EU Audit Reform

An introduction to what the legislation might mean for your business

August 2016

On 17 June 2016, legislation which transforms the professional services market came into effect across the 28 Member States that currently make up the European Union (EU). The rules are complex and far reaching, bringing significant changes to the way businesses must manage their professional service providers. It is important that all affected companies gain a firm understanding of the legislation and take steps to ensure compliance. For a detailed look at the legislation, please see KPMG's broad-ranging Frequently Asked Questions document.

What are the rules?

The baseline legislation has been passed at an EU level, however Member States have a range of options available for use in their local implementation. They are, for instance, permitted in some areas to implement stricter or more lenient rules if they wish. The legislation can be grouped under the following three areas:

- **Mandatory audit firm rotation (MFR):** Companies must change their audit provider at least every 10 years, although Member States are able to extend this period to a maximum of 20 years where a public tender is held after 10 years or 24 years for joint audits. The introduction of MFR is staggered and the date by which companies have to change auditors is based on the tenure of their current auditor on 16 June 2014. For a full picture of the transition timelines, please refer to KPMG's dedicated MFR factsheet.
- **Restrictions on non-audit services (NAS):** Audit firms are restricted from providing certain NAS to their audit clients. Member States have the option to allow the provision of certain services or to further restrict additional NAS. For the full list, please refer to our dedicated NAS factsheet. Permitted NAS may not exceed 70% of the average group statutory audit fees generated by the EU Member State audit firm of the Public Interest Entity (PIE) - irrespective of where the group entities are located - for the previous three years (starting from 2016).

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- **The audit committee**: Audit committees must have sector-relevant experience and at least one member with expertise in accounting or auditing. They are required to manage the audit tender process and must recommend at least two audit firms to the board, with a justified case for one. The process should be fair and not in any way preclude the participation of smaller audit firms. For a more detailed description of how the rules impact audit committees, please refer to our dedicated factsheet or the range of materials from KPMG's Audit Committee Institute.

Given the implementation options available to each EU Member State, a regulatory patchwork now exists across the EU. To understand how the rules vary from country to country, please check our interactive map which contains links to detailed country factsheets. Although the legislation came into effect on 17 June 2016, not all EU countries have yet confirmed their local rules. For any country not showing as green on the map, it is likely that the EU baseline rules will apply in the meantime - however it is vital to confirm this locally as in some instances interim measures may have been agreed. It is also important to remember that the baseline rules exclude the option to extend the MFR tenure beyond 10 years, or to permit the provision of certain tax and valuation services from the statutory auditor.

Which businesses are affected?

The audit legislation applies to any EU company categorised as a public interest entity (PIE). This may include subsidiaries of businesses headquartered outside of the EU, meaning the impact is global.

In the EU baseline legislation there is a list of specific criteria for defining a PIE, however Member States are permitted to broaden this definition.

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. The baseline definition affects companies governed by the law of an EU Member State, including:

- Credit institutions
- Insurance undertakings
- Issuers of transferable securities, trading on EU regulated markets

Consequences for businesses

The new rules affect thousands of companies. In particular, cross-border businesses with multiple EU PIEs will need to understand how their geographic footprint impacts their obligations. This task is made more complex by the variation in rules between EU Member States. For example, in Germany and Sweden banks and insurance companies are not allowed to extend their audit firm tenure beyond 10 years, whereas other PIEs are allowed to extend by a further 10 years following a tender.

The changes introduced by the new legislation are not unique to the EU - they are part of a growing global trend. In India, for example, similar rules have been introduced. These include mandating companies to tender their audits by 1 April 2017 and imposing an audit rotation period of five years, with the option of extending for a further five following a tender. Differing rules such as these provide an added challenge for global organisations, which will need to decide on a strategy for managing their professional service providers.

Although much of the legislation is already considered best practice in certain Member States, audit committees will still need to consider how they can demonstrate adherence to the requirements. These include the need to provide transparent selection criteria during an audit tender and produce a report that shows the process was fair and “non-discriminatory”. In addition, each Member State’s competent authority, as well as the European Competition Network, are required to report at least every three years on developments in

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the PIE audit market - focusing on concentration, audit quality and the effectiveness of audit committees.

With so much change and lingering uncertainty over which derogations Member States will choose, it is recommended that companies take swift action, if they have not done so already. The earlier businesses - especially large multi-nationals - can assess how the legislation affects them in all their jurisdictions, the stronger their position will be.

Will the EU rules apply in the UK following the vote to leave the EU?

There are many uncertainties as a result of the UK's vote to leave the EU. The EU audit legislation, which has already been implemented, will apply until the UK formally leaves, which is expected to take at least two years.

The Financial Reporting Council, the UK regulator, has implemented the EU legislation and introduced additional and stricter provisions. Therefore KPMG in the UK believes it is unlikely, although not impossible, that these new standards will be unwound.

For more information on the potential impact of Brexit, please see the UK firm's dedicated microsite.

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Assessing the impact

Below are key considerations to help start your planning:

1. Does your company have any businesses in the EU which are, or may be, classified as PIEs?
2. Has local legislation been confirmed in all the EU Member States where your business has a presence?
3. How long have you been with your current auditor and when is the date by which you need to rotate in each jurisdiction where you have an EU PIE?
4. Have you considered whether some of your business's non-EU operations may be impacted? (e.g. non-EU branches of an EU PIE are affected by the NAS rules in the same way as the PIE).
5. Does your audit committee have the right expertise and a full understanding of their new responsibilities?
6. Do your service providers require early engagement to ensure adequate preparation for upcoming 'clean periods' in order to manage necessary transitions?
7. Have you agreed a strategy for how you will manage your professional service providers?

To find out more about how the legislation may affect your business, please contact your local KPMG member firm.

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