



Governance *in brief* European Parliament approves EU audit legislation

Headlines

- All EU public interest entities are required to rotate their auditors after ten years, with a Member State option to extend this period to 20 years if there is a tender at the ten year point.
- The legislation introduces restrictions on the nature and extent of non-audit services.
- The legislation will come into effect in mid 2016, following Member State decisions on options, giving companies time to plan ahead.
- With the EU position now settled, the way in which the Competition Commission's proposals will be taken forward can now be clarified, allowing audit committees to finalise tendering timetables and policies.

Another step towards EU audit reform

The European Parliament has voted to approve the EU audit legislation. Formal approval is needed by the 28 Member States of the EU for the legislation to become law but this is expected to follow shortly.

The actual legislation is consistent with that released in draft in December and will impact **all** European public interest entities i.e. EU incorporated entities with **debt or equity** traded on an EU regulated market as well as **all** banks, building societies and insurance companies. For this purpose, 'EU regulated market' includes the Main Market of the London Stock Exchange but excludes AIM. The legislation applies to subsidiaries of non-EU parents that are public interest entities in their own right.

Once approved by the Council, the legislation will enter into force 20 days after publication in the Official Journal of the European Union and will apply two years later. Considering this, the time frame for actual application is likely to be between July and September 2016, leaving time for companies and their advisers to plan ahead.

In addition to new rules on audit firm rotation, the legislation introduces certain restrictions around the provision of non-audit services, a 70% non-audit services fee cap, together with proposals to enhance communications between audit committees and auditors.

Mandatory audit firm rotation

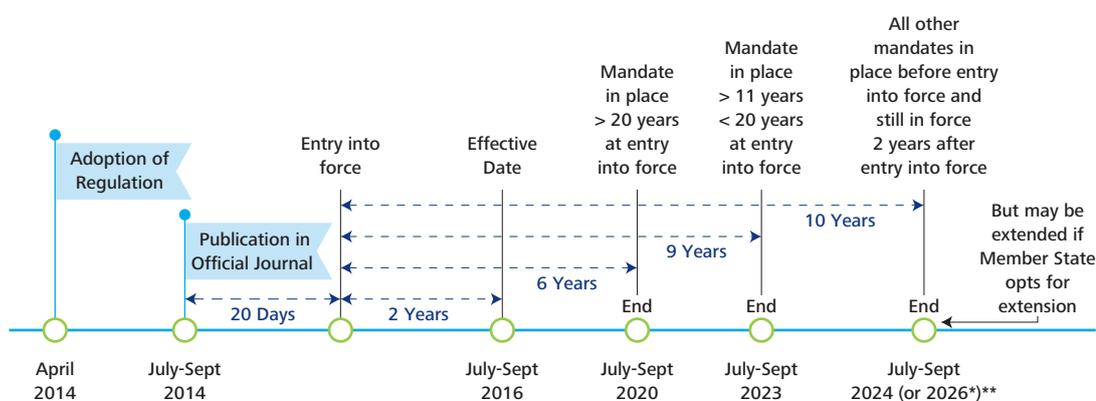
The legislation introduces a requirement that all EU public interest entities rotate their auditors every ten years (Member States can choose to require rotation after a shorter period). If Member States choose to allow it, this period can be extended to a maximum of 20 years if there has been an audit tender after 10 years or a maximum of 24 years if there is a joint audit. We anticipate that the UK will take this option, given the findings of the Competition Commission inquiry. An entity may, on an exceptional basis, request that an extension of up to two years is granted to re-appoint the existing statutory auditor where certain conditions are met. Crucially, this extends to many more UK companies than the Competition Commission inquiry remedies and UK Corporate Governance Code, which only cover tendering by the FTSE 350.

The starting point for the maximum duration period is the date of the first financial year covered by the appointment, which will include the appointment of other firms that the audit firm has acquired or merged with. In the case of uncertainty, the auditor is required to notify the Member State's designated competent authority who will ultimately determine the relevant date of commencement of the relationship.

A four year cooling-off period applies to the audit firm and any members of the audit firm's network prior to re-appointment as the statutory auditor.

Transitional arrangements for audit firm rotation

The good news for companies is that the transitional arrangements set out below do allow a reasonable period for companies to prepare to meet the new audit rotation requirements. These arrangements are based around the duration of the audit appointment at the date of entry into force of the regulation (currently expected to be July-Sept 2014). If at that time the auditor has been in place for 20 years or more, the auditor may continue for up to six years from the date of entry into force of the regulation but is not permitted to renew an audit engagement with the same auditor after that time. If the auditor has been in place for between 11 and 20 years at the date of entry into force, the auditor may continue for up to nine years. For all other situations, the engagement may continue until the end of the first maximum duration, i.e. ten years.



*If 10-year period starts at effective date rather than entry into force – clarification being sought

**Or less if Member State opts to reduce 10 year maximum

Further restrictions on non-audit services

The Regulation includes a detailed list of non-audit services (NAS) that audit firms and members of their networks may not provide to public interest entity audit clients. Member States may prohibit additional non-audit services if they wish.

Provision of permissible NAS by the audit firms or members of their networks to the audited public interest entity, its parent undertaking, or its controlled undertakings requires audit committee approval. Fees for NAS provided by the audit firm may not exceed 70 percent of the average fees paid in the last three consecutive financial years for the statutory audit of the Group and its subsidiaries. NAS required by member state or EU regulation (for example, fees for auditor's reports to financial services regulators) do not count against this cap.

A prohibition on the design and implementation of internal control or risk management procedures related to the preparation and/or control of financial information or financial information technology systems applies during the fiscal year **prior** to the period covered by the audited financial statements.

The proposed cooling-off period on the provision of NAS after the issue of the auditor's final audit report has **not** been taken forward.

The non-audit services requirements will come into force in 2016 (i.e. two years from publication in the Official Journal). There will be clarifications regarding permitted services on implementation in Member States.

Deloitte view

- Audit committees of FTSE 350 companies with March and June year ends will be finalising tendering policies and drafting annual report disclosures on the new “comply or explain” UK Corporate Governance Code requirement to tender every ten years. The EU announcement will influence the tendering policy and timetable. We hope that the Competition Commission’s remedies can be introduced at the same time as the EU requirements to minimise unnecessary complexity.
- The finalisation of the EU position clarifies the landscape but, from the UK perspective, still needed are decisions by BIS and the FRC around Member State options and some clarification around UK specific non audit services, particularly regarding reporting accountant work on IPO and class one transactions.
- Unfortunately, due to the variety of Member State options available, a patchwork of differing requirements may well develop across Europe on implementation – such as different mandatory firm rotation periods and inconsistent prohibitions on non-audit services. Implementation runs the risk of being complex and costly for multinational companies and the profession to manage cross borders, not only in the EU but globally.
- The transitional rules on audit rotation provide enough time for companies to plan across the range of services provided by audit firms, and companies also have two years before the proposed restrictions and 70% cap on non-audit services apply, enabling alternative arrangements to be established well in advance.

List of prohibited non-audit services

Member States may adopt legislation allowing valuation services and certain tax services (preparation of tax forms, identification of public subsidies and tax incentives, support for tax 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. BIS and the FRC will consult on their approach to this in due course but it is important to note that many of these services are currently allowed by the APB’s Ethical Standards provided that suitable safeguards are in place.

Under the new legislation, the following NAS may not be directly or indirectly provided by the audit firms and members of their networks to the audited public interest entity, its parent undertaking or its controlled undertakings in the EU, during a period covered by audited financial statements and until issuing of the audit report:

- **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 process 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:**
 - the 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, including the provision 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 that are the subject of the statutory audit, where such services involve:
 - i searching for or seeking out candidates for such positions
 - ii undertaking reference checks of candidates for such positions
 - structuring the organisation design
 - cost control

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