Future of audit in the European Union

VU International scientific conference

15 October 2015

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Building a better working world

Summary of key points of EU audit legislation

Timing

- The legislation stems from a EC Green Paper “Audit policy: lessons from the crisis”, issued in October 2010.
- The legislation came into force on 16 June 2014 and will have full legal effect from 17 June 2016.
- It applies to financial years beginning on or after this date.

Aim of the legislation

According to the EC, key provisions of the legislation seek to reinforce auditor independence, enhance auditor reporting, auditor transparency, strengthen the role of the audit committees, support consistent oversight and contribute to a more dynamic audit market in the EU.

Form of the legislation

- The legislation is in the form of:
  - A Directive – contains a series of requirements governing every statutory audit in the European Union;
  - A Regulation – contains a series of additional requirements that relate only to the statutory audits of Public Interest Entities (“PIE”).

The EU Implementation Process

Member State Optionality and risk of divergence:

- Amended Directive needs to be implemented in local law
- Regulation has instant legal application
- Around 70 Member state options need to be considered
- Reflects the degree of compromise needed to get the legislation adopted in the first place
- Divergence across the EU is unavoidable

Summary of key points of EU audit legislation

PIE impact in EU

- There are roughly 300,000 companies in the EU that are currently required to have a statutory audit. Of these, approximately 30,000 fall within the PIE definition.

The legislation has a number of consequences for PIEs in the EU, incl.:

- A requirement for mandatory audit firm rotation.
- The prohibition of many non-audit services to a PIE and to parts of its group.
- The introduction of an annual cap on non-audit fees for those non-audit services that are not prohibited.
- Significantly changing auditor’s report (also changing in line with new ISA 700 for all audits / not only PIEs), as well as an additional new report to the audit committee.

New regulatory body in EU

- The Regulation establishes a new body, the Committee of European Auditing Oversight Bodies (“CEAOB”) with responsibility for coordinating the activities of the national Regulators.

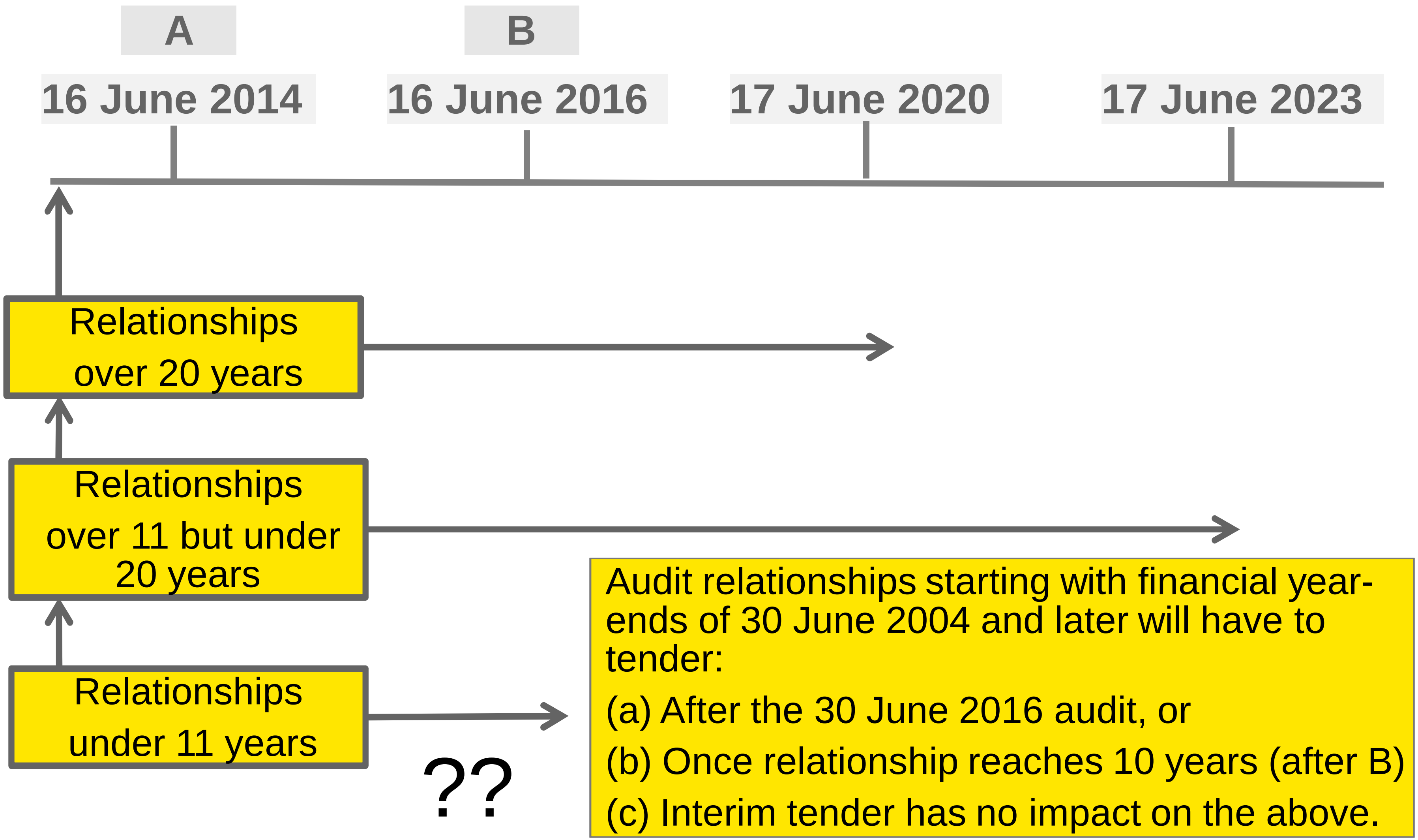
Facilitating EU-wide adoption of International Standards on Auditing (ISAs)

- The legislation empowers the EC to adopt ISAs at the EU level.

PIE definition

- PIE definition:
  a) Companies with shares or securities admitted to trading on an EU regulated market
  b) Credit institutions
  c) Insurance undertakings
  d) Member States may add to the above…

PIE audit firm rotation requirements



Prohibited non-audit services for PIEs – f/y ending 30 June 2017 and beyond

- Period – From the beginning of the period being audited to the issuing of the audit report
- One year earlier for control design and implementation connected with financial reporting

- Provision of **tax services** relating to:
  - Preparation of tax forms,
  - Payroll tax,
  - Customs duties,
  - Identification of public subsidies and tax incentives unless support from the statutory auditor or audit firm in respect of such services is required by law,
  - Support regarding tax inspections by tax authorities unless support from the statutory auditor or audit firm in respect of such inspections is required by law;
  - Calculation of direct and indirect tax and deferred tax;
  - Provision of tax advice.
- **Valuation services**, including valuations performed in connection with actuarial services or litigation support services.
- Services that involve playing any part in the **management or decision-making** of the audited entity.
- **Services linked to the financing, capital structure and allocation, and investment strategy of the audit client**, except providing assurance services in relation to the financial statements, including the provision of comfort letters in connection with prospectuses issued by the audit client.
- **Promoting, dealing in, or underwriting shares in the audited entity.**

Prohibited non-audit services for PIEs – f/y ending on 30 June 2017 and beyond

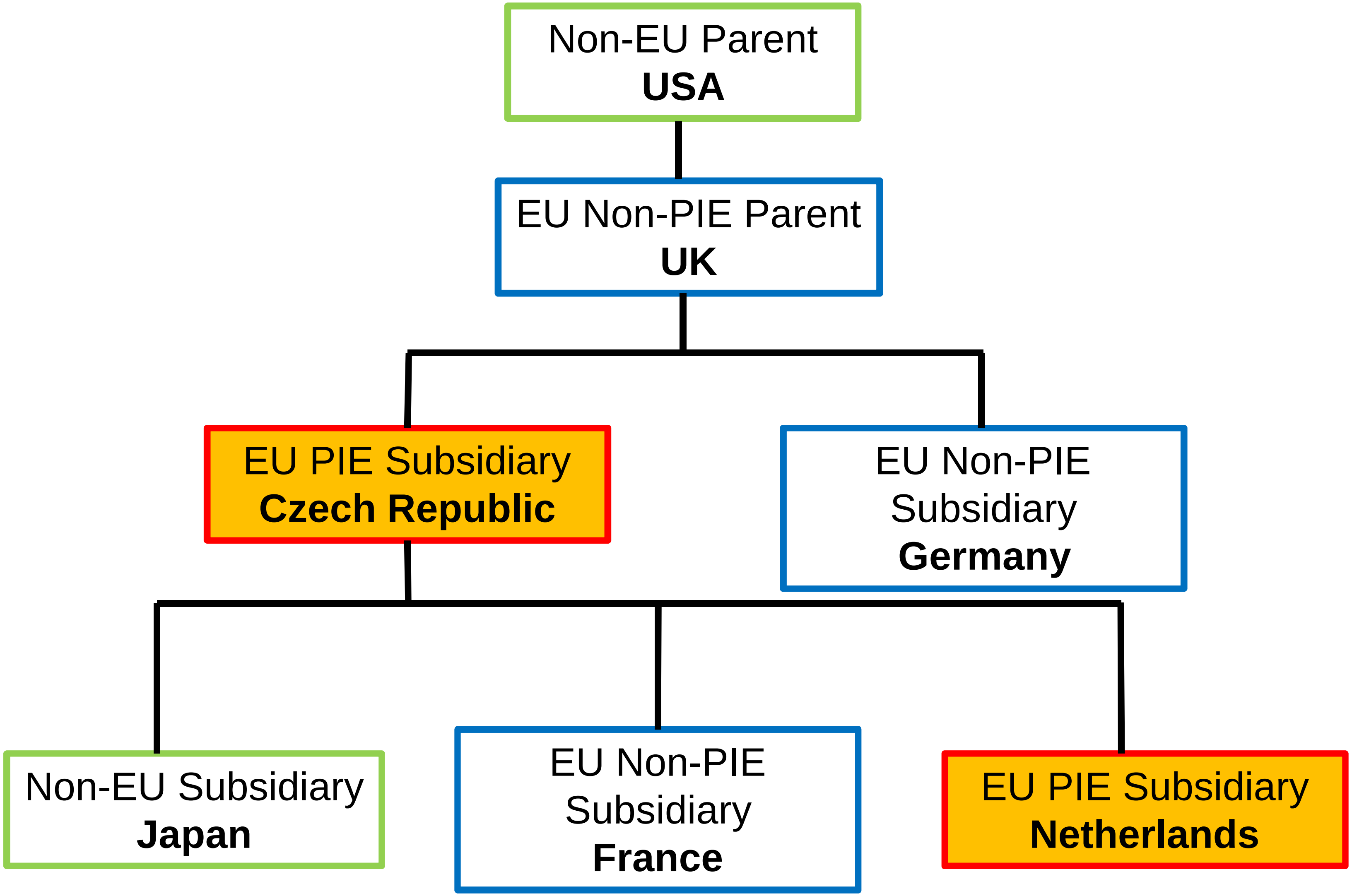
- **Designing and implementing internal control** or risk management procedures related to the preparation and/or control of financial information or financial information technology systems.
- **Bookkeeping** and preparing accounting records and financial statements.
- **Payroll services**
- Services related to the audit client's **internal audit function**.
- **Legal services**, with respect to:
  - The provision of legal advice,
  - Negotiating on behalf of the audit client, or
  - Acting in an advocacy role in the resolution of litigation.
- **Human resources services** with respect to:
  - 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 positions; or
    - Undertaking reference checks of candidates for such positions.
  - Structuring the organisation design and
  - Cost
- **Other services, if the Member State so chooses**

Prohibited non-audit services for PIEs – f/y ending on 30 June 2017 and beyond

Restrictions on non-audit services (NAS)

- **70% cap on fees for non-audit services (NAS)** provided to the audited entity for three consecutive years, based on average group audit fee for the previous three years.
- Expanded list of prohibited services which goes further than either the IESBA code or the SEC rules in places.
- Two of the significant services added on the prohibited list are most tax services and valuation services. Member States have the option to allow those services subject to materiality checks by the audit committee.

Whose law applies?



New auditor's report (for financial reporting periods ending 15 December 2016 and later)

- The aim of amendments – to make the auditor's report more informative and to enhance the value of auditor communication.
- Apart from the increased transparency and informational value, the new auditor's report is expected also to:
  - Enhance communication between the auditor's and investor's as well as those charged with governance.
  - Result in increased attention by management and those charged with governance to those financial statement note disclosures, to which the auditor draws attention in the auditor's report.
  - Help the auditor to freshly look upon matters, to which he wants to draw attention in the auditor's report, thereby possibly adding to increased professional skepticism.

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New auditor’s report

- Main changes – mandatory for listed entity (voluntary for other) audits:
  - New „Key audit matters“ section, – those matters, that in the auditor’s judgment, were most important during the audit / points of highest attention
  - Disclosure of key audit partner

New auditor’s report

- Changes for all auditor’s reports:
  - „Opinion“ section is presented first, followed by the “Basis of opinion” section.
  - Information related to going concern matter:
    - Explanation on management and auditor responsibilities.
    - Separate section (“Uncertainty related to going concern”) in those cases when there exists a material uncertainty, which is adequately disclosed in the financial statements.
    - New requirement to question management’s judgment regarding financial statements disclosures in “close call” situations related to going concern.
  - Prominent affirmation on compliance with requirements for independence and professional ethics.
  - Enhanced description of auditor’s responsibilities and the audit itself.

Market monitoring of Quality & Competition

Starting in June 2016 and every three years thereafter, the European Competition Network and the Oversight Bodies must monitor and assess:

1. Audit Quality deficiencies
2. Market Concentration levels
3. Audit Committee performance
4. Measures to mitigate risks from 1 and 2

Market challenges

Short-term challenges: (from now to mid-2016)

- Interpretational issues
- Transitional regime for audit firm rotation

Medium-term challenges:

- Increased tendering activity
- Effect of divergent legislative frameworks

Longer-term challenges:

- Maintaining audit quality and sustainability of the profession
- Three-yearly European Competition Network reviews
  - What will be the impact on audit market concentration?
  - What will be the impact on audit quality?

Tentative conclusions

The EU legislation has provided an opportunity to the profession to demonstrate its value to the Capital Markets:

- More meaningful auditor reports
- Greater transparency surrounding discussions with audit committees
- Strengthened audit committees
- Two-way dialogue with prudential authorities

But there are significant challenges to be overcome:

- Increased divergence in regulation around the world
- Greater pressure to deliver improved audit quality against a backdrop of regulatory divergence
- The risk of unintended consequences from excessive tendering and NAS restrictions

Questions?

Thank you!

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