KPMG
cutting through complexity

March 2015

EU AUDIT REFORM – WHAT YOU NEED TO KNOW

FACT SHEET: THE IMPACT OF THE EU AUDIT LEGISLATION BEYOND THE EU

The new European Union (EU) legislation does not directly apply to entities outside of the EU – but certain European subsidiaries of non-EU parents could be scoped in to the requirements.

The rules become effective as from 17 June 2016, however, multi-nationals should take steps now to understand if and how the legislation affects their EU subsidiaries.

What are the key requirements that could have some impact for entities outside of the EU?

The two key provisions which could have some impact are mandatory firm rotation (MFR) and the restrictions around Non-Audit Services (NAS). The MFR and NAS Fact Sheets should be read in conjunction with this Fact Sheet as they contain background details that support the concepts outlined below:

	MFR	NAS
Baseline measure:	• 10-year mandatory audit firm rotation for all EU Public-Interest Entities (PIEs) (maximum duration period).	• Expands the list of NAS the statutory auditor, and certain of its network firms, cannot provide. • A fee cap of 70% on permitted NAS performed by the statutory auditor.
Member State options available to:	• Extend the maximum duration period once up to a maximum of 20 years (in the event of a public tender) or 24 years (for a joint audit). • Implement a shorter maximum duration period of less than 10 years.	• Prohibit additional NAS. • Permit certain tax and valuation services. • Set the NAS fee cap lower than 70%. • Establish stricter rules around permitted NAS.
Effective date:	• Transition period depends on the length of the current audit firm's tenure as at 16 June 2014.	• NAS prohibitions apply to the first financial year end commencing after 17 June 2016.

MFR – How do the rotation rules apply to EU subsidiaries of a non-EU parent?

If a non-EU parent has subsidiaries in the EU, and any of these subsidiaries are EU PIEs in their own right – then irrespective of size, these PIE subsidiaries will have to rotate in line with the national law of the Member State where they are incorporated.

As Member States have a certain degree of flexibility around the rotation it is entirely possible that EU PIEs within a multi-national group will need to rotate at different times and according to different rules.

MFR – Do the MFR rules apply to non-EU subsidiaries of an EU parent?

If a PIE parent company in the EU has subsidiaries outside of the EU, then these subsidiaries are not covered by the PIE definition, because they are not '*governed by*' the law of an EU Member State. As such non-EU subsidiaries would not be impacted by the MFR rules.

If an EU PIE within a multi-national group is required to rotate/tender will that trigger the need for the whole group to tender/to rotate auditors?

No – there is no requirement for the whole multi-national group to tender or rotate. However, for purely practical reasons the EU parent may choose to rotate auditors of the entire group, including non-EU subsidiaries, in line with the law prevailing in the parent company's country of incorporation.

A dual listing within the EU and outside of the EU – is this an EU PIE?

Non-EU governed companies that are also listed on a regulated market[1] in the EU would not fall within the PIE definition and would not be required to rotate their statutory auditors.

For example a Jersey or Guernsey incorporated company with debt listed on a regulated market in the EU will not be a PIE as the Channel Islands are not a part of the EU.

1 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2011:209:0021:0028:EN:PDF

Ask yourself ...

Is the entity a public interest entity (PIE[2])?

Governed by the law of an EU Member State? **AND** **An issuer of transferable securities, trading on an EU regulated market?**	Generally defined as companies incorporated in an EU Member State. Transferable securities are those which are negotiable on an EU regulated market. Not all markets in the EU are considered regulated – the European Securities and Markets Authority (ESMA) maintains a full list of all EU regulated markets on their website.[3]	**The entity is a PIE**
OR		
A credit institution?	An undertaking of which the business is to take deposits or other repayable funds from the public and to grant credits for its own account.	**The entity is a PIE**
OR		
An insurance undertaking?	This includes direct insurers, life insurers and undertakings in reinsurance business. Insurance broking is not within the definition, however a group 'captive' insurer established in the EU would be included.	**The entity is a PIE**
OR		
An entity designated by Member States as a PIE	For instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.	**The entity is a PIE**

2 See Article 2(13) of the Directive http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02006L0043-20140616&from=EN
3 http://mifiddatabase.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

Who do the NAS restrictions apply to?

The Regulation contains a list of prohibited NAS (see NAS Fact Sheet) that cannot be provided by the statutory auditor or its network, to a company that is an EU PIE, to the PIE's EU parent company(ies) or to the PIE's EU controlled undertakings. However, there are additional considerations for services provided by the network to controlled undertakings outside the EU as outlined on the next page.

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

Another member firm of the statutory auditor's network (other than the auditor of the EU PIE itself), can potentially provide NAS included on the list of prohibited NAS to a controlled undertaking outside of the EU but only if the statutory auditor of the EU PIE can justify that the independence of their audit is unaffected.

However, there are still three types of services that are always deemed to affect independence of the statutory auditor of the EU PIE regardless of the nature of possible safeguards put in place. As such these three services are always 'absolute prohibitions' and can never be provided by members of the statutory auditor's network to controlled undertakings incorporated outside of the EU, regardless of where these services are provided. The absolute prohibitions are as follows:

- 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 information technology systems (Article 5.1(e)).

See the example Non-EU group structure chart below.

Consider a non-EU bank or insurer with banking/insurance controlled undertakings in several EU countries. How do the EU NAS rules apply?

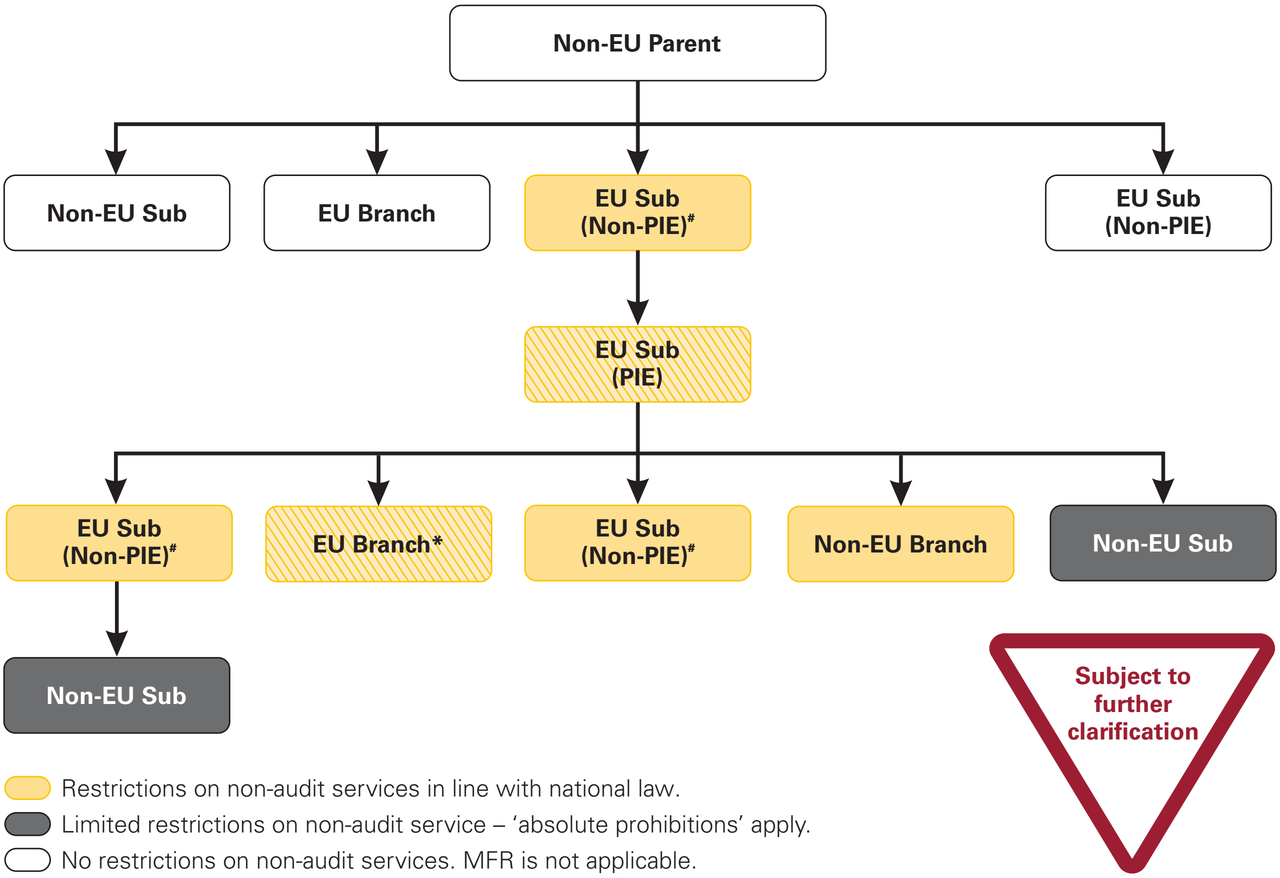
As each EU banking/insurance controlled undertaking will be an EU PIE, no member of the audit firm's network may provide prohibited NAS to each PIE nor any company in the direct ownership chain of that PIE (either upwards or downwards) if they are governed by EU law. The rules regarding 'absolute prohibitions' relating to controlled undertakings of the PIE outside the EU will also apply.

The EU prohibitions on NAS **do not** apply:

- To non-EU parent companies/group companies upstream from the EU PIE; nor
- To sisters of the EU PIE regardless of whether formed in the EU if they are not in the direct ownership chain of the EU PIE.

See the example Non-EU group structure chart below.

Example non-EU group structure: For illustrative purposes only



Restrictions on non-audit services in line with national law.
Limited restrictions on non-audit service – 'absolute prohibitions' apply.
No restrictions on non-audit services. MFR is not applicable.
MFR applies and restrictions on non-audit services in line with national law.

* MFR only applies in this scenario when the EU Branch is also subject to a statutory audit. Restrictions on non-audit services in line with national law still apply.

\# Subject to Member State interpretation – consult your local KPMG contact.

How does the Regulation apply to branch offices?

EU branches of non-EU based credit institutions or insurance undertakings do not fall within the PIE definition.

EU branches of an EU PIE are subject to all aspects of the Regulation as they form part of an EU PIE.

Non-EU branches of an EU PIE would be caught in that the NAS prohibitions would apply equally to the branch inside/ outside the EU as to the rest of the legal entity inside the EU.

Note there is still scope for Member States to designate additional PIEs which could bring branches within the national definition.

See the example Non-EU group structure chart on page 3.

Ask yourself …

How many EU jurisdictions do I have a footprint in?

Do I have any branches that fall downstream of an EU PIE?

When do the NAS restrictions apply?

The restrictions on NAS would apply to the first financial year beginning on or after 17 June 2016.

The statutory auditor's network would be prohibited from providing any of the 'absolute prohibitions' from this same point in time.

How does the 'clean period' requirement apply to entities outside of the EU?

'*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.*' (Article 5.1(E) is the only prohibited NAS that cannot be provided by the auditor one year before the first period as statutory auditor ('one year clean period'). This service also constitutes one of the 'absolute prohibitions' which has an impact outside of the EU. However, it appears that the 'one year clean period' requirement would not apply to entities outside of the EU.

Does the NAS fee cap have any extra-territorial effect?

$$\frac{\text{Permitted NAS provided by the Statutory Auditor}}{\text{Group statutory audit fees generated by the Statutory Auditor}} < 70\%$$

The cap applies only to permitted NAS provided by the statutory auditor of the EU PIE to the EU PIE, its controlled undertakings and its parent entity.

Statutory audit fees generated by the EU PIE's statutory auditor for work performed for non-EU parent companies of the PIE and non-EU controlled undertakings of the PIE would be included in the calculation of group statutory audit fees to the extent that the service is provided by the EU PIE's statutory auditor in a given EU Member State.

The cap does not apply to NAS or group audit fees of the statutory auditor's network firms.

Ask yourself …

What is my current spend on NAS by the auditors-both upstream and downstream from the EU PIE?

There are many Member State options – how do I know which rules will be applicable to my EU subsidiaries?

It's now up to each of the 28 EU Member State to translate the legislation into country law by 17 June 2016. Until each Member State has completed this process, global multi-nationals will not have a complete picture of the new requirements and the impact to their European operations.

Are similar laws and regulations being considered outside of the EU – for example, MFR exists in India?

Companies should also be aware that countries outside of the EU are considering, or may have already implemented, similar requirements.

For further information please speak to your usual KPMG contact.

kpmg.com

Publication name: *EU Audit Reform – what you need to know: Fact sheet: The impact of the reforms beyond the EU*

Publication date: March 2015