EU hands down a game changer

On 3 April 2014 the European Parliament voted on final European Union (EU) audit legislation. Among other provisions, the legislation will impose mandatory audit firm rotation as well as significant restrictions on non-audit services for Public Interest Entities (PIEs) across the EU. Some technical formalities remain but we expect the legislation to be finalised in July 2014, and generally to take effect two years later on or around 1 July 2016, although the timing could slip a few months. Special transition arrangements will apply to the provisions on mandatory firm rotation.

The legislation is generally directed at audits of PIEs, which include companies with shares traded on an EU "regulated market" and certain other organisations such as banks, insurance companies and other financial entities. In the UK this will include companies with listed debt or equities on the main market but not AIM. The legislation also applies to EU PIE subsidiaries of companies headquartered outside the EU.

Key provisions in the legislation

The legislation is wide-ranging. The key provisions include:

- Mandatory audit firm rotation for PIEs after a maximum of 10 years, although EU Member States can extend this period by a further 10 years if a tender is required or 14 years in the case of a joint audit.

- Transitional provisions which bring the new rotation regime in over time. They are as follows and apply from mid-2014 if a company has been audited by the same firm for:
  - more than 20 years, regardless of when it last tendered, it will need to rotate within 6 years (i.e., by mid-2020);
  - between 11 and 20 years, regardless of when it last tendered, it will need to rotate within 9 years (i.e., by mid-2023);
  - less than 11 years, the company has at least 12 years before it must rotate its auditor, if the UK opts to extend the maximum tenure to 20 years, then the company will be able to extend by a further period.
Significant restrictions on non-audit services to PIE audit clients, including many tax and advisory services, are as follows:

- Fees for permissible NAS should not exceed 70% of the statutory audit fee, based on an average group audit fee for the preceding three years. There is significant uncertainty as to how this will work in practice because the legislation is imprecise. For example, it is uncertain whether the intention is to restrict fees for permitted NAS to that amount on an annual basis or to limit the total fees over a rolling three year period to that amount. In addition, the cap applies where permissible NAS have been provided for three or more consecutive years. It is not clear whether this will be retrospective, neither is it clear whether the three-year clock will reset if, in one year, no NAS were provided.

- The NAS restrictions in the legislation are assumed to apply from the start of the financial period and the issuing of the audit report (the ‘Prohibited Period’). Services that involve “designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or financial information technology systems” may not be provided in the financial year preceding the prohibited period either.

- At the option of member states certain prohibited services, particularly in the tax arena, may be provided by the auditor if the audit committee decides they are immaterial to the financial statements. It is not yet known which Member States will exercise this option, or how Member States will choose to interpret the language in the legislation.

What happens next?

The legislation is complex and unclear in many places. There is no EU-wide regulatory body that has the authority to issue guidance on interpretation. This means that guidance will need to be provided by individual regulators at a member state level. Inconsistencies of interpretation across the EU are therefore possible. That said, it is plain to see that reforms will have practical implications for companies’ professional services strategies and audit tender timetables.

When taking both the audit firm rotation and NAS restrictions together, we believe PIEs need to make decisions in the next 18-24 months, not only about their auditor tender and rotation strategy, but also their other major professional services procurement.

For FTSE350 companies in particular, UK-specific audit reforms on tendering put forward by the Financial Reporting Council and Competition Commission will bring additional regulatory complexity and practical timing issues.
Other provisions
There are other changes in the legislation which also need to be worked through. Examples include:

Audit committees

► Audit committees will be required to approve the provision of all ‘permissible’ NAS, and if relevant issue guidelines on their assessment of the ‘immateriality’ of certain ‘prohibited’ tax services.

Auditor’s report

► The audit report will need to provide a statement on any material uncertainty that might cast significant doubt about an entity’s ability to continue as a going concern. The auditor’s opinion for PIEs will also need to be supported with a description of the most significant risks of material misstatement, including fraud, with a summary of the auditor’s response to those risks.

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