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European audit reform for PIEs: a closer look

The European Parliament and Council of Ministers have approved a Regulation and a Directive intended to reform the audit market in the EU. The Regulation was published in the Official Journal of the European Union on May 27, 2014. The legislation will enter into force on June 16, 2014: there is a two-year transition period which means that most of the key provisions will come into effect on June 17, 2016. There are separate transitional provisions for mandatory firm rotation. This article will provide you with insights on the key requirements of the new legislation and our view of its effects.

The Regulation and Directive contain a series of requirements that relate to the approximately 30,000 Public Interest Entities (PIEs) in the EU. PIEs, as newly defined in the Directive, include all EU entities that have securities listed on an EU regulated market, credit institutions and insurance undertakings - whether listed or not. The Member States may also expand the PIE definition to include other entities.

New rules for Public Interest Entities

Areas of change this legislation effects include, among others:

- Mandatory audit firm rotation (MFR)
- Further restrictions on non-audit services (NAS)
- Expanded auditor reporting requirements
- Strengthening the role of audit committees

The provisions in the Regulation on mandatory firm rotation and non-audit services will have a significant impact on PIEs. The key requirements are summarized below:

Mandatory Firm Rotation

- 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 on an individual basis.
- 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 at the end 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.

Restrictions on Non-Audit Services 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 (applied on a 3 year rolling basis).
- Member States have the option to add to the list of prohibited NAS and apply a cap that is lower than 70%.

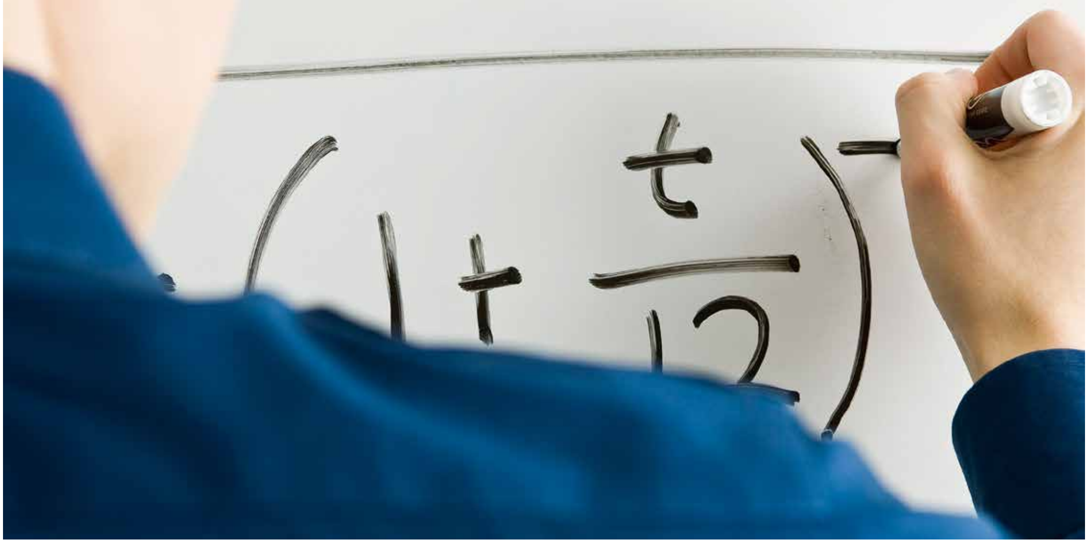
> **"Our auditors and advisors remain committed to working in the public interest with regulators, governments and the business community to ensure that the new legislation is implemented as effectively as possible."**

Opportunities in terms of audit quality

The new legislation on the EU audit will bring about significant changes. 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, and we have consistently supported the elements of the legislation that are consistent with these aims. 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. The principles of the new auditor's report are substantially consistent with ongoing international developments, such as those led by the IAASB and will enhance understanding of the audit process, including critical judgments made during the audit.

Enhancing the role of the audit committee means they are required to 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. We also see that the 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.

Finally, the creation of a new **Committee of European Audit Oversight Bodies (the CEAOB)** is something we support and 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 Systemically Important Financial Institutions (SIFIs).

Increasing costs and complexity

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.**

What is the difference between a Directive and a Regulation?

A **Directive** is EU legislation that has to be implemented by each of the 28 Member States and incorporated into their respective national laws.
The Directive contains a series of requirements governing every statutory audit in the EU. The key matter dealt with in the Directive is the definition of a Public Interest Entity (PIE) but further changes include:

- More emphasis on independence
- Quality assurance
- New mechanism to adopt International Standards on Auditing (ISAs) at European level
- Public auditor reporting and additional internal reporting to audit committees of PIEs

A **Regulation** is a form of EU legislation which promotes "maximum harmonization" across the EU. A Regulation takes immediate effect following a transitional period of usually two years. Member States still need to amend their national laws to ensure they are consistent, but the Regulation rules supreme.
The Regulation contains a series of additional requirements that relate only to the statutory audits of Public Interest Entities (PIEs). The provisions on mandatory firm rotation (MFR), tendering and the list of prohibited non-audit services (NAS) are contained in the Regulation and so are only applicable to PIEs.

- Mandatory Firm Rotation (MFR) combined with further restrictions on non-audit services (NAS) will lead to a **reduction in choice** on the market place.
- The significant degree of flexibility in interpretation and implementation of the new rules will certainly result in a patchwork of different requirements across the EU, which will cause an unnecessarily **complex and costly** regulatory compliance environment for companies and their auditors in the EU.
- The new EU independence rules effectively prohibit many NAS that are permitted under other internationally recognized 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.
- Although the EU Regulation is primarily aimed at EU entities, the rules will also impact groups based **outside the EU** like EU based subsidiaries of non-EU parent companies to the extent that those entities meet the definition of an EU PIE.

It now falls to each of the National Governments of the 28 Member States to adapt to and apply the new legislation. All stakeholders need to begin to plan today for when these rules will apply in practice. The legislation remains imprecise in certain instances and the details of how the legislation will be applied still require analysis and interpretation. It is expected that guidance will be issued by the European Commission as well as by individual regulators within the Member States.
At KPMG we are up for the challenge. Our auditors and advisors remain 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. We will be glad to assist you with any questions you may have.