



EUROPEAN COMMISSION
Directorate General Internal Market and Services

CAPITAL AND COMPANIES
Audit and Credit Rating Agencies

Brussels, 3 September 2014

Q&A - Implementation of the New Statutory Audit Framework

The overall objective of this Q&A is 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 Q&A covers practical questions raised by the profession, the industry, investors, academics, and other stakeholders on the implementation of the new EU regulatory framework composed of: (i) 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 (“the Directive”); and (ii) 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 (“the Regulation”).

Where possible, the Q&A aims to provide preliminary guidance on the questions raised. The process of implementation of the new EU regulatory framework entails close cooperation between the European Commission, national regulators and supervisors. Several aspects remain to be clarified together with the Member States, as they make progress in the preparation of national transposition measures.

The Q&A is hence a work in progress. Additional questions can be submitted to Markt-F4@ec.europa.eu. All covered questions and related answers can be retrieved under the table of contents tab.

DISCLAIMER:

This Q&A is not a legal document. This is an unofficial opinion of Directorate General for Internal Market and Services. The answers provided therein are not binding on the European Commission as an institution.

I. Entry into force/application

Which will be the first relevant financial year once the new EU regulatory framework applies?

The new requirements will apply to the first financial year starting after the date of application of the new EU regulatory framework. For instance, as the new EU regulatory framework will be applicable on 17 June 2016 and that the financial year of a PIE ends on 30 June 2016, the first audit report to be produced under the new EU regulatory framework would cover the financial year ending on 30 June 2017.

How will the Directive and the Regulation interact?

The new legal framework is based on two legislative instruments: a Directive amending the existing Statutory Audit Directive and a new Regulation on specific requirements regarding statutory audit of public-interest entities. The Regulation will enter into force on 17 June 2014, but will only become applicable 2 years following the entry into force. In the meantime, Member States have also two years to transpose the Directive. In some instances, provisions on the same topics are found in both instruments – audit reporting, independence, adoption of international auditing standards, audit oversight etc.

The Directive allows Member States to designate as PIEs other entities that are of significant public relevance because of the nature of their business, their size or the number of their employees. Can a Member State decide to apply only certain of the requirements under the Regulation for those entities, designated as PIEs under national law?

No. Where a Member State designates a certain category of entities as PIEs under its national law, then all the requirements regarding the statutory audit of PIEs contained in the new Regulation apply to this category of entities.

II. Next steps

The new EU regulatory framework contains a number of Member State options. Will the Commission centralise information to provide an overview of these options?

The new EU regulatory framework requires the Member States to notify the Commission when they make use of any of the options set out in the Directive and the Regulation. The Commission will compile and make public the information on the way the Member States have implemented the new EU regulatory framework.

Is any review foreseen?

The new legal framework does not require a review of the application of the Directive and the Regulation. Nevertheless, the Commission will closely monitor the implementation of the new EU regulatory framework and will ensure that the new texts are efficiently and consistently enforced.

In addition, the new EU regulatory framework requires the Commission to submit a report on the application of the Regulation to the European Parliament and to the Council at the latest five years after the end of the transitional period. The Commission is also required to complete a review of the operation and effectiveness of the system of cooperation between competent authorities within the framework of the CEAOB five years after the entry into force of this Regulation.

III. Structure of fees on services other than audit

How to calculate the 70% cap?

The Regulation establishes that when a statutory auditor or an audit firm has been providing non-audit services to the audited PIE for a period of three or more consecutive financial years, the total fees for such services in the fourth year shall be limited to a maximum of 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.

The calculation of the cap is based on the fees generated for non-audit services during the previous consecutive three years, provided that the audited entity was a PIE during those two three years as well. There are two basic requirements for this provision to be applicable: both audit services and non-audit services must have been provided by the same statutory auditor/audit firm to a given PIE for at least three consecutive years. If the statutory auditor/audit firm stopped providing audit services during any of those three years, the provision will not be applicable, as in that case those services would no longer be provided to the “audited entity”.

If the statutory auditor/audit firm interrupts for at least one year the provision of non-audit services, then the provision will not be applicable either, as those services need to be provided for at least three consecutive years to fall under the scope of the Article. The competent authority remains entitled to address every instance where it considers there might be fraud or collusion, between the audited entity and the statutory auditor/audit firm, to unlawfully prevent the provision from being applied (e.g. the services are actually provided in a given year but the fees are formally allocated to the following year).

At which level should the fees be calculated?

All calculations for the cap shall be done at group level – i.e. they need to take into account not only the audited entity but also, where applicable, its parent undertaking, its controlled undertakings and the consolidated financial statements of that group of undertakings. So, for instances, if audit fees in year 1 are 200€, audit fees in year 2 are 220€ and audit fees in year 3 are 140€, then the average on the 3-year basis would be 180€. 70% of this amount is 126€, which means that in the fourth year the statutory auditor/audit firm would not be able to charge more than 126€ for the non-audit services.

The audited entity only became a PIE last year. Should the cap apply?

No. The Regulation applies to PIEs and to the audits of PIEs. Thus, the calculation of the fees for the cap should only be done if and when the audited entity be a PIE.

Are fees perceived by the subsidiaries calculated for the purposes of the calculation of the cap?

Yes. Article 4 refers to the provision of non-audit services, by the statutory auditor or the audit firm, to the audited entity its parent undertaking or its controlled undertakings. The geographical location of these entities, that are part of the group, is irrelevant. Every fee generated within the group must be taken into account, as that is the only way to ensure the statutory auditor’s or audit firm’s independence towards the audited entity and its group.

Does the cap apply at the level of the network?

No, the cap itself applies to a given statutory auditor/audit firm only. The fees generated by the services provided by members of the network are not relevant for the purposes of the calculation of the cap.

Is there a new definition for the term "network" of audit firms?

No, the new rules do not amend the definition under Directive 2006/43/EC. Thus, a network is defined as the larger structure which is aimed at cooperation and to which a statutory auditor or an audit firm belongs, and which is clearly aimed at profit- or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, a common business strategy, the use of a common brand-name or a significant part of professional resources.

IV. Prohibition of non-audit services

Is there a cooling-in period for the provision of non-audit services?

The Regulation provides for a cooling-in period for the provision of non-audit services, i.e. the audit firm cannot provide statutory audit services to its client, where it has provided certain non-audit services one year prior to the period between the beginning of the period audited and the issuing of the audit report. However this applies only with regard to one service - 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. Thus, if an audit firm has provided this service to a PIE, it must refrain from providing statutory audit services to that PIE the following year.

What is the meaning of the expression "*any part in the management or decision-making*" used in Article 5 of the Regulation?

Services that involve taking "*any part in the management or decision-making of the entity*" include working capital management, providing financial information, business process optimisation, cash management, transfer pricing, creating supply chain efficiency and the like.

Is the provision of due diligence services to audit clients allowed?

The Regulation allows the provision of 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 the same line of reasoning, due diligence is also one of the allowed non-audit services and can be provided to audit clients. However, the fees perceived for the provision of these services, as well as other allowed non-audit services, fall within the threshold of 70%.

What does the term "*aggressive tax planning*" mean?

The Commission recommendation on aggressive tax planning of 6 December 2013¹ provides further guidance on how this term is to be interpreted.

How are the terms "*parent undertaking*" and "*controlled undertaking*" to be defined?

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.

¹http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf This Communication has been welcomed by the ECOFIN Council conclusions 14 May 2013, 9549/13, FISC94.

The term "*controlled undertaking*" is defined in point (f) of Article 2(1) of the Transparency Directive 2004/109/EC as any undertaking (i) in which a natural person or legal entity has a majority of the voting rights; or (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; or (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; or (iv) over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control.

The Regulation contains several Member States' options. How do the new rules apply to groups of companies where a PIE has non-PIE subsidiaries in several Member States? Given that Member States may prohibit services other than those listed in the Regulation and that the prohibitions in Article 5 apply to the PIE, its parent undertaking or its controlled undertakings in the EU, which Member States' prohibitions apply to the PIE's subsidiaries – the PIE's home country prohibitions or the subsidiaries'?

In order to determine whether the statutory auditor is allowed to provide certain service to a subsidiary of a PIE, the law of the Member State where the subsidiary is located applies. As an example, if a PIE is located in one Member State and has non-PIEs subsidiaries in other Member States with more prohibited non-audit services, the auditor cannot provide to the non-PIE subsidiaries those additional services that are prohibited under the national laws of these other Member States.

Is the provision of non-audit services to subsidiaries of EU PIEs allowed outside the EU?

In principle, the Regulation prohibits the provision of some non-audit services only within the EU. Thus, Article 5(5) of the Regulation states that for entities incorporated in third countries which are controlled by the audited PIE, the statutory auditor or the members of his/her network are not forbidden to provide non-audit services from the list of prohibited non-audit services. However, the new rules require an assessment on a case by case basis as to whether there is a conflict of interest and whether the independence of the firm might be compromised. If that is the case, auditor or the members of his/her/its network need to take measures to mitigate the risks.

There are certain services the provision of which is considered to affect auditors independence and is incapable of mitigation by any safeguards – such as being involved in the decision-taking of the audited entity and the provision of the services such as bookkeeping and preparing accounting records and financial statements and the 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.

V. Rotation of audit firms

How to calculate the duration of the audit engagement?

The duration of the audit engagement is to be calculated as from the first financial year covered in the audit engagement letter in which the auditor has been appointed for the first time to carry out statutory audits of the PIE.

If a company becomes a PIE and has the same auditor pre and post its PIE status change, does tenure as auditor before it became a PIE count towards the relevant limits?

The requirement to rotate the audit firm applies to PIEs only and the calculation of the duration starts from the moment that the company becomes a PIE. Thus, if a company has had its auditor for a number of years before listing, then the duration of the audit engagement should be calculated as from or the date of the listing.

Is the period set for the mandatory rotation of the audit firm compatible with internal audit partner rotation, which is currently taking place every seven years in the EU?

The compatibility between the internal and the external rotation is ensured as the rotation period for the internal audit partner is shorter than the rotation period for the audit firm. In addition, Member States are allowed to set shorter periods for the external rotation.

Can a Member State that activates the option for the extension of the maximum duration of the audit engagement in case of tendering set a shorter period than 20 years?

Member States can opt for a maximum duration of the audit engagement shorter than 20 years for tendering or 24 years in case of joint audit, as the Regulation states that this is a "maximum duration".

In addition, Member States are allowed to set stricter additional conditions for the carrying out of the tendering procedure. They can require multiple tendering procedures, for instance every 5 years. (10+5+5). However, in order to benefit from the extension of 10 years, the tender should take effect upon expiry of the 10-year initial period.

Is there an obligation to tender for joint audit after the expiry of the 10-year period?

The Regulation allows for the possibility for Member States to extend the maximum duration of the audit tenure up to 24 years, where, after the expiry of the 10-year period, more than one statutory auditor has been engaged by the PIE. There is, however, no obligation to organise a public tender under the requirements set out in the Regulation, in order to benefit from the extension. Thus, where a PIE wishes to maintain its auditor for an additional duration of 14 years, after the expiry of the 10-year initial period, it would be allowed to do so, on the condition that a second auditor or audit firm has been appointed by the PIE.

If a PIE organises a tender that takes effect upon the expiry of the 10-year initial period, can it automatically keep its auditor for additional 10 years?

The possibility to extend the 10-year duration is dependent on the use of one of the two options provided for in the Regulation (10-year extension for organising a public tender and 14-year extension in case of joint audit). If a Member State has not opted for neither of the options,

then PIEs would need to rotate the audit firm after the expiry of the 10-year period, irrespectively of the fact whether they organise a public tender or have made use of joint audit.

What if the audit client has subsidiaries which operate in different jurisdictions (EU and non-EU) which are required to apply different auditor rotation rules?

The Regulation does not have any extraterritorial effects – it applies to PIEs that operate within the EU only. Thus, if a PIE incorporated in the EU has a subsidiary incorporated in a third country, there is no legal obligation upon this PIE to rotate its auditors in this third country, unless the law of the latter states so. However, it could be anticipated as a positive spill-over effect of the reform, that PIEs operating within the EU would also rotate their auditors in third countries for practical and cost-effective reasons.

What is the treatment of branches and subsidiaries in Europe of non-EU PIEs?

Regarding the treatment of subsidiaries of non-EU PIEs and whether they are subject to the requirements of the Regulation, it all depends on whether the subsidiary falls within the definition of a PIE under the Regulation, irrespectively of where the parent company is headquartered.

However, regarding branches of non-EU PIEs, they do not have legal personality, thus do not fall under the scope of the Regulation.

The Regulation states that when organising a tender the PIE shall not preclude from participation in the selection procedure audit firms below a 15% threshold? Does this entail the intention to limit the freedom of the PIE to invite audit firms of their choosing?

The purpose of this requirement is not to limit the freedom of the PIE to invite audit firms to the tendering procedure, but on the contrary – not to restrict the choice of the auditors and to open-up the market for mid-tier audit firms.

VI. Audit report

Which instrument governs the audit report?

The Directive provides a set of requirements regarding all statutory audits, whereas the Regulation provides certain specific auditor reporting requirements for PIEs. The requirements on the audit report established under the Directive are to be transposed into the national legal frameworks. Those requirements will be complemented by those established under the Regulation, in the case of an audit of a PIE.

The fact that the requirements can be found both in the Directive and in the Regulation will not cause some practical difficulties?

No. There is no room for inconsistencies, as Member States are prevented from establishing requirements that would contradict the Regulation. For each audited entity the statutory auditor or audit firm will produce one audit report only, which will have to meet the requirements set out in the Directive and, in case of a PIE, also the requirements set out in the Regulation.

Is there a model or template for the new audit report?

No. Neither the Directive nor the Regulation impose any standardised language for the audit report. It is up to the Member States to define, if appropriate, the way in which the contents of the audit report are to be presented.

vii. International Standards on Auditing (ISAs)

What does the term ISAs cover? Is ISQC1 within the definition? How about the IESBA Code of Ethics?

"The International Auditing Standards" comprise International Standards on Auditing (ISAs), International Standard on Quality Control (ISQC 1) and other related Standards issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB), in so far as they are relevant to the statutory audit. The ISQC1 falls under the definition of "international auditing standards", whereas the IESBA Code of Ethics does not.

In addition, the adoption of non-relevant ISAs, such as for example standards applicable to audits in the public sector, is not envisaged. The ISAs relevant for an EU adoption are those addressing statutory audits of financial statements of private entities as foreseen by the EU *acquis*. However some parts of these relevant ISAs may address or refer to areas beyond the scope of statutory audits, such as audits in the public sector or contractual audits.

How would the ISAs be adopted at EU level?

The amended Directive confers competences on the European Commission to adopt the International Auditing Standards (ISAs) at EU level via delegated acts with the objective of fostering a level playing field for the entire EU audit market and avoiding any possible fragmentation. The possibility of its adoption for the audit of PIEs is also envisaged under the Regulation, as a safeguard to ensure legal soundness and to avoid inconsistencies.

As long as the Commission has not adopted the International Auditing Standards covering the same subject-matter, the national standards, procedures or requirements that are in force in the Member States will remain applicable.

Any possible future decision by the European Commission on this matter will depend on the outcome of the assessment of the ISAs regarding the criteria established by the co-legislators. As provided in the Directive, ISAs can only be adopted if they:

- have been developed with proper due process, public oversight and transparency;
- are generally accepted internationally;
- contribute to a high level of credibility and quality to the annual or consolidated financial statements;
- are conducive to the Union public good; and
- do not amend or supplement any of the requirements contained in the Directive or the Regulation, apart from those specifically mentioned in the texts.

Can Member States impose additional requirements to the ISAs if adopted at EU level?

In addition to the international standards on auditing adopted by the European Commission, Member States may impose "add-ons" only if these stem from specific national legal

requirements or to the extent necessary to increase the credibility and quality of financial statements. They shall communicate them to the Commission before their adoption.

What about the use of ISAs in relation to the statutory audit of small undertakings?

Where a Member State requires the statutory audit of small undertakings, it may provide that the application of the auditing standards is to be proportionate to the scale and complexity of the activities of such undertakings.

VIII. AUDIT COMMITTEE

Do all companies have to establish an audit committee?

The new rules lay down more enhanced requirements regarding audit committees. In principle, each public-interest entity should have an audit committee. However, exemptions from this obligation to have an audit committee may be granted to audited entities that are for instance:

- A small or medium-sized undertaking and the functions of the audit committee are performed by an administrative or supervisory body;
- PIEs with a body performing equivalent functions to an audit committee in accordance with legal provisions in the Member State in which the entity is registered;
- PIEs which are undertakings for collective investment in transferable securities (UCITS) or alternative investment funds.

This exemption takes into account the fact that, where those funds function merely for the purpose of pooling assets, the employment of an audit committee is not appropriate.

What are the requirements imposed to members of an audit committee?

As 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, its independence and technical competence has been reinforced:

- 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;
- a majority of its members shall be independent (instead of 'at least one' in the current statutory audit Directive of 2006). However, where all members of the audit committee are members of the administrative or supervisory body, Member States may provide an exemption from this requirement;
- 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.

What is the new role of the audit committee?

In order to secure the quality of audit, the functions assigned to the audit committee have been extended in various ways. So for example, if the statutory auditor or the audit firm becomes excessively dependent on a single client, the audit committee will be able to decide on the basis of proper grounds whether the statutory auditor or the audit firm may continue to carry out the statutory audit. In addition as role played by the audit committee in the corporate governance is more important than in the past, Member should ensure that competent authorities monitor the performance of audit committees.

The audit committee shall inter alia:

- inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and explain how the statutory auditor contributed to the integrity of the financial statements;
- monitor the financial reporting process and submit recommendations or proposals to ensure its integrity;
- monitor the effectiveness of the internal quality control and risk management system and, where applicable, its internal audit, regarding the financial reporting of the audited entity, without breaching its independence;
- monitor the process of the audit of statutory or consolidated financial statements, in particular, its performance, taking into account any findings and conclusions by the competent authority;
- review and monitor the independence of the statutory auditor, in particular the appropriateness of the provision of non-audit services to the audited entity following an assessment of the threats to independence and the safeguards that can be applied to mitigate or eliminate those threats; and
- be responsible for the procedure for the selection of the statutory auditor or audit firm and shall submit a recommendation to the administrative or supervisory body of the audited entity for the appointment of statutory auditors or audit firms.

Finally, in order to enable the audit committee to fulfil its tasks, communication between the statutory auditor or the audit firm and the audit committee were reinforced. Further to the regular dialogue which should take place during a statutory audit, it is important that the statutory auditor or the audit firm submit to the audit committee an additional and more detailed report on the results of the statutory audit. This additional report should be submitted to the audit committee no later than the audit report.

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