

## Auditor reporting and oversight



On June 16, 2014, after publication in the Official Journal, European Union (EU) audit legislation entered into force. For all provisions including those pertaining to nonaudit services (NAS), the effective date is June 17, 2016 (first financial year starting on or after June 17, 2016), except for mandatory firm rotation (MFR) requirement where specific transitional measures are provided. Certain member states have provided other start dates for the specific provisions of this legislation. The legislation is in the form of a [Directive](#) and a [Regulation](#). A number of options have been afforded to member states to be decided on at the local level. Member states are currently determining the implementation of various provisions as they have two years to transpose the EU audit legislation into their national law.

Many provisions in the legislation are intended to strengthen corporate governance and to enhance transparency of audits to investors and audit committees. The provisions that have received the most attention, such as MFR and prohibited NAS, are contained in the [Regulation](#) and only apply to public interest entities (PIEs) and their statutory auditors.

This legislation is complex, and the summary descriptions of legislative and implementation considerations outlined below do not constitute legal advice. Several areas of the legislation require interpretation and may evolve over time, and market participants may wish to seek legal advice before taking measures to comply with the legislation.

## Auditor responsibilities

The legislation relating to auditor reporting includes a series of requirements that should enhance investors' understanding of the audit process including critical judgements made during the audit. The legislation contains detailed provisions affecting statutory audits and the way they are conducted. The new auditor reporting requirements will apply to the first financial year starting after the date of application of the legislation (i.e., for the year ending June 30, 2017, and beyond).

Each PIE, subject to certain exceptions below, must have an audit committee composed of nonexecutive members:

- Auditors will be required to carry out statutory audits in compliance with the international auditing standards (ISAs, ISQC1, and other related standards issued by International Federation of Accountants) as adopted by the European Commission. However, member states may apply national audit standards, procedures, or requirements, under certain terms.<sup>1</sup>
- Audit report for 'all' statutory audits in the EU (not just PIEs) must provide a statement on any material uncertainty related to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern.<sup>2</sup>
- For PIEs only, the audit report must provide a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, summary of auditor's response to those risks, and key observations arising with respect to those risks.

- Audit firms may perform audits in another member state provided that the key audit partner carrying out the audit has been duly approved as a statutory auditor in that other member state.
- The legislation also establishes new nonpublic reporting requirements from the auditor to the audit committee of the audited PIE.

## Auditor oversight

- PIE audits must be supervised by competent authorities that are independent of the profession and may delegate tasks to other bodies. Oversight of non-PIE audits will continue to be largely performed by the professional bodies.
- New Committee of European Auditing Oversight Bodies (CEAOB) will be established and be composed of one member from each member state and one member with no voting rights appointed by the European Securities and Markets Authority.
- Competent authorities supervising credit institutions, insurance undertakings, and the auditors of these entities should establish an effective dialogue and share responsibility for doing so.
- At least annually, the European Systemic Risk Board (ESRB) and CEAOB must organize a meeting with the auditors of all global systemically important (financial) institutions within the EU to inform the ESRB of sectoral or any significant developments in those institutions.
- Member states must put in place effective, proportionate, and dissuasive penalties to apply to the auditors and audit firms if statutory audits under EU law are not carried out in conformity with the legislation.

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<sup>1</sup> Described in the Article 9 of the Regulation [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0077.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0077.01.ENG)

<sup>2</sup> Described in the Article 10 of the Regulation [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0077.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0077.01.ENG)

## Report to the Audit Committee (extract)

The Regulation states that the auditor must explain the results of the statutory audit in an additional report to the audit committee, which shall at least:

- (a) include the declaration of independence referred to in point (a) of Article 6.2;
- (b) Where the statutory audit was carried out by an audit firm, the report shall identify each key audit partner who was involved in the audit;
- (c) where the statutory auditor or the audit firm has made arrangements for any of his, her, or its activities to be conducted by another statutory auditor or audit firm that is not a member of the same network, or has used the work of external experts, the report shall indicate that fact and shall confirm that the statutory auditor or the audit firm received a confirmation from the other statutory auditor or audit firm and/or the external expert regarding their independence;
- (d) describe the nature, frequency, and extent of communication with the audit committee or the body performing equivalent functions within the audited entity, the management body, and the administrative or supervisory body of the audited entity, including the dates of the meetings with those bodies;
- (e) include a description of the scope and timing of the audit;
- (f) where more than one statutory auditor or audit firm have been appointed, describe the distribution of tasks among the statutory auditors and/or the audit firms;
- (g) describe the methodology used, including which categories of the balance sheet have been directly verified and which categories have been verified based on system and compliance testing, including an explanation of any substantial variation in the weighting of system and compliance testing when compared to the previous year, even if the previous year's statutory audit was carried out by other statutory auditor(s) or audit firm(s);
- (h) disclose the quantitative level of materiality applied to perform the statutory audit for the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions account balances or disclosures, and disclose the qualitative factors, which were considered when setting the level of materiality;
- (i) report and explain judgements about events or conditions identified in the course of the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty, and provide a summary of all guarantees, comfort letters, undertakings of public intervention, and other support measures that have been taken into account when making a going-concern assessment;
- (j) report on any significant deficiencies in the audited entity's or, in the case of consolidated financial statements, the parent undertaking's internal financial control system, and/or in the accounting system. For each such significant deficiency, the additional report shall state whether or not the deficiency in question has been resolved by the management;
- (k) report any significant matters involving actual or suspected noncompliance with laws and regulations or articles of association, which were identified in the course of the audit, in so far as they are considered to be relevant in order to enable the audit committee to fulfil its tasks;
- (l) report and assess the valuation methods applied to the various items in the annual or consolidated financial statements including any impact of changes of such methods;
- (m) in the case of a statutory audit of consolidated financial statements explain the scope of consolidation and the exclusion criteria applied by the audited entity to the nonconsolidated entities, if any, and whether those criteria applied are in accordance with the financial reporting framework;
- (n) where applicable, identify any audit work performed by third-country auditor(s), statutory auditor(s), third-country audit entity(ies) or audit firm(s) in relation to a statutory audit of consolidated financial statements other than by members of the same network as to which the auditor of the consolidated financial statements belongs;
- (o) indicate whether all requested explanations and documents were provided by the audited entity;
- (p) report:
  - i. any significant difficulties encountered in the course of the statutory audit;
  - ii. any significant matters arising from the statutory audit that were discussed or were the subject of correspondence with management; and
  - iii. any other matters arising from the statutory audit that in the auditor's professional judgement, are significant to the oversight of the financial reporting process

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