Member state options and cross-border impact

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.

Member state options

The flexibility afforded to the member states could result in a patchwork of the legislation. The Directive and the Regulation contain more than 50 member state options in many of the key provisions, including:

- Expanding the list of PIEs;
- Reducing the length of the initial maximum duration period to less than 10 years;
- Extending the initial maximum duration period by a further 10 or 14 years where a tender is carried out or a joint audit is introduced;
- Adding to the list of prohibited NAS with stricter rules around 'clean periods' or establishing stricter conditions under which permitted NAS may be provided; and
- Requiring stricter rules on a fee cap.

Key extraterritorial implications

PIE definition

Each company with EU operations needs to assess its company’s structure to determine if any of its entities meet the definition of a PIE prescribed by the legislation. Each entity should be looked at individually as there are no separate rules for entities that belong to a group of companies.

- Non-EU companies that are listed on the regulated markets in the EU do not appear to qualify as PIEs.
- EU branch offices of non-EU credit institutions and non-EU insurance undertakings in principle should not be affected by the legislation—but legislation of member state where branch is located is to be checked to determine if they qualify as PIEs.
- EU subsidiaries of non-EU parents qualify as PIEs if the subsidiaries themselves fit the criteria.

MFR scenarios

- If a non-EU parent has subsidiaries in the EU, and any of these subsidiaries are PIEs in their own right, then the PIE subsidiaries will be subject to the legislation and have to rotate in line with the national law of the member states where they are incorporated.
- If a PIE parent company in the EU has non-EU subsidiaries, whilst these subsidiaries are never caught by the PIE definition (because they are outside the EU and therefore not ‘governed by’ the law of an EU member state), the EU parent may choose to rotate auditors of the entire group, including non-EU subsidiaries, in line with the law prevailing in the parent company’s country of incorporation.
- In the scenario where both parent and its subsidiary are incorporated in different member states of the EU, the PIE subsidiary auditor will have to rotate in line with the national law of the member state where that PIE subsidiary is incorporated. This may be a different period than that applying to the PIE parent entity.
- This answer differs if a credit institution or an insurance undertaking in the EU has a branch also in the EU as the EU-based branch forms part of an EU entity which is itself a PIE. MFR rules of the ‘parent’ will apply. For example, a UK bank with a branch in Ireland where the Irish branch is required to have a statutory audit; the statutory auditor must rotate in line with the UK MFR rules.

NAS considerations

Where a member of the network of the statutory auditor provides NAS to entities outside the EU that are subsidiaries of a PIE, the statutory auditor of the PIE must apply ‘threats and safeguards’ approach when assessing the impact of those services on its own independence. There are three absolute prohibitions that are deemed to compromise the independence of the PIE auditor regardless of the nature of possible safeguards put in place:

- Bookkeeping and preparing accounting records and financial statements;
- 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; and
- Services that involve playing any part in the management or decision making of the audited entity.

Companies with EU operations that may be covered by the legislation should monitor developments as interpretive issues are clarified and individual EU member states implement the law.