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The new European Union (EU) statutory audit legislation will go into effect June 17, 2016 (first financial year starting on or after June 17, 2016, with the exception of mandatory rotation, which is subject to a transition period). Some member states are already beginning to enact change, and businesses are taking steps to proactively comply with these measures. Certain member states have provided other start dates for the specific provisions of this legislation.

**What does this legislation mean?**

The legislation has two components — a directive and a regulation.

The directive contains a series of requirements governing every statutory audit in the EU and amends the existing Statutory Audit Directive of 2006. The regulation contains a series of additional requirements that have received much attention, but relate only to the statutory audits of public interest entities (PIEs). These additional requirements include mandatory firm rotation (MFR) and prohibited nonaudit services (NAS).

Estimates indicate that there are approximately 300,000 companies in the EU that are currently required to have a statutory audit. Of these, approximately 30,000 are thought to fall within the PIE definition and will need to comply with the additional requirements.

**Where does the legislation apply?**

This legislation will be applicable in the 28 EU member states as well as Iceland, Liechtenstein, and Norway as these countries are bound by the legislation as members of the European Economic Area (EEA). EU member states have until June 17, 2016, to transpose the legislation into their national law and decide on a number of options that have been afforded to them. The formal agreement of the EEA Joint Committee on the date of application of the regulation and the transposition date of the directive for Iceland, Liechtenstein, and Norway is still pending.

**Does this legislation affect my business?**

The legislation applies to any entity, including subsidiaries of multinationals headquartered outside of the EU that falls within the definition of a PIE. Complexities occur when there are multiple subsidiaries operating in different EU member states, as member states have the opportunity to tailor the local legislation. It will not be fully apparent how this legislation affects multinationals until each member state enacts legislation by June 2016.

**Key aspects of the legislation and implementation considerations**

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.
PIE: Definition and scope

The definition of a PIE was included in the Statutory Audit Directive (2006). The new (2014) PIE definition includes:

1. Companies with transferable securities listed on EU regulated markets (as opposed to all markets in the EU) and governed by the law of an EU member state (requirement is consistent with the same category under Statutory Audit Directive (2006));
2. Credit institutions authorized by EU member states’ authorities (requirement is broadly the same as in Statutory Audit Directive (2006) except member states are no longer allowed to exempt nonlisted PIEs from the requirements of this category);
3. Insurance undertakings authorized by EU member states’ authorities (requirement is broadly the same as in Statutory Audit Directive (2006) except member states are no longer allowed to exempt nonlisted PIEs from the requirements of this category);
4. Other entities a member state may choose to designate as a PIE (requirement is consistent with the same category under Statutory Audit Directive (2006)).

The PIE definition applies to individual entities and is irrespective of size; however, member states may designate additional entities as PIEs and may use a size criteria in some cases. There are no separate rules for entities that belong to a group of companies. If an individual entity qualifies as a PIE, generally the Regulation will apply in its entirety to that PIE irrespective of whether its parent company is a PIE and irrespective of whether its parent is outside the EU.

The definition of a “public interest entity” varies across member states. Special caution should be exercised when considering the definition of PIE in any member state. Refer to the 2014 survey published by the Federation of European Accountants for further details regarding variation in the current PIE definition across member states (this definition may be changed when the regulation is implemented in the relevant member state law).

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1 See Article 2(13) of the Directive for a full definition:
2 Transferable securities are defined in Article 4, paragraph 1 (18) of the 2004 Markets in Financial Instruments Directive (MiFID) and under Article 4, paragraph 1 (44) of the 2014 Markets in Financial Instruments Directive (MiFID 2) and generally mean those classes of securities that are negotiable on the capital market with the exception of instruments of payment.
3 Listing of the regulated markets is available at:
4 References to companies that are governed by the law of an EU member state are generally understood to mean companies that are incorporated in that member state. Companies incorporated outside the EU that are listed on a regulated market within the EU would not generally qualify as an EU-governed company.
**MFR general requirements**

- The initial engagement period for a statutory auditor or audit firm should not be less than one year, but not exceed 10 years. Tenure is counted from the start of the first accounting period audited, and only during the period when the entity was considered to be a PIE. In the case of a listing—where a company has had its auditor for a number of years before the listing date, the duration of the audit engagement should only be calculated from the beginning of the financial year in which the listing became effective. Member states may (1) adopt a rotation term of less than 10 years or (2) extend rotation period to:
  - Maximum 20 years in case of tendering, or
  - Maximum 24 years in case of joint audit.
- Competent member states’ authority (e.g., audit oversight authority and/or securities regulator) may extend the auditor appointment for a further two-year term on an exceptional basis.
- Four-year cooling-off period is required.
- The requirement for ‘key audit partners’ to rotate after a maximum of seven years, followed by a three-year cooling-off period is retained under the new legislation; however, member states have an option to elect shorter partner rotation periods.

**Tendering**

A PIE is required to have a tender process with the close involvement of the audit committee when considering either the selection of a new auditor or the reappointment of an existing auditor at the end of the initial maximum duration period of 10 years if extension is allowed by a member state. Audit committees are responsible for submitting a recommendation to the supervisory body of the audited entity for the appointment of the auditors. The recommendations should include at least two possible choices for the auditors and a justified preference for one of them.

**Joint audit**

A member state may adopt the option to allow extension to 24 years in the case of a joint audit. A PIE does not need to have a joint audit throughout the first 10-year period in order to qualify for an extension of that engagement for up to 24 years; however, the PIE would be required to have joint auditors for the entire extended period (i.e., up to 14 years).

**Timeline for transitional measures**

The transitional provisions depend on the length of the audit relationship at the date of entry into force of the Regulation on June 16, 2014. The fact that a tender may have been carried out recently, and the existing auditor having been reappointed, does not have an impact on the transitional measures described below:

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Category A: PIE which has the same auditor for $> = 20$ years on June 16, 2014 (i.e., audit relationships started in the financial year ended May 31, 1995, or earlier), may not enter into or renew the audit engagement with the incumbent auditor as of June 17, 2020.

Category B: PIE who has the same auditor for $< 20$ but $> = 11$ years on June 16, 2014 (i.e., first year that was audited began after June 16, 1994 (i.e., July 1, 1994, to June 30, 1995), but not later than June 16, 2003 (i.e., June 1, 2003, to May 31, 2004)) may not enter or renew the audit engagement with the incumbent auditor as of June 17, 2023.

Category C: PIE who has the same auditor for $< 11$ years, on June 16, 2014, then the period before June 17, 2016, should be taken into account in calculating the duration of the audit tenure, according to the European Commission. The rotation requirements for this tranche of engagements would begin to apply to the first financial year starting on or after June 17, 2016, according to a recent statement by European Commissioner Hill (to be checked against relevant member state legislation or guidance, when issued), except if a member state has specifically opted to allow extension to 20 years in case of tendering or 24 years in case of joint audit.
Overview

The legislation includes a detailed list of NAS that audit firms and members of their networks may not provide to a PIE statutory audit client, its EU parent, or its EU controlled undertakings (subsidiaries):

• NAS permitted to be provided to the audited PIE is subject to audit committee approval (and application of general principles of independence).
• Member states may prohibit additional NAS and establish stricter rules for NAS, which are nonprohibited.
• Member states may adopt legislation allowing valuation services and certain tax services (i.e., preparation tax forms; identification subsidies and tax incentives; support retax inspections; calculation of direct and indirect tax and deferred tax and tax advice) providing that these services have no direct effect, or have an immaterial effect on the audited financial statements.

NAS fee cap

Fees for permissible NAS should not exceed 70% of the average audit fees paid in the last three consecutive financial years:

• The cap restricts permitted NAS in the fourth year (i.e., if in years one, two, and three, total statutory audit fees are €100, €120, and €170, respectively, then permitted NAS in fourth year are capped at 70% of the average of €130 (i.e., €91)).
• Services required by EU or national legislation are excluded.
• Competent authorities may exempt audit firm from the cap “on an exceptional basis” for a maximum of two financial years.
• Member states may further restrict NAS by adjusting the 70% cap.
• NAS restrictions apply for the first financial year after the date of application of the legislation (i.e., entities with a fiscal year ending December 31 would need to comply starting January 1, 2017).
• However, cooling-in period is required during the fiscal year prior to the period covered by the audited financial statements for some NAS (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).

In order to be able to carry out a statutory audit for a fiscal year starting on or after June 17, 2016 (when the Regulation starts applying), according to the European Commission, the cooling-in prohibition starts as from the fiscal year beginning on or after June 17, 2015. For example, for a PIE with June 30 year-end, the cooling-in period would have started to apply as of July 1, 2015. For a calendar year company, the cooling-in period would apply as of January 1, 2016.

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9 Described in the Article 5 of the Regulation
10 Described in the Article 4 of the Regulation
Restrictions:

These include the following prohibitions:

• Provision of tax services relating to:
  – Preparation of tax forms
  – Payroll tax
  – Customs duties
  – Identification of public subsidies and tax incentives, unless support from the statutory auditor or audit firm in respect of such services is required by law
  – Support regarding tax inspections by tax authorities, unless support from the statutory auditor or audit firm in respect of such inspections is required by law
  – Calculation of direct and indirect tax and deferred tax
  – Provision of tax advice

• Services that involve playing any part in the management or decision making of the audited entity

• Bookkeeping and preparing accounting records and financial statements

• Payroll services

• Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or financial information technology systems

• Valuation services, including valuations performed in connection with actuarial services or litigation support services

• Legal services, with respect to:
  – Provision of general counsel
  – Negotiating on behalf of the audit client
  – Acting in an advocacy role in the resolution of litigation

• Services related to the audit client’s internal audit function

• Services linked to the financing, capital structure and allocation, and investment strategy of the audit client, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audit client

• Promoting, dealing in, or underwriting shares in the audited entity

• Human resources services with respect to:
  – Management in a position to exert significant influence over the preparation of the accounting records or financial statements, which are the subject of the statutory audit, where such services involve:
    • Searching for or seeking out candidates for such positions or
    • Undertaking reference checks of candidates for such positions
  – Structuring the organization design and
  – Cost control
Audit Committees’ role

Overview
The legislation includes several provisions designed to strengthen audit committees of EU companies and to provide more transparency into the activities of the audit committee and the statutory audit. Most of the requirements for audit committees set out in the legislation are already being performed today and represent ‘best practice.’ These requirements are now being enshrined into the law.

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

- At least one member of the audit committee must have competence in accounting and/or auditing.
- The committee members as a whole should have competence relevant to the company’s business sector.
- Exceptions to having a separate audit committee include (member state option):
  - PIE which is a subsidiary undertaking provided that there is an audit committee at the group level that complies with the requirements of this legislation.
  - PIEs which are Undertakings for Collective Investments in Transferable Securities or alternative investment fund.
  - PIE whose sole business is to act as an issuer of asset-backed securities.
  - Any credit institution that only has debt, not shares, listed on a regulated market where debt does not exceed €100 million in total, and the credit institution has not issued a prospectus marketing debt.

Audit committee responsibilities
A PIE is required to have a tender process with the close involvement of the audit committee when considering either the selection of a new auditor or the reappointment of an existing auditor. All permitted NAS provided by the audit firm or a member of the network to the PIE, its parent undertaking, or its controlled undertakings require audit committee approval. Audit committees are required to issue guidelines regarding the provision of tax and valuation services if a member state exercises its option to permit such.

Audit committees must monitor auditor independence and review a nonpublic report prepared by auditors specifically for the audit committee that includes:

- More detailed information on the results of the audit.
- Disclosure of quantitative level of materiality applied to perform the statutory audit, materiality level(s) for particular classes of transactions and account balances or disclosures, and qualitative factors used to determine materiality.
- Reporting and explaining judgments about events or conditions identified during 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 providing a summary of all measures that have been taken into account when making a going-concern assessment.

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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).

- 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.\(^{14}\)
- 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.\(^{15}\)
- 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 auditors and audit firms if statutory audits under EU law are not carried out in conformity with the legislation.

\(^{14}\) 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

\(^{15}\) 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
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.
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.