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Defining Issues®

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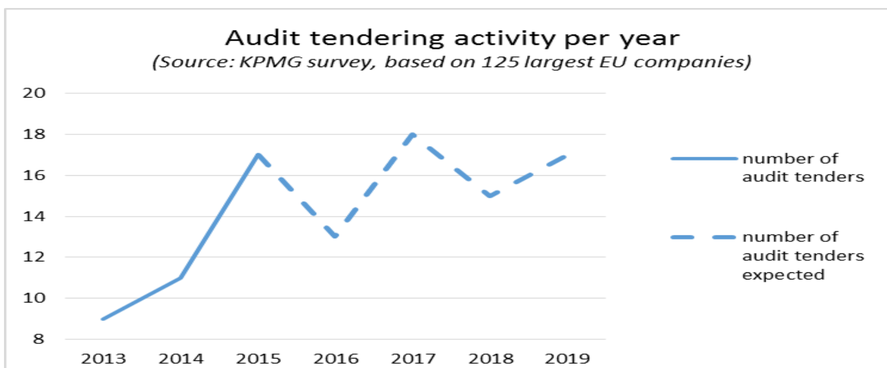
EU Audit Reforms: The Countdown Begins

Only two months remain before the European Union (EU) audit reforms come into full effect. These reforms will affect many U.S. companies, especially those with an EU parent or subsidiary that is listed, or has banking or insurance activities.

This edition of *Defining Issues* examines where EU countries stand in adopting audit reform legislation, and discusses transition requirements.[1]

Key Facts for U.S. Companies

- Starting June 17, 2016, EU audit reforms impose mandatory audit firm rotation and prohibit certain non-audit services for an EU company that is determined to be an EU Public Interest Entity (PIE).



- The full effect of the audit reforms will not be known until all EU countries have finished incorporating the reforms into their national laws. However, the tendering activity for audit services has significantly risen over the past three years, and is expected to remain high for at least the next four years.
- About a third of the largest 125 EU companies, many with significant U.S. operations, have already put their audit out for bid, with 75 percent of those tenders resulting in a change of auditor. (S*ource: KPMG survey*).
- The audit reforms increase the audit committee's role and affect its composition. Non-audit services must be pre-approved by the PIE's EU-based audit committee.

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[1] For additional information, see KPMG's Defining Issues No. 15-37, EU Audit Reforms May Affect U.S. Companies, available at kpmg.com/us/FRN.

How Will U.S. Companies Be Affected?

Although U.S. domestic companies are not directly subject to the audit reforms, they may be affected if they have an EU PIE entity in their chain of control. This could occur if one of their subsidiaries or parent is domiciled in an EU country and:

- Has debt or equity securities that trade on an EU-regulated market;
- Is a credit institution or engages in insurance activities; or
- Has been designated as a PIE by an EU country because of its size or significance.

These U.S. companies may need to take the following actions.

- Rotate auditors on some of their subsidiaries.
- Limit the non-audit services that their auditors provide. In some EU countries, restrictions on tax and valuation services could be more severe than the restrictions imposed by the SEC, PCAOB, and AICPA independence requirements. Fee cap mechanisms could also restrict the amount of non-audit services that the auditor and its member firms provide to the PIE and its group entities.
- Establish audit committees for their EU PIE subsidiaries and obtain approvals from that audit committee, as well as the group audit committee, for audit and non-audit services.

Due to the large number of EU companies affected, the Mandatory Audit Firm Rotation will be implemented progressively. The longer the audit relationship as of June 16, 2014, the longer the company has to rotate its auditor.

Mandatory Audit Firm Rotation[2]

Mandatory Audit Firm Rotation	
Baseline Measures	• 10-year mandatory audit firm rotation for EU PIEs • Four-year cooling-off period before the incumbent auditor can perform the audit for the same PIE
Country Options	• Reduce the maximum period to less than 10 years • Extend the maximum period up to 20 years when the audit is put out for bid, or 24 years when the audit is conducted jointly by two or more audit firms
Transition Period	Depends on the length of the current audit firm's tenure as of June 16, 2014 • If current audit tenure is 20 years or more, the auditor may not be renewed after June 17, 2020. For example, a renewal in 2020 before the June 17 cutoff date, for the 2020 calendar year audit would be permitted. This applies equally to single or multi-year engagements – e.g. in

[2] For a comprehensive understanding of the reforms, see KPMG's Shedding Light on EU Audit Legislation.

	France a six-year engagement may be renewed prior to June 17, 2020, for a further six years • If current audit tenure is 11 to 19 years, the auditor may not be renewed after June 17, 2023 • If current audit tenure is less than 11 years, rotation is required as of the first fiscal year beginning on or after June 17, 2016

Each EU country has the option to allow certain tax services and valuation services if they do not affect the auditor's independence.

Prohibitions against Non-audit Services

Non-audit Services	
Baseline Measures	• List of non-audit services that the statutory auditor and network-member firms cannot provide to an EU PIE, its EU parent, or to EU-controlled subsidiaries • One year cooling-in period before a firm can be engaged as auditor after providing services related to "designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial IT systems." • This cooling-in period prevents these services from being performed in the year before the audit begins, but does not apply if they are provided outside of the EU • Permissible non-audit services capped at 70 percent of the audit fees paid to the auditor of the EU PIE
Country Options	• Prohibit additional non-audit services • Permit certain tax and valuation services • Establish a stricter fee cap, which could include the firm's network-member fees in the computation
Effective Date	• Non-audit service prohibitions apply to the first fiscal year beginning on or after June 17, 2016; therefore, for calendar year 2017 audits, a newly-appointed auditor must stop providing: – Prohibited non-audit services subject to the cooling-in period by January 1, 2016, and – Other prohibited non-audit services by January 1, 2017

Example: Effect of Non-audit Service Prohibitions on a U.S. Subsidiary

Company B

- Company B is incorporated and listed in the EU. As an EU PIE, Company B is subject to the non-audit service prohibitions beginning June 17, 2016.
- Company B, a calendar year-end company, wishes to appoint Audit Firm A as its auditor for its December 31, 2017, audit.
- Company B's U.S. subsidiary is, and will continue to be, audited by another audit firm's network.

Audit Firm A

- The U.S. member firm of Audit Firm A's network currently provides certain tax and IT services to the U.S. subsidiary of Company B. The IT services consist of the design and implementation of a new accounting system.
- Audit Firm A needs to assess the effect of the non-audit services rendered in the United States by its member firm, even if it does not audit the U.S. subsidiary.

Tax Services. Audit Firm A first considers whether the EU country in which Company B is located allows an auditor or its member firm to provide tax services to an audit client and, if so, which tax services are permitted. If the tax services are permitted, then Audit Firm A applies a threat-and-safeguard evaluation to determine whether the tax services provided in the United States will affect its independence as Company B's auditor.

Design and Implementation of a New Accounting System. Certain services are always deemed to compromise the independence of the PIE's auditor. One example of a service that is equally prohibited within the EU and the United States is designing and implementing financial IT systems. These services are subject to the cooling-in period. However, the cooling-in period does not apply to services rendered in the United States. Therefore, Audit Firm A's U.S. member firm can provide IT services to Company B's subsidiary in 2016, but must stop providing these services no later than December 31, 2016, as the audit relationship starts January 1, 2017.

Countries are taking different approaches to implementing the audit reforms, and many intend to implement more restrictive rules than the EU baseline requirements.

Countries Diverging from Baseline Requirements

Listed below are areas in which countries have diverged, or may diverge, from the baseline requirements of the EU audit reforms.[3]

	Minimum Audit Tenure	Maximum Audit Tenure	Some Tax and Valuation Services Permitted	Other Reform Aspects
Baseline Measures	1 year	10 years	No	
Key Finalized Provisions				
Germany	1 year	10 years for financial institutions and insurance companies 20 years for other corporations when the audit is put out for bid	Yes	
Spain[4]	3 years	10 years or 14 years for joint audits	Yes	Broader definition of a PIE includes pension funds, mutual funds, and corporations above certain thresholds, mutual guarantee societies, payment entities, and electronic money institutions

[3] For up-to-date country information, see KPMG's EU Audit Reform: Interactive Map of Member State Legislation.

[4] For additional background, see KPMG's EU Audit Legislation in Spain.

Despite being so close to the June 17, 2016, effective date, only four of the 28 countries impacted by the new audit reforms – Spain, Portugal, Slovakia, and most recently Germany – have finalized their legislation.

	Minimum Audit Tenure	Maximum Audit Tenure	Some Tax and Valuation Services Permitted	Other Reform Aspects
Key Expected Provisions				
France	6 years	24 years	No	Joint audit mandatory
Italy	10 years	Potential extension if the audit is put out for bid No extension expected for joint audit	Unlikely	
Luxembourg	1 year	20 years when the audit is put out for bid	Yes	
Netherlands	1 year	10 years	No	Additions to the list of prohibited non-audit services
UK	1 year	20 years when the audit is put out for bid	Yes, subject to independence analysis, which applies a more restrictive criteria of *clearly inconsequential*	Fee-cap calculation potentially includes non-audit services provided by all network-member firms

The audit reforms apply to companies in 28 EU countries: Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom. They also apply to Iceland, Liechtenstein, and Norway.

Switzerland is not part of the EU and currently does not intend to adopt the EU audit reforms or to change its existing legal requirements related to auditor independence.

KPMG Observations

The varying audit firm rotation requirements could result in a PIE being required to have two audits performed by different firms (a local statutory audit and an audit for group purposes), which would increase the cost of doing business abroad. Companies may also face reduced choices given the limited number of auditors that can meet the multiple independence requirements while having the requisite expertise and geographic coverage. Duplicate audit committee pre-approvals of non-audit services may be required.

Other jurisdictions such as India and Brazil have, or are considering, similar measures, making this an increasingly complex regulatory environment for multinational companies to navigate.

U.S. companies with an international footprint need to start monitoring the consequences of the reforms on their filings, operations, and transactions.

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