

EU Audit Reform

An update on the UK consultations

FRC: 'Enhancing Confidence in Audit: Proposed revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees'ⁱ

BIS: 'Consultation on the technical legislative implementation of the EU Audit Directive and Regulation'ⁱⁱ

The Financial Reporting Council (FRC) and the Department for Business, Innovation & Skills (BIS) have published the final stages of the above Consultations, giving us more detail on how EU Audit Reform will play out in the UK. They set out proposals to introduce the EU Directive and Regulation on Audit Reform.

Who do the new rules apply to?

The new rules will apply to Public Interest Entities (PIEs) as defined by the EU. A PIE is any entity incorporated in an EU Member State with:

- Debt or shares traded on an ESMA (EU regulated) market. In the UK, that is the London Stock Exchange premium listings; or
- A credit institution that is non-listed and licenced under regulation to take deposits in the EU; or
- An insurance undertaking, for example, non-listed undertakings with regulated insurance activities, whether they are life, non-life or reinsurance.

For certain other companies such as AIM-listed entities, the draft revisions to the Ethical Standard include some concessions from the existing non-audit services restrictions. Those with stock, shares and debt listed on unregulated markets that are not traded, are excluded from the definition of 'listed entity', while some provisions only apply to those with a market capitalisation of £100 million or more.

The provisions of the existing Ethical Standard will still apply to unlisted audited entities that are not PIEs or otherwise subject to enhanced requirements as set out above. However, there are some significant proposed amendments relating to tax services, which we have summarized on the next page.

Mandatory Firm Rotation and Audit Tendering

The rules on tendering and Mandatory Firm Rotation (MFR) have been clarified by the BIS consultation. What we now know is:

All PIEs must put their audit out to tender at least every 10 years and change their auditor every 20 years following a tender process (whether it is an individual or joint audit).

- Following a 20-year audit tenure, the audit firm(s) must wait at least four years before they can be reappointed as auditor.
- The UK is adopting the EU transition arrangements for longstanding audit relationships. Please refer to the MFR table below.
- An extension of the maximum duration of up to two years may be granted by the competent authority in exceptional circumstances.
- Following a tender process, the Audit Committee should recommend at least two choices for auditor to the Board and state a justified preference for one of them.

Non-audit services provided to PIEs by auditors

For PIEs, there are no changes to the EU 'blacklist' of prohibited services – we have outlined these on the following page. There is also no 'whitelist', which was suggested in the initial December 2014 Consultation. The FRC has also taken up the Member State option to permit certain tax services and valuations, but only where they have no direct effect – or a 'clearly inconsequential' one – on the audited financial statements. At the moment 'clearly inconsequential' is not defined. Therefore, it is not clear what the impact will be.

A "cooling in" period applies for certain design and implementation services in the year before the first year under the new rules.

Fee caps for PIEs

The EU Regulation caps fees for (permissible) non-audit services in any year at 70% of the average audit fee income from that client over the 3 preceding financial years.

In the UK, this fee cap will apply in accounting periods beginning on or after 17 June 2019. The EU provided that the calculation period for the 70% fee cap over three years would restart if there was a year in which no non-audit services were provided by the auditor, but the FRC has decided that this break will not apply in the UK.

The draft Ethical Standard clarifies that permissible non-audit services should include those provided to all group companies by the audit firm and its network.

However, non-audit services required by law, including work required because of a rule issued by a regulator such as the Prudential Regulation Authority and the Financial Conduct Authority, are exempt for the purposes of calculating the cap. This will also apply to work undertaken to comply with the Listing Rules, but not to a report under the Standard for Investment Reporting to the extent the report is not otherwise required by law or regulation.

It is worth noting that audit firms can make a request to the FRC for a dispensation from the 70% fee cap for up to two years for example, in those years where non-audit services fee levels are high because of a capital markets transaction. Companies may of course also approach firms other than their auditors to provide non-audit services.

Tax services provided to any audit client

As well as implementing the Regulation and the Directive, two important proposed changes affect the provision of tax

services to all audited entities, including private companies, by extending existing prohibitions to all tax services that:

- are provided on a contingent fee basis. At the moment, the prohibition only applies where the outcome of the tax services depend on the proposed application of tax law which is uncertain or has not been established.
- involve "acting as an advocate in the resolution of an issue" where the amounts are material. Currently, the prohibition only applies where the issue is before an appeals tribunal or court. This proposal could prohibit support in relation to other disputes and negotiations with the revenue authorities, where the amounts are material, which may particularly affect private companies that commonly use their auditor for tax work.

Using your auditor for non-audit services

What should you consider in light of these rules?

- Does the company meet the definition of a PIE or is it otherwise subject to enhanced requirements (eg large AIM listed companies)?
- As a matter of policy, is the company willing to use the auditor for anything that is not prohibited? And does the company wish to apply a limit lower than the required 70% cap for non-audit services?
- Are there services currently undertaken by the auditor will not be permitted in the future or, in the case of services prohibited in the "cooling-in" period for work in connection with financial information systems/controls, currently being performed? If so, who else can provide these and are there adequate plans for an orderly transition of these services?
- Where an audit tender is planned in the near future, does the company understand the extent of the provision by other audit firms of services which would be prohibited? And does it have plans to ensure the orderly transition of those services so as not to limit the choice of audit firm?

When will this come into effect?

The final confirmation of the UK's application of the EU rules is expected next spring and should come into effect for accounting periods starting on or after 17 June 2016. Keep up to date by visiting our website kpmg.com/uk regularly.

Prohibited Services

The following prohibitions apply to PIEs, with effect from the first accounting period beginning on or after 17th June 2016.

A. Tax services:

- I. Preparation of tax forms, *
- II. Payroll tax,
- III. Customs duties,
- IV. Identification of public subsidies and tax incentives unless support from the audit firm in respect of such services is required by law, *
- 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, *
- VI. Calculation of direct and indirect tax and deferred tax, *
- VII. Provision of tax advice *

B. Services that involve playing any part in the management or decision-making of the audited entity;

C. Bookkeeping and preparing accounting records and financial statements;

D. Payroll services;

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 information technology systems;

F. Valuation services, including valuations performed in connection with actuarial services or litigation support services; *

G. Legal services, with respect to:

- I. The provision of general counsel,
- II. Negotiating on behalf of the audit entity,
- III. Acting in an advocacy role in the resolution of litigation;

H. Services related to the audit entity's internal audit function;

I. Corporate finance type services:

Services linked to the financing, capital structure and allocation, and investment strategy of the 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;

J. Promoting, dealing in, or underwriting shares in the audited entity;

K. HR services:

Human resources services with respect to:

- I. Management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:
 - a. Searching for or seeking out candidates for such positions; or
 - b. Undertaking reference checks of candidates for such positions.
- II. Structuring the organisation design.
- III. Cost control.

Services in point E are prohibited in the financial year prior to the year subject to audit (the 'cooling in' period).

* Potentially permitted services

A number of prohibited services (as identified by asterisks) may still be provided, subject to audit committee approval and after an assessment of threats, if the following requirements are complied with:

- I. No direct or clearly inconsequential effect, separately or in aggregate, on financial statements;
- II. Estimation of the effect on the financials is comprehensively documented and explained in the additional report to the audit committee;
- III. In line with principles of independence in Section 1 of the Ethical Standard; and
- IV. The audit firm would not place significant reliance for the purpose of the audit on the work performed by the audit firm in performing these services.

How MFR works:

I first appointed my auditor:	Next tender required for:	Can I re-appoint the incumbent auditor?	Must have a new auditor for:
Before 17th June 1994	The first financial year beginning on or after 17th June 2020.	No, you must change auditor*	The first financial year beginning on or after 17th June 2020
Between 17th June 1994 and 16th June 2003	First financial year beginning on or after 17th June 2023.	No, you must change auditor*	The first financial year beginning on or after 17th June 2023
Between 17th June 2003 and 16th June 2006	The first financial year beginning on or after June 17th 2016, if a tender in accordance with the Regulation has not taken place in the ten years prior.	You can re-appoint for a further term of up to 10 years	The first financial year beginning on or after 17th June 2026
From 17th June 2006	The first financial year after the initial term of 10 years has been reached, e.g.: appointed for 2009 year-end, tender due for 2019 year-end. An audit tender resulting in the reappointment of the incumbent auditor up to 10 years before 17 June 2016 should be treated as a tender for the purposes of the transitional provisions.	You can re-appoint for a further term of up to 10 years	The first financial year after the maximum engagement period of 20 years has been reached

* However the FRC may in exceptional circumstances grant an extension of two years

ⁱ <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Enhancing-Confidence-in-Audit-File.pdf>

ⁱⁱ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/471898/BIS-15-605-technical-consultation-on-the-audit-directive-and-regulation.pdf

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