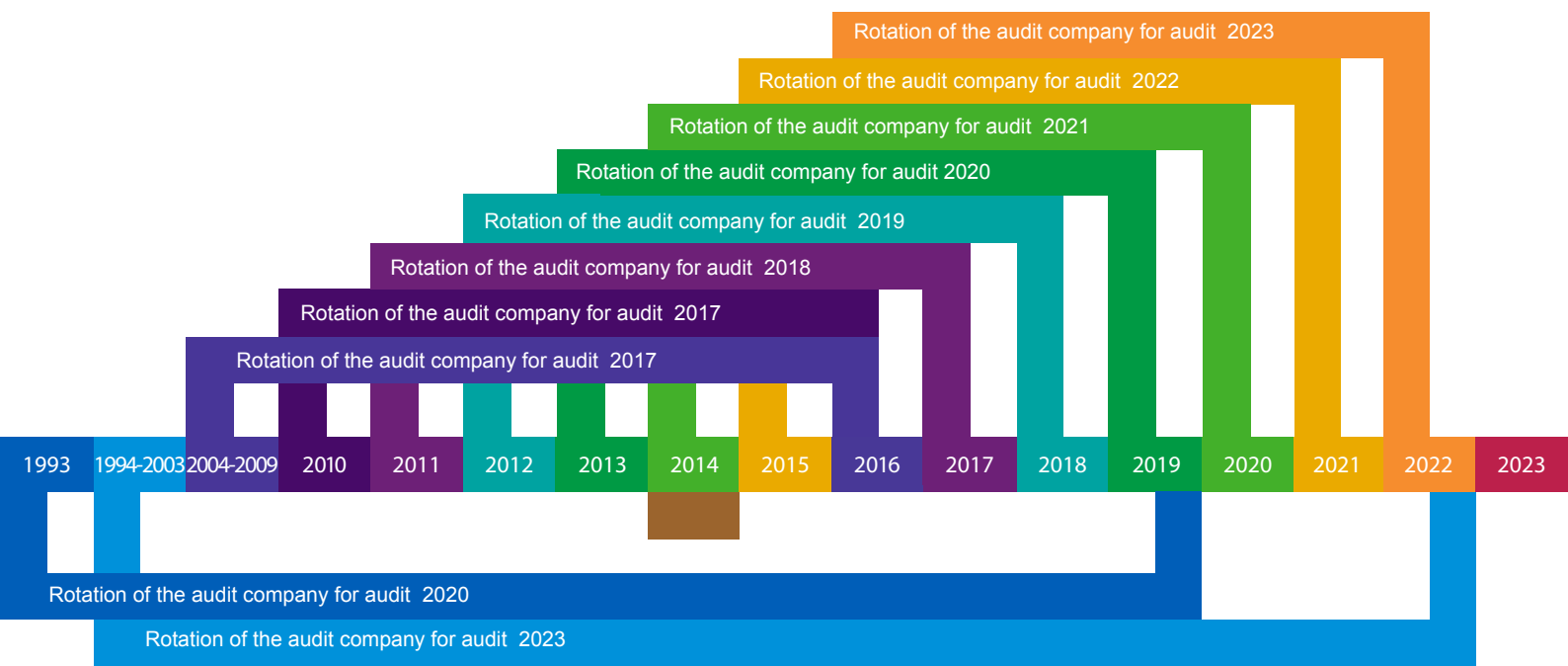
## Prohibition of restrictive provisions in the audit appointment.

## Introduction of restrictions regarding appointments after the finalization of a statutory financial audit.

- New terminology: “audit company” will replace the term “specialized audit entity”
- Differentiation of audit types – statutory (required by law and the EU law) and voluntary (different from the statutory one)
- Contract provisions for the restriction of auditor choice are prohibited to certain categories or lists of auditors. Such clauses are void.
- A registered auditor who is appointed and who has signed an engagement letter may be released before the appointed time only if there are legitimate reasons. In such cases, the audited entity and the registered auditor notify the Commission for Public Oversight of the Registered Auditors and the Institute of Certified Public Accountants of Bulgaria indicating the reasons within 7 days. In the case of a PIE audit, the relevant regulators and supervisors regarding the activity of the audited entity are notified.
- Restrictions regarding employment with the entity after finalization of the statutory financial audit are introduced. Individual registered auditors, responsible auditors, as well as all professionals, partners and other individuals participating in the implementation of the related statutory financial audit, may not be employed in an audited entity within 1 year and, in the case of a PIE audit, 2 years as of the date of finalization of the audit regarding the following positions:
  1. Management position;
  2. A member of an audit committee or a body carrying out audit committee functions;
  3. A member of the executive or supervisory body.



# Rotation of registered auditors of PIEs



\* The counting of the years starts from the beginning of the audited year.

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