Defining Issues®

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Contents

EU Audit Reforms May Affect U.S. Companies

New European Union (EU) audit reforms that will take effect by mid-2016 may affect U.S. companies, especially those with an EU parent or those with banking, insurance, or certain other subsidiaries domiciled in the EU.

Although the full impact of the reforms will not be known until June 2016 when all 28 EU countries have completed incorporating the reforms into their respective national laws, this edition of *Defining Issues* outlines some of the potential impacts on U.S. companies.

Key Facts for U.S. Companies

- Audit firm rotation and non-audit service restrictions are imposed for the statutory audits of all EU companies that are determined to be a Public Interest Entity (PIE). PIEs are governed by the law of an EU country, and, regardless of size:
  - Have debt or equity securities trading on an EU-regulated market (including investment funds);
  - Are credit institutions or engage in insurance activities (including insurance captives); or
  - Are designated by a country because of their significant public relevance, nature of their business, market share, or number of employees (potentially including pension funds of U.S. entities domiciled in the EU).
- Audit firm rotation becomes mandatory after a maximum of 10 years. EU countries may, however, adopt shorter rotation periods or allow PIEs to extend the maximum duration to:
  - 20 years when its audit is put out to bid; or
  - 24 years for situations involving a joint audit.
- PIEs are precluded from using their external audit firm for most tax and advisory services, including some services that are currently permissible under SEC, PCAOB, and AICPA independence rules. Countries can impose further restrictions. Non-audit services must be pre-approved by the PIE’s audit committee.
- Auditor reporting requirements and audit committee responsibilities are increased under the reforms.

Each EU country may adopt more restrictive prohibitions on auditor rotation or non-audit services, which will likely result in a complex regulatory patchwork across the 28 EU countries.

Key Impacts for U.S. Companies

- EU PIE subsidiaries of U.S. companies will need to rotate auditors, comply with non-audit services prohibitions, and establish an audit committee following the EU law in the country where each EU PIE subsidiary is domiciled.
- When the U.S. member firm of the statutory auditor of an EU PIE parent provides non-audit services to its U.S. subsidiary, the group auditor must assess the impact of those services on its independence. Additionally, certain services will always be prohibited (e.g., those that involve management or decision-making functions, bookkeeping, and designing and implementing internal control or risk management procedures).

EU Audit Reform Overview

On April 3, 2014, the European Parliament voted to approve audit reforms. The reforms will take effect from June 17, 2016. However, each country must incorporate these provisions into its national law and has the option to impose more stringent restrictions or extend them to additional companies. This variability is likely to result in a patchwork of different legislation that U.S. companies operating in multiple EU countries will need to navigate.

Who Will Be Affected?

The reforms apply to the statutory audits of all companies that meet the EU country definition of a PIE.

Companies that are U.S. domestic registrants under SEC rules and have an EU-based holding company as the ultimate parent (e.g., incorporated in Ireland, the U.K., the Netherlands, or Luxembourg) and have their securities dual-listed on a U.S. exchange and an EU-regulated market will be subject to the reforms.

The reforms generally exempt U.S.-incorporated companies, however, there are exceptions:

- U.S.-based companies may be impacted if their group structure includes an EU PIE; and
- EU branches of U.S.-based credit institutions or insurance activities may be impacted if a country designates them as being subject to the law.

Who Will Not Be Affected?

U.S. companies that are not incorporated in an EU country but have securities listed on a regulated market in the EU generally would not be affected.

The audit reforms do not affect companies with equity or debt securities listed on EU markets that are not regulated. For example, some stock exchanges have markets that are only exchange-regulated and are not subject to the reforms. These include the Luxembourg Euro MTF, London AIM, and the Irish GEM markets. However, countries may still decide to require these listed companies to comply with the reforms. U.S. entities with EU-incorporated subsidiaries that raise capital in these markets will need to monitor developments in each country.

Effective Date

Non-audit services provisions will be effective for the first fiscal year beginning on or after June 17, 2016. Most of the other requirements under the EU audit reform will be effective as of June 17, 2016.

There are separate transitional provisions for mandatory firm rotation.

28 European Union Countries *			
Austria	Belgium	Bulgaria	Croatia
Cyprus	Czech Republic	Denmark	Estonia
Finland	France	Germany	Greece
Hungary	Ireland	Italy	Latvia
Lithuania	Luxembourg	Malta	Netherlands
Poland	Portugal	Romania	Slovakia
Slovenia	Spain	Sweden	United Kingdom

*The audit reforms apply to companies in these 28 EU countries as well as Iceland, Liechtenstein, and Norway. Switzerland is not part of the EU and currently does not intend to adopt the EU audit reforms or to change its existing legal requirements related to auditor independence.

Mandatory Audit Firm Rotation

Key Provisions for Mandatory Audit Firm Rotation	
Baseline Measure	• 10-year mandatory audit firm rotation for all EU countries
Country Option	• Extend the maximum period up to 20 years in the event of a public audit bid or 24 years for a joint audit • Reduce the maximum period to less than 10 years
Transition Period	• Transition period depends on the length of the current audit firm's tenure as of June 16, 2014

Each EU country may enforce a different maximum audit tenure and may further tailor the transition rules. Auditor rotation will not be required before 2016.

Transitional Measures for Mandatory Firm Rotation

The transitional requirements are based on the length of the existing auditor/client relationship as of June 16, 2014:

- If current audit tenure is 20 years or more, rotation is required by 2020;
- if current audit tenure is 11 to 19 years, rotation is required by 2023; and
- If current audit tenure is less than 11 years, the new rules on the maximum duration period apply as of June 17, 2016.

For example, an audit firm that was initially appointed for a PIE's calendar year 2004 audit and had served this client continuously would be in its 11th year of auditing on June 16, 2014. Therefore, the new rules would apply as of June 17, 2016. Assuming that the maximum tenure in the country where the company is incorporated is 10 years, it is currently unclear if the company would be required to switch auditors for the 2016 audit or only after its 2016 audit is completed. Interpretation of the transition rules will need to be monitored within each EU country.

Implications for U.S. Subsidiaries of an EU Parent

A U.S. subsidiary with an EU parent that is a PIE will not be directly affected by the mandatory rotation requirements because the U.S. subsidiary is not governed by an EU country. However, many companies may prefer to rotate auditors of their entire group, which could then impact U.S. subsidiaries.

Implications for a U.S. Parent with an EU Subsidiary

A U.S.-based multinational company may have European subsidiaries that are PIEs and will be required to rotate their statutory auditors to comply with the law in the country where the subsidiaries are incorporated. As each country has a certain degree of flexibility around rotation requirements, it is possible that EU subsidiaries within a multinational group will need to rotate at different times and follow different rules. Accommodating different audit firm rotations across the group may create new practical and reporting challenges for the U.S. parent and its group auditor.

For example, the group auditor may conclude that it should refer to the work of the newly appointed subsidiary auditor in the group auditor's PCAOB or U.S. GAAS audit report if the subsidiary is significant and is audited by a non-network member firm.[1]

For SEC filing purposes, when the group auditor's report refers to a non-network member firm that audits a significant subsidiary, a domestic registrant is required to include the subsidiary auditor's report in its periodic filings (e.g., Form 10-K) or registration statements (e.g., Form S-3) that include or incorporate by reference the group financial statements. A separate consent from the subsidiary auditor also is required when that separate audit report is used or referred to when raising capital. This will be a particular challenge for banking and insurance groups because many of their EU subsidiaries will be affected by the reforms.

[1] Audit firms typically are organized across borders by creating a network of independent member firms that are affiliated with each other.

Each EU country has the option to allow certain tax services (e.g., preparation of tax forms, tax advice, tax-only valuations, transfer pricing, and studies), subject to a threats-and-safeguards approach. We expect that countries that already have restrictions on these tax services (e.g., France and Netherlands) will not exercise the option to allow these services.

If a U.S. group auditor issues an audit report in accordance with both U.S. GAAS or PCAOB Auditing Standards and International Standards on Auditing (ISA), the audit report cannot refer to the work of another auditor due to ISA's prohibition on division of responsibilities in the audit report. The group auditor may need to perform additional audit procedures so it can take responsibility for the work of the subsidiary's auditor to comply with ISA requirements. This may occur when a U.S.-based company is dual-listed on a non-U.S. stock exchange.

Non-audit Service Restrictions

Key Provisions for Non-audit Services	
Baseline Measure	• Expanded list of non-audit services that the statutory auditor, and some network firms, cannot provide • One-year waiting period before the auditor can be engaged after providing some non-audit services • Permissible non-audit services capped at 70 percent of the audit fees paid to the statutory auditor of the EU PIE
Country Option	• Prohibit additional non-audit services • Permit certain tax and valuation services • Lower the non-audit services fee cap
Effective Date	• Non-audit services prohibitions apply to the first fiscal year beginning on or after June 17, 2016

Prohibited Non-audit Services

The reforms' prohibitions on non-audit services restrict auditors from providing most tax and advisory services, including some that are currently permitted by SEC, PCAOB, and AICPA independence rules.

While the list of prohibited services may differ among countries, most EU countries are likely to prohibit auditors from performing the following services:

- Most tax services;
- Services that play any part in the management or decision-making process of the audited entity;
- Bookkeeping and preparing accounting records;
- Payroll services;
- Valuation services;
- Services related to the audited company's internal audit function;
- Designing and implementing internal control or risk procedures related to the preparation or control of financial information or designing and implementing financial information technology systems;
- Corporate finance services, including those linked to the company's financing, capital structure and allocation, and investment strategy;

- Promoting, dealing in, or underwriting shares in the audited entity; and
- Legal and HR services.

The prohibitions also extend to the fiscal year immediately preceding the appointment of the statutory auditor for services relating to designing and implementing internal control or risk procedures related to the preparation or control of financial information, or designing and implementing financial information technology systems.

Services that are not on the list of prohibited services generally are permitted, subject to the general principles of independence and audit committee pre-approval.

Implications for U.S. Subsidiaries of an EU Parent

The statutory auditor and any member of its network cannot provide prohibited services to the PIE, its EU parent companies, and EU-controlled entities.

Generally, the prohibition on non-audit services will not impact U.S. subsidiaries of an EU parent company that is a PIE. However, a threats-and-safeguards approach must be used by the parent company and its statutory auditor to assess the impact on the auditor's independence of non-audit services provided to the company's U.S. subsidiaries by the auditor's U.S. member firm.

The U.S. member firm of the parent company’s statutory auditor network is prohibited from providing the following services to the U.S. subsidiary, regardless of safeguards or whether the U.S.-member firm audits the U.S. subsidiary:

- Services that involve management or decision-making functions of the entity;
- Bookkeeping and preparing accounting records and financial statements; and
- Designing and implementing internal control or risk management procedures related to the preparation or control of financial information, or designing and implementing financial information technology systems.

Implications for a U.S. Parent or Sister of an EU Company

The three prohibitions listed above do not apply to the U.S.-based parent of the EU company that is a PIE nor to its sisters if they are not in its direct ownership chain.

Implication of the Fee Cap for U.S. Companies

Permissible non-audit services are capped at a maximum of 70 percent of the average of the fees paid to the statutory auditor of the EU PIE in the last three consecutive years for the statutory audit of the EU PIE and its group inside and outside the EU.

The cap only applies to the non-audit services provided by the statutory auditor to the PIE, its parent, and controlled entities. In calculating the ratio, non-audit services provided by the statutory auditor’s network firms would be excluded from the numerator. Thus, it is likely that the fee cap has limited consequences for U.S. companies.

Audit Committee Requirements

A U.S. parent company needs to establish an audit committee for each EU-based subsidiary that is a PIE to comply with the reforms. Audit committees established at the group level in the U.S. under the Sarbanes-Oxley Act of 2002 and U.S. listing standards are not sufficient to meet the EU requirements.

Enhanced Role

Audit committee pre-approval is required for all permissible non-audit services after having assessed the threats and safeguards to auditor independence. Permissible non-audit services to be provided to a PIE that is a subsidiary of a U.S. company would need to be pre-approved both by the U.S. parent company's audit committee and the EU subsidiary's audit committee to comply with both U.S. and EU requirements.

The audit committee should be composed of independent non-executive members of either the administrative body (i.e., board of directors) or the supervisory body. Audit committee members also can be directly appointed at the annual general meeting. At least one member of the audit committee must have competence in accounting or auditing.

The reforms require a written report by the statutory auditor addressed to the audit committee. The content of this written report is broadly consistent and comparable with information provided to audit committees in accordance with PCAOB Auditing Standard No. 16, *Communication with Audit Committees*.

Other Issues

Companies should also be aware that countries outside of the EU (e.g., India, Brazil) have already implemented similar requirements and other jurisdictions are considering doing so.

The need to comply with possibly globally unsynchronized audit rotation requirements, combined with restrictions on non-audit services, could narrow audit and advisory service provider options for many companies.

Auditor rotation should also be anticipated for some period in advance of the mandatory requirements to more efficiently transition to the new auditor. For example, services involving the design and implementation of certain internal control procedures must not have been performed in the fiscal year immediately preceding the first fiscal year to be audited. In addition, contracts for other services may span several years and would be difficult to terminate quickly without significant cost or disruption.

It is expected that audit firms and networks of member firms will further strengthen their independence and compliance systems and procedures to comply with the new rules. In any case, it also will be necessary for multinational companies to develop their own internal controls and processes to monitor audit committee appointments, auditor rotations and the audit bidding process, and non-audit services.

For additional information on EU audit reforms, please visit KPMG's Website

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