

## European Commission: Audit Reform



The European Commission has issued proposals that, if adopted, will bring sweeping changes to the EU audit market and the role of the audit committee.

The proposals issued by the European Commission on 30 November, are the latest stage in a consultation process that started with the publication of the Green Paper Audit Policy – Lessons from the Crisis in October 2010.

The proposals have two main thrusts:

- to reduce concentration in the market for audits, with new requirements imposed for audit tendering and auditor appointment; and
- to address perceived threats to auditor independence, such as long tenure and non-audit services, by mandating audit firm rotation and imposing significant new limits on non-audit services, and potentially requiring the largest networks to be composed of audit-only firms within the EU.

The Commission is also proposing changes to the form and content of an auditor's report to shareholders, the requirements relating to Audit Committees and to the structure and regulation of the audit market in the EU.

The proposals introduce an expanded definition of a Public Interest Entity (PIE) which, in addition to listed entities, encompasses a range of financial institutions and a new 'Large PIE' category (broadly listed companies with a market capitalisation, or relevant financial institutions with balance sheet/assets under management, in excess of €1 billion).

The proposals now pass from the EC to be considered by the European Parliament and the Council in a process which may take two or more years.

### A Directive and a Regulation

The Directive amends the current Statutory Audit Directive, applying to all statutory audits. A final Directive would need to be implemented by EU member states into national law.

The Regulation contains requirements regarding statutory audits of PIEs. An EU Regulation would apply directly throughout the EU without any member state adoption or tailoring.

### Mandatory audit firm rotation

Under the Regulation, the auditor of a PIE would have to be appointed for at least two but no more than six years. The maximum appointment term would be nine years if there were joint auditors for the entire period. There is a limited ability to obtain permission to extend appointment terms in exceptional circumstances.

In most EU countries, this proposal would represent a major change with significant cost implications due both to the frequent rotation of audit firms and also the tendering requirements noted below. It will also constrain the Audit Committee's (and shareholders') choice of audit firm and could be detrimental to audit quality.

### Mandatory audit tendering

The Audit Committee of a PIE would be required to identify at least two choices, unless it is proposing reappointment of the incumbent auditor (subject to the maximum six or nine year tenure described above). It would identify which firm it preferred and would have to provide a justification of its recommendation. At least one of the firms invited to tender at the start of the process must be a smaller firm, i.e. one that has less than a 15% share of the audit fees of Large PIEs in that member state. The Regulation contains specific requirements for the process that the Audit Committee must follow. EU-level regulatory bodies would also develop further guidelines on the process for auditor selection.

Auditor appointments for credit institutions or insurance undertakings would be subject to a veto right of the relevant prudential supervisory authority. These requirements would restrict the Audit Committees' discretion to decide when and how to tender.

## Prohibition on contractual clauses limiting the audit choice

Any contractual requirement that limits an entity's choice of auditor would be precluded, including, for example a bank specifying a requirement, as a condition of a loan, that an entity appoint a specific audit firm or a category of audit firm.

## Restrictions on non-audit services

Under the Regulation, there would be very few non-audit services that could be provided by the audit firm or other firms within the audit firm's network to a PIE or its parent/subsidiaries within the EU.

Permitted 'related financial audit services' would be limited to:

- audits and reviews of interim financial statements;
- assurance on regulatory reporting by financial institutions;
- certification on compliance with tax requirements when such attestation is required by national law; and
- assurance on corporate governance and social responsibility statements.

However, the fees for related financial audit services to an audit client would be limited to 10% of the audit fees paid by that entity.

A limited number of non-audit services would be permitted. Within the EU, they would be subject to pre-approval on a case-by-case basis by the Audit Committee (e.g. comfort letters for investors and human resource services) or the relevant competent authority (e.g. acquisition due diligence services and designing and implementing financial information technology systems).

It would be possible for non-audit services to be provided by the auditor (or by a member of the audit firm's network) to a non-EU entity that is controlled by the EU entity. However, before such services are provided the auditor would have to assess whether their independence would be compromised by such services, using a threats and safeguards approach.

## Audit-only firms

This requirement would apply to any network:

- whose member firms have combined annual audit revenues within the EU over €1,500 million; and
- which has at least one member firm that generates more than one third of its annual audit revenues from audits of Large PIEs.

If these thresholds are exceeded then all of the member firms of that network, including those outside the EU, would be banned from providing non-audit services within the EU.

This requirement seems intended to apply only to the Big 4 networks. It could impair the ability of member firms of the affected networks to access the breadth and depth of expertise they currently bring to their audits.

## Audit Reports

The proposals identify over 20 items that would have to be addressed in the auditors' report on the financial statements – a significant extension to the current requirements. Furthermore, the auditor also would be required to provide an additional, more detailed report to the Audit Committee which explains in detail the results of the audit, presenting and justifying inter alia:

- the scope of the audit;
- the auditors' risk assessment;
- audit work carried out;
- judgements about material uncertainties that raise questions about the entity's ability to continue as a going concern;
- whether the bookkeeping, accounting, financial statements and additional reports covered by the audit 'show appropriateness';
- all instances of non-compliance, including non-material instances if they are considered important to the Audit Committee;
- an assessment of the valuation methodologies used to prepare the financial statements; and

This report would not be public but could be made available to regulators upon request.

## Audit Committee requirements

The Regulation requires all PIEs, with certain concessions for subsidiaries and certain types of financial institution, to have an Audit Committee comprised of non-executives or shareholder-appointed members. At least one member must have competence in auditing and another must have competence in accounting and/or auditing. Also the committee members as a whole must have competence relevant to the sector in which the audited entity is operating.

The Audit Committee's responsibility with respect to the oversight of the audit and the appointment and dismissal of the auditor is made more explicit. In particular, the Audit Committee is to 'supervise the completeness and integrity of the draft audit reports'; be 'responsible for the procedure on the selection of the statutory auditor(s)'; and 'authorise on a case by case basis, the provision by the statutory auditor [of those non-audit services that are still permitted]'.

While the governance standards in many EU countries are well developed, the requirements of the Regulation are likely to result in changes to the composition and activity of the Audit Committee.

If you would like further information on any of the matters discussed above, please talk to your usual KPMG contact or contact:

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