

## EU AUDIT REFORMS – WHAT YOU NEED TO KNOW



**EU legislation to reform the statutory audit market was adopted in April 2014. The new legislation will apply from 17 June 2016 – with the exception of mandatory firm rotation, which is subject to separate transition arrangements.**

The legislation – in the form of a [Directive](#)<sup>1</sup> and a [Regulation](#)<sup>2</sup> – means that mandatory firm rotation of statutory audit firms will be introduced into the EU on a 10 yearly basis or less for all EU public interest entities (PIEs). There will also be additional restrictions on the non-audit services that audit firms can provide to their PIE statutory audit clients as well as enhanced reporting and corporate governance requirements. Overall this has significant implications for how companies will select, structure and manage their professional adviser relationships.

### Where do the rules apply?

This new legislation will apply in the 28 EU Member States and in Iceland, Liechtenstein and Norway as they are members of the European Economic Area. There will also be implications outside the EU.

### The Regulation affects EU PIEs – What is an EU PIE?

The definition of a PIE is set out in Article 2(13) of the Directive and ultimately determines the entities that fall within the scope of the Regulation. PIEs are categorised, irrespective of size, as follows:

- all entities that are both governed by the law of a Member State and listed on a [regulated market](#)<sup>3</sup>;
- all credit institutions in the EU, irrespective of whether they are listed;
- all insurance undertakings in the EU, irrespective of whether they are listed and irrespective of whether they are life, non-life, insurance or reinsurance undertakings; or
- all entities designated as PIEs by the Member State.

**Note:** categories (b) and (c) exclude branches of non-EU based credit institutions and insurance undertakings.

### How will Member States implement the EU legislation?

The Regulation contains 21 Member State options, with a further 30+ options in the Directive, giving Member States flexibility in implementing the new rules. This also means a continued period of uncertainty as Member States start to consider their local interpretation of the legislation and may lead to a patchwork of rules across the EU – both in terms of the mandatory firm rotation periods and which non-audit services are prohibited. Each Member State has two years

until 17 June 2016 to consider whether and how it wishes to amend the EU baseline locally.

Stakeholders will have the opportunity during the transition period to make their views known to national legislators as Member States adapt their legislative frameworks to the Regulation, transpose the Directive, and select from the options available to them.

### What do I need to know about this Legislation?

See our fact sheets on the following topics.

- Mandatory firm rotation for PIEs and transition arrangements.
- Restrictions on certain non-audit services to PIE audit clients.
- Audit committee role and responsibilities; and auditor oversight.
- Auditor reporting requirements.

<sup>1</sup> [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0196.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG)

<sup>2</sup> [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0077.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0077.01.ENG)

<sup>3</sup> [http://mifidatabase.esma.europa.eu/index.aspx?sectionlinks\\_id=23&language=0&pageName=REGULATED\\_MARKETS\\_Display&subsection\\_id=0&action=Go&ds=16&ms=1&ys=2014&mic\\_code=MIC%20Code&full\\_name=Full%20Name&cpage=2](http://mifidatabase.esma.europa.eu/index.aspx?sectionlinks_id=23&language=0&pageName=REGULATED_MARKETS_Display&subsection_id=0&action=Go&ds=16&ms=1&ys=2014&mic_code=MIC%20Code&full_name=Full%20Name&cpage=2)

## FACT SHEET: MANDATORY FIRM ROTATION FOR PUBLIC INTEREST ENTITIES AND TRANSITION ARRANGEMENTS



The new EU legislation introduces additional requirements for EU public interest entities (PIEs<sup>1</sup>), including mandatory firm rotation (MFR). The key MFR provisions are as follows.

Baseline measure <sup>2</sup>	10-year mandatory audit firm rotation for all PIEs in the EU
Member State options available to: <sup>3</sup>	Extend the period once for up to a maximum further <b>10 years</b> where a public tendering process is conducted – to a <b>maximum term of 20 years</b> .
	Extend the period once for up to a maximum further <b>14 years</b> where there is a joint audit arrangement – to a <b>maximum term of 24 years</b> .
	Implement a <b>shorter rotation period</b> . For example, Italy will be able to retain their existing rotation requirement of nine years.

### When does a tender have to be performed in order to extend the initial 10-year period to 20 years?

The latest possible time for a tender to be performed is after the end of the initial engagement period of up to 10 years. However, in practice companies may decide to put the audit out to tender before the end of this period. Guidance on how to conduct a tender and evaluate external auditors is available in the [KPMG Audit Committee Institute's handbook](#).<sup>4</sup>

### To qualify for the 14-year extension, is a joint audit required throughout the initial 10-year period?

No, a company does not need to have a joint audit throughout the first 10-year period in order to qualify for an extension up to 24 years. However, a Member State would need to allow the extension in cases where a company decides to have a joint audit, and the company would be required to have a joint audit for the entire 14-year extended period.

### Are there any circumstances in which the company can extend beyond the MFR requirements?

At the request of the audited entity, the national regulators or supervisory authorities can extend the maximum term once for a further two years in 'exceptional circumstances' and only where there has been either a joint audit or a public tender.

1 See Article 2(13) of the Directive for a full definition: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0196.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG)

2 Article 5 of the Regulation.

3 See summary of all Member State options at: [http://www.fee.be/index.php?option=com\\_content&view=article&id=1412&Itemid=106&lang=en](http://www.fee.be/index.php?option=com_content&view=article&id=1412&Itemid=106&lang=en).

4 <https://www.kpmg.com/Ca/en/services/Audit/AuditCommittee/Documents/ACI-Audit-Committee-Handbook.pdf>

## How will the MFR rules apply cross-border where a group operates in many EU states, each with a different regime?

Each EU PIE within the group will have to comply with the MFR rules applicable to the EU Member State in which it is based.

## How do the MFR rules apply to non-EU companies?

If a non-EU parent has controlled undertakings in the EU, and any of these controlled undertakings are PIEs in their own right, then the PIE's controlled undertakings will have to rotate their statutory auditor in line with the national law of the Member State where they are incorporated.

If a PIE parent in the EU has non-EU controlled undertakings, then those undertakings are not caught by the PIE definition and therefore they are not required to rotate their auditor.

## Do the new MFR requirements replace the need to rotate key audit partners?

No. There is still a requirement for key audit partners to rotate after a maximum of seven years, although a number of Member States require shorter partner rotation periods. This is also one of the Member State options. The regulation has extended the cooling off period from two years to three years.

## If a company becomes a PIE – e.g. on a flotation – and has the same auditor before and after its PIE status change, does tenure as auditor before it became a PIE count towards the relevant limits?

No – the period as auditor before the year in which the company becomes a PIE is not included in determining when the relevant limits are reached for the purpose of establishing which MFR transition rules apply.

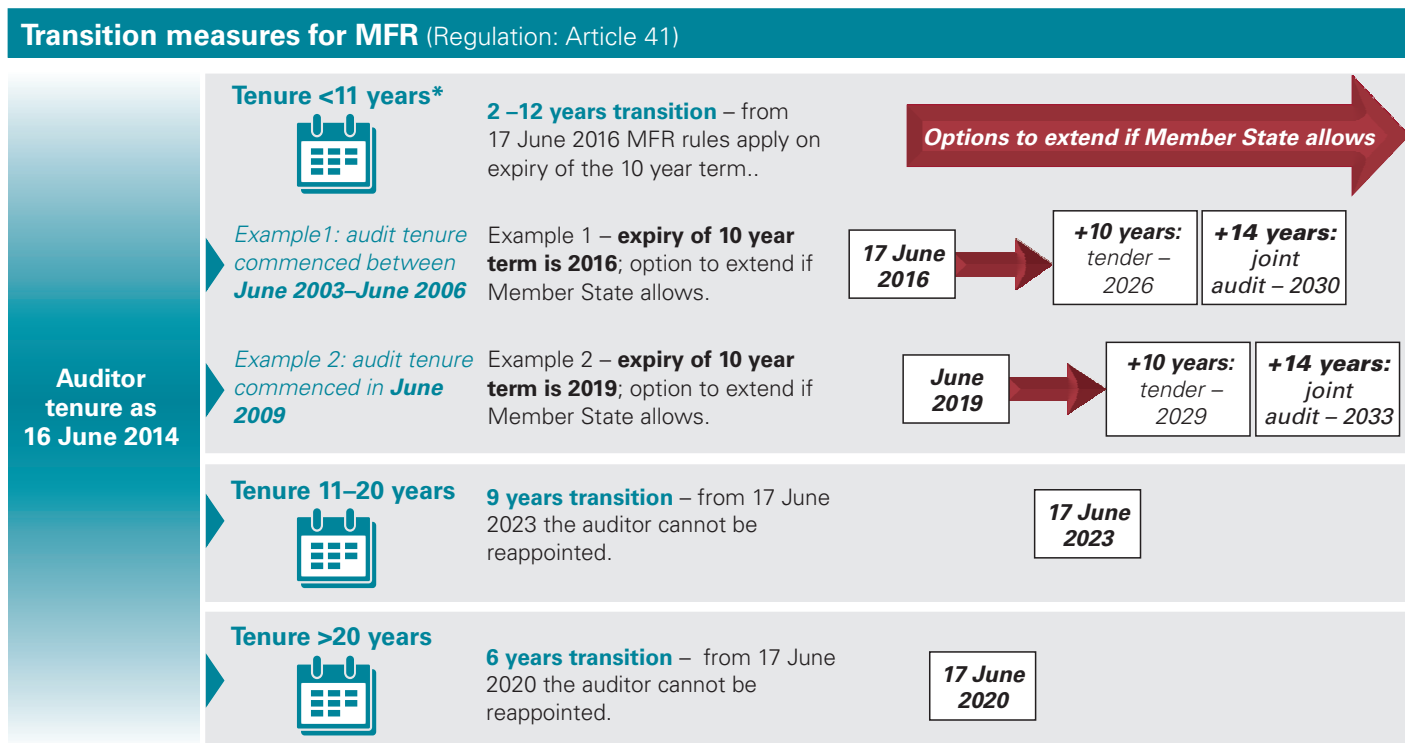
## If two PIE companies merge to create a new legal entity (also a PIE) and the same auditor is engaged before and after the merger, then what are the relevant time limits for MFR transition?

If a new legal entity is created because of the merger and is itself a PIE, then the audit tenure for MFR transition purposes generally starts to count from the date of creation of the new legal entity. However, legal advice may be required to assess the specifics of each case.

## What are the transition rules for MFR?

There are specific MFR transition rules in Article 41 of the [Regulation](#)<sup>5</sup>. These are based on the length of the existing statutory auditor/client relationship as at 16 June 2014 and are outlined in the diagram below.

<sup>5</sup> [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.007701.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.007701.ENG)



\* **Note: The regulation is unclear. The position for < 11 years above reflects the European Commission's interpretation and is still subject to scrutiny by EC Legal Services.** An alternative interpretation (which is not supported by the EC) is that a company should have at least **12 years from 16 June 2014**, the date of entry into force, before the rotation requirements begin to apply.

# What are the practical considerations for selection and management of professional advisers in light of this regulatory change?

All EU PIEs will be affected by EU audit reform legislation. How and when they are affected will differ from company to company, depending on a number of variables and the views of investors. The chart below identifies a number of initial considerations.

## Immediacy and depth of the impact of the new rules



### Ask yourself ...

### Considerations

<p><b>How many EU PIEs are in the group?</b></p> <p>Few ..... ? ..... Many</p>	<p>The rules may affect more entities than first thought.</p>
<p><b>What is the extent of my global footprint?</b></p> <p>Local (EU only) ..... ? ..... Global</p>	<p>The rules may affect undertakings located outside of the EU.</p>
<p><b>What is the longevity of the current auditors as at 16 June 2014?</b></p> <p>Low ..... ? ..... High</p>	<p>This will affect all EU PIEs but auditor longevity and mergers and acquisitions drive the timing of rotation as we transition to the new rules.</p>
<p><b>What level of outsourcing activities or global contracts exist with audit firms? (other than current auditors)</b></p> <p>Low ..... ? ..... High</p>	<p>The type of service may limit the number of audit firms available to tender for the statutory audit.</p>
<p><b>Does my business require auditors with specialised skills?</b></p> <p>General ..... ? ..... Specialised</p>	<p>The expertise needed may limit the number of audit firms with the right skill set available to tender for the statutory audit.</p>
<p><b>Where are my EU PIE subsidiaries located? Are there cross border implications?</b></p> <p>Known ..... ? ..... Unknown</p>	<p>Differing rotation rules may create a patchwork of auditors in the group – audit coverage by the group auditor may become an issue.</p>

For further information please speak to your usual KPMG contact.

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# FACT SHEET: RESTRICTIONS ON CERTAIN NON-AUDIT SERVICES TO PUBLIC INTEREST ENTITY AUDIT CLIENTS



## The new EU legislation introduces additional requirements for EU public interest entities (PIEs<sup>1</sup>), including non-audit services (NAS) prohibitions and fee capping.

The statutory auditor (and any member of their network) carrying out the statutory audit of a PIE is not allowed 'directly or indirectly to provide to the audited entity, to its parent undertaking or to its controlled undertaking within the EU any prohibited NAS.' The list of prohibited NAS will be more extensive for most EU Member States than it is today, with tax services significantly affected – unless Member States take the derogation to permit certain tax services. The table below lists the prohibited NAS:

 <b>PROHIBITED NAS</b> Article 5(1)		
<p><b>A. Tax services.</b></p> <ul style="list-style-type: none"> <li>i. Preparation of tax forms.</li> <li>ii. Payroll tax.</li> <li>iii. Customs duties.</li> <li>iv. Identification of public subsidies and tax incentives unless support from the statutory auditor or audit firm in respect of such services is required by law.</li> <li>v. Support regarding tax inspections by tax authorities unless support from the statutory auditor or audit firm in respect of such inspections is required by law.</li> <li>vi. Calculation of direct and indirect tax and deferred tax.</li> <li>vii. Provision of tax advice.</li> </ul> <p><b>B. Services that involve playing a part in the management or decision making of the audited entity.</b></p>	<p><b>C. Bookkeeping and preparing accounting records and financial statements.</b></p> <p><b>D. Payroll services.</b></p> <p><b>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 IT systems.</b></p> <p><b>F. Valuation services, including valuations performed in connection with actuarial services or litigation support services.</b></p> <p><b>G. Legal services, with respect to:</b></p> <ul style="list-style-type: none"> <li>i. the provision of general counsel;</li> <li>ii. negotiating on behalf of the audit entity; and</li> <li>iii. acting in an advocacy role in the resolution of litigation.</li> </ul> <p><b>H. Services related to the audit entity's internal audit function.</b></p> <p><b>I. Services linked to the financing, capital structure and allocation, and investment strategy of the</b></p>	<p><b>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.</b></p> <p><b>J. Promoting, dealing in or underwriting shares in the audited entity.</b></p> <p><b>K. Human resources services with respect to:</b></p> <ul style="list-style-type: none"> <li>i. management in a position to exert significant influence over the preparation of the accounting records or financial statements that are the subject of the statutory audit, where such services involve:             <ul style="list-style-type: none"> <li>a. searching for or seeking out candidates for such positions; or</li> <li>b. undertaking reference checks of candidates for such positions;</li> </ul> </li> <li>ii. structuring the organisation design; and</li> <li>iii. cost control.</li> </ul>

1 See Article 2(13) of the Directive for a full definition: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0196.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG).



## When will the NAS restrictions apply?

The NAS restrictions will become applicable from 17 June 2016 onwards.

## Can Member States add to or reduce the list of prohibited NAS?

Member States may add to the NAS prohibitions and may adopt legislation to further restrict NAS. However, they may not reduce the prohibited list, which is therefore a minimum baseline.

## What does 'playing any part in the management or decision-making' mean?

It is possible to interpret these words very widely, but it is thought that the logical interpretation would be the more familiar prohibition against the statutory auditor 'acting as management' or 'doing anything that is the responsibility of management'.

Recital (8) to the Regulation gives some guidance suggesting that services such as: 'working capital management, providing financial information, business process optimisation, cash management, transfer pricing, creating supply chain efficiency and similar.' However, further guidance is expected as Member States adopt the legislation.

## How are 'services linked to the financing, capital structure and allocation, and investment strategy of the audit client' defined?

The wording is not clear on which precise services it is seeking to prohibit. However as the recitals to the Regulation specifically refer to due diligence services, such services would be permitted.

## What is meant by 'cost control' in relation to human resources services?

The term 'cost control' applied to human resources services is potentially very broad. However, in this context it is qualified under the heading of 'human resources services' as being part of a line of exclusions that relate to recruitment, selection and job or organisation design. As such, it may be reasonable to assume that this exclusion relates specifically to advising on compensation and benefit costs – i.e. individual performance and reward services – which are part of the same 'family' of HR services. However further clarification of the meaning of this prohibition is expected.

## Is there a cooling-off/in requirement in relation to NAS prohibitions?

The statutory auditor cannot provide prohibited NAS to a PIE audit client during the period of the audit up to the release of the audit report.

For internal control-related services (Article 5.1(E)), there is also a 'cooling-in' restriction on provisions during the financial year immediately preceding the start of the audit.

The prohibition applies not only to the incoming auditor of the PIE itself, but also to any member of the auditor's network that provides these specific services either to the audited entity itself or to its parent undertaking(s) in the EU or its controlled undertakings in the EU.

## How do the NAS prohibitions apply to controlled undertakings incorporated outside the EU?

In general, the Regulation should not have any effect outside the EU. Another member firm of the network (other than the auditor of the PIE itself), whether it is in the EU or not, can potentially provide services included on the list of prohibited services to such controlled undertakings, but only if the auditor of the EU PIE can justify that the independence of its audit is unaffected.

However, three types of services are always deemed to affect the independence of the statutory auditor of the EU PIE and can never be provided by members of the network to controlled undertakings incorporated *outside* the EU, regardless of where these services are provided. These are:

- services that involve playing any part in the management or decision making of the audited entity (Article 5.1(B));
- bookkeeping and preparing accounting records and financial statements (Article 5.1(C)); and
- designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial IT systems (Article 5.1(E)).



## Are there any exceptions when the prohibited NAS may actually be permitted?

A number of tax services, as well as valuation services, **may still be provided** in certain cases, subject to a Member State derogation that requires the audit committee to conclude that the services in question comply with the following:

- they have **no direct or have immaterial effect**, separately or in the aggregate, on the audited financial statements;
- the estimation of the effect on the audited financial statements is **comprehensively documented** and explained in the additional report to the audit committee referred to in Article 11; and
- the principles of **independence** laid down in Directive 2006/43/EC are complied with by the statutory auditor or the audit firm.

This derogation is another Member State option and therefore is unlikely to be applied consistently across the EU.

However, tax services relating to payroll tax and customs duties are not included in the Member State option and therefore are never permitted.

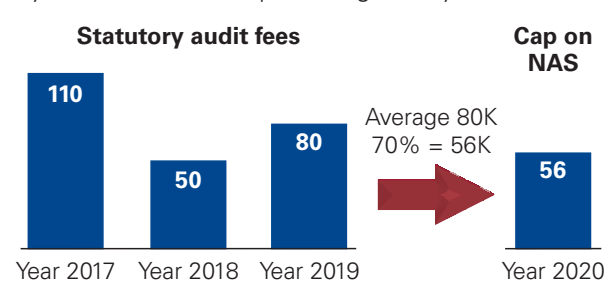


## What are the permitted NAS?

An auditor and its network can provide any NAS that is not explicitly prohibited to the audited PIE, its parent undertaking or its controlled undertakings (subject of course to general principles of independence). Approval of the audit committee is needed following an assessment of the threats to independence and the safeguards in place to mitigate or eliminate those threats. For further guidance on the role of the audit committee, see the [KPMG Audit Committee Institute's handbook](#).<sup>2</sup>

## Are there any restrictions in relation to permitted services?

Permitted services (other than those imposed by national or EU legislation) provided by the statutory auditor are subject to a cap of 70 percent 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 undertaking and controlled undertakings and of the consolidated financial statements of that group of undertakings. The relevant details of the fee cap are summarised in the table below. However, further guidance is expected as Member States adopt the legislation.

<p><b>How is the cap calculated?</b></p>	<p>Article 4 suggests that statutory audit fees include those of the PIE as well as those of its parent entity and controlled undertakings where appropriate.</p> <p>In order to determine the base measure of total 'statutory audit fees' one approach is to look at these in a group context (i.e. the statutory audit fees of the audited PIE aggregated with the statutory audit fees of any parent entities and/or controlled undertakings either inside or outside of the EU). The 70% cap is then computed on the average of these statutory audit fees over the preceding three years.</p> <p><b>Example:</b></p>  <table border="1" data-bbox="766 873 1372 1153"> <caption>Statutory audit fees and Cap on NAS</caption> <thead> <tr> <th>Year</th> <th>Statutory audit fees</th> <th>Cap on NAS</th> </tr> </thead> <tbody> <tr> <td>Year 2017</td> <td>110</td> <td></td> </tr> <tr> <td>Year 2018</td> <td>50</td> <td></td> </tr> <tr> <td>Year 2019</td> <td>80</td> <td></td> </tr> <tr> <td>Year 2020</td> <td></td> <td>56</td> </tr> </tbody> </table>	Year	Statutory audit fees	Cap on NAS	Year 2017	110		Year 2018	50		Year 2019	80		Year 2020		56
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<p><b>Can Member States opt for a stricter NAS fee cap than 70 percent?</b></p>	<p>Yes – Member States may establish stricter rules including stricter rules on a NAS fee cap.</p>															
<p><b>What are the transition arrangements for the NAS fee cap – do we need to count NAS fees before the legislation becomes law on 17 June 2016?</b></p>	<p>The NAS fee cap provision in the regulation is not retrospective and will not start to apply until 17 June 2016 onwards. Only then would the NAS fee cap 'clock' start to tick, at which point there would be three consecutive years before the cap would then apply in year four.</p>															
<p><b>What happens to the fee cap if our audit firm provides permitted services for only two years and there is then a break?</b></p>	<p>Any break in the consecutive nature of the permitted service would result in the clock effectively resetting itself back to zero.</p>															
<p><b>Are any services specifically excluded from the cap rule?</b></p>	<p>Yes. Article 4 explicitly states that services required by national or EU legislation are exempted from the calculation of the cap.</p> <p>In addition, a Member State option exists whereby the national regulator or supervisor at the statutory auditor's request may exempt the auditor from the fee cap requirement for no more than two financial years.</p>															
<p><b>Who is responsible for the operation of the cap?</b></p>	<p>The statutory auditor, with oversight by the audit committee.</p>															
<p><b>Does the cap have an extra-territorial effect?</b></p>	<p>The cap applies only to permitted NAS provided by the statutory auditor to the PIE and its parent(s) and controlled undertakings in the EU. However, it appears that statutory audit fees of non-EU parent companies of the PIE and of its non-EU controlled undertakings would be included in the calculation of the total 'statutory audit fees' on which the EU cap would be based.</p>															

<sup>2</sup> <https://www.kpmg.com/Ca/en/services/Audit/AuditCommittee/Documents/ACI-Audit-Committee-Handbook.pdf>

## What are the practical considerations for selection and management of professional advisers in light of this regulatory change?

All EU PIEs will be affected by EU audit reform legislation. How and when they are affected will differ from company to company, depending on a number of variables and the views of investors. The chart below identifies a number of initial considerations in relation to NASs.

### Immediacy and depth of the impact of the new rules



#### Ask yourself ...

#### Considerations

<p><b>How many EU PIEs are in the group?</b></p>	<p>Few ..... ? ..... Many</p>	<p>The rules may affect more entities than first thought.</p>
<p><b>What is the extent of my global footprint?</b></p>	<p>Local (EU only) ..... ? ..... Global</p>	<p>The rules may affect undertakings located outside of the EU.</p>
<p><b>What is my current spend on non-audit services by the auditors – both upstream and downstream from the EU PIE (non-EU subs may also affect the calculation)?</b></p>	<p>Low ..... ? ..... High</p>	<p>Fees in excess of 70 percent of three-year average audit fees are prohibited.</p>
<p><b>What level of outsourcing activities or global contracts exist with audit firms? (other than current auditors)</b></p>	<p>Low ..... ? ..... High</p>	<p>The type of service may limit the number of audit firms available to tender for the statutory audit.</p>
<p><b>Do I have any large transformation projects currently underway with assistance provided by audit firms?</b></p>	<p>Few ..... ? ..... Many</p>	<p>May limit the ability for potential audit firms engaged in these projects to become independent.</p>
<p><b>What is my visibility over non-audit spend by the current auditor at my PIE's EU parent?</b></p>	<p>Low ..... ? ..... High</p>	<p>The full list of potential independence issues may not be complete. Understand the full extent of services provided by our auditors.</p>
<p><b>Does my business require consultants with specialised skills?</b></p>	<p>General ..... ? ..... Specialised</p>	<p>The expertise needed may limit the number of audit firms with the right skill set available to tender.</p>

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## **FACT SHEET: AUDIT COMMITTEE ROLE AND RESPONSIBILITIES; AND AUDITOR OVERSIGHT**



**The new EU legislation, in the form of a Directive and a Regulation, introduces additional requirements specific to the role and responsibilities of audit committees; as well as changes to auditor oversight.**

### **What are the major changes to the role of the audit committee?**

Provisions affecting audit committees are contained in both the [Directive](#)<sup>1</sup> and [Regulation](#)<sup>2</sup>. The Directive states that 'Member States shall ensure that each public-interest entity (PIE) has an audit committee. The audit committee shall be either a stand-alone committee or a committee of the administrative body or supervisory body of the audited entity.' However, the functions assigned to the audit committee may be performed by the administrative or supervisory body as a whole.

In reality, most of the requirements for audit committees set out in the legislation are already being performed today and represent 'best practice'. So the only change of substance is the fact that these requirements are now being enshrined in law.

The table below outlines the requirements of all EU audit committees. However, Member States may decide that the certain PIEs are not required to have an audit committee and as such may opt to allow exemptions in certain scenarios as discussed further on page 2.

#### **Article 39.6 of the Directive states that the audit committee shall:**

- a. **inform** the administrative or supervisory body of the audited entity of the outcome of the statutory audit and **explain** the role of the audit committee in that process;
- b. **monitor** the financial reporting process and **submit recommendations** or proposals to ensure its integrity;
- c. **monitor** the effectiveness of the undertaking's internal quality control, risk management systems and internal audit (where applicable), regarding the financial reporting of the audited entity, without breaching its independence;
- d. **monitor** the performance of audits – taking into account the findings and conclusions of the audit reviews carried out by the competent authorities;
- e. **review** and **monitor** the independence of the statutory auditors<sup>3</sup>; and
- f. be **responsible** for the **procedure** for the selection of the statutory auditor.

1 [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0196.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG).

2 [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0077.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0077.01.ENG).

3 The use of the word 'auditors(s)' in this document refers to auditor(s) and/or audit firms.

## The Regulation sets out specific activities required of a PIE's audit committee – what are these?

The Regulation implements a number of new monitoring, reporting and approval provisions that will require more oversight by audit committees of PIEs. These are summarised in the table below.

Activities	Key provisions affecting audit committee oversight of PIE statutory audits
<b>Monitoring the level of audit fees</b>	Monitor the percentage of fees received from a PIE by the statutory auditor – including oversight by the audit committee of the operation of the 70% fee cap for permitted non-audit services (Article 4).
<b>Assessment of compliance</b>	Oversee the process by which the statutory auditor assesses the provision of permitted services, ensuring that the following requirements are complied with: <ol style="list-style-type: none"> <li>they have no direct or have immaterial effect, separately or in the aggregate, on the audited financial statements;</li> <li>the estimation of the effect on the audited financial statements is comprehensively documented and explained; and</li> <li>the process complies with the principles of independence (Article 5.3).</li> </ol>
<b>Pre-approval of permitted NAS</b>	Assess the threats to independence and the safeguards that the statutory auditor will apply to mitigate these threats, before approving permitted services. All permitted services require approval from the audit committee following this assessment (Article 5.4).
<b>Issuing guidelines and policy</b>	Issue guidelines and appropriate policy in relation to services that may be permitted subject to Member State derogation in relation to certain tax services and valuation services, provided that they are immaterial, comprehensively documented and independent – i.e. in line with the requirements of Article 5.3 above (Article 5.4).
<b>Appointment of statutory auditors</b>	Assess and recommend potential statutory auditors. The audit committee is responsible for the procedure and recommendation for the selection of the statutory auditors. The recommendation should consist of two choices for the audit engagement and the justified preference for one of them (Article 16.2).
<b>Extension of audit tenure</b>	Recommend extension of audit tenure only if appropriate. The maximum initial period (of up to 10 years) may be extended (for Member States that opt to permit extension) only if the audit committee recommends at the general meeting of shareholders that the engagement be renewed, and the proposal is approved (Article 17).
<b>Monitoring auditor independence</b>	Monitor auditor independence. The statutory auditor should confirm its independence annually to the audit committee of the audited entity and discuss any threat to its independence as well as the safeguards applied to mitigate those threats (Article 6.2).

## What is the audit committee's role in the audit tender process?

Audit committees are responsible for submitting a recommendation to the administrative or supervisory body of the audited entity for the appointment of the auditor. The recommendation should include at least two possible choices for the audit engagement and a justified preference for one of them.

Tender documents should contain transparent and non-discriminatory selection criteria to be used for the evaluation of proposals.

The audited entity has to prepare a report on the conclusions of the selection procedure, which is validated by the audit committee, to demonstrate that the selection procedure was conducted in a fair manner.

For further guidance on the role of the audit committee and tendering, see the [KPMG Audit Committee Institute's handbook](#).<sup>4</sup>

<sup>4</sup> <https://www.kpmg.com/Ca/en/services/Audit/AuditCommittee/Documents/ACI-Audit-Committee-Handbook.pdf>

## When is such a tender process required?

This procedure takes place for the new appointments of any statutory auditor and in particular applies to:

- first time appointments; and
- any reappointment when the audit reaches the initial maximum duration of the audit engagement.

## Who can be on an audit committee?

Provisions covering the make-up of the audit committee are set out in Article 39.1 of the Directive and are summarised in the table below.

✓	The audit committee should be <b>composed of independent non-executive members</b> of either the administrative body or the supervisory body.
✓	Audit committee members can be directly appointed at the annual general meeting. However, a majority of the members of the audit committee have to be <b>independent of the audited entity</b> .
✓	At least one member of the audit committee has to have <b>competence in accounting and/or auditing</b> .
✓	The committee members as a whole should have <b>competence relevant to the sector</b> in which the company has its business.
✓	The Chair of the audit committee is <b>appointed by its members</b> or by the supervisory body of the audited entity. Note – Member States can opt to require the Chairman be elected annually by the shareholders general meeting.

## Are there any exemptions from the requirement to have an audit committee?

Article 39.1 of the Directive states that 'Member States shall ensure that each public-interest entity has an audit committee.' However, Member States may opt to exempt certain PIEs as summarised in the table below.

Member State option <sup>5</sup>
Where all members of the audit committee are <b>members of the administrative or supervisory body</b> of the audited entity, Member States may provide that the audit committee is to be exempt from the independence requirements.
Member States may decide that <b>certain subsidiary undertakings, credit institutions, undertakings for collective investment in transferable securities (UCITS) and issuers of asset-backed securities</b> are not required to have an audit committee.
Member States may require or allow a PIE not to have an audit committee provided that it has a <b>body or bodies performing equivalent functions to an audit committee</b> , established and functioning in accordance with provisions in place in the Member State in which the entity to be audited is registered.
In such a case, the entity has to disclose which body carries out those functions and how that body is composed.

## Who will be responsible for auditor oversight in the EU and what is their remit?

National oversight bodies still remain responsible for oversight at a Member State level. However, a new body is to be established, a Committee of European Audit Oversight Bodies (CEAOB), which will take over the existing role of the European Group of Auditor Oversight Bodies (EGAOB) and will oversee cooperation between Competent Authorities.

The CEAOB will be chaired by and comprise of the national authorities responsible for auditor oversight and will have the following responsibilities:

- facilitate the exchange of information, expertise and best practices for the implementation of this legislation;
- provide expert advice to the Commission as well as to the competent authorities, at their request, on issues related to the implementation of this legislation;
- contribute to the technical assessment of public oversight systems of third countries and to the international cooperation between Member States and third countries;
- contribute to the technical examination of international auditing standards, including the processes for their elaboration, with a view to their adoption at EU level;
- contribute to the improvement of cooperation mechanisms for the oversight of public-interest entities' statutory auditors, audit firms or their networks;
- carry out other coordinating tasks in the cases provided for in this legislation.

5 See summary of all Member State options at: [http://www.fee.be/index.php?option=com\\_content&view=article&id=1412&Itemid=106&lang=en](http://www.fee.be/index.php?option=com_content&view=article&id=1412&Itemid=106&lang=en).

## What are the practical considerations for audit committees in light of this regulatory change?

All EU statutory audits will be affected by the EU audit reform legislation. How and when they are affected will differ from company to company, depending on a number of variables and the views of investors. The chart below identifies a number of initial considerations in relation to the role and responsibility of audit committees.

### Immediacy and depth of the impact of the new rules



#### Ask yourself ...

#### Considerations

<p><b>Does our entity have/require an audit committee? Should I establish one?</b></p> <p style="text-align: center;">No ..... ? ..... Yes</p>	<p>Member State options may allow certain entities to be exempt from requiring an audit committee based on size and complexity.</p>
<p><b>Do I have adequate resources on the audit committee?</b></p> <p style="text-align: center;">Insufficient ..... ? ..... Sufficient</p>	<p>Review the terms of reference of an audit committee. Assess the independence, competence and capacity of its members.</p>
<p><b>Will the requirements be significantly different from how we operate today?</b></p> <p style="text-align: center;">No ..... ? ..... Yes</p>	<p>The legislation may require a change of approach to governance, structure and even culture in some operations as the new legislation becomes applicable throughout the EU. The impact will be more significant in markets with less mature corporate governance regimes.</p>
<p><b>How formalised is our approach to independence – e.g. is our NAS policy fit for purpose?</b></p> <p style="text-align: center;">No policies ..... ? ..... Formalised approach</p>	<p>There should be clarity around what non-audit services are permissible and what are prohibited. Permissible services require audit committee approval.</p>
<p><b>Do we have established procedures for carrying out an audit tender?</b></p> <p style="text-align: center;">No procedures ..... ? ..... Well established</p>	<p>The audit committee now has explicit responsibility for audit tenders and should ensure transparent, non-discriminatory selection criteria are used; including an assessment of the performance of auditors.</p>

For further information please speak to your usual KPMG contact.

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## FACT SHEET: AUDITOR REPORTING REQUIREMENTS



**The new EU legislation introduces additional reporting requirements for the statutory auditor of EU public interest entities (PIEs<sup>1</sup>) covering the statutory audit report, audit committee reporting and reporting to supervisory bodies of PIEs.**

### 1. Audit report<sup>2</sup>

The legislation relating to auditor reports includes a series of requirements designed to enhance investors' understanding of the audit process, including the critical judgements made during the audit. The table below summarises the key requirements.

#### For an EU PIE, the audit report has to at least ...

- a. state by whom or by which body the statutory auditor<sup>3</sup> was appointed;
- b. indicate the date of the appointment and the period of total uninterrupted engagement, including previous renewals and reappointments of the statutory auditor;
- c. in support of the audit opinion, provide:
  - i. a description of the most significant assessed risks of material misstatement, including due to fraud;
  - ii. a summary of the auditor's response to those risks; and
  - iii. where relevant, key observations arising with respect to those risks.

The audit report has to include, for items (i)–(iii) above, a clear reference to the relevant disclosures in the financial statements;
- d. explain to what extent the statutory audit was considered capable of detecting irregularities, including fraud;
- e. confirm that the audit opinion is consistent with the additional report to the audit committee;
- f. declare that the prohibited non-audit services (NASs) were not provided and that the statutory auditor remained independent of the audited entity in conducting the audit; and
- g. indicate any services, in addition to the statutory audit, that were provided by the statutory auditor to the audited entity and its controlled undertaking(s), and which have not been disclosed in the management report or financial statements.

1 See Article 2(13) of the Directive for a full definition: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0196.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG).

2 See Article 10 of the Regulation: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0077.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0077.01.ENG).

3 The use of the word 'auditors(s)' in this document refers to auditor(s) and/or audit firms.

## For ALL statutory audits in the EU (not just statutory audits of PIEs), the auditor also has to:

Express clearly their opinion on:

- a. whether the annual financial statements give a true and fair view in accordance with the relevant financial reporting framework; and,
- b. where appropriate, whether the annual financial statements comply with statutory requirements.

Provide a statement on any material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern.

Include an opinion and a statement, both of which have to be based on the work undertaken in the course of the audit.

## What are the key new requirements for audit reports?

As summarised in the table above, both the Regulation and the Directive contain detailed provisions relating to the content of the audit report.

For **PIEs**, the audit report will need to provide, in support of the audit opinion:

- a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud;
- a summary of the auditor's response to those risks; and
- where relevant, key observations arising with respect to those risks.

For **ALL** statutory audits in the EU (not just statutory audits of PIEs), the audit report will need to:

- 'provide a statement on any material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern'.

## Are the new audit report requirements in line with the IAASB<sup>4</sup> requirements?

Much of the audit report will be consistent with the existing IAASB requirements, although there are still likely to be some unique EU disclosures – e.g. a declaration that no prohibited non-audit services have been provided to the audited entity and a separate indication of the length of the auditor-client relationship.

The IAASB is currently debating whether audit reports should include a description of the significant risks of material misstatement, a summary response to those risks and, where relevant, key observations arising with respect to those risks. To the extent possible, the most recent discussions have been factored into the new legislation; however, the wording of any final IAASB modifications may not be exactly the same as the Regulation.

## 2. Additional report to the audit committee<sup>5</sup>

Statutory auditors of PIEs will be required to provide a written report to the audit committee. This is already the case in some Member States, but this requirement will now apply for PIEs throughout the EU. This report will provide more detailed information on the results of the audit performed, together with explanatory text.

## What are the key requirements of the report to the audit committee?

Auditors will be required to disclose 'the quantitative level of materiality applied to perform the statutory audit for the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions account balances or disclosures, and disclose the qualitative factors which were considered when setting the level of materiality'.

Auditors will also be required to 'report and explain judgements about events or conditions identified in the course of the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty, and provide a summary of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been taken into account when making a going concern assessment'.

The table at Appendix 1 outlines the key requirements.

4 International Auditing and Assurance Standards Board

5 See Article 10 of the Regulation: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0077.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0077.01.ENG)

## Are the requirements a significant departure from current practice?

Although many of the requirements do not constitute a significant departure from current practice, there are some new requirements, more specificity required and some that require further clarification, including:

- 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 of which balance sheet categories have been directly verified and which have been based on system and compliance testing;
- a report on 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 the 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 the deficiency in question has been resolved by the management; and
- the significant difficulties, if any, encountered during the audit.

The full list of requirements for the report to the audit committee is set out in the Appendix.

## When does the additional report have to be provided to the audit committee?

The statutory auditor has to submit the additional report to the audit committee not later than the date of submission of the audit report.

## Does the additional report to the audit committee have to be in writing?

The auditor has to discuss with the audit committee any key matters addressed in the additional report, and in particular any significant deficiencies in the audited entity's financial statements, internal financial control systems and accounting systems.

## Will the additional report to the audit committee be a public document?

No – however, on request, and in accordance with national law, the auditor is required to make available without delay the additional report to the competent authorities.

## Are there any Member State options in relation to either auditor reporting or audit committee reporting?

Yes – there are numerous Member State options in the legislation, including on auditor reporting requirements. The table below summarises the key options.

### Member State options<sup>6</sup>

Member States may lay down additional requirements in relation to the content of the audit report.

Member States may lay down additional requirements in relation to the content of the additional report to the audit committee and may additionally require that this additional report be submitted to the administrative or supervisory body of the audited entity (in addition to the audit committee).

Member States may allow the audit committee to disclose that additional report to such third parties as are provided for in their national laws.

## 3. Other reporting requirements

### Reporting irregularities – Article 7 (Regulation)

If the Statutory auditor of the PIE has 'reasonable grounds to suspect that irregularities, including fraud with regard to the financial statements of the audited entity, may occur or have occurred' then the Regulation requires that the statutory auditor informs the audited entity; invites it to investigate the matter; and takes appropriate measures to deal with and prevent any recurrence of such irregularities in the future. If the audited entity does not investigate the matter or take appropriate action the statutory auditor is required to inform the Competent Authority.

<sup>6</sup> See summary of all Member State options at: [http://www.fee.be/index.php?option=com\\_content&view=article&id=1412&Itemid=106&lang=en](http://www.fee.be/index.php?option=com_content&view=article&id=1412&Itemid=106&lang=en).

## Report to supervisors of PIEs – Article 12 (Regulation):

Auditors are required to report on any information identified during the course of the statutory audit of the PIE that may relate to the following.

### Report to supervisors of PIEs:

- a. a material breach of the laws, regulations or administrative provisions that lay down, where appropriate, the conditions governing authorisation or that specifically govern pursuit of the activities of the PIE;
- b. a material threat or doubt concerning the continuous functioning of the PIE; and
- c. a refusal to issue an audit opinion on the financial statements or the issuing of an adverse or qualified opinion.

The statutory auditor has the same duty to report any information referred to in points (a), (b) or (c) above that they become aware of in the course of carrying out the statutory audit of an undertaking that has close links<sup>7</sup> with the PIE.

Member States may require additional information from the statutory auditor provided that it is necessary for effective financial market supervision as provided for in national law.

## Transparency reporting – Article 13 (Regulation):

Any statutory auditor of PIEs is required to publish an annual transparency report that includes the following.

### Transparency report

- A list of the PIEs for which statutory audits were carried out during the preceding financial year.
- Information about the total turnover of the statutory auditor divided into:
  - revenues from the statutory audit of annual and consolidated financial statements of PIEs and entities belonging to a group of undertakings whose parent undertaking is a PIE;
  - revenues from the statutory audit of annual and consolidated financial statements of other entities;
  - revenues from permitted non-audit services to entities that are audited by the statutory auditor; and
  - revenues from non-audit services to other entities.
- A description of the internal quality control system of the statutory auditor and a statement on the effectiveness of its functioning.
- An indication of when the last quality assurance review was carried out.
- A statement concerning the statutory auditor's independence practices, which also confirms that an internal review of independence compliance has been conducted.
- A description of the statutory auditor's policy concerning the rotation of key audit partners.
- Other specific details on the legal structure, ownership of the audit firm, network affiliation and governance structure.

The transparency report will be made public within four months of the end of each financial year on the auditors website. KPMG's 2013 International transparency report is available on our [website](#)<sup>8</sup>.

For further information please speak to your usual KPMG contact.

<sup>7</sup> Has the meaning assigned to that term in point (38) of [Article 4\(1\) of Regulation \(EU\) No 575/2013](#) of the European Parliament and of the Council.

<sup>8</sup> <http://www.kpmg.com/global/en/about/governance/pages/transparency-report.aspx>



## Appendix 1: Report to the audit committee

The Regulation states that the auditor has to explain the results of the statutory audit in an additional report to the audit committee, which at least:

- a. includes a **declaration of independence**;
  - b. where the statutory audit was carried out by an audit firm, identifies each **key audit partner involved** in the audit;
  - c. where the statutory auditor or the audit firm has made arrangements for any of its activities to be conducted by another statutory auditor or audit firm that is not a member of the same network, or has used the work of external experts, indicates that fact and **confirms that the statutory auditor** or the audit firm **received a confirmation from the other statutory auditor** or audit firm and/or the external expert regarding their independence;
  - d. **describes the nature, frequency and extent of communication with the audit committee** or the body performing equivalent functions within the audited entity, the management body and the administrative or supervisory body of the audited entity, including the dates of meetings with those bodies;
  - e. includes a **description of the scope and timing** of the audit;
  - f. where more than one statutory auditor or audit firm have been appointed, **describes the distribution of tasks** among the statutory auditors and/or the audit firms;
  - g. describes the methodology used, including which categories of the balance sheet have been **directly verified** and which categories have been **verified based on system and compliance testing**, including an explanation of any substantial variation in the weighting of system and compliance testing when compared with the previous year, even if the previous year's statutory audit was carried out by other statutory auditor(s) or audit firm(s);
  - h. discloses the **quantitative level of materiality applied** to perform the statutory audit for the financial statements as a whole and, where applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures, and discloses the qualitative factors that were considered when setting the level of materiality;
  - i. reports and explains **judgements about events or conditions** identified in the course of the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty, and provides a summary of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been taken into account when making a going concern assessment;
  - j. reports on any **significant deficiencies** in the audited entity's or, in the 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 has to state whether the deficiency in question has been resolved by management;
  - k. reports any significant matters involving **actual or suspected non-compliance with laws and regulations** or articles of association that were identified in the course of the audit, in so far as they are considered to be relevant in order to enable the audit committee to fulfil its tasks;
- l. reports and assesses the **valuation methods applied** to the various items in the annual or consolidated financial statements, including any impact of changes of such methods;
  - m. in the case of a statutory audit of consolidated financial statements, explains the scope of consolidation and the exclusion criteria applied by the audited entity to the non-consolidated entities, if any, and whether those criteria applied are in accordance with the financial reporting framework;
  - n. where applicable, identifies any audit work performed by third-country auditor(s), statutory auditor(s), third-country audit entity(ies) or audit firm(s) in relation to a statutory audit of consolidated financial statements other than by members of the same network as to which the auditor of the consolidated financial statements belongs;
  - o. indicates whether all requested explanations and documents were provided by the audited entity; and
  - p. reports:
    - i. any significant difficulties encountered in the course of the statutory audit;
    - ii. any significant matters arising from the statutory audit that were discussed or were the subject of correspondence with management; and
    - iii. any other matters arising from the statutory audit that in the auditor's professional judgement are significant to the oversight of the financial reporting process.