EU AUDIT REFORM

What the final rules mean for companies

Introduction

On 3 April 2014, the European Parliament adopted the texts of a new Directive amending the current Directive on Statutory Audits of Annual Accounts (Directive 2006/43) and a Regulation on specific requirements regarding statutory audit of "public-interest entities". The Directive needs to be transcribed into national laws by each member state, but the Regulation is binding. It is expected that each will be adopted by the European Commission in May 2014 for implementation across the EU by 2016.

The overriding aims of the reform are to improve audit quality and restore investor confidence in financial information. The EU Commissioner and Michel Barnier, key architect of the reforms, views them as "an essential ingredient for future investment and economic growth."

The main objectives of the reform are to:

1. Further clarify the role of the statutory auditor
2. Reinforce the independence and the professional scepticism of the statutory auditor
3. Facilitate the cross-border provision of statutory audit services in the EU
4. Contribute to a more dynamic audit market in the EU
5. Improve the supervision of statutory auditors and the coordination of audit supervision by competent authorities in the EU.

Whilst the headlines in the press concerned the imposition of compulsory auditor rotation and the introduction of a 70% cap on non-audit services, the new Directive and Regulation introduce a series of detailed changes which will affect the operation of the audit committees of all listed companies and bring audit tender and auditor rotation into focus for non-FTSE350 premium listed companies for the first time.

Highlights

- **Mandatory auditor rotation for EU listed companies**
- **Tendering and rotation coming to non-FTSE350 listed companies**
- **70% cap on non-audit services provided by auditors**
- **Introduced by Regulation allowing no "comply or explain"**
- **UK opt outs are limited**

Who do the new rules apply to?

Broadly, the measures contained in the Directive will apply to all UK companies, their auditors and the regulators of the audit profession.

"Public Interest Entities" (PIEs) will need to take particular note of the measures which will be introduced by the Regulation as there is little provision for variation by Member States. PIEs are defined in Directive 2013/34 as listed companies and non-listed credit institutions and insurance undertakings. In addition, Member States can designate as PIEs other undertakings that are of significant public relevance, because of the nature of their business, their size or the number of their employees.

When do the new rules apply?

The Member States in the Council are expected to formally adopt the texts by mid-April. Publication in the Official Journal of the EU will follow in the second quarter of 2014.The Directive will enter into force 20 days after its publication and Member States have two years to adopt and publish the provisions necessary to comply with the revised regulatory framework. The Regulation will also enter into force 20 days after its publication, and will apply two years after that. As a result, both texts are expected to be implemented in around mid 2016.

However, some specific provisions will become applicable later. For instance, rotation periods are subject to specific transitional periods. Similarly, the prohibition of the "Big Four Only" contractual clauses will apply three years after the entry into force of the Regulation, unless the UK Government or the Competition Commission were to bring in such a prohibition earlier.

Timing

- **Likely to enter force Summer 2016**
- **But timings around rotation fixed to Summer 2014 date**

Detailed provisions

Mandatory audit firm rotation

Following the entry into force of the new rules, PIEs will be required to change their statutory auditors or their audit firms every 10 years as a maximum. If Member States choose, this period can be extended to a maximum of 20 years where there has been an audit tender after 10 years, or a maximum of 24 years if there is a joint audit. The UK is expected to take this option. A PIE may, on an exceptional basis, request that an extension of up to two years be granted to re-appoint the existing statutory auditor where certain conditions are met.

The duration of the audit engagement is calculated as from the date of the first financial year covered in an audit engagement letter. In the case of uncertainty as to the length of engagement, determination will be by the Member State's designated competent authority on request by the auditor. A four-year cooling-off period applies prior to re-appointment as statutory auditor.

Transitional arrangements are put in place, which are based around the duration of the audit appointment at the date of entry into force of the regulation (currently expected Summer 2014):

- Those PIEs who have had the same auditor for 20 years or more at date of entry must change auditors within 6 years (ie 2020)
- Those PIEs who have had the same auditor for between 11 and 20 years or more at date of entry must change auditors within 9 years (ie 2023)
- All other PIEs with auditors in place at date of entry can continue until the first date of maximum duration (ie expected to be 20 years from the first financial year audited in the UK for sole audits).

Auditor rotation

- **UK likely to take option for rotation after 20 years provided tender at 10 year point**
- **Companies have at least 6 years from now to change auditor**
- **Some tender requirements**

Clauses of contracts which restrict the choice of auditor will be null and void. This will override the existing Code guidance to Audit Committees which recommends disclosure of such contracts. PIEs will also have to inform the appropriate authorities of attempts by third parties to influence improperly the appointment of auditors.

Rules on tendering

There are certain clauses of the Regulation which specify how tenders are to be carried out. In particular, the tender documents must allow firms to understand the business of the audited entity and the type of statutory audit.

Auditor tendering

- **Specific rules on how to tender**
- **Publication of selection criteria**
- **Demonstration that selection is fair**

The tender documents must contain transparent and non-discriminatory selection criteria that will be used by the audited entity to evaluate the proposals made by statutory auditors or audit firms. The PIE must prepare a report on the conclusions of the selection procedure, which would then be validated by the audit committee. The PIE must be able to demonstrate, upon request, to the national competent authority that the selection procedure was conducted in a fair manner.

Outgoing auditors will have to make certain reports available to the incoming auditors.

Mandatory audit report changes

The Regulation broadly adopts most of the changes to the audit report recently applied by the FRC to companies in the FTSE 350 index and the enhanced reporting to their audit committees.

The role of the audit committee

The role of audit committees in auditor-related recommendations to the Board of PIEs will be put on a statutory footing.

Non-audit services

The Regulation provides for:

- a list of prohibited non-audit services
- a cap on other non-audit services where the audit firm or any member of its network provides such services for a consecutive period of 3 years or more. The total fees are limited to no more than 70 % of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent and subsidiaries.

There is some scope for member state interpretation of prohibited non-audit services and some doubt as to the exact interpretation of others, but the following non-audit services will be broadly prohibited:

- most tax compliance and advice
- bookkeeping services
- design and implementation of internal control or risk management procedures
- services related to internal audit
- valuation services
- headhunting and organisational design services
- services linked to the financing, capital structure and investment strategy of a client except for some comfort letters in respect of prospectuses.

For the design and implementation of internal control work or risk management procedures, the prohibition applies for the financial year prior to the audit.

However, member states will have some discretion as to whether to allow some tax and valuation services. So BIS and the FRC will need to make decisions on the Member State options and provide early clarity. We would highlight reporting accountant work on IPOs and class one transactions as a particular area of interest for UK companies. The rules will come into force in 2016 (two years from the publication of the Regulation).

Non-audit services

- **List of prohibited non-audit services**
- **Cap of 70% on non-audit services provided by the auditor**
- **Some scope for BIS and the FRC to set and interpret the final lists**
- **Rules into force in 2016**
- **But some services require a 1 year cooling off**
- **Careful management of non-audit services needs to begin now**

Independence rules

The Regulation will place on a statutory footing a number of existing rules enforced by professional standards to ensure the independence of auditors. These include:

- neither firms, nor those closely involved in the audit, owning directly any shares or financial instruments in clients
- non-employment by companies of ex-audit partners connected with the client for a period of at least 2 years; this includes as non-executive directors and membership of their audit committees.

continued overleaf

Independent Audit comment

Our view

- **EU Regulation creates scope for shareholder litigation**
- **Many more audit tenders as rotation rules will apply to all listed companies**
- **Transitional rules are reasonable, but start planning now.**

We concur with the view that this is an important step in improving investor confidence and trust. However, with the use of a Regulation, the European Commission has seized control of the audit agenda from national governments and there is significantly reduced flexibility for the UK and the use of the "comply or explain" principle adopted in the UK Corporate Governance Code. Issues such as the independence of auditors are now elevated to a statutory footing with the possibility of legal actions tightening procedures at audit firms and their clients.

The requirement for mandatory rotation (which we believe is likely in many cases to create an audit tender after 10 years) will now extend to many more UK companies than the proposed Competition Commission inquiry remedies and UK Corporate Governance Code, which only covered the FTSE 350. We expect that, over time, this will lead to a more dynamic market across all audited entities.

The inclusion in the Regulation of provisions related to how the tender is carried out are broadly in line with best practice. However the potential involvement of national Competent Authorities may give disgruntled shareholders another avenue for pursuing grievances.

We believe that the transitional arrangements for auditor rotation do allow a reasonable period for firms to make changes. However, firms who have had or will have had, by May 2016, their auditors for more than 20 years, must start planning their change now.

In particular, the management of provision of non-audit services to avoid independence and conflict issues could get very tricky. Companies will need to consider the interaction of the maximum tenure rules with the prohibition on certain non-audit services and ensure that firms who provide non-audit services are not themselves prohibited from becoming future auditors. The timing provisions within prohibited audit services related to internal control and risk management design further complicates the process.

What the new rules will do to audit fees is open to conjecture. Firms will certainly look to recover tender costs and early year discounts within their fees over shorter timescales than they are used to. And there is an argument that the prohibition on certain non-audit fees will lead to increased audit fees (through the reduction of cross-subsidy) as well as reinforcing attitudes we have seen recently where audit firms may decide not to participate in certain tenders.

We now await the response of the Competition Commission later this year to see whether audit committees and their chairmen are going to have to adapt to yet more change. We hope that any further remedies required can be timed to coincide with the 2016 date.

Contact

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