




AUDIT - REGULATION AND DIRECTIVE

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A new **Regulation for the audit of public interest entities** (PIEs - listed companies, banks, insurance companies) and an amended Directive for audits in general had to be transposed into the national law of the member states by 17 June 2016.

In the course of the discussions in the Working Party many member states had concerns that some of the provisions, especially those in the Regulation, would **impose unnecessary regulation** on business and even risk **damaging audit quality**.





One provision of the proposed Regulation was especially controversial: it regarded the **mandatory rotation of audit firms** (Art. 17). The following arguments were put forward:

- This is expensive for companies and auditors and will cause audit fees to increase. The right to appoint, evaluate and determine the tenure of auditors should be retained formally by shareholders, and exercised in practice by the company's audit committee.
- Audit committees might end up having to select a firm they believe is less capable simply because of the rotation rules, which runs counter to the objectives of improving audit quality.

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- There was also an intensive discussion as to **the list of services, that an auditor (or audit firm) is not allowed to provide** (Art.5) and regarding the **fee-cap for permitted non-audit services** (Art.4).
 - The final text of the regulation gives MS some options to soften those provisions.
 - The **amendments to the Audit Directive have been less controversial**, some of its provisions – like those on the audit committee – have to be applied only to PIEs.

DIRECTIVE 2014/56/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 16 APRIL 2014 AMENDING DIRECTIVE 2006/43/EC ON STATUTORY AUDITS OF ANNUAL ACCOUNTS AND CONSOLIDATED ACCOUNTS


- Directive **2006/43/EC** of the European Parliament and of the Council already laid down the conditions for the approval and registration of persons that carry out statutory audits, the rules on independence, objectivity and professional ethics applying to those persons, and the framework for their public oversight.
- The Commission however considered it necessary to further harmonise those rules to allow for greater transparency and predictability of the requirements applying to auditors and to enhance their independence and objectivity.

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- Statutory auditors and audit firms play a crucial role by actively challenging the management. It is therefore important that the professional scepticism exercised by statutory auditors and audit firms vis-à-vis the audited entity be reinforced. Auditors and their employees should refrain from carrying out the statutory audit of an entity if they are not independent, e.g. if they have a business interest or financial interest in it.
 - **Audit committees**, or bodies performing an equivalent function within the audited public-interest entity, have a decisive role to play in contributing to high-quality statutory audit. It is particularly important to reinforce the independence and technical competence of the audit committee by requiring that a majority of its members be independent and that at least one of its members have competence in auditing and/or accounting.


ARTICLE 22 - INDEPENDENCE OF THE AUDITOR

1. Member States shall ensure that, when carrying out a statutory audit, a statutory auditor or an audit firm, and any natural person in a position to directly or indirectly influence the outcome of the statutory audit, is independent of the audited entity and is not involved in the decision-taking of the audited entity.

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.




Member States shall ensure that a statutory auditor or an audit firm takes all reasonable steps to ensure that, when carrying out a statutory audit, his, her or its independence is not affected by any existing or potential conflict of interest or business or other direct or indirect relationship involving the statutory auditor or the audit firm carrying out the statutory audit and, where appropriate, its network, managers, auditors, employees, any other natural persons whose services are placed at the disposal or under the control of the statutory auditor or the audit firm, or any person directly or indirectly linked to the statutory auditor or the audit firm by control.



The statutory auditor or the audit firm shall not carry out a statutory audit if there is any threat of self-review, self-interest, advocacy, familiarity or intimidation created by financial, personal, business, employment or other relationships between:

- the statutory auditor, the audit firm, its network, and any natural person in a position to influence the outcome of the statutory audit, and
- the audited entity, as a result of which an objective, reasonable and informed third party, taking into account the safeguards applied, would conclude that the statutory auditor's or the audit firm's independence is compromised.



2. Member States shall ensure that a statutory auditor, an audit firm, their key audit partners, their employees, and any other natural person whose services are placed at the disposal or under the control of such statutory auditor or audit firm and who is directly involved in statutory audit activities, and persons closely associated with them within the meaning of Article 1(2) of Commission Directive 2004/72/EC (*), do not hold or have a material and direct beneficial interest in, or engage in any transaction in any financial instrument issued, guaranteed, or otherwise supported by, any audited entity within their area of statutory audit activities, other than interests owned indirectly through diversified collective investment schemes, including managed funds such as pension funds or life insurance.

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NEW ARTICLE 28 ON AUDIT REPORTING

1. The statutory auditor(s) or the audit firm(s) shall present the results of the statutory audit in an audit report. The report shall be prepared in accordance with the requirements of auditing standards adopted by the Union or Member State concerned, as referred to in Article 26.

2. The audit report shall be in writing and shall:

(a) identify the entity whose annual or consolidated financial statements are the subject of the statutory audit; specify the annual or consolidated financial statements and the date and period they cover; and identify the financial reporting framework that has been applied in their preparation;

(b) include a description of the scope of the statutory audit which shall, as a minimum, identify the auditing standards in accordance with which the statutory audit was conducted;

(c) include an audit opinion, which shall be either unqualified, qualified or an adverse opinion and shall state clearly the opinion of the statutory auditor(s) or the audit firm(s) as to:

- (i) whether the annual financial statements give a true and fair view in accordance with the relevant financial reporting framework; and,
- (ii) where appropriate, whether the annual financial statements comply with statutory requirements.

If the statutory auditor(s) or the audit firm(s) are unable to express an audit opinion, the report shall contain a disclaimer of opinion;


(d) refer to any other matters to which the statutory auditor(s) or the audit firm(s) draw(s) attention by way of emphasis without qualifying the audit opinion;

(e) include an opinion and statement, both of which shall be based on the work undertaken in the course of the audit, referred to in the second subparagraph of Article 34(1) of Directive 2013/34/EU;

(f) 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;

(g) identify the place of establishment of the statutory auditor(s) or the audit firm(s).

Member States may lay down additional requirements in relation to the content of the audit report.

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- 3.** Where the statutory audit was carried out by more than one statutory auditor or audit firm, the statutory auditor(s) or the audit firm(s) shall agree on the results of the statutory audit and submit a joint report and opinion. In the case of disagreement, each statutory auditor or audit firm shall submit his, her or its opinion in a separate paragraph of the audit report and shall state the reason for the disagreement.
- 4.** The audit report shall be signed and dated by the statutory auditor.....

ARTICLE 39 ON THE AUDIT COMMITTEE


(must be applied only by PIEs:)

I. Member States shall ensure that each public-interest entity has an audit committee. The audit committee shall be either a stand-alone committee or a committee of the administrative body or supervisory body of the audited entity. It shall be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity or, for entities without shareholders, by an equivalent body.

At least one member of the audit committee shall have competence in accounting and/or auditing.

The committee members as a whole shall have competence relevant to the sector in which the audited entity is operating.

A majority of the members of the audit committee shall be independent of the audited entity. The chairman of the audit committee shall be appointed by its members or by the supervisory body of the audited entity, and shall be independent of the audited entity. Member States may require the chairman of the audit committee to be elected annually by the general meeting of shareholders of the audited entity.



2. By way of derogation from paragraph 1, Member States may decide that in the case of public-interest entities which meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC of the European Parliament and of the Council (*), the functions assigned to the audit committee may be performed by the administrative or supervisory body as a whole, provided that where the chairman of such a body is an executive member, he or she shall not act as chairman whilst such body is performing the functions of the audit committee.

Where an audit committee forms part of the administrative body or of the supervisory body of the audited entity in accordance with paragraph 1, Member States may permit or require the administrative body or the supervisory body, as appropriate, to perform the functions of the audit committee for the purpose of the obligations set out in this Directive and in Regulation (EU) No 537/2014.

3. By way of derogation from paragraph 1, Member States may decide that the following public-interest entities are not required to have an audit committee:

6. Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, inter alia:

- (a) inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and explain how the statutory audit contributed to the integrity of financial reporting and what the role of the audit committee was in that process;
- (b) monitor the financial reporting process and submit recommendations or proposals to ensure its integrity;
- (c) monitor the effectiveness of the undertaking's internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the audited entity, without breaching its independence;
- (d) monitor the statutory audit of the annual and consolidated financial statements, in particular, its performance, taking into account any findings and conclusions by the competent authority pursuant to Article 26(6) of Regulation (EU) No 537/2014;
- (e) review and monitor the independence of the statutory auditors or the audit firms in accordance with Articles 22, 22a, 22b, 24a and 24b of this Directive and Article 6 of Regulation (EU) No 537/2014, and in particular the appropriateness of the provision of non-audit services to the audited entity in accordance with Article 5 of that Regulation;
- (f) be responsible for the procedure for the selection of statutory auditor(s) or audit firm(s) and recommend the statutory auditor(s) or the audit firm(s) to be appointed in accordance with Article 16 of Regulation (EU) No 537/2014 except when Article 16(8) of Regulation (EU) No 537/2014 is applied.

REGULATION (EU) NO 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 16 APRIL 2014 ON SPECIFIC REQUIREMENTS REGARDING STATUTORY AUDIT OF PUBLIC-INTEREST ENTITIES AND REPEALING COMMISSION DECISION 2005/909/EC

Especially the crisis of the financial markets in 2008 (after the collapse of the Lehman bank in the US) made the Commission believe, that more stringent rules are necessary also on auditing to prevent further similar damages to the financial system of the EU.

Because of the significant public relevance of public-interest entities, which arises from the scale and complexity of their business or from the nature of their business, the credibility of the audited financial statements of public-interest entities should be reinforced.

Consequently, the special provisions for the statutory audits of public-interest entities set out in Directive 2006/43/EC have been further developed in Regulation (EU) No 537/2014.

RECITAL 5 OF THE REGULATION:

It is important to lay down detailed rules with a view to ensuring that the statutory audits of public-interest entities are of adequate quality and are carried out by statutory auditors and audit firms subject to stringent requirements. A common regulatory approach should enhance the integrity, independence, objectivity, responsibility, transparency and reliability of statutory auditors and audit firms carrying out statutory audits of public-interest entities, contributing to the quality of statutory audits in the Union, thus to the smooth functioning of the internal market, while achieving a high level of consumer and investor protection. The development of a separate act for public-interest entities should also ensure consistent harmonisation and uniform application of the rules and thus contribute to a more effective functioning of the internal market. ...

SEE ALSO: LAST SENTENCE OF RECITAL 13:

In addition to the information required to be provided under Article 28 of Directive 2006/43/EC, the audit report should in particular include sufficient information on the independence of the statutory auditor or the audit firm and on whether the statutory audit was considered capable of detecting irregularities, including fraud.



The three most important and controversial issues regarded the provisions of Art. 4, Art. 5 and Art. 17

- on a **limitation of fees** for allowed non audit services,
- on **prohibited non-audit services** and
- on the **rotation of the audit firm**.

The following texts repeat the original provisions of the Regulation, less important parts/paragraphs have been left out, underlinings have been added.

ART. 4 REGARDING THE FEE-CAP:


2. When the statutory auditor or the audit firm provides to the audited entity, its parent undertaking or its controlled undertakings, for a period of three or more consecutive financial years, non-audit services other than those referred to in Article 5 (1) of this Regulation, the total fees for such services shall be limited to no more than 70 % of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertaking, of its controlled undertakings and of the consolidated financial statements of that group of undertakings.



ART. 5 REGARDING PROHIBITED SERVICES:

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For the purposes of this Article, prohibited non-audit services shall mean:

- (a) tax services relating to:
 - (i) preparation of tax forms;
 - (ii) payroll tax;
 - (iii) customs duties;
 - (iv) identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law;
 - (v) support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspections is required by law;
 - (vi) calculation of direct and indirect tax and deferred tax;
 - (vii) provision of tax advice;

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- (b) services that involve playing any part in the management or decision-making of the audited entity;
 - (c) bookkeeping and preparing accounting records and financial statements;
 - (d) payroll services;
 - (e) 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;
 - (f) valuation services, including valuations performed in connection with actuarial services or litigation support services;
 - (g) legal services, with respect to:
 - (i) the provision of general counsel;
 - (ii) negotiating on behalf of the audited entity; and
 - (iii) acting in an advocacy role in the resolution of litigation;
 - (h) services related to the audited entity's internal audit function;



(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;

(j) promoting, dealing in, or underwriting shares in the audited entity;


(k) human resources services, with respect to:

(i) management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:



- searching for or seeking out candidates for such position; or
- undertaking reference checks of candidates for such positions;

(ii) structuring the organisation design; and

(iii) cost control.





2. Member States may prohibit services other than those listed in paragraph 1 where they consider that those services represent a threat to independence. Member States shall communicate to the Commission any additions to the list in paragraph 1.



3. By way of derogation from the second subparagraph of paragraph I, Member States may allow the provision of the services referred to in points (a) (i), (a) (iv) to (a) (vii) and (f), provided that the following requirements are complied with:

- (a) they have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements;
- (b) the estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee referred to in Article 11; and
- (c) the principles of independence laid down in Directive 2006/43/EC are complied with by the statutory auditor or the audit firm.



4. A statutory auditor or an audit firm carrying out statutory audits of public-interest entities and, where the statutory auditor or the audit firm belongs to a network, any member of such network, may provide to the audited entity, to its parent undertaking or to its controlled undertakings non-audit services other than the prohibited non-audit services referred to in paragraphs 1 and 2 subject to the approval of the audit committee after it has properly assessed threats to independence and the safeguards applied in accordance with Article 22b of Directive 2006/43/EC. The audit committee shall, where applicable, issue guidelines with regard to the services referred to in paragraph 3.

Member States may establish stricter rules setting out the conditions under which a statutory auditor, an audit firm or a member of a network to which the statutory auditor or audit firm belongs may provide to the audited entity, to its parent undertaking or to its controlled undertakings non-audit services other than the prohibited non-audit services referred to in paragraph 1.

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ART. 17 REGARDING THE DURATION OF THE AUDIT ENGAGEMENT:

1. A public-interest entity shall appoint a statutory auditor or an audit firm for an initial engagement of at least one year. The engagement may be renewed.


Neither the initial engagement of a particular statutory auditor or audit firm, nor this in combination with any renewed engagements therewith shall exceed a maximum duration of 10 years.

2. By way of derogation from paragraph 1, Member States may

- (a) require that the initial engagement referred to in paragraph 1 be for a period of more than one year;
- (b) set a maximum duration of less than 10 years for the engagements referred to in the second subparagraph of paragraph 1.





3. After the expiry of the maximum durations of engagements referred to in the second subparagraph of paragraph 1, or in point (b) of paragraph 2, or after the expiry of the durations of engagements extended in accordance with paragraphs 4 or 6, neither the statutory auditor or the audit firm nor, where applicable, any members of their networks within the Union shall undertake the statutory audit of the same public-interest entity within the following four-year period.




4. By way of derogation from paragraph 1 and point (b) of paragraph (2), Member States may provide that the maximum durations referred to in the second subparagraph of paragraph 1 and in point (b) of paragraph 2 may be extended to the maximum duration of:

- (a) 20 years, where a public tendering process for the statutory audit is conducted in accordance with paragraphs 2 to 5 of Article 16 and takes effect upon the expiry of the maximum durations referred to in the second subparagraph of paragraph 1 and in point (b) of paragraph 2; or
- (b) twenty four years, where, after the expiry of the maximum durations referred to in the second subparagraph of paragraph 1 and in point (b) of paragraph 2, more than one statutory auditor or audit firm is simultaneously engaged, provided that the statutory audit results in the presentation of the joint audit report as referred to in Article 28 of Directive 2006/43/EC.



5. The maximum durations referred to in the second subparagraph of paragraph 1 and in point (b) of paragraph 2 shall be extended only if, upon a recommendation of the audit committee, the administrative or supervisory body, proposes to the general meeting of shareholders or members, in accordance with national law, that the engagement be renewed and that proposal is approved.

6. After the expiry of the maximum durations referred to in the second subparagraph of paragraph 1, in point (b) of paragraph 2, or in paragraph 4, as appropriate, the public-interest entity may, on an exceptional basis, request that the competent authority referred to in Article 20(1) grant an extension to re-appoint the statutory auditor or the audit firm for a further engagement where the conditions in points (a) or (b) of paragraph 4 are met. Such an additional engagement shall not exceed two years.



7. The key audit partners responsible for carrying out a statutory audit shall cease their participation in the statutory audit of the audited entity not later than seven years from the date of their appointment. They shall not participate again in the statutory audit of the audited entity before three years have elapsed following that cessation.

By way of derogation, Member States may require that key audit partners responsible for carrying out a statutory audit cease their participation in the statutory audit of the audited entity earlier than seven years from the date of their respective appointment.

The statutory auditor or the audit firm shall establish an appropriate gradual rotation mechanism with regard to the most senior personnel involved in the statutory audit, including at least the persons who are registered as statutory auditors. The gradual rotation mechanism shall be applied in phases on the basis of individuals rather than of the entire engagement team. It shall be proportionate in view of the scale and the complexity of the activity of the statutory auditor or the audit firm.

The statutory auditor or the audit firm shall be able to demonstrate to the competent authority that such mechanism is effectively applied and adapted to the scale and the complexity of the activity of the statutory auditor or the audit firm.

8.