THE EUROPEAN AUDIT REFORM

WHAT IS IT & HOW WILL IT IMPACT YOU?

MAZARS

1 LOOKING BACK : WHAT LAUNCHED SUCH A REFORM?

2 WHAT CHANGES DOES THIS REFORM INTRODUCE?

3 JOINT AUDIT…. WHAT IS IT?

4 HOW DOES THIS REFORM IMPACT AMERICAN COMPANIES?

1.1 LOOKING BACK | **WHAT LAUNCHED SUCH A REFORM?**

THE 2008 FINANCIAL CRISIS

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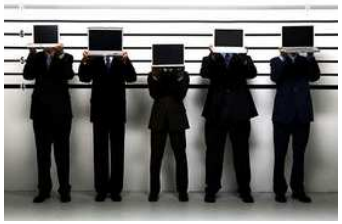
1.2 LOOKING BACK | **WHAT LAUNCHED SUCH A REFORM?**



Who's to blame?

- Banks
- Credit rating agencies
- Hedge funds
- Supervisors or Central banks
- Auditors????

EU Consultation

- Need to open the international audit market
- Need for a more integrated European market
- Need for safeguards to ensure the independence of auditors
- Need for more catalysts

The EU Audit Reform

- The **Directive** 2014/56/EU amends the Directive 2006/43/EC and applies to all statutory audits.
- The **Regulation** (EU) No 537/2014 includes new requirements governing statutory audits of Public Interest Entities (PIEs)

2.1 THE EU AUDIT REFORM | **PRIMARY CHANGES TO COME**

List of prohibited non-audit services | Cap on permitted non-audit services | Increases the role of the Audit Committee | Broader reporting required for PIE auditors | Creation of the EU Audit Oversight Body | Mandatory rotation

1. Tax services
2. Services that involve playing a part in the management or decision making of the audited entity
3. Bookkeeping and preparing accounting records and financial statements
4. Payroll services
5. 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
6. Valuation services
7. Legal services
8. Services related to the audit entity's internal audit function
9. 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
10. Promoting, dealing in or underwriting shares in the audited entity
11. Human resources services

→ **Member States** can add services to the list of prohibited Non-Audit Services if threats to the auditor's independence are identified.

2.2 THE EU AUDIT REFORM | **PRIMARY CHANGES TO COME**

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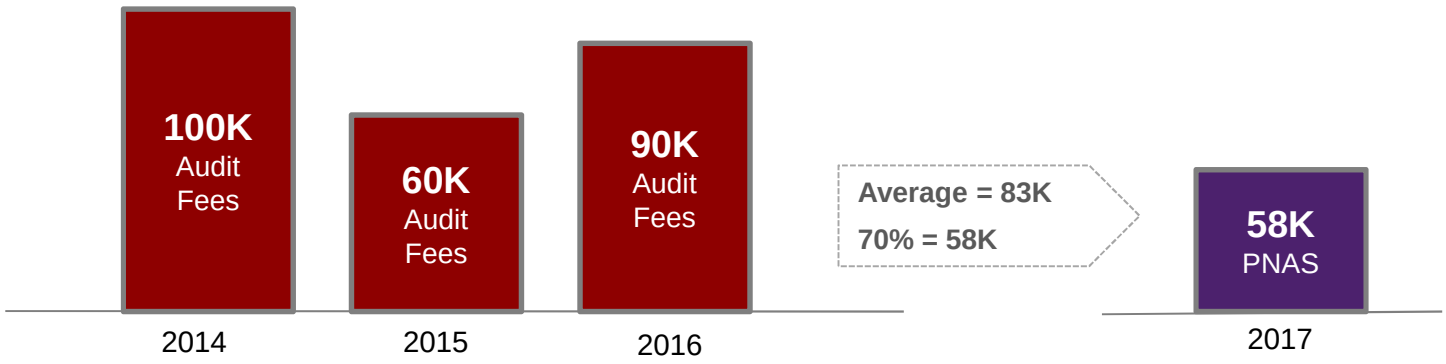
Fees for permitted non-audit services ≤ 70% of the average audit fees over the preceding three years

EXAMPLE



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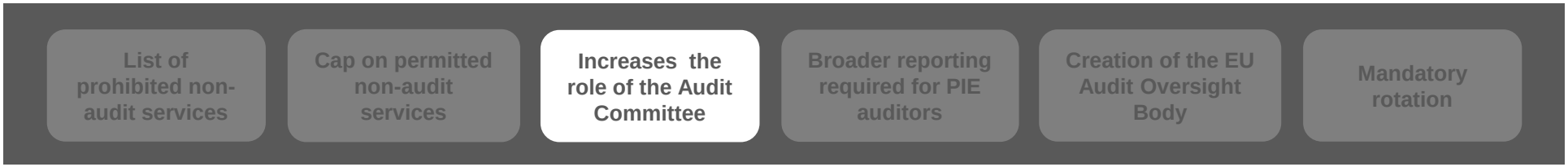
2.3 THE EU AUDIT REFORM | **PRIMARY CHANGES TO COME**



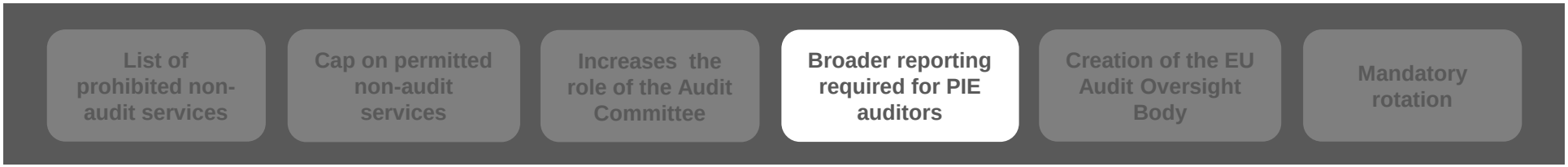
Composition of the Audit Committee's is reinforced by ensuring its members' **independence** and **competencies.**

- Composed of non-executive members
- Competencies relevant to the audited entity
- One member with expertise in accounting and auditing
- Majority of the members shall be independent

The role of the Audit Committee is also expanded…

- Monitoring certain critical management processes
- Overseeing the tendering process and appointment of the Statutory Auditor(s)
- Monitoring the statutory audit
- Communicating with the Board of Directors or Supervisory Board

2.4 THE EU AUDIT REFORM | **PRIMARY CHANGES TO COME**



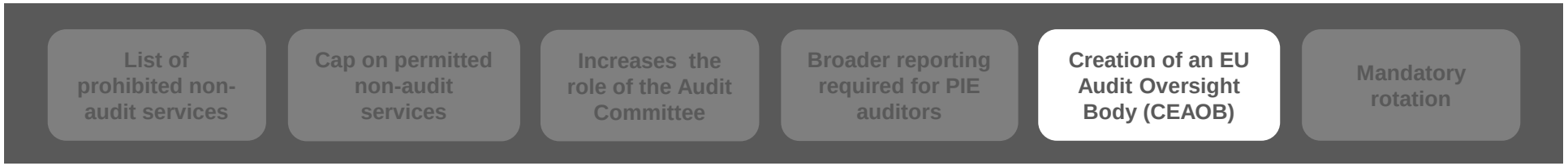
1. **More detailed audit reports to shareholders** in order to promote accountability and transparency.

2. Information relating to their **engagement and their independence, the scope and conduct of their audit**, a commentary on key risks identified and how they have been addressed by the audit.

3. **A specific report to the Audit Committee** before issuing the audit report to shareholders to support their audit opinion.

4. **Report irregularities**, to the company and the relevant Competent Authorities, notably in relation to ongoing concern.

2.5 THE EU AUDIT REFORM | **PRIMARY CHANGES TO COME**



COMMITTEE OF EUROPEAN AUDITING OVERSIGHT BODIES (CEAOB)

1. Facilitate the **exchange of information, ensure expertise and promote best practices**
2. Provide **expert advice to the Competent Authorities**,
3. Contribute to the **technical assessment of public oversight systems of third countries** and to the international cooperation between Member States and third countries.
4. Contribute to the **technical examination of International Standards on Auditing**, including the processes for their development, with a view to their adoption at the EU level;
5. Contribute to the **improvement of the cooperation mechanisms regarding oversight of PIE Audit Firms and their networks;**
6. Carry out **other coordinating tasks** in cases provided in the Regulation.

2.6 THE EU AUDIT REFORM | **PRIMARY CHANGES TO COME**

List of prohibited non-audit services | Cap on permitted non-audit services | Increases the role of the Audit Committee | Broader reporting required for PIE auditors | Creation of the EU Audit Oversight Body | **Mandatory rotation**

OF PARTNERS…

Appointment of Key Audit Partners

7 YEAR MANDATE

Rotation

3 YEAR
COOLING OFF PERIOD

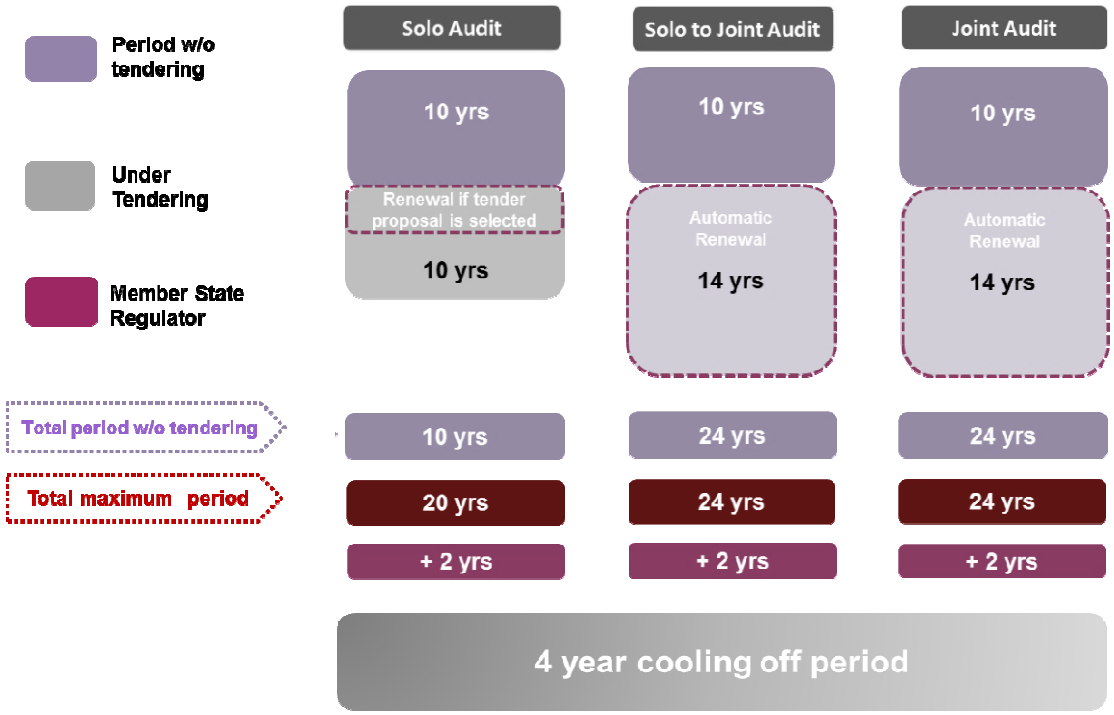
→ **Member States** can also adopt a shorter mandate for key audit partners

2.7 THE EU AUDIT REFORM | **PRIMARY CHANGES TO COME**

List of prohibited non-audit services | Cap on permitted non-audit services | Increases the role of the Audit Committee | Broader reporting required for PIE auditors | Creation of the EU Audit Oversight Body | **Mandatory rotation**

The EU has recognized the merits of Joint Audit by allowing companies practicing this system to keep on their auditors for a longer period without having to tender.

OF AUDIT FIRMS…



→ **Member States** can also adopt stricter rotation schemes

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3.0 JOINT AUDIT | **WHAT IS IT?**

PIE

Audit Firm A

Audit Firm B

One audit opinion

3.1 JOINT AUDIT | THE BENEFITS OF SUCH A SYSTEM

- Enables entities to benefit from the technical expertise of more than one audit firm.
- Increases the technical knowledge base by encouraging a more multi-player audit market.
- Offers additional scope for benchmarking best practice across the market.

Technical knowledge

- Stimulates innovation and awareness.
- Enables smooth and sequenced rotation of audit firms.
- Offers the audited group a broader spectrum of skills and coverage.

Quality

- Reinforces auditor independence.
- Reduces the risk of over-familiarity.
- Reinforces the auditors' ability to stand their ground.
- Promotes a critical eye.

Independence & objectivity

- Enables new entrants into the PIE audit market, encouraging competition.
- Enables the smaller firms to grow.
- Mitigates the risk of the Big 4 becoming the Big 3.

Macro economic policy

3.2 JOINT AUDIT | **DEMYSTIFIED**

1. Will joint audit translate into additional costs for audited companies? NO

- Additional work rarely exceeds 2,5 - 5%
- This additional work is often not charged to the audited company.
- Joint audit creates a more competitive environment that is conducive to a reasonable price/volume balance for the market.
- Additional cost must be compared with the additional security provided by the ‘four eyes principles’ and reciprocal review.

2. Will joint audit will create an additional burden on audited companies? NO

- The scope of the joint audit is well defined from the beginning to avoid any duplication of tasks.
- Additional work ONLY involves coordination meetings between the two auditors to plan the auditors’ responses to the assessed risks, finalizing audit conclusions, and forming an opinion.

3. Will joint audit damage audit quality? NO

- Auditor skepticism can only occurs with the “four eye principal”.

4. Will joint audit restrict the choice of available audit firms? NO

- Joint audit promotes a diverse audit market by providing an incentive for new audit firms to invest in expertise and geographic coverage. A powerful capacity building measure.
- As evidence, after several decades of joint audit in France, the top 250 listed companies are audited by 101 audit firms.
- Companies can still choose a Big 4 as their auditor combined with the expertise of another audit firm.

http://www.mazars.com/Home/Insights/Mazars-welcomes-the-European-Audit-Reform/The-EU-Audit-Reform-An-Encouraging-Step/What-you-need-to-know-about-Joint-Audit

4. IMPACTS OF THE REFORM | DIFFERENCE BETWEEN A DIRECTIVE AND A REGULATION

The European Audit Reform was adopted in June 2014. It is comprised of a Directive which applies to ALL statutory audits and a Regulation applying ONLY to statutory audits of Public Interest Entities (PIEs)

1 **The Directive:**

- One of the key issue to consider is the definition of a PIE. Each of the 28 Member States may expand the definition to include other entities.

2 **The Regulation:**

- Mandatory firm rotation provision, tendering and prohibited non-audit services are some of the many changes previously cited which are included in the regulation.

4. IMPACTS OF THE REFORM | DEFINITION OF A E.U. PIE

THE REFORM AFFECTS PUBLIC INTEREST ENTITIES (PIEs)

The definition of PIE in Europe includes all E.U. entities as follows:

Listed Entities & Entities with Listed Debt
(on a E.U. Stock Exchange)

Entities incorporated in a EU member state with transferable securities (shares or debt) on a regulated market of any member state of the European Union.

Credit Institutions
(whether listed or not)

Undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits on its own account or electronic money institutions.

Insurance Undertakings
(whether listed or not)

The taking up and pursuit of the self-employed activity of direct insurance carried on by insurance undertaking which are either established in a member state or whish to become established there.

4. IMPACTS OF THE REFORM | **ON NON-EU COMPANIES**

Although the EU legislation is primarily aimed at EU entities, the rules will also impact groups based outside of the EU. EU based subsidiaries of non-EU group which meet the definition of an EU PIE will have to comply.

4. IMPACTS OF THE REFORM | **IMPLEMENTATION DEADLINES**

The measure will be implemented progressively to ensure that the market can cope with the new regulation. Transitional arrangements will vary depending on the length of the audit appointment at the date of Entry Into Force (EIF) – June 17, 2014

1

AUDIT ENGAGEMENTS IN PLACE **FOR 20 YEARS** OR MORE ON EIF

May be renewed until June 17, 2020 (6 years after entry into force). After that, mandatory rotation applies.

2

AUDIT ENGAGEMENTS IN PLACE **for 11 YEARS or more, but less than 20 YEARS** ON EIF

May be renewed until June 17, 2023 (9 years after entry into force). After that, mandatory rotation applies.

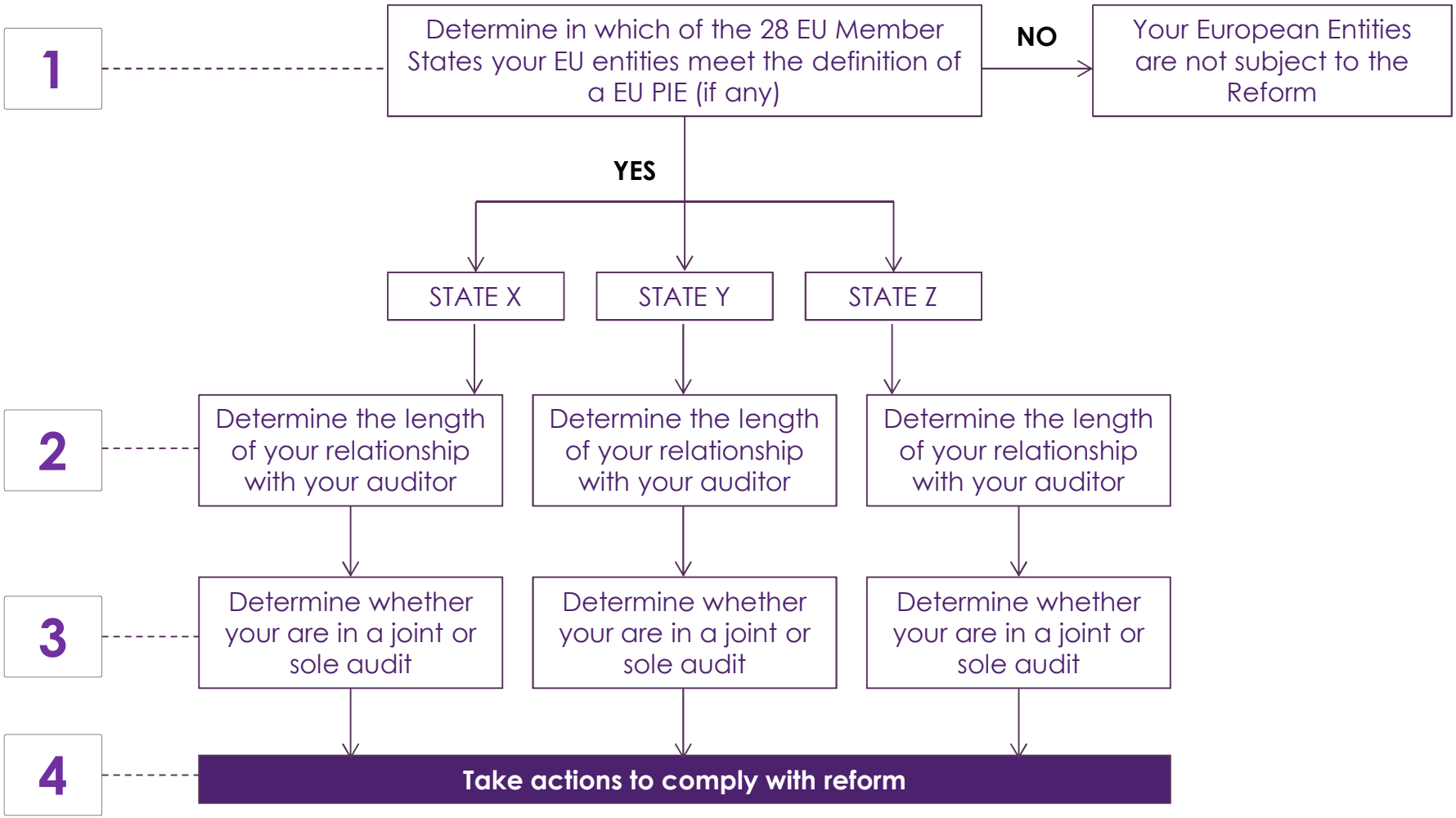
3

AUDIT ENGAGEMENTS IN PLACE **FOR 10 YEARS** OR LESS ON EIF

May continue without tendering until the end of the maximum duration. After that, rotation applies. For Sole audits, an extension to 20 years is possible in the case of a tenders or 24 years if a switch is made to joint audit.

4. IMPACTS OF THE REFORM | ON AMERICAN COMPANIES

IS YOUR COMPANY IMPACTED BY THE REFORM?



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4. IMPACTS OF THE REFORM | CASE STUDY

Case Study – Credit Institution Example

Current Situation

- Global Headquarters in NY
- Listed on the NYSE
- Audited by the same audit firm since the 1970s
- Presence in 25+ countries in Europe
- European subsidiaries audited by the same audit firm as well

European Audit Reform Rule

- The E.U entities of the company meet the definition of a PIE as a credit institution
- The audit firm has been auditing the company in a Sole Audit for more than 20 years on Entry into Force (June 2014)
- The mandate may be renewed until June 2020, after this date, rotation applies.

Consequences for the company

- The transitional period applies to the auditors of this company
- It can renew their audit firm's mandate until 2020. For example, in 2018, the audit firm can be renewed for a new mandate.
- Once renewed, the mandate can go until its term, but it cannot be renewed after 2020
- If the audit firm is renewed in France in 2018, it can stay on as the auditing firm until the end of its 6 years mandate. But in the UK, the end date would be 2020 (1 year mandate).
- The company might want to change its European auditor during the transition period to avoid doing it gradually in every country

4. IMPACTS OF THE REFORM | CASE STUDY

Case Study – Insurance Undertaking Example

Current Situation

- Global Headquarters in NY
- Listed on the NYSE
- Audited by the same audit firm since early 2000s
- Presence in 20 countries in Europe
- European subsidiaries audited by the same audit firm as well

European Audit Reform Rule

- The European entities of the company meets the definition of a PIE as an insurance undertaking
- The audit firm has been auditing the company in a Sole Audit for more than 11 years but less than 20 years on Entry into Force (June 2014)
- The mandate may be renewed until June 2023, after this date, rotation applies.

Consequence for the Company

- The transitional period applies to the auditors of the Company
- It can renew its audit firm mandate until 2023. For example, in 2022, the audit firm can be renewed for a new mandate.
- Once renewed, the mandate can go until its term, but it cannot be renewed after 2023.
- If the audit firm is renewed in France in 2022, it can stay on as the auditing firm until the end of its 6 years mandate. But in the UK, the end date would be 2023 (1 year mandate).
- The company might want to change its European auditor during the transition period to avoid doing it gradually in every country

4. IMPACTS OF THE REFORM | **CASE STUDY**

Case Study – Listed Entity Example

Current Situation

- Global Headquarters in NY
- Common Stock listed on the NYSE, SIX Swiss Exchange and Euronext Paris
- Audited by the same audit firm since the mid 1990s
- Presence in Europe, mostly in the UK
- European subsidiaries audited by the same audit firm firm as well

European Audit Reform Rule

- The company's European entity meets the definition of a PIE as a listed entity as their common stock is listed on the Euronext.
- The audit firm has been auditing the company in a Sole Audit for more than 20 years on Entry into Force (June 2014)
- The mandate may be renewed until June 2020, after this date, rotation applies.

Consequence for the Company

- The transitional period applies to the auditors of the company
- The company can renew its audit firm's mandate until 2020.
- Once renewed, the mandate can go until its term, but it cannot be renewed after 2020.
- EX: If the audit firm is renewed in France in 2019, it can stay on as the auditing firm until the end of its 6 years mandate. But in the UK, the end date would be 2020 (1 year mandate).
- The company might want to change its EU auditor during the transition period to avoid redundancy.

5. CONCLUSION | **KEY TAKEAWAYS**

The national governments of the 28 Member States are to adapt and apply the new legislation (directive and regulation) .

Stakeholders need to begin planning today in order to anticipate the application of the new legislation, which all Member States are required to apply by June 2016. In some instances, certain parts of the legislation still require analysis and interpretation by Member States. Further guidance is expected to be issued by the European Commission as well as by individual regulators.