KPMG

cutting through complexity

3 April 2014

EU audit reforms – the KPMG view

The European Parliament has now voted to approve a Regulation and a Directive intended to reform the audit market in the EU. It remains 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, consequently all stakeholders need to begin to plan now for the new rules.

The changes that this new legislation will bring about are significant. KPMG's view has always been that any measures should have a clear and unequivocal benefit to audit quality, provide for a robust framework for auditor independence and strengthen corporate governance. We believe the adoption of International Standards on Auditing, expanded auditor reporting requirements and strengthening of the role of independent audit committees will positively contribute towards audit quality; in this regard we are supportive of the changes.

We continue to believe, however, that other aspects of the legislation, such as mandatory firm rotation combined with significant restrictions on non-audit services, will inevitably reduce choice for shareholders, while increasing costs and complexity.

The key requirements of the new legislation are summarised below

Public Interest Entities (PIEs)

- The Regulation affects the statutory audits of PIEs.
- 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.

International Standards on Auditing (ISAs)

- The European Commission is empowered to adopt ISAs within the EU.

Auditor reporting to shareholders

- The Regulation contains expanded auditor reporting requirements aimed at enhancing investors' understanding of the audit process including critical judgements made during the audit.

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Audit Committees

- Audit Committee approval is required for all permissible non-audit services after having assessed the threats and safeguards to auditor independence. Audit committees may also issue guidelines regarding the provision of tax and valuation services if a Member State exercises its option to permit these.
- The Regulation requires a written report by the statutory auditor to the Audit Committee.

Restrictions on Non-Audit Services (NAS) to audited entities

- 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 NAS prohibitions include, inter alia, tax compliance, tax advice, corporate finance and valuation services. Member States also have the option to allow certain tax and valuation services on condition that they do not have a direct effect on the financial statements or, if they do, that the effect is immaterial.
- The prohibitions in the Regulation are far more extensive than the rules currently in place in many EU Member States today and go well beyond the international independence requirements in the IESBA Code or indeed the SEC's independence rules in the US.
- The prohibitions also extend to the financial year immediately preceding the appointment of the statutory auditor ("clean period") with regard to designing and implementing internal control or risk procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems.
- Permissible NAS are also "capped" if they exceed 70% of the statutory audit fee.
- Member States have the option to add to the list of prohibited NAS and apply a cap that is lower than 70%.

Mandatory Firm Rotation (MFR)

- Every company that falls within the PIE definition is required to rotate their auditors after a ten year period and Member States are allowed to adopt a shorter period.
- The Regulation also grants Member States the option to allow PIEs to extend the rotation period to (i) a maximum of 20 years if a public tender takes place on expiry of the 10 year period or (ii) to a maximum of 24 years where a joint auditor is appointed.
- Non-EU groups that have an EU based PIE in their group structure will be required to rotate the auditors of those subsidiaries.

Transition arrangements for the legislation

- 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.
- There are specific transitional provisions for the mandatory audit firm rotation requirements which come into effect progressively starting with long tenure audit engagements (>20 years); these have a six year transition period from the date of entry into force. PIEs will therefore be required to change their auditors no later than 2020 on such engagements.

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KPMG'S VIEW OF THE LEGISLATION

KPMG has consistently supported the elements of the legislation that are consistent with the aim of enhancing audit quality, strengthening corporate governance and promoting greater transparency for all stakeholders. In particular:

1. Auditing Standards and auditor reporting

- The adoption of International Standards on Auditing will help to promote greater consistency throughout the EU.
- We support expanded auditor reporting; the principles of the new report are substantially consistent with ongoing international developments such as those lead by the IAASB.

2. Enhancing the role of the audit committee

- We support strong, independent audit committees and believe that they should be actively involved in assessing audit quality and auditor independence, including approving any non-audit services to be provided by the auditor. We therefore support the measures taken to strengthen the role of the Audit Committee.
- Expanded reporting by the statutory auditor to the Audit Committee will promote greater transparency around the audit process, improving the awareness of audit committee members by increasing the focus on key audit issues.

3. Strengthening of auditor oversight and communication with prudential regulators

- We welcome the creation of a new Committee of European Audit Oversight Bodies (the CEAOB) which we believe will contribute to promoting greater consistency in the EU.
- Increased three-way communication between auditors, banks and prudential regulators covering the major financial institutions should help to enhance the overall risk assessments made by the European Systemic Risk Board and promote greater transparency on broader systemic issues in the EU that may be identified from audits of SIFIs.

While there are certain positive aspects to the reforms, we continue to believe that other aspects of the legislation run counter to the original objectives of the reform which were to enhance audit quality, increase market choice and reduce concentration. In many areas the legislation will, on the contrary, increase complexity and cost for business, reduce choice and create inconsistencies between Europe and the rest of the world.

1. Mandatory Firm Rotation (MFR) combined with further restrictions on non-audit services

- We believe that mandatory audit firm rotation will reduce choice in the market place by removing the incumbent auditor from the tender process; other firms will also be unable to tender due to the expanded restrictions on non-audit services.

2. A regulatory patchwork in the EU

- There are approximately 20 Member State options in the new Regulation giving Member States a significant degree of flexibility in interpretation and implementation of the new rules. Unfortunately, this flexibility will result in a patchwork of different requirements across the EU. The patchwork will create an unnecessarily complex and costly regulatory compliance environment for companies and their auditors in the EU.

3. Inconsistency with existing internationally recognised standards

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

4. Significant extra-territorial reach

- Although the EU Regulation is primarily aimed at EU entities, the rules will also impact groups based outside the EU. The EU PIE definition will impact, for example, EU based subsidiaries of non-EU parent companies to the extent that those subsidiaries are either credit institutions, insurance undertakings or have debt or equity admitted to trading on an EU Regulated Market. To the extent that those entities meet the definition of an EU PIE they will be affected by all of the above measures.

It now falls to each of the National Governments of the 28 EU Member States to adapt to and apply the new legislation. KPMG is fully committed to working in the public interest with regulators, governments and the business community to ensure that the new legislation is implemented as effectively as possible.

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