UK asks questions about implementing EU audit reform

The message could not be clearer. Choices now under consideration by the UK Government and Financial Reporting Council will have important consequences for you and your company. So take the time now to understand the impact on your business and have your say.

On 17 December 2014 the UK Government (Department for Business Innovation & Skills – BIS) and Financial Reporting Council (FRC) issued discussion papers. Both explore options for the implementation of the EU’s audit legislation (Regulation and Directive) which came into force on 17 June 2014, although many of its features do not take effect until 17 June 2016.

The outcome will affect many things: the procurement of professional services, the work of your audit committee, and the tender, appointment and tenure of your external auditor.

This document is an update. For a general explanation of the EU reforms please go to our website.

What happens next?

We encourage you to analyse the discussion papers and the potential impact on your business of the options outlined in them; they give you an opportunity to have your say.

Ultimately, and well in advance of June 2016, you will need to review the professional services you receive including those provided by your auditor or potential auditor.

You will also need to check when you will have to tender the audit and/or change auditor, and identify how to make that an efficient, effective and compliant process.

Responses to the discussion papers may determine the scope of your options, and the extent to which you can either mitigate the effect of the changes and/or take advantage of them. The deadline for responding to BIS is 19 March 2015. Subject to the responses it receives, BIS will issue a detailed consultation in the summer of 2015 on how it plans to proceed.

The deadline for responding to the FRC is 20 March 2015. Once the FRC has considered the responses to its questions, and decided which options to take, it will amend its standards accordingly via a further consultation in 2015.

Both discussion papers are substantial documents which cover a multitude of issues. We flag some of the key points below but this is by no means an exhaustive list. Because they are discussion papers, they ask fairly open questions, rather than setting out a near final position.

This is therefore a real opportunity for companies to influence the decisions which are made. The policymakers are listening and are particularly keen to hear from companies about the impact.

**Key options under consideration**

- Should the rules apply to a broader population of companies in the UK?

  EU legislation applies to public interest entities (PIEs) e.g. UK incorporated FTSE companies, banks and insurance companies\(^2\). Member states may extend the PIE definition.

  BIS does not propose to widen the PIE definition. However the FRC is separately considering whether it should be extended for non-audit services restrictions (see below).

- For how long should the UK allow companies to keep their audit firm and when should they tender?

  EU legislation requires companies to rotate their auditor every ten years. There are options to either extend or reduce this period.

  One possibility is extending the rotation period to twenty years if there is a competitive tender. When this tender should take place is unclear.

  BIS proposes extending the maximum permitted audit firm tenure from ten to twenty years, provided there is a competitive tender.

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\(^2\) For more information on PIEs see [http://www.ey.com/Publication/vwLUAssets/EY_UK_EU_analysis/0001420683/$FILE/EY_UK_EU_analysis.pdf](http://www.ey.com/Publication/vwLUAssets/EY_UK_EU_analysis/0001420683/$FILE/EY_UK_EU_analysis.pdf)
BIS is concerned that EU tendering requirements here are not flexible enough for companies because the requirements appear to suggest the tender can only take place at the end of the first ten year period.

BIS proposes a number of alternatives to fix this, including options for tendering earlier than at ten years. These are not currently covered by the EU legislation and some options would appear to add further inflexibility. There is also a suggestion that this would be backed by a requirement to make a disclosure about the intended date of the next tender in the Directors’ Report; such date to be binding once it is two years away or less.

What about transitional periods for rotating my auditor?

EU legislation provides transitional periods for rotation. If the PIE appointed its auditor:

- before 17 June 1994, it cannot reappoint that auditor after 16 June 2020; and

The rules do not provide transitional guidance for auditor appointments that took place on 17 June 2003 or later.

BIS believes the duration of the audit engagement should be calculated from the first financial year for which the auditor was appointed.

For PIEs who appointed their auditors between 17 June 2003 and 16 June 2006 BIS says that those PIEs will need to conduct a tender and either re-appoint the existing auditors or appoint new auditors so that the new audit engagement takes effect on or before 16 June 2016.

While this works if the PIE changes auditors, it is uncertain how such tenders can be effective to extend the maximum tenure period (see above) until UK law allows this to happen; that could give companies caught only a few months before 17 June 2016 to conduct a qualifying tender.

BIS is silent as to when companies who appointed their auditors on 17 June 2006 or later should tender their audits.
To what extent will auditors be restricted from providing non-audit services (NAS) to PIEs?

EU legislation contains extensive prohibitions including tax services and corporate finance. These restrictions only apply to services provided by the audit firm and its network to related group components based in the EU.

The FRC observes that, to comply, it would have to increase the range of restricted NAS in its Ethical Standards. It proposes a number of alternatives to deal with the issues arising including:

- Applying the EU NAS restrictions to a broader population of companies. This is because the FRC’s definition of a “listed entity” which it currently uses to restrict NAS provision by auditors is broader than the EU’s PIE definition.

- Restricting NAS provision even further than EU. This includes a proposal to move to the concept of a small list of permitted services instead of a list of prohibitions.

- Extending prohibitions on the provision of NAS by the audit firm and all members of its network to also include related group companies based outside the EU.

- Removing some NAS restrictions for non-PIEs which are otherwise subject to its current Ethical Standards.

- Exercising an option to allow certain immaterial tax and valuation services.

To what extent will permissible NAS fees be capped?

EU legislation says that fees for permissible NAS should be capped at 70% of a rolling three year average of group audit fee. It only applies to the NAS fees provided by the auditor of the PIE.

BIS believes NAS cap should apply to the first accounting year beginning on or after 17 June 2019 provided that audit services and NAS have been provided by same auditor for all of three preceding years.

FRC does not currently propose to lower the 70% cap on NAS fees as it says that it could limit the ability of companies to obtain permissible NAS.

FRC proposes to allow companies to apply to it for exemptions from the cap for a period no greater than two years, in circumstances where the cap might limit certain NAS which could harm the interests of the company and its shareholders.
The FRC is also considering whether it should extend the cap to fees for NAS provided by other firms in the same network, including parts of a network based outside the EU.

Will these changes have implications for the audit committee?

All the publicity about the reforms has been about rotation, tendering and non-audit services. However, as well as the audit committee’s role in relation to tendering, rotation and non-audit services, various other changes are introduced for both the composition and the responsibilities of the audit committee, such as a requirement for the audit committee as a whole to have experience of the sector in which the company operates. It is unclear whether this means that each member must have that experience.

It may also be a surprise to some unlisted insurers and banks that they are now required to have an audit committee.

What happens if companies breach the legislation?

The papers are practically silent on the point. The question of sanctions for companies and/or directors who breach these requirements is still a matter for discussion and consultation further down the line.

Want to know more?

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