European Union Audit Legislation

Note – These Frequently Asked Questions (FAQs) have been developed with and reflect a general consensus among the audit firms. The opinions expressed in these FAQs may also evolve as Member States begin to consider implementation of the Legislation. This FAQ document has been prepared to assist in the interpretation of the EU audit Legislation but it does not constitute legal advice. Where users are in doubt as to the interpretation of this EU audit Legislation they are encouraged to seek individual legal advice.

Abbreviations, definitions, and references:


**EC** European Commission

**EC Q&A** European Commission Frequently Asked Questions issued on 3 September 2014

**EU** European Union

**IESBA** The International Ethics Standards Board for Accountants


**MFR** Mandatory firm rotation

**NAS** Non-audit services

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01
General – Legislative Process

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1.1 What is the form of the Legislation?
The Legislation is in the form of a Directive and a Regulation.

The Directive contains a series of requirements governing every statutory audit in the EU and amends the existing Statutory Audit Directive of 2006.

The Regulation contains a series of additional requirements that relate only to the statutory audits of Public Interest Entities (PIE). The provisions on mandatory firm rotation (MFR), tendering, and the list of prohibited non-audit services (NAS) are contained in the Regulation and only apply to PIEs and their statutory auditors (and their networks as far as NAS are concerned).

1.2 When will this new Legislation come into effect?

Regulation – There is a two year delay in the application of most provisions from the date it entered into force (16 June 2014) which pushes the effective date for practical purposes to the first financial year starting on or after 17 June 2016. Note – There are separate transitional provisions for MFR (see Section 4).

Note also that there are several Member State options which will only come into effect once/if a Member State decides to apply them. There is no deadline for this (see Section 13).

Directive – Unlike the Regulation, the Directive will need to be transposed by the respective Member States into their national laws in order to become effective law. Member States have a two year period in which to do so such that by 17 June 2016 Member States shall adopt and publish the measures necessary to comply with this Directive (see Question 1.3 below).

1.3 Where will the new audit Legislation apply?

This new Legislation will apply in the 28 EU Member States and also in Iceland, Liechtenstein, and Norway as these countries are bound by this Legislation as members of the European Economic Area. See Section 12 for implications of the Legislation outside the EU.
1.4 Will there be any guidance issued to assist with interpretation?

The interpretation of EU legislation is ultimately up to the European Court of Justice, and is meant to be based on an interpretative methodology that examines the plain language, overall scheme and purpose of the measure in question.

The EC has issued some frequently asked questions\(^1\) to facilitate the implementation of the new EU regulatory framework on statutory audit and contribute to a consistent application of the new framework across the Union. The EC Q&A is described as a 'work in progress' and may be updated.

A new oversight body is to be established, a Committee of European Audit Oversight Bodies (CEAOB) replacing the existing EGAOB – see Section 11 for further details. The CEAOB will comprise the national authorities responsible for auditor oversight and part of its remit, under Article 30.7, will be to:

(a) facilitate the exchange of information, expertise and best practices for the implementation of this Regulation and Directive 2006/43/EC.

(b) provide expert advice to the Commission as well as to the Competent authorities, at their request, on issues related to the implementation of this Regulation and Directive 2006/43/EC.

Article 30.9 states – For the purposes of carrying out its tasks, the CEAOB may adopt non-binding guidelines or opinions. The EC shall publish the guidelines and opinions adopted by the CEAOB.

We anticipate that the responsible Regulator in each country will also issue guidance.

\(^1\)http://ec.europa.eu/internal_market/auditing/docs/reform/140903-questions-answers_en.pdf
Public Interest Entities (PIES) and scope of the legislation
Public Interest Entities (PIES) and scope of the legislation

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Overview

2.1 Is the PIE concept a new one?
No. The 2006 Statutory Audit Directive (the 8th Directive) included the same definition. However, a previous Member State option contained in Article 39 of the old 8th Directive has now been deleted (see Question 2.7). The key difference with this Legislation is that the practical impact of being a PIE compared to a non-PIE is now much increased (see Question 2.2).

2.2 What is the implication of being defined as a PIE?
The Regulation introduces additional obligations (i.e. MFR, NAS prohibitions and NAS fee cap) only on the statutory auditors of PIEs (and on members of the network of the statutory audit regarding NAS prohibitions – see Section 7) and on PIEs themselves.

The new EU Legislation also requires that an engagement quality control review be performed (Article 8 in the Regulation) for the statutory audits of PIEs.

Finally, an auditor of a PIE must prepare an annual Transparency Report that meets the requirements of Article 13 of the Regulation.

As such, an understanding of the PIE definition is important (see Question 2.6).

2.3 What is the impact of having an EU PIE in a group?
The Regulation applies to individual entities.

If an individual entity qualifies as a PIE, the Regulation will apply in its entirety to that PIE irrespective of whether its parent company is a PIE or not and irrespective of whether its parent is outside the EU or not.

However, the NAS prohibitions (see Section 7), the NAS fee cap (see Section 8) and the requirement for Audit Committee approval (see Section 9) will also impact parent undertakings and controlled undertakings of the PIE, with some territorial limitations.
2.4 Is there any exemption to the impact of being a PIE?

The only potential exemption in the legislation to the impact of being a PIE is in relation to co-operatives and savings banks. This largely relates to the German and Austrian markets and is expected to have limited application elsewhere.

The definition of a co-operative referred to in the Regulation\(^2\) is as follows:

'cooperative' means a European Cooperative Society as defined in Article 1 of Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE) (1), or any other cooperative for which a statutory audit is required under Community law, such as credit institutions as defined in point 1 of Article 1 of Directive 2000/12/EC and insurance undertakings within the meaning of Article 2.1 of Directive 91/674/EEC.'

The exemption is only intended to apply where the statutory audit of co-operatives (defined above) is characterised by a system that does not allow them to choose their statutory auditor or audit firm freely and the auditors act on a non-profit making basis. As such, independence is deemed not to be an issue. If the audited entity engages a 'regular' audit firm to do the audit then there is no possibility for derogation from being in the scope of the Regulation.

2.5 Does the exemption for cooperative and savings banks extend to their subsidiaries given that they might fall within the definition of a PIE in their local markets? Are these subsidiaries also subject to the exemption option given in Article 2(3) of the Directive even if they are not cooperatives or savings banks in their own right?

The Directive grants individual Member States the possibility to exempt subsidiaries of co-operatives and savings banks. It is not clearly stated in the Directive whether these subsidiaries also need to be savings banks or cooperatives.

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1. Article 2(3) of Regulation 537/2014 of 16 April 2014
2.6 How is a PIE defined in the new Legislation?

The Regulation will impact EU entities that fall within the definition of a public interest entity (PIE).

The PIE definition is contained in the new statutory audit Directive (as amended on 16 April 2014) and is as follows:

a) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4.1 of Directive 2004/39/EC

b) credit institutions as defined in point 1 of Article 3.1 of Directive 2013/36/EU of the European Parliament and of the Council, other than those referred to in Article 2 of that Directive

c) insurance undertakings within the meaning of Article 2.1 of Directive 91/674/EEC

d) entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees

2.7 Has the amended Directive changed the PIE definition from the old 8th Directive definition?

The definition of a PIE itself is unchanged. However, a previous Member State option contained in Article 39 of the old 8th Directive has now been deleted. That option permitted a Member State to exempt unlisted PIEs from the requirements of Chapter 10 of the old 8th Directive. These entities will, from now on, have to comply with all of the obligations of a larger, listed PIE.

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3Point 1 of Article 3 (1) of Directive 2013/36/EU refers to point 1 Article 4(1) of Regulation (EU) No 573/2013 = an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do;jsessionid=OJIL:2013:176:0001:0337:EN:PDF).

4Article 2(1) of Directive 91/674/EEC refers to 2 directives: Directive 73/239/EEC which has been several times amended (last modification with Directive 2002/13/EC) and directive 79/267/EEC which has been repealed by Directive 2002/83/EC (life insurance); also note that these 2 directives will be repealed as from 1 January 2016, date of application of the new Solvency II Directive (directive 2009/138/EC).
2.8 How does the Regulation affect multi-national corporations where the ultimate parent company is incorporated outside the EU?

Unless the group contains an EU PIE (see Question 2.3), they will not be affected. Where the group does contain an EU PIE see Section 12.

2.9 What is meant by ‘governed by the law of a Member State’?

References to companies that are ‘governed by the law of an EU Member State’ are generally understood to mean companies that are incorporated in that Member State. So, companies incorporated outside the EU that are listed on a regulated market within the EU would not generally qualify as an EU-governed company.

However, some countries have domestic provisions which cause their corporate law to apply to companies which have their operational headquarters in that country, even though that company is incorporated elsewhere. Any company caught by such a provision would also be regarded as governed by the laws of that Member State.

In addition, being a tax resident and subject to a Member State’s tax law does not make a company ‘governed by the law of an EU Member State’ – the concept of being ‘governed by’ relates only to the company law that applies to a company.

2.10 Does the Regulation apply to branch offices?

We understand the position to be as follows:

- Where a credit institution or insurance undertaking in the EU has a branch also in the EU, as the EU based branch forms part of an EU entity which is itself a PIE, then the Regulation also applies to the EU based branch – to the extent that provisions of the Regulation are relevant. For example, the NAS prohibitions that apply to the PIE also apply to the branch as part of the PIE.

- In addition, where the EU branch is required by law to have a statutory audit then the statutory auditor will also be subject to MFR. We understand that the MFR rules of the ‘parent’ of the branch will apply. For example, a UK bank with a branch in Ireland and the Irish branch is required to have a statutory audit: the statutory auditor must rotate in line with the UK MFR rules.
Non-EU branches of an EU PIE would be caught in that the NAS prohibitions (see Question 7.21) would apply equally to the branch inside/outside the EU as to the rest of the legal entity inside the EU.

EU branches of non-EU based credit institutions or insurance undertakings do not fall within the PIE definition.

The issue of branches, is also set out in the EC Q&A.

2.11 Are funds captured by the PIE definition?

Funds in general (e.g., UCITS or AIFs) are not PIEs unless so designated by a Member State under the existing Member State option. See Question 2.6.

However funds which are governed by the law of a Member State and have their prices listed on an EU regulated market are caught by the PIE definition.

Note that a fund listed on an EU regulated market but registered outside of the EU, and assuming it does not meet one of the other PIE definitions (credit institution, insurance undertakings or entities designated as PIEs by Member States), would not be classed as a PIE as it is not ‘governed by the law of an EU Member State’ (see Question 2.9).

2.12 Are smaller/medium sized listed entities caught by the PIE definition or is there a size criterion?

The categories of PIE prescribed by the EU capture all PIEs irrespective of size such that small and medium-sized entities that have shares or debt admitted to trading on a regulated market as well as credit institutions and insurance undertakings will be caught. There are many entities within these categories which are either quite small and/or have relatively restricted operations. The additional category of entities designated by Member States as PIEs may contain size criteria in some cases.

There is however, a specific derogation for co-operative bodies, savings banks or similar (or their subsidiaries) — see Question 2.4.

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Transferable securities

2.13 What are transferable securities?
Transferable securities are defined in Article 4, paragraph 1 (18) of the 2004 Markets in Financial Instruments Directive (MiFID) and under Article 4, paragraph 1 (44) of the 2014 Markets in Financial Instruments Directive (MiFID 2), as follows:

‘Transferable securities’ means those classes of securities which are negotiable on the capital market (with the exception of instruments of payment) such as:

- shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares
- bonds or other forms of securitised debt, including depositary receipts in respect of such securities
- any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures

2.14 Does a company with listed debt fall within the PIE definition?
As noted in Question 2.13, the definition of transferable securities includes debt. Whether the company is a PIE will depend on whether the company in question is an EU incorporated undertaking (i.e., a company governed by the laws of a Member State) whose debt is admitted to trading on an EU regulated market. The specific markets that are defined as regulated markets are published by the European Securities and Markets Authority (ESMA).

However, not all markets in the EU fall within this definition for this purpose. For example, neither the Luxembourg Euro MTF nor the Irish GEM markets are currently defined as ‘regulated’. As such, companies with debt listed on such markets will not be PIEs for this reason alone (although they could be if they fall within one of the other PIE categories: credit institutions, insurance undertakings, or designated by the relevant Member State as PIEs).
2.15 Is commercial paper considered to be listed debt under the definition of a PIE?

No, we do not believe that commercial paper qualifies as listed debt. MiFID 2\(^7\) Article 4 is where the definition of transferable securities comes from, and commercial paper seems to be classified as a ‘money-market instrument’:

(17) ‘money-market instruments’ means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment.

Under MiFID 2, Annex 1, Section C, listing financial instruments, money market instruments are listed as a separate item from transferable securities which suggests that commercial papers are not transferable securities.

Regulated markets

2.16 What are regulated markets?

Regulated markets are defined in Article 4, paragraph 1 (14) of MiFID\(^8\) and under Article 4, paragraph 1 (21) of MiFID 2, as follows:

‘Regulated market’ means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments — in the system and in accordance with its non-discretionary rules — in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III.’

Not all markets in the EU fall within this definition. For example, the London AIM market is not covered. The European Securities and Markets Authority (ESMA) maintain a list of EU regulated markets\(^9\). The additional category of entities designated by Member States as PIEs could include entities listed on unregulated markets.

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\(^7\)For more information on MiFID (2004/39/EC) and MiFID 2 (2014/65/EU), please go to http://www.esma.europa.eu/page/Markets-Financial-Instruments-Directive-MiFID-II

\(^8\)See footnote 6 above

2.17 What Member State law applies to an entity governed by the law of one Member State but with securities admitted to trading solely on an EU regulated market in another Member State?

Although it is through its listing in the second Member State, ‘host’, that the entity qualifies as a PIE, it is generally understood that the Member State law that governs the entity will be that of its ‘home’ Member State as this is the law that governs the company itself. For example, a company incorporated and head quartered in Luxembourg that is listed on a regulated market in Ireland would have to apply the mandatory audit firm rotation and NAS prohibitions of Luxembourg, not Ireland.

2.18 What happens if an EU entity is listed on an EU regulated market but has no securities actually traded on that market?

An entity (governed by the law of an EU Member State) does not need to be actively traded on an EU regulated market to qualify as a PIE; it is enough that it is listed on a regulated market. This position is based on the definition of a PIE which mentions ‘entities governed by the law of a Member State’ whose transferable securities are admitted to trading on a regulated market of any Member State. This entity would only cease to be a PIE if it were to be delisted from the EU regulated market.
Credit institutions

2.19 Are there any exemptions to the credit institutions definition in Article 2.13(b) of the Directive?

Yes – certain specific institutions listed in Article 2 of The Capital Requirements Directive IV (2013/36/EU) (CRD 4) are excluded from the EU PIE scope. They are as follows:

- central banks
- post office giro institutions
- in Belgium, the Institut de Réescompte et de Garantie/Herdiscontering- en Waarborginstituut
- in Denmark, the Eksport Kredit Fonden, the Eksport Kredit Fonden A/S, the Danmarks Skibskredit A/S and the KommuneKredit
- in Germany, the Kreditanstalt für Wiederaufbau, undertakings which are recognised under the Wohnungsgemeinnützigkeitsgesetz as bodies of State housing policy and are not mainly engaged in banking transactions, and undertakings recognised under that law as non-profit housing undertakings
- in Estonia, the hoiu-laenuühistud, as cooperative undertakings that are recognised under the hoiu-laenuühistu seadus
- in Ireland, credit unions and the friendly societies
- in Greece, the Ταμείο Παρακαταθηκών και Δανείων (Tamio Parakathikion kai Danion)
- in Spain, the Instituto de Crédito Oficial
- in France, the Caisse des dépôts et consignations
- in Italy, the Cassa depositi e prestiti
- in Latvia, the krājaizdevu sabiedrības, undertakings that are recognised under the krājaizdevu sabiedrību likums as cooperative undertakings rendering financial services solely to their members
- in Lithuania, the kredito unijos other than the Centrinė kredito unija
- in Hungary, the MFB Magyar Fejlesztési Bank Zártkörűen Működő Részvénytársaság and the Magyar Export-Import Bank Zártkörűen Működő Részvénytársaság
in the Netherlands, the Nederlandse Investeringsbank voor Ontwikkelingslanden NV, the NV Noordelijke Ontwikkelingsmaatschappij, the NV Industriebank Limburgs Instituut voor Ontwikkeling en Financiering and the Overijsselse Ontwikkelingsmaatschappij NV

in Austria, undertakings recognised as housing associations in the public interest and the Österreichische Kontrollbank AG

in Poland, the Spółdzielcze Kasy Oszczędnościowo – Kredytowe and the Bank Gospodarstwa Krajowego

in Portugal, the Caixas Económicas existing on 1 January 1986 with the exception of those incorporated as limited companies and of the Caixa Económica Montepio Geral

in Slovenia, the SID-Slovenska izvozna in razvojna banka, d.d. Ljubljana;

in Finland, the Teollisen yhteistyön rahasto Oy/Fonden för industriellt samarbete AB, and the Finnvera Oyj/Finnvera Abp

in Sweden, the Svenska Skeppshypotekskassan

in the United Kingdom, the National Savings Bank, the Commonwealth Development Finance Company Ltd, the Agricultural Mortgage Corporation Ltd, the Scottish Agricultural Securities Corporation Ltd, the Crown Agents for overseas governments and administrations, credit unions and municipal banks.

Note – an entity that is not licensed to take deposits is not a credit institution and, by extension, not a PIE.
2.20 In certain Member States there are regulated entities that are not banks (e.g., broker dealers or securities trading companies). Would broker dealers and other such non-bank regulated entities be PIEs per the EU definition?

Where such entities are neither credit institutions (i.e., meaning an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account) nor are they regulated by one of the specified regulated markets, then they would not be classed as an EU PIE.

For example, UK broker dealers or securities traders regulated by the FCA/PRA that are not banks would be unlikely to fit the PIE definition as FCA/PRA is not one of the specified markets. However, it is possible that a Member State could decide to include such entities within the PIE definition as is permitted by Article 2(13)(d) of the Amended Directive.

Insurance undertaking

2.21 What is an ‘insurance undertaking’ for the purpose of the EU Audit Legislation?

The definition of an Insurance undertaking is defined in Directive 91/674/EEC on the annual and consolidated accounts of insurance undertakings.

An ‘insurance undertaking’ is any undertaking that carries out a regulated insurance activity which:

- Includes direct insurers, life assurance, general insurance, reinsurance and permanent health insurance.
- Excludes mutual insurers.

Insurance broking does not fall within the definition but a group ‘captive’ insurer would be if it was established in the EU.
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3.1 What are the requirements for mandatory audit firm rotation?

The initial engagement period of a statutory auditor or audit firm must not be for less than one year and must not exceed 10 years. In many Member States the statutory auditor is appointed on an annual basis. In such cases the first annual appointment can be renewed a further nine times so as to reach the initial maximum duration period of 10 years.

However, in some Member States the statutory auditor is appointed for an engagement period other than one year (e.g., a three-year mandate is currently required in Belgium, a six-year mandate in France and a nine-year mandate in Italy). Member States have the option to elect an initial maximum duration period that is shorter than the 10 years (see Section 13). For example, with a current three-year mandate, the initial maximum duration period for a Belgian statutory auditor would be nine years (i.e., three mandates of three years) whilst Italy will be able to maintain their existing maximum duration period and rotation requirement of nine years.

Member States may also opt to extend the initial maximum duration period – see Question 3.2.

3.2 Can the initial maximum duration period be extended?

Yes – but only if the Member State applies one of two available derogations permitting extension in the event of either a tender or a joint audit arrangement (see also Section 13).

1. Extension due to a tender process – The initial 10-year maximum duration period may be extended by a Member State up to a total period of 20-years, but only if a tender is conducted in accordance with the process specified in Article 16 of the Regulation and takes effect after the expiry of the initial maximum duration period. Note: article 17 mentions a public tender process however there are no obligations in article 16 to publish a call for tenders.
2. Extension due to a joint audit arrangement – The initial 10-year maximum duration period (or a shorter period if elected by a Member State) may be extended by a Member State up to a total of 24 years for companies that choose to have two auditors (i.e., a joint audit) after the initial maximum duration period (see Section 6). Note that in this case:

- A tender at the end of the initial maximum duration period is not required.
- The extension for joint audit appears to apply irrespective of whether or not a joint audit has been in place during that initial maximum duration period (see Section 6).

There are specific transitional rules for a staggered introduction of MFR (see Section 4).

3.3 How do I calculate the duration of audit tenure?

The principle to be applied in working out the duration of audit tenure for rotation requirements is set out in Article 17.8 of the Regulation as follows:

“the duration of the audit engagement shall be calculated as from the first financial year covered in the audit engagement letter in which the statutory auditor or audit firm has been appointed for the first time for the carrying out of consecutive statutory audits for the same PIE.”

Tenure is therefore counted from the start of the first accounting period audited. For the avoidance of doubt, it does not start to count from the actual date of the appointment or the date of the engagement letter or the date of the AGM at which the appointment is ratified.

For example, if a new statutory auditor is appointed to perform the audit of a PIE for the year ended 31 December 2011, then this will count as year one of the auditor relationship.

3.4 What is the impact of mergers of audit firms on the calculation of audit tenure?

The Regulation provides that for the purposes of the provisions on audit firm rotation, the audit firm is to include other firms that it has acquired or with which it has merged.
If there is uncertainty as to the date at which the audit firm started carrying out a statutory audit of a PIE, such as due to firm mergers, acquisitions, or changes in ownership structure, the audit firm must inform the relevant Member State’s competent authority which will determine the relevant date for the purposes of the rotation requirement.

The exact facts and circumstances of each relevant transaction or situation would in any event need to be examined carefully.

3.5 What is the impact of mergers, acquisitions or changes in structure of PIEs on the calculation of the audit tenure?

In such cases legal advice may be required to assess the detailed terms of the merger which could impact the way in which audit tenure is calculated. In addition, if there is uncertainty as to the date at which the audit firm started carrying out a statutory audit of a PIE, the view of the competent authority may be sought.

However, as a general principle, if two entities merge to create a new legal entity then tenure for MFR transition purposes would be calculated from the date of the creation of the new legal entity to the extent that it is a PIE. Nevertheless, this may need to be checked under the relevant Member State law.

In cases of major acquisitions, management buy-outs or other significant corporate events a reasonable interpretation would be that if they do not result in the formation of a new legal entity and the existing auditor does not change as a result of the transaction, then this is not treated as a ‘new’ start to the audit relationship – although, again, legal advice should be sought. Clearly a PIE with such a situation will also consider the corporate governance and market perspective and may wish to consult with the relevant competent authority.

3.6 For the purpose of understanding duration of tenure for mandatory firm rotation requirements, does the period before the entity became a PIE count towards total audit tenure?

In calculating audit tenure for the purpose of MFR rules the date an entity first became a PIE is key. This position was confirmed by the EC Q&A which stated that “the calculation of the duration starts from the moment that the company becomes a PIE.”
In the case of a listing – where a company has had its auditor for a number of years before the listing date, the duration of the audit engagement should only be calculated as from the date of the listing. For example, Audit Firm X have been auditors for 10 years but the entity only listed four years ago – in 2010 – in this scenario the audit duration will be counted from 2010.

3.7 When must a tender be performed?
The audited entity may perform a tender and change its auditor at any time provided the maximum duration is observed. However see Question 3.8 below if the Member State has exercised the option to permit reappointment of the existing auditor and the audited entity wishes to consider such reappointment. See also Section 5.

Note – there is also no restriction preventing the current statutory auditor from participating in a tender for NAS work due to commence upon expiry of the statutory audit relationship. See Section 7.

3.8 When must a tender be performed in order to extend the maximum duration period?
Where the Member State has elected to permit the extension of the initial maximum duration period and the audited entity wishes to consider reappointing the existing auditor, companies may carry out the tender at an earlier point in time, but the appointment resulting from the tender ‘takes effect after the expiry of the initial maximum duration period’ (i.e., at the end of the initial maximum duration period of up to 10-years).

3.9 Do the new audit firm rotation requirements replace the need to rotate audit partners?
No. There is still a requirement for ‘key audit partners’ to rotate after a maximum of seven years, followed by a three-year cooling-off period. These requirements are broadly in line with the IESBA Code – although the Code only requires a two-year cooling-off period.

Member States have the option to elect shorter partner rotation periods (see Section 13). A number of Member States currently have shorter partner rotation periods of six or five years.
3.10 What are the transition arrangements for rotation of key audit partners?

Article 17.7 states that:

“the key audit partners responsible for carrying out a statutory audit shall cease their participation in the statutory audit of the audited entity no later than seven years from the date of their appointment”

So for example, a key audit partner first appointed auditor to a PIE with a December 2013 year-end would be able to remain key audit partner for seven years until the 31 December 2019 year-end audit – after which they would need to rotate.

However if the audited entity only becomes a PIE when the Regulation becomes applicable as from 17 June 2016, the seven year period is measured from the point the entity becomes a PIE (i.e., 17 June 2016). In that case, the key audit partners could be involved in the audit for seven years from this date.

Note that it is a Member State option to reduce the key audit partner rotation requirements from seven years.

3.11 Is there any cooling-off requirement for the incumbent auditor once the audit firm rotates off the audited entity?

Yes – there is a four year cooling-off period. Article 17.3 of the Regulation states that neither the statutory auditor nor, where applicable any members of their networks within the Union can perform the statutory audit for that same PIE for a period of four years.

3.12 Will all entities within a corporate group be required to rotate at the same time?

There are two scenarios that must be considered:
EU PIE parent with non-PIE subsidiaries

The EU PIE parent company auditor will rotate in line with the national law of the Member State where the PIE parent is incorporated. Although the subsidiaries are not PIEs in their own right and therefore not subject to mandatory rotation, the parent company may well want to appoint one auditor for the entire group. So the non-PIE subsidiary auditors may in practice rotate at the same time.

EU PIE parent with an EU PIE subsidiary

The PIE subsidiary auditor will have to rotate in line with the national law of the EU Member State where that PIE subsidiary is incorporated. This may well be a different period than that applying to the PIE parent. If the subsidiary period is longer than the parent period, then from a practical standpoint the parent period may dictate when the audit is rotated. This would have to be the case if the parent company preferred to have just one auditor for the entire group. However, if the subsidiary’s national rotation period is shorter than the parent’s national rotation period; the subsidiary will have to rotate even if the parent retains its existing auditor.

3.13 Will the EU Member States that already have mandatory firm rotation requirements be able to keep their current regimes?

Yes, to the extent that these requirements are compatible with the Regulation. For example, Italy will be able to maintain their existing maximum period and rotation requirement of nine years.

3.14 What are the implications for group auditors and the application of ISA 600?

Until such time as the Member States have decided how they will implement the rotation requirements (i.e., what will be the initial maximum duration period and will any extension be allowed) it is hard to be definitive (see Section 13).

Once this is known, the implications for a group auditor will need to be assessed on a case by case basis. Issues are likely to arise where a group has multiple PIEs in the EU and has PIE subsidiaries which will be required to rotate their auditors over a shorter period than the period applying to the parent company auditor. Similarly there will be issues for inbound groups with EU PIEs, where the parent and other parts of the group have no rotation requirement or a different rotation requirement. See Question 3.12.
04

Transitional arrangements for MFR

Enter
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4.1 What are the transitional provisions for MFR?

There are specific transitional provisions in the Regulation (Article 41) that govern the application of the MFR requirements. These are based on the length of the existing auditor/client relationship at the date of entry into force (16 June 2014) as follows:

a) Where the auditor/client relationship is 20 years or more when the Regulation entered into legal force on 16 June 2014, (i.e., audit relationships started in the financial year ending 31 May 1995 or earlier) the company cannot enter into or renew an audit engagement with its incumbent auditor as from 17 June 2020.

b) Where the auditor/client relationship is between 11 and 20 years when the Regulation entered into force on 16 June 2014, (i.e., audit relationships started in the financial year ending from 30 June 1995 up until and including 31 May 2004) the company cannot enter into or renew an audit engagement with its incumbent auditor as from 17 June 2023.

c) Where the auditor/client relationship is less than 11 years on 16 June 2014, (i.e. audit relationships started in the financial year ending 30 June 2004 onwards) then the period before 17 June 2016 should be taken into account in calculating the duration of the audit tenure, according to the EC. So the rotation requirements (per Article 17 – see Section 3) for this tranche of engagements would begin to apply immediately, if the maximum tenure has been reached, to any auditor reappointments occurring after 17 June 2016. See Question 4.6.

In all cases the tenure of the engagement will be calculated on the date of entry into force (16 June 2014) to determine which transitional rules apply.

4.2 How do I calculate the tenure of an audit engagement for the purposes of the transitional regime?

As described in Question 3.3 the calculation of tenure should be from the start of the first accounting period audited – in other words treat the first accounting period audited as ‘year 1’. It is not explicitly stated in the Legislation that the calculation of tenure should be on the same basis for the transitional regime as for normal rotation, but this is logical and was supported by the EC’s letter of 2 September 2014 to Member States on the transitional arrangements.
4.3 How do the rules apply to a year-end that straddles the application date of 17 June 2016? Can an audit firm complete the year end 31 December 2016 audit where the audit relationship already exceeds 10 years?

As a general principle, in their FAQs published in September 2014 the European Commission confirmed that “the new requirements will apply to the first financial year starting after the date of application of 17 June 2016”. On this basis, an audit for a financial year beginning on 1 January 2016 would not be affected by the legislation.

However, in a subsequent letter to the EU audit oversight bodies in September 2014, Director General Jonathan Faull indicated that, for public interest entities (PIEs) that had been using the same statutory auditor for more than 10 years as of 16 June 2014, they would need to change their auditor by 16 June 2016. The European Commission’s view is that, whilst the general principle set out in their FAQs is applicable to the majority of the Regulation, there are special transitional measures governing audit firm rotation. The effect of the European Commission’s interpretation is that, for PIEs that come within the scope of Article 41(3), many of those with a 31 December year end would need to change their auditors following completion of the 2015 audit. In theory, this requirement could therefore apply to audits of financial years ending as early as 30 June 2015, i.e., not just those with a 31 December 2015 year end.

A further effect of the European Commission’s interpretation is that if a PIE is currently using an audit network to provide prohibited non-audit services for which a “cooling in” period applies, that PIE would then need to have terminated those arrangements before 30 June 2014 in order to enable the audit network to be eligible to tender for the 30 June 2016 audit. This clearly raises practical difficulties.

The situation is further complicated by the fact that many Member States will not have finalised their position on whether or not to permit the extension of an audit relationship, following a tender in accordance with Article 17(4), by the time that PIE audit committees would need to begin their tender process. It will thus be extremely difficult for such audit committees to determine which auditors are eligible to tender and, notably, whether the incumbent auditor can participate in the selection process or not.
Consequently it would seem that the most pragmatic solution would be that the auditor should be allowed to complete the 2016 audit that straddles the 17 June application date. A tender would then be required for the 2017 audit. If by then the Member State has chosen to take up the option to allow for an extension the incumbent auditor could then participate in the tender process.

NOTE: Interpretation points
- The position outlined in the 2 September 2014 letter of the European Commission differs from the view expressed in the final paragraph above.
- Clarification has been requested from the European Commission given the practical difficulties highlighted above.

A. Audit/client relationship of 11 years or more at 16 June 2014 (i.e., Article 41.1 and 41.2)

4.4 Where the statutory auditor has been in place for more than 20 years as at 16 June 2014, can the auditor perform the statutory audit for the year beginning 1 January 2020?

Our interpretation is that a renewal that takes place in, say, the first quarter of 2020 (i.e. before the 17 June 2020 cut off) for the audit of a company’s financial statements for the year ending 31 December 2020 would be permitted. This applies equally to single or multi-year engagements – e.g., in France a six-year engagement may be renewed prior to 17 June 2020 for a further six years, three years in Belgium etc.

Conversely, a renewal in, say, the third quarter of 2020 (i.e. after the 17 June 2020 cut off) for the audit of a company’s financial statements for the year ending 30 June 2021, would not be permitted.
B. Audit/client relationship is less than 11 years at 16 June 2014 (i.e., Article 41.3)

4.5 How do I interpret the transitional provisions where my audit/client relationship is less than 11 years?

For this category, the EC has indicated in a letter dated 2 September 2014 addressed to the EU audit oversight bodies and posted on the EC website, that the period before 17 June 2016 should be taken into account in calculating the duration of the audit tenure and so the rotation requirements (per Article 17) for this tranche of engagements would begin to apply immediately as from 17 June 2016.

This interpretation means that auditor/PIE relationships first entered into for accounting periods beginning between 17 June 2003 and 16 June 2006 will be immediately affected on 17 June 2016. This is because by the time such engagements reach the date of application of the Legislation of 17 June 2016 they will have already reached the permitted initial maximum duration period of 10 years (or less if Member States opt for a shorter initial tenure period – see Question 3.1).

For this tranche of audit/client relationships, after 17 June 2016 the engagement cannot be renewed unless the relevant Member State has taken up the option to allow for an extension (see Question 3.2 and Section 13).

Where an auditor/client relationships was first entered into for accounting periods beginning between 17 June 2006 and 17 June 2016 (assuming a 10 year initial maximum duration period), a tender will be required (where the relevant Member State has taken up the option to allow for an extension) to take effect upon expiry of the initial maximum duration period (subject to Member State options the relationship may be extended). So in these scenarios the usual initial maximum duration applies but will see a staggered introduction (see Questions 3.1 and 3.2).
4.6 Where the first accounting period of the auditor/client relationship is for the year ended 30 June 2004, can we still do the audit in FY 2016?

In the case of an audit relationship where the first client-auditor relationship related to the accounting period beginning 1 July 2003 for an accounting period ended 30 June 2004, then the audit relationship would be classed as being less than 11 years at the date of entry into force (16 June 2014). As such the PIE in this example, would need to (depending on the Member State options implemented in their country) rotate or tender to extend (see Question 4.7) its audit for the accounting period ending 30 June 2017. It is our understanding that provided the audit for the 30 June 2016 audit was entered into prior to 17 June 2016, then the incumbent auditor may complete this audit before either rotation or tendering is required.

NOTE: Interpretation points:

- The EC hold a different view, as expressed in a letter dated 2 September 2014 meaning that such relationships would need to end by 16 June 2016 — in the above scenario completion of the 30 June 2016 audit would not be permitted. See also Question 4.3.

4.7 When the audit engagement has reached the initial maximum duration period by 17 June 2016 or thereafter, can the engagement be extended?

The engagement can be extended if the relevant Member State adopts the option to allow for an extension and the PIE complies with the derogation provisions e.g. tender. See Questions 3.1 and 3.2 for further details.

In addition paragraph 6 of Article 17 of the Regulation allows a PIE to apply to the competent authorities (i.e., the auditor oversight body), on an exceptional basis, for an extension of its audit relationship by not more than two years.

4.8 Where a PIE needs to tender/rotate its audit for the first accounting period starting after 16 June 2017, when does the tender need to take place?

There are no specific provisions in the Legislation and we would expect the general principles in Questions 3.7 and 3.8 to apply.
4.9 My Member State is opting for an initial maximum duration period of say 8 years, – i.e., less than the maximum 10 years. How am I impacted?

The auditor/client relationships first entered into for accounting periods starting between 17 June 2003 and 16 June 2008 will be immediately impacted. The reason is that by the time such engagements reach the date of application of the Legislation of 17 June 2016 they will have already reached the maximum permitted tenure as specified by their Member State of eight years – therefore the provisions of Article 17 (see Section 3) will immediately apply to any auditor reappointments occurring after 17 June 2016.

4.10 If a PIE has held a recent tender for its audit before the entry into force of the Regulation (i.e. before 16 June 2014) and decided to retain the incumbent, will this tender be taken into account in establishing when a company needs to rotate its auditor?

The transitional provisions take account of the length of the client/audit relationship as at the date of entry into force of the Regulation, being 16 June 2014. The fact that a tender has just been carried out and the existing auditor has been reappointed has no impact on the cumulative relationship with the company being audited in these circumstances. This would suggest that a second tender might be required within a few years of the original tender. However, this is still subject to confirmation. See Question 4.1 for the transition rules.

If a new auditor is appointed as a result of a tender performed pre-17 June 2016 for an accounting period commencing after 17 June 2016 then Article 17 will immediately apply and tenure for the new auditor would be counted from the start of the first full accounting period audited commencing as from 17 June 2016 (see Question 3.3).
05
Tendering
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5.1 Is there a tendering requirement introduced by the Regulation?

Article 16 of the Regulation introduces tendering for all auditor appointments of EU PIEs other than auditor renewals. PIEs will be obliged to have a tender process with the close involvement of the audit committee when considering either the selection of a new auditor, or the re-appointment of an existing auditor at the end of the initial maximum duration period of 10 years (where permitted by their Member State).

Where a Member State has opted to allow an extension of up to 24-years in the case of a joint audit, and where there was only one statutory auditor for the initial maximum duration period, it is not clear if a tender is required for the second auditor after the initial maximum duration period or not. No tender is required to renew the appointment of the first auditor. It is not unreasonable to assume that a tender would be required after 10 years in order to select the second audit firm. Ultimately this will be an area for Member States to decide on as part of their implementation.

5.2 Is there a difference in the requirements that need to be followed where there is the appointment of a new auditor, as opposed to where there is the simple reappointment of an existing auditor?

Yes. The tender requirements in Article 16(3) of the Regulation need not be followed where there is the renewal of an existing auditor. Otherwise a tender must be carried out in accordance with the obligations set out in Article 16(3).

5.3 Is there an exemption available to the tendering requirement?

No, all PIEs have to tender when required – See Question 5.1. However Article 16.4 says that Public-interest entities which meet the criteria set out in points (f) and (l) of Article 2(1) of Directive 2003/71/EC (copied below) shall not be required to apply the criteria described in Article 16.3 when conducting their selection procedure.
(f) ‘small and medium-sized enterprises’ means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria:

- An average number of employees during the financial year of less than 250
- A total balance sheet not exceeding €43,000,000
- An annual net turnover not exceeding €50,000,000

(t) ‘company with reduced market capitalisation’ means a company listed on a regulated market that had an average market capitalisation of less than €100,000,000 on the basis of end-year quotes for the previous three calendar years.

5.4 Are there any requirements regarding which audit firms are to be invited to tender?

Not explicitly. Article 16.6 says that contractual clauses between a PIE and a third party restricting the shareholders’ choice of auditor in general meeting shall be null and void, which implies that invitations to tender should similarly not be restricted. A PIE is free to invite any audit firms to submit proposals but the organisation of the tender process must not preclude the participation of smaller audit firms (defined in Article 16.3.a as those who received less than ‘15 % of the total audit fees from public-interest entities in the Member State concerned in the previous calendar year’). It is not clear how this requirement to ‘not preclude’ the participation of smaller audit firms is to be interpreted. Audit committees are responsible for submitting a recommendation to the supervisory body of the audited entity for the appointment of the auditors. The recommendations should include at least two possible choices for the audit engagement and a justified preference for one of them.
5.5 If a PIE would voluntarily choose to rotate its auditors before the end of the transition period, would the provisions of Article 16.3 apply for selecting a new auditor?

No, Article 41.4 of the Regulation on MFR transition stipulates that the provisions for auditor selection mentioned in Article 16.3 of the Regulation need only apply to tendering for audit engagements that commence after expiry of the maximum duration period (of 10 years). As such they do not appear to apply to voluntary changes of auditors before the end of the first transition period.

5.6 Does the end of the tender process itself represent the end of the engagement of the incumbent auditor?

No. This will depend on the relevant Member State law but typically a new auditor will need to be appointed and the incumbent auditor’s appointment will formally cease at the General Assembly/Meeting adopting the audited financial statements which will occur after the end of the tender process. The incumbent auditor is in place until such time.
06
Joint Audit

Enter
6.1 To qualify for the 14 year extension, is a joint audit required throughout the initial 10 year period?  

6.2 Is a joint audit required throughout the second (extended) period?  

6.3 MFR and joint audit: Assume that firm A audited a PIE since 2006 for 8 consecutive years only. Before 2006, firm B audited the same PIE for another 5 years in a joint audit alongside firm A. Do the 5 years firms A and B audited the PIE in a joint audit apply when determining how many years firm A audited the PIE as at 16 June 2014?
6.1 To qualify for the 14 year extension, is a joint audit required throughout the initial 10 year period?

No, a company does not need to have a joint audit throughout the first 10-year duration period in order to qualify for an extension of that engagement for up to 24 years (i.e., 10-year initial maximum duration period plus maximum 14-year extension for joint audit).

However, firstly, a Member State must explicitly allow the extension in cases where a company decides to have a joint audit. Secondly, the company would then be required to have a joint audit for the entire extended period.

6.2 Is a joint audit required throughout the second (extended) period?

Yes. The extension is allowed, providing ‘the statutory audit shall result in the presentation of a joint audit report.’

6.3 MFR and joint audit: Assume that firm A audited a PIE since 2006 for 8 consecutive years only. Before 2006, firm B audited the same PIE for another 5 years in a joint audit alongside firm A. Do the 5 years firms A and B audited the PIE in a joint audit apply when determining how many years firm A audited the PIE as at 16 June 2014?

Yes – the five years whilst both A and B were joint auditors will have to be considered in determining tenure because in a joint audit each of the auditors needs to form their own opinion on the financial statements of the PIE.

Adoption of joint audit for part of the audit engagement does not have an influence on the length of tenure. In the example above, the start of the engagement period for the purpose of calculating tenure of firm A is 2001.
07

Non-Audit Services (Nas) – Prohibited List Of Services
Non-Audit Services (Nas) — Prohibited List Of Services

A. Overview of the NAS prohibitions

7.1 How do the provisions on prohibited services work?

7.2 What NAS can be provided?

7.3 Is there any flexibility regarding prohibited NAS such as Member State options?

What are the NAS prohibitions?

7.4 What tax services are prohibited?

7.5 Which Member States will exercise the option to permit tax services?

7.6 Are all valuation services prohibited?

Other Non-Audit Services

7.7 “Services that involve playing any part in the management or decision-making of the audited entity” are prohibited. What does this mean?

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Application of the NAS prohibitions – to whom do they apply and when?  

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7.15 To what extent do the NAS prohibitions apply to affiliates of the PIE?  

7.16 What is a ‘parent undertaking’?  

7.17 What is a ‘controlled undertaking’?  

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7.19 Article 5.1 stipulates that non-PIE parent and controlled undertakings of an audited PIE entity would be caught by NAS restrictions. Would this provision also apply if the PIE in the chain is ‘designated by the Member State’ but is not designated as a PIE in the country of the parent or subsidiary undertaking?  

7.20 How do the NAS prohibitions apply to cross border groups?  

7.21 How do the NAS prohibitions apply to branches?  

7.22 Is the determination of control strictly based on the accounting definition or is there a scenario when legal control should be referenced?  

Timing Considerations  

7.23 For what period do the NAS rules apply?  

7.24 When do the new NAS rules start to apply? For example, what about a December 2016 year-end?
A. Overview of the NAS prohibitions

7.1 How do the provisions on prohibited services work?
The Regulation contains a list of services that cannot be provided (‘prohibited services’) by a statutory auditor and its network to a company that is a PIE, to the PIE’s EU parent company(ies) or to the PIE’s EU controlled undertakings.

For services provided by the network to controlled undertakings outside the EU, a ‘threats and safeguards’ approach is required although a limited number of absolute prohibitions still apply (see Section 12).

The interpretation of the Regulation on the list of prohibited NAS will be dealt with as part of Member State implementation of legislation. Member States will likely issue guidance in due course. This FAQ considers the following:

Understanding the nature of the NAS that are prohibited (see Questions 7.4 to 7.13)

• Determining to whom the prohibitions apply and timing implications (see Questions 7.14 to 7.24).

7.2 What NAS can be provided?
Services that are not on the list of prohibited services are permitted, subject to the general principles of independence and audit committee approval.

All permitted NAS provided by the audit firm or a member of the network to the PIE, its parent undertaking or its controlled undertakings require audit committee approval (see Question 9.3).

In addition, a cap on the fees from such permitted services may also apply to the statutory audit firm (see Section 8).

7.3 Is there any flexibility regarding prohibited NAS such as Member State options?
Member States may add to the list of prohibitions and may adopt legislation further restricting NAS.

With one important exception, Member States may not set a lower threshold in relation to NAS prohibition – the prohibited list is therefore a minimum baseline. However the exception to this is a Member State option relating to certain tax and valuation services.
Although the Regulation prohibits valuation services and almost all tax services, Member States have an option to allow valuation and certain tax services (preparation of tax forms, identification of public subsidies and tax incentives, support for tax inspections, calculation of direct and indirect tax and deferred tax, and tax advice), provided that these services have no direct effect, or have an immaterial effect either separately or in the aggregate, on the audited financial statements, the estimation of the effect on the audited financial statements is comprehensively documented and the principles of independence are complied with. (See Questions 7.4 to 7.13).

B. What are the NAS prohibitions?

Tax and valuation services – including the Member State option

7.4 What tax services are prohibited?

The services listed in sub-paragraph A of Article 5.1 cover a wide range of tax services including tax compliance, the calculation of taxes and tax advisory. However, the tax services at (a) (i), (iv), (v), (vi) and (vii) may still be provided in certain cases, i.e., where the Member State applies the derogation (see Question 7.3) provided:

- they have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements
- the estimation of the effect on the audited financial statements is comprehensively documented, and the principles of independence are complied with).

Such services would also need to be:

- approved by the audit committee (see Question 9.3)
- within the fee cap if it is applicable (see Section 8)
- not prohibited by any other prohibition in the Regulation (see Article 5).
- not otherwise prohibited under Member State law (see Section 13)
7.5 Which Member States will exercise the option to permit tax services?

At this stage it’s not clear which Member States will exercise the option to permit certain tax services. However, the expectation is that Member States which have in the past broadly allowed the provision of tax services by auditors or which have a domestic legal approach similar to the new EU Regulation will continue to do so.

By contrast, some Member States which already have restrictions on tax services are unlikely to exercise the option (see Section 13).

7.6 Are all valuation services prohibited?

Yes — including valuations performed in connection with actuarial services or litigation support services. However, Member States have the option to allow these services subject to exactly the same conditions as apply for tax services i.e., not having a ‘direct effect’ or ‘have immaterial effect’.

Other Non-Audit Services

7.7 “Services that involve playing any part in the management or decision-making of the audited entity” are prohibited. What does this mean?

The Regulation does not provide a specific definition of these services although Recital 8 provides some guidance, stating that the type of services that should be considered as prohibited services might include activities such as:

“working capital management, providing financial information, business process optimisation, cash management, transfer pricing, creating supply chain efficiency and the like.”

A statutory auditor has long been prohibited from taking on management responsibilities (e.g., leading, directing, controlling a client’s business activities or personnel or making decisions for the client) under existing international and national codes of independence in other jurisdictions. These prohibit the statutory auditor “acting as management” or “doing anything that is the responsibility of management.”
The prohibition in the Regulation of “… playing any part in the management or decision-making of the audited entity” should be interpreted as meaning that when the auditor is overseeing, directing or supervising the personnel of an audited entity, or when the auditor makes decisions for that audit entity, then he or she would be “playing a part in the management or decision making of the audited entity.”

However, when the auditor assists an audited entity in analysis and data gathering or provides options from which management may choose, or provides advice and recommendations upon which management may or may not act, accept or approve, then such services do not result in the auditor “playing a part in the management or decision making of the audited entity”. Rather in such situations the auditor is offering his/her professional expertise and opinion to the audited entity’s management, and it is management’s sole responsibility to choose to accept or decline that advice.

Accordingly, in the context of providing a permissible service (i.e. one that is not prohibited by Article 5) the auditor should refrain from making any decisions on behalf of management during the course of the audit engagement.

To avoid the risk that the auditor may, or may be seen to be, involved in decision making, and consistent with the IESBA principles and the SEC rules, the engagement partner (in conjunction with the audit engagement partner, where appropriate) must always be satisfied the client’s management makes all judgments and decisions that are the responsibility of management. This includes ensuring that the client’s management:

a. designates an individual who possesses suitable skill, knowledge and experience to be responsible at all times for the client’s decisions and to oversee the services

b. provides oversight of the services and evaluates the adequacy of the results of the services performed for the client’s purpose

c. accepts responsibility for the actions, if any, to be taken arising from the results of the services
The audit firm should ensure that the management of the audited entity expressly acknowledge their responsibilities as described above (for example in the engagement contract).

Furthermore, the audit firm should state expressly that its advice and recommendations are matters for consideration and decision by the management of the audited entity.

In conclusion, providing advice and recommendations to an audited entity in relation to matters for which management makes decisions and accepts responsibility would seem to be an acceptable way of delivering assistance to management in connection with services mentioned in Recital 8 (working capital management, providing financial information, business process optimisation, cash management, transfer pricing, creating supply chain efficiency and the like).

7.8 Are recommendations regarding internal control considered a prohibited service under Article 5.1(e) ‘designing and implementing internal control service’ ... and hence prohibited in the financial year immediately preceding the financial year audited (‘clean period’)?

Providing internal control recommendations does not involve the act of design and implementation of the controls themselves, and merely provides feedback to Management for them to act upon, or not, as they see fit. Recommendations on internal controls could be made, for example, as part of the statutory audit function. Accordingly, an audit firm would not be prohibited from providing recommendations regarding internal controls in the clean period.

Where the service involves the act of ‘design and implementation’ regarding the operation of internal controls then it would fall into Article 5.1(e).

7.9 Are there restrictions on legal services?

Yes. The Regulation prohibits legal services, with respect to:

(g)(i) The provision of general counsel
(g)(ii) Negotiating on behalf of the audit client
(g)(iii) Acting in an advocacy role in the resolution of litigation
7.10 What is meant be the term “general counsel”?

One interpretation is that the prohibition regarding general counsel is interpreted as applying to the following three elements:

- The appointment of a partner or employee of an audit firm to serve as an audit client’s General Counsel – this is supported by the IESBA Code which states this service would create self-review and advocacy threats that are so significant that no safeguards could reduce the threats to an acceptable level.

- Providing legal services that involve the audit firm and the network from playing a part in the management or decision-making of the audited entity as reinforced by Article 5.1(b).

- For any other legal services, the audit firm should look to the principles of independence laid down in Directive 2006/43/EC and the requirements and guidance of the IESBA Code to identify threats and develop appropriate safeguards. For example, when providing a legal opinion regarding a transaction, the threats would depend on factors such as the nature of the service and the materiality of the transaction in relation to the financial statements, among others.

**Note: Interpretation points**

The position outlined above is aligned with international standards and reflects a relatively narrow definition of what might be regarded as “general counsel”. An alternative interpretation and one which aligns with the way in which the words “general counsel” have been translated in some (but not all) language versions of the Regulation is that “general counsel” means any form of legal advice. Some have challenged this broad interpretation on the basis that, if it were correct, it would render obsolete the separate prohibitions covered by Article 5(g)(ii) and 5(g)(iii).

7.11 How are Corporate Finance type services impacted by the legislation?

Article 5.1(i) and (j) of the EU Audit Reform Regulation prohibit the following services:

(i) services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity.
In addition, recital 8 stipulates that:

Services linked to the financing, capital structure and allocation, and investment strategy of the audited entity should be prohibited except the provision of services such as due diligence services, issuing comfort letters in connection with prospectuses issued by the audited entity and other assurance services.

The wording of Article 5.1(i), is not specific as to what type of services are prohibited.

One approach will be for Member States to look to the IESBA Code for a description of the types of services which traditionally fall under the heading of “corporate finance services” (see below). This would assist in defining those services more precisely which seem intended to be captured under the prohibition in Article 5.1(i). However, this should likely be interpreted to cover services an audit firm might not necessarily have labelled as “corporate finance” but which do impact the financing and capital structure of a PIE (e.g., assistance in connection with restructuring debt). It is clear from recital 8 that due diligence services are not intended to be prohibited.

The IESBA Code describes Corporate Finance services as:

- assisting an audit client in developing corporate strategies
- identifying possible targets for the audit client to acquire
- advising on disposal transactions
- assisting finance raising transactions
- providing structuring advice

However, the exclusion for assurance services should also be interpreted broadly as it seems clear that services typically provided by an auditor in connection with capital markets regulation and corporate transactions (buy and sell-side) should continue to be permitted (subject to the fee cap and other controls).
7.12 Do the NAS prohibitions also apply to assurance services?
The exclusion for assurance services from the prohibited list should be interpreted broadly as it seems that assurance services typically provided by an auditor in connection with capital markets’ regulation and corporate transactions (buy and sell-side), including due diligence services, continue to be permitted (subject to the NAS fee cap and other controls).

If the assurance service falls within the prohibition on Corporate Finance type services (per Article 5.1(i)) (see Question 7.11), then they are permissible if they relate to the provision of assurance in relation to the financial statements, including the provision of comfort letters prepared in connection with a prospectus.

However, to the extent that an assurance service falls by exception within any of the prohibited services (e.g., ‘playing any part in the management ...’ (see Question 7.7), internal audit work) then, yes, the prohibitions will apply to assurance services.

7.13 Are there restrictions on the provision of Human Resource Services?
Yes. In addition to a restriction on services relating to, in broad terms, the recruitment of senior people for the client’s finance function with which auditors are familiar, the Regulation also prohibits human resource services with respect to ‘structuring the organisation design’ and ‘cost control.’

C. Application of the NAS prohibitions – to whom do they apply and when?

Application:

7.14 How do the NAS prohibitions apply to the Statutory Auditor’s network?
The NAS prohibitions apply to the statutory auditor of the PIE and any member of the statutory auditor’s network. Note that the definition of a ‘network’ remains in place from the definition under Directive 2006/43/EC.
7.15 To what extent do the NAS prohibitions apply to related entities of the PIE?

The statutory auditor of the PIE and any member of its network cannot provide prohibited services to:

- the PIE itself
- its EU formed parent undertakings
- its EU formed controlled undertakings

There are limited restrictions applicable to controlled undertakings outside the EU (see Section 12).

For the definition of ‘parent undertaking’ see Question 7.16.

For the definition of a ‘controlled undertaking’ see Question 7.17.

The prohibitions do not apply to services provided to equity affiliates either of the PIE or any of its parent(s) or controlled undertakings in the EU.

The prohibitions do not apply to services provided to sister companies of the PIE.

For services provided by the statutory auditor’s network to controlled undertakings of the PIE outside of the EU, a ‘threats and safeguards’ approach is required giving some scope to provide services by the network – although a limited number of absolute prohibitions still apply (see Question 12.4).

7.16 What is a ‘parent undertaking’?

Neither the Regulation nor the Directive contains a definition of a ‘parent undertaking.’

However, the EC point to the definition in the Accounting Directive 2013/43/EU (Article 2(9)), defining a ‘parent undertaking’ as an entity that owns or controls another entity either directly or indirectly (and thus includes more than just the PIE’s immediate parent).
It follows from Article 2(9) of the Accounting Directive that the element of control is what defines a parent undertaking/controlled undertaking relationship. Neither the Accounting Directive nor any other relevant EU legislative act defines the concept of ‘control’. However, the Accounting Directive does contain a number of relevant Recitals and Articles as regards the concept of ‘control’:

**Recital 31 to the Accounting Directive provides:**

‘Consolidated financial statements should present the activities of a parent undertaking and its subsidiaries as a single economic entity (a group). Undertakings controlled by the parent undertaking should be considered as subsidiary undertakings. Control should be based on holding a majority of voting rights, but control may also exist where there are agreements with fellow shareholders or members. In certain circumstances control may be effectively exercised where the parent holds a minority or none of the shares in the subsidiary. [...]’

**Article 22(1) of the Accounting Directive provides:**

1. A Member State shall require any undertaking governed by its national law to draw up consolidated financial statements and a consolidated management report if that undertaking (a parent undertaking):

   (a) has a majority of the shareholders’ or members’ voting rights in another undertaking (a subsidiary undertaking)

   (b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking

   (c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for such contracts or clauses shall not be required to apply this provision

   (d) is a shareholder in or member of an undertaking
(i) a majority of the members of the administrative, management or supervisory bodies of that undertaking (a subsidiary undertaking) who have held office during the financial year, during the preceding financial year and up to the time when the consolidated financial statements are drawn up, have been appointed solely as a result of the exercise of its voting rights

(ii) controls alone, pursuant to an agreement with other shareholders in or members of that undertaking (a subsidiary undertaking), a majority of shareholders’ or members’ voting rights in that undertaking. The Member States may introduce more detailed provisions concerning the form and contents of such agreements. […]’

**Article 22(2) of the Accounting Directive provides:**

2. In addition to the cases mentioned in paragraph 1, Member States may require any undertaking governed by their national law to draw up consolidated financial statements and a consolidated management report if:

(a) that undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking)

(b) that undertaking (a parent undertaking) and another undertaking (the subsidiary undertaking) are managed on a unified basis by the parent undertaking.

Our reading of Article 22 of the Accounting Directive is that an undertaking controls another undertaking if one of the conditions listed in Article 22(1) is met (in which case the Accounting Directive requires consolidated accounts) but that there may be other cases of control in addition to those listed in Article 22(1). Indeed, Article 22(2) gives Member States the option to require consolidated accounts where an ‘undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking).’
A combined reading of Articles 22(1) and 22(2) leads us to three conclusions:

• First, the list of cases of control in Article 22(1) is not exhaustive
• Second, there may be cases where there is control but nevertheless not a requirement to consolidate accounts (Article 22(2) provides that Member States ‘may’ require consolidated accounts)
• Third, the fact that the Accounting Directive does not define the concept of ‘control’ and the fact that Article 22(2) essentially defers to the Member States’ discretion suggest to us that the question as to whether there is ‘control’ may well be a question of national law

There is also a current debate as to whether the IFRS definition of control might apply rather than the accounting directive definition and this is of particular relevance in the private equity context.

7.17 What is a ‘controlled undertaking’?

The concept of control is addressed in the EC Q&As.

‘The term ‘parent undertaking’ is defined in point (9) of Article 2 of the Accounting Directive 2013/43/EU as an undertaking which controls one or more subsidiary undertakings. See Question 7.16.

The term ‘controlled undertaking’ is defined in point (f) of Article 2.1 of the Transparency Directive 2004/109/EC as meaning any undertaking:

i) in which a natural person or legal entity has a majority of the voting rights

ii) of which a natural person or legal entity has the right to appoint or remove a majority of the members of the administrative, management or supervisory body and is at the same time a shareholder in, or member of, the undertaking in question

iii) of which a natural person or legal entity is a shareholder or member and alone controls a majority of the shareholders’ or members’ voting rights, respectively, pursuant to an agreement entered into with other shareholders or members of the undertaking in question

iv) over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control
In most cases the position will be obvious but in cases where doubt exists, specialist advice should be sought.

Whether a pension fund is a ‘controlled undertaking’ will depend on its facts. Each case will have to be considered individually. However, in some Member States, pension funds are defined as PIEs in their own right – in such cases, the Regulation will fully apply.

7.18 Are joint ventures deemed to be controlled undertakings? For example, a 50%/50% JV between a listed PIE (UK) and a listed PIE (Germany)?

Whether a joint venture entity is a ‘controlled undertaking’ of a PIE will depend on the exact facts and circumstances – see Questions 7.16 and 7.17 for the criteria to be taken into consideration.

Typically a 50%/50% joint venture entity would not be considered to be a ‘controlled undertaking’ of either of the PIEs that own the joint venture entity as neither PIE would fulfil the ‘control’ criteria (for example, each would have half of the voting rights, not the majority, and be entitled to appoint half of the members of the administrative, management or supervisory body, not the majority).

Taking the example of a 50%/50% joint venture between a listed PIE (UK) and a listed PIE (Germany), the statutory auditor of either PIE would therefore not be subject to the specific prohibitions of Article 5 of the Regulation when providing NAS to the joint venture although the general principles of independence under Member State law and the IESBA Code would of course apply.

If however a PIE would have a majority of the voting rights, say 51%, in the joint venture entity or have the right to appoint the majority of its directors or other indicators of control such as golden share or veto rights over major operating decisions, the joint venture entity would qualify as a controlled entity of that PIE and its auditor would not be allowed to provide the NAS prohibited under Article 5 of the Regulation to that joint venture entity.
7.19 Article 5.1 stipulates that non-PIE parent and controlled undertakings of an audited PIE entity would be caught by NAS restrictions. Would this provision also apply if the PIE in the chain is ‘designated by the Member State’ but is not designated as a PIE in the country of the parent or subsidiary undertaking?

Yes. If an entity qualifies as a PIE in a Member State by virtue of that Member State having applied the option in Article 2(13)(d) of the Directive, then the prohibitions on non-audit services will apply to that entity (because it is a PIE) as well as any parents or controlled undertakings in the EU, even if they are not PIEs.

7.20 How do the NAS prohibitions apply to cross border groups?

Article 5.1 of the Regulation stipulates that an audit firm, or any of its network firms (in the world), cannot provide any prohibited non-audit services to the audited entity, its parent and its controlled undertakings in the EU.

Article 5 does not distinguish in the case of parent or controlled undertakings of the audited entity between PIEs and non-PIEs.

The question is how the principles set out in article 5.1 should be applied to audited entities with PIE parents and/or PIE subsidiaries in various EU member states which have:

1. enacted the member state option to allow tax and valuation services
2. prohibited additional services
3. not made use of the options above

Based on initial views in the EC September 2014 Q&A, it is our understanding that if the audited entity had subsidiaries in other EU member states, such subsidiaries would have to comply with the law of the member state in which they were established (principle of local law).
Also, if the local law of the non-PIE subsidiary is more restrictive than the EU Regulation, the auditor cannot provide to non-PIE subsidiaries those additional services.

7.21 How do the NAS prohibitions apply to branches?
The answer will depend on whether the branch is a branch of an EU PIE or of a non-EU entity and where it is located. Our understanding is as follows:

- If it is an EU based branch of a non-EU entity then the EU branch will not fall within the scope of the PIE definition. As such, the NAS prohibitions would not apply. This applies even if the branch is a credit institutions or insurance undertaking in the EU (see Question 2.10).

- If it is an EU based branch of an EU entity, then the application of the NAS prohibitions will depend upon whether that EU entity is a PIE. For an EU PIE which has a branch inside/outside the EU, the NAS prohibitions would apply equally to the branch inside/outside the EU as to the rest of the legal entity inside the EU.

7.22 Is the determination of control strictly based on the accounting definition or is there a scenario when legal control should be referenced?
For instance, when a Private Equity upstream entity utilises the IFRS 10 investment exemption and does not consolidate entities over which it has a measure of control, is the lack of consolidation sufficient to conclude that private equity entity is not a ‘parent undertaking’?

No – in our view a lack of consolidation is not sufficient per se to conclude that an entity does not qualify as a ‘parent entity’. The EC Q&A refers to the Accounting Directive for a definition of a ‘parent company’ as an undertaking which controls one or more subsidiary undertakings and to the Transparency Directive for the term ‘controlled undertaking’ (as set out in Question 7.17 above), and both Directives refer to control through owning a majority of voting rights (legal control) but also to cases of de facto control.
Timing Considerations

7.23 For what period do the NAS rules apply?
The NAS rules apply to the period between the beginning of the period (i.e., financial year) audited and the issuing of the audit report according to Article 5.1(a).

In addition, Article 22 of the Directive ‘Independence and objectivity’ contains a provision relating to general independence: ‘Independence shall be required at least during both the period covered by the financial statements to be audited and the period during which the statutory audit is carried out.’

7.24 When do the new NAS rules start to apply? For example, what about a December 2016 year-end?
The NAS prohibitions will only apply after the Regulation becomes applicable and there is no retrospective application of this provision.

The EC Q&A stated that ‘the new requirements will apply to the first financial year starting after the date of application of the new legislation’ (i.e., 17 June 2016). This view is also supported by the Federation of European Accountants (FEE).

Therefore following this principle the restrictions on NAS would apply to the first accounting period beginning on or after 16 June 2016. This would mean that for a PIE with a 31 December 2016 year-end, the new restrictions on NAS would apply from 1 January 2017 (i.e., for the 31 December 2017 year end). If the auditor/PIE relationship ends with completion of the audit of the financial year ending on 31 December 2016, the new restrictions on NAS for the incoming auditor would apply from 1 January 2017 until the issuing of the audit report (see Question 7.23).
08

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Calculation considerations

8.1 How is the 70% NAS fee cap calculated (i.e. which statutory audit fees need to be taken into account)?

Article 4 of the Regulation states that, for the purpose of calculating the fee cap, statutory audit fees include those generated by the statutory auditor for; the audit of the financial statements/consolidated financial statements of the EU PIE as well as those of its parent entity and controlled undertakings 'where appropriate'. The fees are those paid to the statutory auditor firm in a given EU Member State, but not to its network.

The EC has provided some clarification on what is meant by 'where appropriate'. They say that in order to determine the amount of 'statutory audit fees', these have to be assessed in a group context (i.e., the statutory audit fees paid by the audited PIE aggregated with the statutory audit fees of any parent entities and/or controlled undertakings either inside or outside of the EU. In other words, the denominator will be the group statutory audit fees generated by the statutory auditor of the EU PIE in a given EU Member State irrespective of where the group' entities are located. The average of these statutory audit fees is then computed over the preceding three consecutive years.

When calculating the numerator, only permitted NAS provided by the statutory auditor of the EU PIE to the EU PIE, its controlled undertakings and its parent entities are brought in to the calculation.

We understand that for the purpose of the calculation fees (both audit and non-audit fees) from non-PIE subsidiaries and/or non-PIE parents and/or EU branches are also included in the cap calculation to the extent that the service is provided by the EU PIE’s Statutory auditor in a given EU Member State.

8.2 Is the cap calculation based on fees paid, billed or on an accrual basis?

It is our understanding that the calculation of fees would be based on the disclosures made by the EU PIE in its financial statements (both for audit and non-audit services), as per the statutory requirements i.e., on an accruals basis.
8.3 Are any NAS excluded from the cap?
Yes, Article 4 explicitly excludes NAS that are required by EU law or the law of a Member State clearly stating that:

“For the purposes of the limits specified in the first subparagraph, non-audit services, other than those referred to in Article 5.1, required by Union or national legislation shall be excluded.”

So such services will not be restricted in any way. For example a Contribution-in-Kind report in Belgium or the Certification of a Corporate Tax Return in Greece would not be caught by the cap because both services are required, by national law, to be performed by the statutory auditor.

In exceptional circumstances, a competent authority can grant a two-year dispensation (see Question 8.11).

Scope of the cap
8.4 Does the cap apply to members of the audit firm’s network?
No. The cap does not apply to permitted services provided by members of the statutory audit firm’s network. The cap only applies to the ‘statutory auditor or the audit firm’ who provides the permitted services to the audited PIE, its parent undertaking(s) or its controlled undertakings in a given Member State (see Question 8.1).

For example, if ABC UK audits a UK PIE, the cap will only apply to permitted services provided by ABC UK, as statutory auditor to any of the entities referred to above. As members of the ABC network, ABC France and ABC Germany can provide permitted NAS to the parent company or controlled undertakings of the UK PIE without limit (providing that these subsidiaries are not PIEs in their own right), because neither ABC France nor ABC Germany are the statutory auditors of the UK PIE.

However, if ABC UK (noted above) were to also provide permitted NAS to a subsidiary of the UK PIE incorporated in France, those services would be subject to the cap.
8.5 Does the cap have an extra-territorial effect?

We understand that the cap applies to permitted NAS provided by the statutory auditor to; the PIE and its parent(s) and controlled undertakings (see Question 8.1). The geographical location of these entities, that are part of the group, is irrelevant.

As discussed in Question 8.1 above, it also appears that statutory audit fees of non-EU parent companies of the PIE and of its non-EU controlled undertakings would be included in the calculation of total ‘statutory audit fees’ upon which the EU cap would be based to the extent that the service is provided by the EU PIE’s Statutory auditor in a given EU Member State. However, the 70% cap itself only applies to the statutory auditor of the EU PIE and not to the members of that statutory auditor’s network.

Timing Considerations

8.6 What is the first financial year for the purpose of calculating the 70% cap — i.e., do we need to count NAS fees prior to the Legislation becoming law?

Our interpretation is that this provision in the Regulation is not retrospective and only starts to apply as from 17 June 2016. Only then, would the NAS fee cap ‘clock’ start to tick, at which point there would be three years (assuming three consecutive years of NAS being provided by the statutory auditor) before the cap would then apply in year four.

For example; where a PIE has a 31 December year end, then the first financial year to count towards the cap calculation would be the year ending 2017. Assuming three consecutive years of service this would mean the cap would first apply to the financial year commencing 1 January 2020. If in years 1, 2 and 3, total statutory audit fees paid are €100, €120 and €170 respectively, then permitted NAS in year four are capped at 70% of the average audit fees of €130 (i.e., €91).

8.7 What happens to the ‘rule’ if we provide permitted NAS for only 2 years and there is then a break – does the 3 year consecutive clock reset?

Yes. Any full-year ‘break’ in the consecutive nature of the permitted NAS will result in the clock resetting itself back to zero. As such, a further three consecutive years of permitted NAS without any cap could be supplied before the cap would take effect again.
**Member State options**

8.8 Can Member States opt for a stricter cap?
Yes – Member States may establish stricter rules for setting the cap.

8.9 Can Member States also opt to introduce stricter time application e.g., start the clock immediately in 2016?
As part of Member State implementation a Member State may opt to ‘apply more stringent requirements than set out in the article’. This would appear to include introducing a stricter time application such that the cap would apply immediately from 2016 or to apply a stricter approach to the three cumulative years and the ‘clock’ resetting.

8.10 If a Member State has implemented a NAS permitted list (‘white list’), does the 70% cap calculation include the fees for white list services performed?
The only permitted exclusion from the fee cap calculation in Article 4 is where services are ‘required by Union or national legislation’. Our understanding is that a service being permitted by a Member State per the white list does not also mean it is ‘required by law’ and as such it follows that such a service would be subject to the fee cap. For example, reporting accounting work may be a permitted service but as it’s not ‘required by law’ it would be subject to the cap. However, Member States may take a different view. See also Question 8.11.

8.11 With some services (e.g. capital markets work) the fee for NAS in one year could easily exceed the average audit fee for the last three years. Is there any flexibility in the Regulation to allow for this?
Yes. Member States have an option which, if exercised, would allow the Regulator in the relevant Member State, upon a request by the statutory auditor, to exempt that auditor from the cap in relation to an entity for a maximum period of two years. Where Member States exercise this option, it is anticipated that the Regulator might use this exemption to deal with this sort of situation. See also Question 8.10.
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Audit Committees

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9.1 Are there any changes to the role of the audit committee?

In reality, most of the requirements for audit committees set out in the Directive and Regulation are already being performed today and represent ‘best practice’. So the only change of substance is the fact that these requirements are now being enshrined in law meaning those companies that have previously applied some but not all areas that are now covered by the law will need to make changes.

One area where the Directive is quite prescriptive relates to the appointment (or re-appointment) of the statutory auditor. Whilst in most cases the audit committee related requirements are accepted practice, there is clear encouragement to audit committees to consider smaller audit firms as part of the tender process. In addition, all contractual clauses entered into between a PIE and a third party (e.g., a bank) that restrict the choice of that company’s shareholders to only appoint certain categories or lists of statutory auditors or audit firms to carry out the statutory audit of that entity ‘shall be null and void’. This refers to so-called ‘Big 4 only’ clauses.

Finally, the new report from the statutory auditor to the audit committee represents an important change. Whilst much of the content of this report would have already been discussed by the auditor as a matter of best practice, it now has the underpinning of EU Legislation.

9.2 Is there a requirement for audit committees to have a policy on tendering for non-audit services?

No. This was a proposal from the European Parliament which was deleted as part of the informal trilogue negotiations.

9.3 Is audit committee approval needed for any non-audit services?

Yes. The Regulation requires the audit committee of an EU PIE to approve the provision of all permitted NAS to the PIE itself and to its EU controlled undertakings. It seems the approval of the audit committee of the PIE must also be obtained in the case of the provision of services to its EU parent undertakings. Further clarification is needed as to whether audit committees shall approve the provision of permitted services only within the EU. However, the EC has frequently confirmed that the EU legislation does not have an extra-territorial effect.
9.4 The audit committee is also required to issue guidelines regarding the provision of tax and valuation services if a Member State exercises its option to permit them (see Question 7.4). There does not appear to be anything preventing audit committees giving ‘blanket’ approvals to certain types of permitted service in advance.

Who can be on an audit committee? Are there any limits?

Provisions covering the composition of the audit committee now sit in the Directive (Article 39). The audit committee should be composed of independent non-executive members of either the administrative body (i.e., Board of Directors) or the supervisory body (i.e., as exists in, for example, the German two-tier system). Audit committee members can also be directly appointed at the Annual General Meeting.

At least one member of the audit committee must have competence in accounting and/or auditing. The committee members as a whole should have competence relevant to the sector in which the company has its business.

9.5 What are the requirements for auditor reporting to audit committees?

Statutory auditors of PIEs will be required to provide a specific written report to the audit committee (Article 11 of the Regulation). This is already the case in some Member States but this requirement will now apply throughout the EU. This report will provide more detailed information on the results of the audit, together with explanatory text. Auditors will be required to disclose, in particular,

“the quantitative level of materiality applied to perform the statutory audit for the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions, account balances or disclosures, and disclose the qualitative factors which were considered when setting the level of materiality.”

Auditors will also be required to:

“report and explain judgments about events or conditions identified in the course of the audit that may cast significant doubt on the entity’s ability to continue as a going concern and whether they constitute a material uncertainty; and provide a summary of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been taken into account when making a going concern assessment.”
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10.1 What is the impact of the Legislation on the auditor report?

The Legislation relating to auditor reporting includes a series of requirements that should enhance investors’ understanding of the audit process including critical judgements made during the audit.

Both the Regulation and the Directive contain detailed provisions affecting statutory audits and the way they are conducted. These include such things as the content and nature of the audit report, audit working papers, the role of audit committees, audit tender processes and many others.

The audit report for all statutory audits in the EU (i.e., not just statutory audits of PIEs) will need to ‘provide a statement on any material uncertainty relating to events or conditions that may cast significant doubt about the entity’s ability to continue as a going concern’ (Article 28.2(f) of the Directive).

For PIEs only, the audit report will need to ‘provide, in support of the audit opinion, the following: (i) a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, (ii) a summary of the auditor’s response to those risks, and (iii) where relevant, key observations arising with respect to those risks’ (Regulation Article 10.2(c)).

For additional reporting requirements to the audit committee see Section 9.

10.2 For which year-end will I first be required to produce an audit report under the terms of the new Legislation?

The EC Q&A states that ‘the new requirements will apply to the first financial year starting after the date of application’ of 17 June 2016. Applying that principle the first audit report to be produced under the new Legislation would be for the year ending 30 June 2017 and beyond.

10.3 Does the statutory auditor who signs the audit report need to be registered as a statutory auditor in the Member State where the opinion is issued?

It is generally understood that the signing partner must be a member of the local profession in the Member State where the opinion will be issued.

Article 14 of the Amended Directive on Statutory Audit (2014/56/EC) now includes a Member State option to allow a statutory auditor in one EU Member State to become a member of the profession in another Member State following up to a three-year adaptation period. But there is no guarantee that this option will be adopted consistently across the EU.
Furthermore, at the end of the adaptation period, the auditor has to undergo ‘an assessment’, probably in the local language of the other EU Member State. Although what that assessment should entail has not yet been defined, Member State responses as part of the legislative process did not show much support for the adaptation period concept. So the Member State option may have little impact on EU mobility of potential signing partners.

10.4 Does the Engagement Quality Control Reviewer need to be registered as a statutory auditor in the country where the audit opinion is issued?

An Engagement Quality Control Review is an existing requirement of international standards (i.e., ISA 220 and ISQC1). It is established practice for the EQC reviewer to be not only a statutory auditor but someone with experience that is relevant to the company for which the review is required. This is particularly the case in complex industries such as banking, insurance, energy or telecommunications and is an essential component of a quality audit. The EQC review is now incorporated into Article 8 of the Regulation. As such, it has now become a formal and legal obligation for the audit of every PIE as defined by the Member States. The Regulation requires the EQC reviewer to be a statutory auditor. The definition of a statutory auditor would include any statutory auditor formally recognised in the EU in accordance with the Amended Directive.

Note: Interpretation points

European Commission officials have recently indicated that the EQC reviewer should be registered as a statutory auditor in the country where the audit opinion is to be issued. Further clarification will be sought on this point.
10.5 The IAASB has recently released new and revised auditor reporting standards. How do these align with the auditor reporting requirements included in Article 10 of the Regulation?

Much of the audit report will be consistent with the IAASB requirements, although there are still likely to be some unique EU disclosures (e.g., a declaration that no prohibited NAS as referred to in Article 5.1 have been provided to the audited entity and a separate indication of the length of the audit/client relationship).

In the area of risks of material misstatement including assessed risks of material misstatement due to fraud, the auditor has to provide a description of these risks, a summary response to those risks and, where relevant, key observations arising with respect to those risks. FEE have produced a helpful paper setting out the recent developments in Auditor Communication including a comparison of EU and IAASB requirements.

10.6 Will the report to the audit committee be a public document?

No. However, the statutory auditor must make the report available to the competent authorities if required by national law.

10.7 Are there any changes in the requirements to prepare transparency reports?

There are no changes of substance to the existing report which will continue to apply to all auditors that have a PIE audit client. The original requirement for large audit firms to prepare a separate Contingency Plan has been deleted.
10.8 Handover files—what exactly do incumbent auditors need to handover and give access to?

Article 23.3 as amended by the Directive states that:

“where a statutory auditor or an audit firm is replaced by another statutory auditor or audit firm, the former statutory auditor or audit firm shall provide the incoming statutory auditor or audit firm with access to all relevant information concerning the audited entity and the most recent audit of that entity”

The new Directive amends Article 23.3 in Directive 2006/43/EC by adding reference to access to all relevant information concerning the audited entity ‘and the most recent audit of that entity.’

It seems sensible to read the new requirement in conjunction with current practice. In particular, it is worth noting that the ISAs do not have extensive guidance on file handover, except for a reference in ISA 230 to ‘the review of matters of continuing significance’ by those responsible for carrying out subsequent audits. As a consequence, there is no widespread practice of full audit file handover.

Our interpretation is that the amendment to previous requirements in Directive 2006/43/EC was not intended to change dramatically current practice for audit file handover, or indeed it would have been more explicit, but simply to include a requirement to provide relevant information (unspecified) from the most recent audit.

In addition to the requirements in the Directive, incumbent auditors of PIEs are also required to grant the new auditors access to the additional reports to the audit committee (per Article 11 of the Regulation — see Question 9.5), as well as any information submitted to the competent authorities in relation to the audit of the PIE, for example: material breach of laws, a material threat to the continued functioning of the PIE or a refusal to issue an adverse/qualified opinion.
11.1 Who will be responsible for auditor oversight and what is their remit? 

11.2 What role does ESMA have to play? 

11.3 Will the audit profession play any future role in the oversight function? 

11.4 Are there new requirements for dialogue between regulators and auditors?
11.1 Who will be responsible for auditor oversight and what is their remit?

National oversight bodies still remain responsible for oversight at a Member State level. However, a new body is to be established, a Committee of European Audit Oversight Bodies (CEAOB), which will take over the existing role of the European Group of Auditor Oversight Bodies (EGAOB). As the similarity of the acronyms suggests, there is not much of a change here other than the fact that the CEAOB will be chaired by the Member States and not chaired by the EC.

The CEAOB will comprise the national authorities responsible for auditor oversight (as does the existing EGAOB) and part of its remit, under Article 30 of the Regulation includes to:

- Facilitate the exchange of information, expertise and best practices for the implementation of this Regulation and Directive 2006/43/EC (Article 30.7(a))
- Provide expert advice to the Commission as well as to the Competent authorities, at their request, on issues related to the implementation of this Regulation and of Directive 2006/43/EC (Article 30.7(b))
- For the purposes of carrying out its tasks, the CEAOB may adopt non-binding guidelines or opinions. The Commission shall publish the guidelines and opinions adopted by the CEAOB (Article 30.9)

11.2 What role does ESMA have to play?

ESMA has no role other than as a non-voting member of CEAOB. The CEAOB will establish a sub-group responsible for performing the ongoing technical assessments of the public oversight systems of third countries. That sub-group will be chaired by an ESMA representative.

11.3 Will the audit profession play any future role in the oversight function?

Yes. Whilst PIE audits will be supervised by competent authorities that are independent of the profession (as is the case today), they may delegate tasks to other bodies.

Oversight of non-PIE audits will continue to be largely performed by the professional bodies.
11.4 Are there new requirements for dialogue between regulators and auditors?

Yes. The competent authorities supervising credit institutions and insurance undertakings and the auditors of these entities shall establish an effective dialogue and share responsibility for doing so. In order to facilitate this dialogue, the European Banking Authority and the European Insurance and Occupational Pensions Authority shall issue guidelines. The disclosure in good faith to these authorities, by the auditor or network, of any information shall not constitute a breach of any contractual or legal restriction on disclosure of information.

At least once a year, the European Systemic Risk Board (ESRB) and Committee of European Auditing Oversight Bodies (CEAOB) shall organise a meeting with the auditors or networks carrying out statutory audits 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 systemically important financial institutions. The disclosure in good faith to the ESRB or CEAOB, by the auditor or network, of any information shall not constitute a breach of any contractual or legal restriction on disclosure of information.
Impact outside of the EU
Impact outside of the EU

12.1 Do the requirements apply to non-EU companies who are listed on a regulated market in the Union? For example, what about dual listing in both EU/Non-EU countries?

12.2 Is there any doubt that the part of the definition of PIEs relating to listed companies only catches companies that are EU incorporated?

12.3 How do the rotation rules apply to non-EU companies?

12.4 How do the NAS restrictions apply to controlled undertakings incorporated outside the EU?

12.5 Does the cap have an extra-territorial effect?
12.1 Do the requirements apply to non-EU companies who are listed on a regulated market in the Union? For example, what about dual listing in both EU/Non-EU countries?

The Regulation specifies that listed PIEs are companies that are ‘governed by’ the law of an EU Member State. This generally refers to companies that are incorporated in an EU Member State (however please note Question 12.2 below). So non-EU companies that are listed on a regulated market in the EU would not, as such, fall within the PIE definition and would not be required to rotate their statutory auditors.

For example, a Jersey or Guernsey incorporated company with debt listed on a regulated market in the EU will not be a PIE as the Channel Islands (like the Isle of Man) are not a part of the EU.

12.2 Is there any doubt that the part of the definition of PIEs relating to listed companies only catches companies that are EU incorporated?

The provision actually refers to entities ‘governed by the law of a Member State’ which is generally accepted as meaning ‘incorporated’ or ‘formed’ under EU law. However, some countries such as France or Belgium (but not, say, the UK) have domestic provisions which cause their corporate law to apply to companies which have their operational headquarters in that country even though that company is incorporated elsewhere. Any company caught by such a provision would also be regarded as governed by the laws of that Member State. Subject to this point, the provision should not catch a company that is tax resident but not incorporated in an EU Member State.

12.3 How do the rotation rules apply to non-EU companies?

If a non-EU parent has subsidiaries in the EU, and any of these subsidiaries are PIEs in their own right, then the PIE subsidiaries will have to rotate in line with the national law of the Member State where they are incorporated.

If a PIE parent company in the EU has non-EU subsidiaries, whilst these subsidiaries are never caught by the PIE definition (because they are outside the EU and therefore not ‘governed by’ the law of an EU Member State), the EU parent may choose to rotate auditors of the entire group, including non-EU subsidiaries, in line with the law prevailing in the parent company’s country of incorporation.
12.4 How do the NAS restrictions apply to controlled undertakings incorporated outside the EU?

Generally, the Regulation will not have effect outside the EU. However, where a member of the network of the statutory auditor provides NAS to entities outside the EU that are subsidiaries of a PIE, the statutory auditor of the PIE must apply a ‘threats and safeguards’ approach when assessing the impact of those services on its own independence.

However, in such circumstances, there still remain three absolute prohibitions of certain services that are deemed to compromise the independence of the PIE auditor regardless of the nature of possible safeguards put in place. These are:

- Bookkeeping and preparing accounting records and financial statements
- 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
- Services that involve playing any part in the management or decision making of the audited entity

However the EU prohibitions on NAS do not apply

- To non-EU parent companies/group companies upstream from the EU PIE
- To sisters of the EU PIE regardless of whether formed in the EU if they are not in the direct ownership chain of the EU PIE

12.5 Does the cap have an extra-territorial effect?

We understand that the cap applies to permitted NAS provided by the statutory auditor to; the PIE and its parent(s) and controlled undertakings. The geographical location of these entities, that are part of the group, is irrelevant. See Question 8.5.
Member state options

Enter
13.1 How will the Member State optionality provided in the Regulation and Directive work and will its impact be significant?  

13.2 Which Member States are likely to adopt a more restrictive position in relation to any of the key areas of the Legislation — e.g., NAS, MFR etc.?  

13.3 Which Member State options apply in a cross border situation?
13.1 How will the Member State optionality provided in the Regulation and Directive work and will its impact be significant?

The Regulation and Directive contain over 50 Member State options in many of the key provisions, which are neatly summarised by FEE here. The key provisions impacted by the options include:

- Expanding the list of PIEs
- Reducing the length of the initial maximum duration period to less than 10 years
- Extending the initial maximum duration period by a further 10 or 14 years where a tender is carried out or a joint audit is introduced
- Adding to the list of prohibited NAS, stricter rules around ‘clean periods’ or establishing stricter rules setting out the conditions under which permitted NAS may be provided
- Requiring stricter rules on a fee cap

Member States will need to adopt specific national legislation to make use of these options, unless they already have such legislation in place. There is no time limit with regard to the options in the Regulation however those in the Directive must be in place by date of application – 17 June 2016.
13.2 Which Member States are likely to adopt a more restrictive position in relation to any of the key areas of the Legislation – e.g., NAS, MFR etc.?

There is no official position on this point; Member States are still in the process of working through their implementation and approach to the options.

13.3 Which Member State options apply in a cross border situation?

In general terms, a company in Member State A will comply with the Legislation as enacted in Member State A. If this company has a parent undertaking in Member State B and a controlled undertaking in Member State C, the parent undertaking will comply with the Legislation as enacted in Member State B and the controlled undertaking will comply with the Legislation as enacted in Member State C.

In a group situation, it would not be unusual for the ultimate parent in the EU to impose its local laws on its controlled undertakings in other Member States. However, in such situations, it is the decision of the parent company that drives this and not the laws of the Member State in which the parent resides.
For a discussion about the new requirements of the legislation and how your company may be affected, you can either contact us below or speak to your usual EY contact.

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