Audit Reform in Luxembourg - what role will the Audit Committee play?

On 17 June 2016, European Directive 2014/56/EU on statutory audits of annual accounts and consolidated accounts, together with EU Regulation n°537/2014 (the new European Union (EU) audit legislation1), entered into force, which impose, among other things, mandatory audit firm rotation as well as significant restrictions on non-audit services for public interest entities (PIEs) in the EU and in the European Economic Area (EEA)2 countries. Multinational companies headquartered outside of the EU also need to be aware of the requirements, as they may apply to some of their EU subsidiaries.

On 23 July 2016, the Directive was transposed and the EU Regulation was implemented into Luxembourg’s corporate law.

Key points

- The new EU audit legislation requires PIEs to mandatory rotate their statutory auditor and restricts the non-audit services they can obtain from their auditor. The legislation is wide-ranging and includes many other new provisions such as:
  - The extension of the content of the audit report
  - An additional report to the audit committee made by the auditor
  - The establishment of the Committee of European Auditing Oversight Bodies (CEAOB)
  - The Commission de surveillance du secteur financier (CSSF) sanctions regime that is applicable to individual PIE audit committee members, other directors, and the PIEs themselves (as well as their external auditors) in the event of non-compliance with the Law of 23 July 2016 on the audit profession (the audit profession Law) and EU regulation
- Multinational companies headquartered outside the EU need to be aware of the requirements because they also apply to EU subsidiaries that meet the definition of an EU PIE
- The new EU audit legislation includes a large number of options for Member States3, which will lead to inconsistent application and a patchwork of different national requirements
- Complying with the legislation will be challenging and will require advance planning. Companies should take steps now to understand if and how the new EU audit legislation will affect them or their EU subsidiaries

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2 European Economic Area contains the European Union Member States and Liechtenstein, Norway and Iceland.

3 Member States are member states of the European Union. Parties to the Agreement on the EEA other than the Member States of the Union are treated as Member States of the European Union States.
The new EU audit legislation, enacted in 2014, and effective for financial years starting on or after 17 June 2016, will usher in far-reaching changes for companies that are PIEs in the EU. Several key provisions of the 2014 new EU audit legislation will greatly affect the audit committees of these companies, as explained below. Yet many audit committees may not be aware of the challenges that lie ahead.

In Luxembourg, the application of the audit profession Law, transposing the Directive, and implementing the EU Regulation, will mark the most significant development since the modified Law of 18 December 2009 concerning the audit profession (which is now repealed).

Under the audit profession Law, Luxembourg's regulatory authority, the CSSF, must, among other things:

- Evaluate PIE audit committee performance as part of audit market monitoring reports that the EU regulators are required to publish every three years
- Establish a sanctions regime that is applicable to individual PIE audit committee members, other directors, and the PIEs themselves (as well as their external auditors) in the event of non-compliance with the audit profession Law and EU regulation, among others:
  - Rotation rules
  - Approval and capping of permitted non-audit services
  - The employment of a former auditor for a key management or directorship position
  - The procedure for the selection of statutory auditor(s) or audit firm(s) after the expiry of the maximum durations of audit mandates

Under the audit profession Law and EU Regulation, audit committees of PIEs shall inter alia:

- Ensure the implementation of rotation rules of statutory auditor(s) or audit firm(s) in accordance with local laws
- Monitor the statutory audit of the annual and consolidated accounts, in particular, its performance, taking into account any findings and conclusions by the CSSF
- Review and monitor the independence of the statutory auditors or the audit firms in accordance with local laws, and in particular the appropriateness of the provision of non-audit services (preapproving non-audit services could be difficult where multinational groups have PIE subsidiaries in multiple jurisdictions, because different Member States will apply different prohibitions with regard to non-audit services)
- Inform the administrative or supervisory body of the outcome of the audit [...] and what the role of the audit committee was in that process

Definition of a PIE

The first question for audit committees to consider is whether their company is an EU PIE or has EU PIE(s) in its group.

Article 1 (20) of the audit profession Law defines a PIE as follows:

- Entities governed by the law of a Member State, whose transferable securities are admitted to trading on a regulated market\(^4\) of a Member State
- Credit Institutions
- Insurance and reinsurance undertakings with the exception of pension fund and captive companies

The EU PIE definition applies to individual entities. There are no separate rules for groups of companies. Many large multinational groups are likely to have more than one PIE in different countries within the EU. These multinational groups will face the need to follow potentially different laws as a result of options left by the EU Regulation to national legislators.

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\(^4\) Regulated market as defined by art 4 § 1(21) of the Directive 2014/65/EU
The general requirement in the new EU audit legislation is that every PIE should establish an audit committee. Although Member States can decide to exempt certain PIEs from that requirement, it is possible that some groups of companies might find themselves legally obliged to establish more than one audit committee. This will require a degree of coordination between those audit committees in order to avoid unnecessary duplication of effort while affording full compliance with the applicable laws.

In Luxembourg, the legislator has opted to exempt the following PIEs from the requirement to establish an audit committee:

- Any PIE which is a subsidiary undertaking of a group and if that group fulfils the requirements of the EU Regulation with respect to rotation rules and submission of an additional report to the audit committee
- Any PIE which is a Luxembourg UCITS or alternative investment fund (AIF)
- Any PIE whose sole business is to act as an issuer of asset backed securities
- Any credit institution whose shares are not admitted to trading on an EU regulated market and which has, in a continuous or repeated manner, issued only debt securities admitted to trading on an EU regulated market, provided that the total nominal amount of all such debt securities remains below EUR100 million and that it has not published a prospectus under the European Directive 2003/71/EC

As the new EU audit legislation is effective as of 17 June 2016, it is essential that audit committees understand the new requirements.
For the first time, the new EU audit legislation requires the European Competition Network\(^5\) and the audit oversight authorities in each Member State to prepare an audit market monitoring report on a three-year basis. The report will focus on topics including concentration levels in the PIE audit market, audit quality and the performance of audit committees, with the first report due to be published soon and the second report in June 2019.

At this stage, it is not clear how the performance of an audit committee will be assessed, although a better indication will be determined once the first audit market monitoring report is published. The way in which the audit committee conducts the audit tendering process will almost certainly form a major part of the assessment.

Regardless of the jurisdiction in which they are based, audit committees will have to be able to demonstrate, upon request, to the competent authority (CSSF for Luxembourg) that the selection procedure was conducted in a fair manner (article 16 3f of the EU Regulation). It is also possible that the review may include the audit committee’s role in the assessment of auditor independence, monitoring the provision of non-audit services and supporting overall audit quality.

The new EU audit legislation will require a PIE either to rotate its auditor or put the audit out to tender after a maximum 10-year period. Each Member State may adopt a shorter time frame for rotation or greater constraints, thus groups with multiple PIEs in several jurisdictions shall anticipate a heavy and complex process.

In Luxembourg, the new legislation will require PIEs to rotate their audit firm:

- After a maximum 10-year period
- After a maximum 20-year period where a public tendering process for the statutory audit is conducted in accordance with law and takes effect upon the expiry of the maximum duration of 10 years

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\(^5\) The European Commission and the national competition authorities in all EU Member States cooperate with each other through the European Competition Network (ECN).
The audit committee is responsible for conducting a tender consistent with certain legal requirements. It must conduct an audit tender in accordance with the requirements that are specific to the PIE’s own jurisdiction. It needs to follow a fair and transparent process when selecting a new auditor.

Furthermore, it must be able to demonstrate that the organization of the tender process contains non-discriminatory selection criteria.

Following the tender, the audit committee must recommend the names of at least two potential auditors. One name will be the preferred choice. The choice and preference will then be presented to the shareholders or members of the audited entity for the appointment of statutory auditors or audit firms (notably the board of directors in case of credit institutions). If the proposal departs from the preference of the audit committee, the reasons for not following the recommendation of the audit committee shall be justified.

Auditors of PIEs will be subject to a maximum cap of non-audit fees. The cap equals 70% of audit fees based on a three-year rolling average. This means that the fees for services provided to the audited PIE, its parent undertaking or its controlled undertakings (irrespective of PIE status and of location) are now limited to no more than 70% of the average of the fees received in the last three consecutive financial years for the statutory auditor(s) of the audited EU PIE and, where applicable, of its parent undertaking, of its controlled undertakings and of the consolidated accounts of that group of undertakings.

Outside a specific list of prohibited services, auditors can provide a range of permissible non-audit services to their audit clients. Prohibited services include providing accounts preparation, structuring, legal and payroll services. Regarding tax and valuation services, Member States may permit them in certain circumstances.

**NAS conditionally authorized in Luxembourg (PIEs only)**

- Luxembourg used the option of Regulation 537/2014 to authorize the following services (always subject to audit committee approval and 70% cap)
  - Tax services relating to: (i) preparation of tax forms; (ii) identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law; (iii) support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspections is required by law; (iv) calculation of direct and indirect tax and deferred tax; (v) provision of tax advice
  - Valuation services, including valuations performed in connection with actuarial services or litigation support services

**Conditions**

- No direct or immaterial effect, separately or in the aggregate, on the audited financial statements
- Estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee
- The principles of independence laid down in the audit profession Law are complied with
In Luxembourg - Prohibited non-audit services (NAS)

- **Prohibited**
  a. During the period between the beginning of the period audited and the issuing of the audit report
  b. For designing and implementing internal control or risk management procedures related to ... : also during the financial year immediately preceding a above

- **Prohibited to the audited PIE and to its parent undertaking and to its controlled undertakings within the EU**

- **Prohibitions that apply to the audit firm and any member of its network**

Prohibited NAS consist of:

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<tr>
<th>Prohibited non-audit services relating to:</th>
<th>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</th>
<th>Payroll services</th>
<th>Legal services:</th>
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<td>(i) Payroll tax</td>
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<td>(i) The provision of general counsel</td>
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<td>(ii) Customs duties</td>
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<td>(ii) Negotiating for an audit client, or</td>
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<td>Services that involve playing any part in the management or decision-making process of the audited entity</td>
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<td>(iii) Acting in an advocacy role in the resolution of litigation</td>
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<td>Services related to the audit client’s internal audit function</td>
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<td><strong>Human resources services:</strong></td>
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<td>Promoting, dealing in, or underwriting shares in the audited entity</td>
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<td>(i) Management with influence over accounting records or financial statements, subject to the statutory audit, where such services involve:</td>
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<td>Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or financial information technology systems</td>
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<td>(1) Searching for candidates for such positions, or</td>
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<td></td>
<td>Bookkeeping and preparing accounting records and financial statements</td>
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<td>(2) Undertaking reference checks of candidates for such positions</td>
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<td>(ii) Structuring the organization design and cost control</td>
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Audit Reform in Luxembourg – what role will the Audit Committee play?

Since audit committees of PIEs will have to preapprove expenditure on permissible non-audit services, they will need to understand the structure of their groups and the different audit arrangements that are in place. The audit committee will need to know which services the PIE requires and which professional services firms will be eligible to provide them.

Moreover, if an audit firm from another network (i.e., a network other than the one performing the group audit) is appointed to audit an entity within the group, the audit committee of the PIE will have to consider carefully whether that entity is, itself, a PIE or if it has parents or subsidiaries in the EU that are PIEs. If so, and to the extent that the incoming auditor has been providing other services elsewhere in the group, those arrangements may need to be terminated.

Where there are multiple PIEs in a group, that requirement can become increasingly complex to monitor, particularly since PIEs in different jurisdictions may have to rotate their auditors at different times.

For example, if a Luxembourg-based bank has a PIE subsidiary in Italy that awards its audit to a particular firm, the prohibitions on which services can be provided by that firm apply to the Italian subsidiary as well as to that subsidiary’s own subsidiaries and its parent companies within the EU. They also apply to the audit firm’s entire global network. If the firm had been providing non-audit services to the bank in Luxembourg, it would no longer be considered independent once it won the Italian audit and would have to stop providing those non-audit services.

Nevertheless, although the prohibitions apply to the audit network globally, they would not prevent the US firm within a network from providing non-audit services to a US parent company. That said, if the US entity was a subsidiary of an EU PIE, while most non-audit services are permissible subject to a threats and safeguards assessment, some services are explicitly banned (e.g., services that involve playing any part in the management or decision-making of the audited entity, bookkeeping and preparing accounting records and 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 Luxembourg, the legislation requires PIEs to rotate its key audit partners⁶, responsible for carrying out their statutory, no later than seven years from the date of their appointment.

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⁶ Key audit partner(s) mean(s):
(a) the statutory auditor(s) designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on behalf of the audit firm
(b) in the case of a group audit, at least the statutory auditor(s) designated by an audit firm as being primarily responsible for carrying out the statutory audit at the level of the group and the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries
(c) the statutory auditor(s) who sign(s) the audit report
Under the new EU audit legislation, the majority of audit committee members must now be independent, and one member must be competent in accounting and/or auditing. Additionally, the new EU audit legislation states that committee members as a whole shall have competence relevant to the sector in which the audited entity is operating.

This is viewed as a significant change from the 2006 Directive, which only required one member of the audit committee to be independent.

The audit profession Law and the EU Regulation require the auditor to submit an additional, more detailed, report to the audit committee on the results of the statutory audit, no later than the date of submission of the audit report.

The additional report to the audit committee shall be in writing. It shall explain the results of the statutory audit carried out and shall among others:

- Include the auditor’s declaration of independence
- Include a description of the scope and timing of the audit
- Describe the methodology used
- Disclose the quantitative level of materiality applied
- Report on any significant deficiencies in the audited entity’s internal financial control system, and/or in the accounting system. For each significant deficiency, the additional report shall state whether or not the deficiency in question has been resolved by the management
- Report and assess the valuation methods applied to the various items in the annual or consolidated accounts including any impact of changes of such methods
- 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 judgment, are significant to the oversight of the financial reporting process

In Luxembourg, the legislator requires the audit committee to pass this on to the board of directors or management body of the PIE.
Audit committees of companies that are based outside the EU, but that have EU PIEs somewhere in their group structure, will also be affected by the new EU audit legislation. Indeed they may not ignore compliance of their legal obligations by their subsidiaries and their audit committees. Thus auditors of PIEs in the EU will have to abide by the new auditor rotation requirements even if the auditors group are not themselves subject to similar rotation requirements, and the independence of their auditors will still need to be monitored.

The audit committee of the non-EU parent company should therefore check that these provisions are properly followed by the audit committees of PIE subsidiaries located in the EU. The audit committee of a non-EU parent would not, however, be subject to sanctions on individual audit committee members enforced by the EU supervisory authorities.

Articles 43, 44 and 48 of the audit profession Law deal with the sanctions regime that is notably applicable to individual PIE audit committee members, directors, management and the PIEs themselves in the event of non-compliance with the audit profession Law and EU regulation.

In Luxembourg, the CSSF has the power to take and/or impose at least the following administrative measures and sanctions for breaches of the provisions of the audit profession Law and, where applicable, of the EU Regulation:

a) Towards the PIE itself, an administrative fine of a maximum of EUR1 million or a maximum of 5% of the total annual net turnover of the company as reflected in the latest accounts approved by the management board or supervisory board

b) Towards individuals, an administrative fine of up to EUR500,000

c) As an alternative to a) and b), an administrative fine of an amount equal to at least twice the benefit derived from the infringement, if it can be determined, even if that amount exceeds the maximum amounts referred to in points a) and b)

d) A temporary prohibition, of up to three years duration, banning a member of an administrative or management body and a member of an audit committee of a PIE from exercising functions in audit firms or PIEs

The sanctions and administrative measures taken by the CSSF may be appealed pursuant to Article 46 of the audit profession Law. The application of the penalty or administrative measure is suspended during the period for appeal and for the duration of the procedure.
An initial priority will be for an audit committee to ascertain to what extent there are PIEs anywhere in their group structure.

If any PIEs are identified, their audit committee should prepare for the new audit legislation by following the steps below:

- The applicable rotation and tendering requirements for the PIE’s audit should be determined, both in terms of length and timing. These will differ according to jurisdiction and the length of the existing audit relationship. The audit committee should decide how to provide proof that it has carried out the audit tendering process in a fair, transparent and non-discriminatory manner.
- Relationships beyond the company’s current auditor should be managed. Audit committees of PIEs need to examine whether audit firms other than the current auditor provide non-audit services to other group companies, determine the nature of any such services, and ascertain whether those firms would be considered sufficiently independent if they were to tender for the audit in the future.
- The audit committee should obtain regular updates from its current auditor on its independence.
- The audit committee should list the non-audit-services provided by its current auditor and members of its auditor’s network to review the appropriateness of the provision of non-audit services to the audited entity in accordance with Article 5 of the EU Regulation.
- The composition of the audit committee should be reviewed to ensure that it complies with the audit profession Law. Is it sufficiently independent and is it composed of individuals who provide the right breadth of sector and accounting or auditing skills? It may be necessary for the audit committee to consider performing its own skills analysis in order to get an accurate picture.
- The audit committee may offer to its members a training course on their new obligations.
- The audit committee should amend the audit charter in order to transpose the requirements of the new EU audit legislation.
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