

The future of assurance

EU audit reform –
what it means for you

Viewpoint

In the first in this series, we look at European Union (EU) audit legislation and explain in general terms what it means for companies and financial institutions that fall within its ambit. Will you be affected by the legislation? What choices will you have? Which decisions should you make? And is your professional services procurement strategy up to scratch?

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Anyone familiar with this legislation knows that it is complex and currently undergoing implementation on a country basis. Therefore, after reading this brief high-level summary, we encourage you to seek independent professional advice on what the potential implications could mean for you.

In summary

- ▶ The legislation comprises a Directive and set of Regulations, which came into force on 16 June 2014.
- ▶ It has to be adopted by all 28 Member States and Iceland, Liechtenstein and Norway no later than 16 June 2016.
- ▶ Each State has approximately 75 ways to do this, depending on which legislative options their respective governments and regulators choose to implement.
- ▶ The outcome will be a patchwork of different regulatory regimes across the EU, manifested in a variety of ways, e.g.:
 - ▶ Entities caught by legislation in one State may be exempt in another.
 - ▶ Limits on audit firm tenures will vary from one State to the next (e.g., from five years in Hungary, eight in Portugal and nine in Italy, to ten in the Netherlands and twenty in the UK).
 - ▶ The severity of restrictions on non-audit services (NAS) will vary across States, and possibly between some individual States and territories outside the EU.

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Will you be affected by the legislation?

Yes, if you are deemed to be an EU Public Interest Entity (PIE). In broad terms, the legislation defines a PIE as:

- ▶ An entity (covering EU parents and EU subsidiaries, plus EU subsidiaries of non-EU parents) incorporated in a State, with equity or debt listed on an EU regulated market.
- ▶ A bank or insurance undertaking, whether private or listed, subject to the laws of a State.
- ▶ A fund (e.g., UCITS or AIF) subject to State law and listed on an EU regulated market.

- ▶ Any other entities that a State recognizes as a PIE, because the government of that State considers these entities to be of significant public relevance (e.g., because of the nature of their business, size, number of employees).

What choices will you have?

The seismic transformations ushered in by the legislation are already pressurizing individual States to make choices in terms of how they implement the legislation locally. These decisions will, in turn, determine the choices open to individual PIEs incorporated in those States.

The baseline, from which States are expected to deviate, can be defined as follows:

Mandatory audit firm rotation

- ▶ Rotation of the external auditor by the 10th year of tenure.
- ▶ Extension of tenure, up to a maximum of 20 years with a competitive re-tender (or 24 years for joint audits), by the decree of an individual State.



- ▶ Four-year cooling-off period required before a previously tenured audit firm can be appointed again by the same PIE.

Restrictions on non-audit services (NAS)

- ▶ Incumbent external auditors and their respective networks to be prohibited from providing to their PIE audit clients (including the PIE's EU parent company and EU controlled undertakings) an extensive list of NAS, including most tax and corporate finance services.
- ▶ Individual States may allow certain tax and valuation NAS to be provided by the external auditor, provided the audit committee is satisfied that the NAS will not have a material effect on the financial accounts.
- ▶ Permissible NAS, provided for three consecutive years to the PIE audit client, to be limited, with a cap on fees charged for NAS delivered in year four (70% of the average group audit fee, calculated as a rolling three-year average).

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Isabelle Santenac and Hywel Ball discuss audit reform



“We will continue to take a lead in raising awareness of the EU’s new audit legislation.”

Which decisions should you make?

The one thing you can be certain of, as an EU PIE, is the need to forge a coherent professional services procurement strategy that explicitly includes your choice of external auditor. Further, if you are a financial services firm, you can take it as read that you will be defined as a PIE by the State in which your business is incorporated and regulated, regardless of whether your parent is in or outside the EU.

Lowest common denominator

As a group PIE, operating in various States with PIE subsidiaries, it may be difficult to

have a single group auditor for the maximum permitted tenure of 20 years (or 24 years). Permitted tenures in different States will reach their expiries at different times.

A solution might be to rotate the auditor in different States simultaneously, driven of course by whichever State has the shortest maximum permitted tenure – the lowest common denominator. Alternatively, depending on how the group is structured across the EU, it may be possible for the PIE to have a small multiple of external auditors, ensuring its external auditor remains the same for most of the States where it is incorporated. However, it will need to consider independence and restrictions on providing NAS, which will be more complex with multiple auditors – as, indeed, will procurement.

Inventory and cleansing

Complying with the legislation will require advanced planning. For some PIEs, this may be sooner than expected. This is because the legislation on audit firm rotation includes transition periods based on the length of the incumbent audit firm’s tenure when the





legislation came into force on 16 June 2014.

As a general rule, PIEs that appointed their external auditor more recently will have more time to switch to another firm. For example, if the firm was appointed on or before 16 June 1994, the PIE will need to switch to another firm for financial years beginning on or after 17 June 2020. If the firm was appointed between 17 June 1994 and 16 June 2003, the PIE would need to have switched firms for financial years beginning on or after 17 June 2023.

However, somewhat counterintuitively, if the firm was appointed between 17 June 2003 and 16 June 2006, the PIE is expected to change its auditor for financial years beginning on or after 17 June 2016: and to then either reappoint the incumbent (if permitted by the State) or switch auditor.

Apart from considering which external audit firms a PIE might wish to invite to tender (the EC requires that a minimum of two firms pitch for each external audit), the PIE needs to be clear about which NAS they currently receive; where and from whom; and for how long. Some NAS received from firms other than the incumbent

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auditor may form important aspects of long-running projects, perhaps due for completion in several years’ time. The PIE will need to weigh up the pros and cons of either maintaining delivery of these specific NAS from a particular audit firm(s), or sourcing them from somewhere else so the firm(s) in question can be made ready as a prospective future external auditor.

Needless to say, for larger and more complex PIEs such as financial institutions, the task of procurement may be especially difficult. Conducting an inventory of all NAS and considering which NAS should

be switched and by when, driven by the legally prescribed timetable for switching the auditor, might also be time-consuming. Some companies will have less time than they first thought to get this right, especially if they changed their auditor in the last 10 years or so.

Is your professional services procurement strategy up to scratch?

These issues reinforce the importance of either reappraising, or perhaps introducing for the first time, a cohesive professional services procurement strategy. Seeking the provision of the external audit and NAS (even if those NAS are sought from another firm or firms) are no longer – as may have been regarded in the past – mutually exclusive tasks.

Identifying the prospective auditor should be an informed decision, with input from the audit committee and consideration given to the quality of the firm's other audit work (e.g., reports issued by the regulators on audit quality). But this decision has to be taken alongside the procurement of the

many NAS required by the PIE, now and in the future.

These considerations need to be made together with the discipline associated with sound procurement practice, including the use of comparable evaluation criteria (e.g., caliber of lead audit partners, quality and continuity of staff, training and back-up, processes and procedures, and geographical reach).

Conclusion

We will continue to take a lead in raising awareness of the EU's new audit legislation, and this means talking about professional services procurement with members of boards and their committees, not just the audit committee and audit committee chair. Indeed, advice on tax planning, corporate finance and transactions, risk management, reporting and just about every other aspect of a PIE's strategy and day-to-day operations will now hinge on the implementation of a piece of legislation conceived for the purpose of improving competition between auditors.



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