cutting through complexity

EU AUDIT REFORM;
redefining the global professional services market

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It's been three years in the making but the way businesses choose and work with their auditors in the European Union (EU) is changing for good.

Companies deemed public interest entities (PIEs) in the EU, as well as multi-nationals headquartered elsewhere with EU based PIE subsidiaries, face new rules on how long they can work with their auditors and restrictions on other work their audit firms are permitted to provide. Audit committee members also face increased responsibilities.

Following publication of the regulations in the EU's official journal in late May the clock is now ticking. The reforms become applicable throughout the EU on 17 June 2016, so time is of the essence.

According to KPMG International's Chairman, John Veihmeyer: "These are significant reforms that have prompted much debate. The time has arrived to take action in assessing how the changes will affect businesses and determining the best responses to these reforms."

The new rules mean PIEs must switch their audit firms at regular intervals, compelling many businesses to end long-standing audit relationships. Businesses may also need to seek other providers for services such as tax and corporate finance as new curbs are placed on the additional services that can be provided by an audit firm to their clients. Audit committee members also face additional responsibilities including scrutinising audit tenders more closely.

The changes constitute a redrawing of client-auditor relationships in the EU, and go further than the guidelines of either the International Ethics Standards Board for Accountants (IESBA) or the independence rules of the SEC, the US financial watchdog.

The new legislation presents an additional challenge, as the final audit environment is unlikely to be uniform across the EU. Member states already enforcing auditor rotation are allowed to keep their existing rules, while all EU member states are permitted to go beyond the EU rules to introduce in some cases tougher measures if they wish. These derogations have the potential to produce a complex patchwork of audit legislation which all companies doing business in the EU will need to navigate. Consequently, it is crucial that businesses understand how their geographic footprint affects their obligations under the new laws.

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> **John Veihmeyer**
> Chairman, KPMG International

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Mandatory firm rotation

One of the biggest changes in the reforms is the introduction of mandatory audit firm rotation, which will force companies to switch auditors on a regular basis. This follows a prolonged debate in Brussels and acts on fears among law makers that extended relationships run the risk of over familiarity between auditors and their clients.

Companies considered PIEs will, under the baseline requirements, be required to rotate their auditor at least every ten years. But in reality the picture is more nuanced, complicated by transitional arrangements and options to allow member states to modify the rules.

The introduction of mandatory firm rotation will be staggered, depending on how long the current auditors have been in place. "The rotation rules will come in progressively," says Rod Devlin, KPMG's Global Audit Quality & Risk Management Partner. "The first tranche of public interest entities to be affected is likely to be those where audit tenure is 11 years or less on 16 June 2014, the date of entry into force of the regulation. Under the European Commission's interpretation such engagements would be subject to the new rules as soon as the 10 year term is reached. This could mean tendering or rotation with effect from 17 June 2016 for client-auditor relationships that were first entered into between 17 June 2003 and 16 June 2006."

The second tranche – those PIEs whose audit tenure is 20 years or more in 2014, will be required to change audit firms no later than 6 years from now, by 2020, whereas those with an audit relationship of 11 – 20 years in 2014 will need to rotate auditors no later than 9 years from now, by 2023.

Once the switch has been made companies can retain their new auditors for up to ten years. But even here there are options available to Member States. The period can be extended to 20 years, if a public audit tender is held after the first ten years or to 24 years if a company is required or decides to appoint joint auditors.

The provisions could give companies more continuity with their auditors than the reforms might initially suggest, a factor audit committees will need to consider when developing their audit policy.

The rule change means parent companies inside and outside the EU will need to know how long each of their EU based PIE subsidiaries has worked with their current audit firms and factor in the lead time needed for tendering and transition to new auditors and other service providers.

They will also need to keep a close watch on how rules may be modified from one EU member state to another. In Italy public companies are currently required to change their auditors after 9 years and the legislation allows them to retain this model if they wish.

"The audit regulation will affect all businesses with PIE companies in the EU regardless of where the parent is domiciled," says Rod Devlin.

> *"Groups will need to look carefully at how the rules are adopted by each EU member state as there are many options available to national governments"*

Rod Devlin
Global Audit Quality & Risk Management Partner

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Restrictions
on other services provided by auditors

The EU Audit Reforms prohibit a number of services from being provided by a PIE's statutory auditor. These restrictions are viewed as a way of strengthening auditor independence.

A list of prohibited services which auditors or members of their network cannot provide to their PIE audit clients has been compiled. Member states may vary these prohibitions within certain constraints.

The new rules will amount to a more extensive web of restrictions than are currently in place in many EU member states. Topping the list of prohibited services is tax advice. Others include bookkeeping and preparation of accounts, valuation services, legal services, services relating to internal audit functions, corporate finance and human resources.

Companies are permitted to buy services from their auditors which are not on the prohibited list. In addition, certain services related to tax form preparations, some tax calculations and the identification of public subsidies and valuation services may also be allowed, but only where the member state specifically permits these as a derogation from the legislation.

All permissible non-audit services provided by the auditors will be capped, their value restricted to no more than 70% of the group audit fee. Individual EU member states are permitted to impose a lower cap and apply tougher restrictions if they wish.

"Any company with operations in the EU will need clear visibility of what additional services are provided by their auditors across all functions and in all the EU jurisdictions. This will then need to be checked against the EU rules, and any enhancements made by individual member states," says Greg Wiebe, KPMG's Global Head of Tax.

"This may entail a substantial piece of work. But it is essential if companies are to understand how to avoid falling foul of the new rules."

"These changes mean that businesses will need to take a holistic view of their relationships with current professional services providers, and determine the role they want them to play, both in the short and long term"

Isabelle Allen
Global Head of Sales and Markets

"The reforms have imposed clear service restrictions which will affect not only the EU's domestic companies but also the European subsidiaries of international enterprises"

Greg Wiebe
Global Head of Tax

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Expanded roles for audit committees

Audit committees are also affected by the new reforms. Despite most of the responsibilities listed in the new regulation being considered "best practice" and already widely in use, the reforms include details which represent big changes for any non-executives overseeing their company's audits.

Perhaps the most substantial change is in respect of the audit tender process. Under the EU Audit Reforms, audit committees will have explicit responsibility for the tender of their company's audit, are encouraged to consider appointing smaller audit firms (not just the 'Big Four') and must recommend at least two options for auditor selection with a justified case for one of them. They will also need to be aware of the different options individual EU member states may decide to adopt, an added complexity for international companies operating in more than one EU member state.

The changes represent a challenge for those on audit committees, according to Tim Copnell, Associate Partner with KPMG's Audit Committee Institute.

> *"The new regulations not only increase the expectations placed on audit committees but have the potential to change the way they think about their auditors and the processes by which they exercise oversight over them"*
>
> **Tim Copnell**
> Associate Partner with KPMG's Audit Committee Institute

One practical issue will be the timetable for tendering where schedules will be driven for many companies by the transitional arrangements for introducing mandatory audit firm rotation and the other services currently provided by their audit firms. There may also be advantages in accelerating the audit tender process ahead of the deadlines to ensure the widest choice of auditor, especially when competition is tight.

Audit committees will also need to be acutely aware of new restrictions on the additional services that can be provided by their audit firm. This will affect an audit committee's policy on non-audit services and their new role of pre-approving all non-audit services provided by their audit firms.

"There is a great deal of detail to come to terms with. Audit committees will need to understand the changes and their implications as well as ensuring there are plans in place to deal with them." adds Copnell.

Impact on business

Taken as a whole, the restrictions will present a challenge to businesses, particularly those who have relied on their auditors to provide additional valued services. Companies will need to balance their preference for an auditor with their preferred advisers in other areas.

Coming to terms with the reforms will require a careful and ordered approach. "Companies across Europe and international businesses with operations in the EU are beginning to understand the significant impact the reforms will have on audits and the services provided by auditors." says John Veihmeyer.

"With the first set of rules to be applied in 2016, there is a great deal of work to be done to prepare. KPMG is a leader in working with companies to respond efficiently and effectively to the new requirements in every EU country where they do business."

For further information please reach out to your local KPMG contact.

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