European Union audit legislation

Our point of view
On 14 April 2014, the Council of Ministers adopted audit legislation that has been under debate since October 2010. With the passage of the legislation essentially complete, we will work to support its successful implementation and to help serve the needs of companies and investors, strengthen the capital markets and enhance confidence in financial reporting.

We continue to have questions, however, as to the legislation’s economic costs and its impact on audit quality and shareholder choice, especially in light of already existing national requirements. We hope to continue our dialogue with policy makers as each Member State moves to implement the legislation so as to assist in the development of rules that will enhance investor confidence and audit quality.

This Point of view highlights the key provisions of the legislation and EY’s views.

Context
The legislation stems from a European Commission (EC) Green Paper, “Audit Policy: Lessons from the Crisis,” issued in October 2010. The EC subsequently published its legislative proposals in November 2011. A large number of stakeholders commented in response to both the Green Paper and the draft legislation. Some of the EC’s more controversial proposals have been removed in the final legislation, including the earlier proposal for audit-only firms.

Nonetheless, the final package of legislation is wide-ranging and includes several requirements that were controversial among stakeholders during the consultation process. Among other provisions, the legislation imposes mandatory audit firm rotation for the statutory auditors of all Public Interest Entities (PIEs) across the EU, as well as significant restrictions on the range of non-audit services that can be provided to these entities by their statutory auditors.

The legislation is generally directed at audits of PIEs, which is defined to include companies with transferable securities traded on an EU “regulated market” and certain other organizations viewed as acting in the public interest, such as banks, insurance companies and other financial entities. EU Member States can supplement the PIE definition. The legislation also applies to EU subsidiaries.
of companies headquartered outside the EU, where those subsidiaries are themselves PIEs, and so will be of significant interest well beyond EU borders.

The legislation still needs to be published in the Official Journal of the EU. We expect the legislation to enter into force in July 2014, albeit with a transitional period for most provisions of at least two years.

The legislation comprises a Regulation, which includes provisions that apply to the statutory audits of PIEs, and a Directive, which applies to all statutory audits in the EU. The Regulation is legally binding and directly applicable in each of the 28 EU Member States from the date it enters into force, although there will be a two-year transitional period until it takes effect. There is a longer three-year transitional period that applies to the banning of so-called “Big 4 only” contract clauses, and even longer transition arrangements for the introduction of mandatory audit firm rotation (see below). With respect to the Directive, Member States have two years to transpose it into their national law. This means that the majority of the provisions of both the Regulation and the Directive will take effect in July 2016.

This is a long and complex piece of legislation, with over 50 Member State options and significant scope for interpretation by Member States. It is likely, therefore, that implementation of the legislation will vary across the EU. This is an important aspect of the new EU legislation and its full impact remains to be seen.

Key provisions of the legislation

According to the EC, key provisions of the legislation seek to reinforce auditor independence, enhance auditor reporting and audit firm transparency, strengthen the role of the audit committee, support consistent audit oversight and contribute to a more dynamic audit market in the EU.

Auditor independence

Auditors serve the public interest, and confidence in our independence is critical to investor confidence in financial reporting and the audit. EY supports measures that promote auditor independence in fact and appearance. There is no evidence, however, that mandatory firm rotation increases auditor independence or audit quality. It also removes the ability of the audit committee to decide whether or when to replace the auditor and in the long run undermines the role of the audit committee.

Regarding non-audit services, we believe it improves audit quality for auditors to be able to provide certain non-audit services to the companies we audit, at the audit committee's discretion. Non-audit services help provide insights investors and other stakeholders are telling us they want. At the same time, we support prohibiting auditors from providing non-audit services that would or could be seen to compromise an auditor's independence. Where such non-audit service prohibitions exist, we believe they should be consistent around the world and aligned with the International Ethics Standards Board for Accountants (IESBA) Code of Ethics.

Mandatory audit firm rotation. The legislation introduces mandatory firm rotation for the statutory auditor of a PIE after a maximum initial engagement period of 10 years, although EU Member States can require an initial engagement period that is shorter than 10 years (provided it is more than one year). Member States may also allow a PIE to extend the initial engagement period by a further 10 years where an audit tender has taken place or 14 years where there is a joint audit.
The EU permitted these variations so that Member States like Italy and the Netherlands could maintain their existing rotation requirements of nine years and eight years respectively, and France could keep its joint audit regime. However, the practical effect of these variations will be to create a complex patchwork of different audit firm rotation periods across the EU, which will be costly for companies and create inefficiencies within the EU audit market. This will be particularly problematic in the banking and insurance sectors, where every subsidiary in the EU will have to rotate its statutory auditors in line with its national law because these subsidiaries will be PIEs in their own right.

The mandatory firm rotation requirements are to be phased in depending on the length of the existing audit relationship on the date the legislation enters into force. For the purposes of what follows, we have assumed that the legislation will enter into force in July 2014, as expected:

- Where the existing audit relationship is 20 years or more in July 2014, the company cannot reappoint its incumbent auditor after July 2020 (i.e., six years later).
- Where the existing audit relationship is between 11 and 20 years in July 2014, the company cannot reappoint its incumbent auditor after July 2023 (i.e., nine years later).
- Where the existing audit relationship is less than 11 years when the legislation enters into force, the transition period is still uncertain.

**Significant restrictions on non-audit services.** The legislation introduces significant new restrictions on the non-audit services a PIE can obtain from its auditor, including:

- Specific tax, consultancy and advisory services;
- Services that involve playing any part in the management or decision-making of the PIE; and
- Services linked to the financing, capital structure and allocation, and investment strategy of the PIE.

Certain of the new EU restrictions go beyond existing international rules under the IESBA Code. Member States can also prohibit additional non-audit services if they wish.

Member States can permit certain tax and valuation services provided they are “immaterial or have no direct effect, separately or in the aggregate, on the audited 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.

**A cap on permitted non-audit services.** The legislation imposes a cap on fees for permitted non-audit services at 70% of the statutory audit fee. The cap will be calculated as 70% of the average statutory audit fees for the previous three years. The cap will be calculated not only for the audited entity but at the group level where the audited entity is part of a group of companies. Audit committees will also be required to approve all permissible non-audit services. The wording of the legislation regarding the cap is not entirely clear and some uncertainties remain in this regard.

**Auditor reporting and audit firm transparency**

_EY supports efforts to reaffirm the relevance of the audit, including enhancing the auditor’s report. We also believe that comparability is vitally important for global investors and global markets. For this reason, we are pleased the new EU auditor reporting requirement is generally consistent with the auditor reporting proposal of the International Auditing and Assurance Standards Board (IAASB)._  

_We continue to support the existing EU audit firm transparency reporting requirements. In addition to the country level transparency reports, we also publish an annual global transparency report to provide an overview of EY’s global processes relating to audit quality, auditor independence and governance matters of our global network._
The auditor’s report:

- The legislation expands the auditor’s report, requiring a description of the most significant assessed risks of material misstatement (including those relating to fraud) together with a summary of the auditor’s response to those risks and, where relevant, key observations arising with respect to those risks. The audit report must also include the date the auditor was appointed and the period of tenure.

- The EU requirement is generally consistent with the auditor reporting proposal of the IAASB to require the communication of key audit matters in the auditor’s report for audits of listed entities. It also has been significantly improved from earlier drafts. For example, earlier proposals for a 10,000-character limit on the auditor’s report and disclosure of every member of the audit team have been dropped.

- The UK Financial Reporting Council (FRC) revised its auditor reporting standard in June 2013, effective for audits of financial statements for periods commencing on or after 1 October 2012. The FRC standard is broadly consistent with the IAASB proposal. These new audit reports in the UK have prompted enhanced discussion with audit committees, contributed to increased dialogue between the company and investors and generally been viewed positively by the audit profession.

An additional report from the auditor to the audit committee. The legislation also introduces a new report from the auditor to the audit committee. This will cover a variety of information, including:

- A declaration of the auditor’s independence;
- The names of all key audit partners;
- A description of the scope and timing of the audit work;
- The overall approach to the audit and any substantial variations as compared to the prior year;
- A disclosure of materiality, explaining judgments about events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern, and whether they constitute a material uncertainty; and
- Addressing significant deficiencies in internal financial controls and matters related to actual or suspected noncompliance with laws and regulations.

Facilitating EU-wide adoption of International Standards on Auditing (ISAs). The legislation empowers the EC to adopt ISAs at the EU level, which we have long advocated. This would help enhance audit quality and support the provision of consistent EU-wide audit services. National standards in force in Member States will remain applicable as long as the EC has not adopted the ISAs covering the same subject matter.

Enhanced audit firm transparency. The legislation carries over the existing EU requirement for audit firms to publish an annual transparency report but adds some additional disclosure requirements:

- A description of the firm’s policy concerning the rotation of key audit partners and staff
- Financial information, showing in particular the firm’s total turnover (i.e., annual gross revenue) divided into audit fees paid by PIEs, audit fees paid by other entities and fees for non-audit services
- Where the firm is a member of a network:
  - The name of each firm that is a member of the network;
  - The countries in which each firm that is a member of the network is qualified as a statutory auditor or has its registered office, central administration or place of business; and
  - The total turnover of the audit firms that are members of the network.

The legislation also requires an audit firm to provide annually to its competent authority a list of the PIEs it audits, broken down by the revenue they generate.
Audit committees

We believe audit committee oversight of the external auditor is fundamental to auditor independence and effectiveness, and we support measures that strengthen audit committee independence and governance.

Audit committees need to be strong and robust, with highly qualified and competent members who are independent of management. They should be appropriately resourced so they can be actively engaged in all aspects of the financial reporting and audit process. Greater transparency to shareholders of the audit committee’s oversight of the external auditor also can promote investor confidence in financial reporting.

Strengthened audit committees. The legislation codifies a number of existing audit committee best practices, including requirements for:

- A majority of audit committee members to be independent;
- At least one member to have competence in auditing and/or accounting; and
- The audit committee as a whole to have competence relevant to the sector in which the company operates.

In addition, the legislation specifies detailed responsibilities for audit committees, including appointing the auditor and monitoring the company’s financial reporting process and the effectiveness of its internal quality control and risk management systems, including the internal audit function. Under the legislation, the audit committee continues to be responsible for monitoring all aspects of the statutory audit (i.e., performance, independence and the provision of non-audit services) as well as reappointment or re-tender decisions.

Supporting consistent audit oversight across the EU

EY supports enhanced coordination among national audit regulators in order to harmonize oversight, promote coordinated inspections and reduce duplication.

Improving coordination of audit oversight:

- Oversight of the audit profession in the EU will continue to be carried out at the Member State level. The legislation requires each Member State to designate a single competent authority to bear ultimate responsibility for the audit public oversight system, where they have not already done so.

- Coordination across national authorities will be supported by a new Committee of European Auditor Oversight Bodies (CEAOB), rather than the European Securities Markets Authority (as the EC originally proposed). There is little difference between the CEAOB and an existing coordinating body – the European Group of Auditors’ Oversight Bodies (EGAOB) – other than the fact that the CEAOB will be chaired by the Member States and not by the European Commission. National oversight bodies will be members of the CEAOB, as they are currently of the EGAOB.

- For the purposes of contributing to the technical assessment of third-country oversight systems, the CEAOB is obliged to request the assistance of European Securities Markets Authority (ESMA).
Audit market concentration and systemic risk

*EY supports those measures that strengthen the EU audit market and increase auditor choice in the EU. For example, it has long been our position that “Big 4 only” clauses should be eliminated, and we are glad to see this included in the new legislation. However, while the legislation may aim to expand auditor choice, there is an open question as to whether the combination of mandatory firm rotation and non-audit services restrictions will in fact lead to multinational companies actually having fewer choices when it comes to selecting an auditor.*

*To promote financial stability, we also support increased interaction and a genuine two-way dialogue between auditors and prudential supervisors of financial institutions. We have a constructive dialogue with many financial supervisors within and outside the EU, both individually as EY and collectively as the accounting profession.*

**Expanded audit tendering requirements.** The introduction of mandatory firm rotation is accompanied by more prescriptive tendering process rules to be followed by the audit committee. For example, the legislation includes a requirement for the audit committee to recommend to the board at least two choices of statutory auditor, together with a justified preference for one of them.

**Removing barriers for smaller audit firms.** In addition to the tendering requirements, the legislation includes several measures to remove barriers to audit firm growth, including prohibiting so-called “Big 4 only” contractual clauses entered into between a PIE and a third party (e.g., a bank) that restrict the PIE’s choice of auditor. Experience in Italy has shown that mandatory firm rotation tends to increase concentration in the audit market, so the inclusion of mandatory firm rotation in the new legislation may in fact ultimately undermine the EU’s apparent intent to support the growth of smaller firms.

**Strengthened two-way dialogue between auditors and prudential supervisors.** The legislation recognizes the value of a two-way dialogue between auditors and prudential supervisors and formalizes the communication already taking place, by requiring supervisors and auditors of financial institutions to establish an effective dialogue and share responsibility for this.

In addition, at least once a year, the European Systemic Risk Board (ESRB) and the new CEAOB must organize a meeting with the auditors of all global systemically important financial institutions within the EU, as identified internationally, in order to inform the ESRB of sectoral or any significant developments in those institutions.

**What’s next?**

Once the legislation enters into effect, which as noted above we expect to be this July, the focus will shift to the Member States as they move to implement the legislation. EY will continue to analyze the legislation to assess its implications for companies, investors and the accounting profession, and will work to support its successful implementation.

Now that the EU debate over mandatory audit firm rotation is reaching an end, we look forward to talking with stakeholders about the broader questions – the evolution of the role and relevance of audit and how the audit profession can continue to serve the public interest by contributing to enhanced investor confidence in the capital markets.

For more information on the legislation and other public policy developments, and EY’s views, please visit ey.com/publicpolicy or contact us.