

EU Audit reform: impacts on Public Interest Entities¹ (PIE) and their Audit Committees (AC)

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In brief

The reform of the EU audit legislation introduced through the Directive 2014/56/EU² and the Regulation (EU) 537/2014³ has been converted into national law and published in the Mémorial on 28 July 2016 (hereafter “the Law”).

The EU audit reform intends to improve the quality of legal audits within the EU, with the implementation of measures which will reinforce the independence of auditors and improve the information given in the audit report, as well as the supervision of the audit profession. This will be particularly the case for the audit of PIE for which a specific report will have to be issued to their AC.

PIE are impacted by this reform and will have to fulfil the new requirements in terms of composition and competences of their AC, which will have to face more duties including more involvement in the monitoring process of auditors from the tendering and the mandatory audit firm rotation to the oversight of the audit performance and the approval of Non-Audit Services (NAS).

A dedicated brochure published in June 2016, prepared with the European Confederation of Director’s Association (ecoDA) and called: “ecoDA - PwC guidance for audit committees” has been issued to guide audit committees through these changes. You can find it here: <http://www.pwc.com/gx/en/services/audit-assurance/publications/eu-audit-reform-legislation.html>.

¹ Public Interest Entities means: (a) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 21 of Article 4 paragraph 1 of Directive 2014/65/EU; (b) credit institutions as defined in point 12 of Article 1 of the law of 5 April 1993 (as amended) related to financial sector, other than the ones defined in article 2 of Directive 2013/36/EU; (c) insurance and reinsurance undertakings as defined under the points 5 and 9 of article 32 paragraph 1 of the law of 7 December 2015 on insurance sector, with the exclusion of undertakings and bodies referred in articles 38, 40 and 42, pension funds referred in point 14 of article 32, paragraph 1, reinsurance captives undertakings referred in point 9 of article 43 of the law of 7 December 2015 on insurance sector.

² 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.

³ 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.

Major changes for public interest entities

Mandatory audit Firm Rotation (MFR)

The general rule is that all PIE in the EU must rotate their auditor after a maximum period of ten years, with the possibility to extend this period once with a further ten years through a tender (or 14 years in case of joint audit). Transition arrangements for this new rule have been foreseen by the legislator depending on the date since when the auditor has been appointed.

New requirements for audit committees (or their equivalent) relating to their oversight of the performance of the audit

With some exceptions (mentioned below), public interest entities should have an Audit Committee (AC), which could be either independent or a committee of the Board or supervisory body of the audited entity.

The AC is composed of non-executive members or members designated by the general meeting, of which at least one person is knowledgeable in audit or accounting. As a general principle, the majority of the AC members are independent from the PIE and so is its president. All AC members are knowledgeable, as a whole, about the activities of the PIE.

In some cases, PIE are exempted from having an Audit Committee (e.g: UCIT, AIF – for more details please refer to Appendix 1 of our “ecoDA - PwC guidance for audit committees”).

The duties of the AC are to:

- inform the Board of the PIE of the outcome of the statutory audit and explain its contribution to the integrity of the financial statements;
- monitor the financial reporting process and submit recommendations to ensure its integrity;
- 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;
- monitor the statutory audit of the annual financial statements, taking into account any findings or conclusions by the regulator, i.e. the CSSF;
- review and monitor the independence of the audit firm, as well as the appropriateness for the provision of permissible non-audit services;
- take charge of the selection procedure of an audit firm and submit its recommendation to the Board.

Additional restrictions on the provision of NAS by the statutory auditor to their PIE audit clients

The legislator has rendered some services incompatible with the audit services; these services are:

- a) tax services relating to payroll tax and custom duties;
- 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) legal services, with respect to: (i) the provision of general counsel, (ii) negotiating on behalf of the audited entity, (iii) acting in an advocacy role in the resolution of litigation;
- g) services related to the audited entity’s internal audit function;
- h) 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;
- i) promoting, dealing in, or underwriting shares in the audited entity;

- j) 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.

Tax (other than the ones mentioned above) and valuation services are authorised in Luxembourg, subject to the following conditions:

- a) the services have no direct or have immaterial effect on the audited financial statements; and
- b) the estimation of the effect is documented and explained in the report made by the auditor to the AC; and
- c) there is no independence issue.

The prohibited list of services above applies also to the EU parent and controlled undertakings of the audited PIE subject to member state options taken.

All other services are allowed, subject to the approval of the AC following an assessment of the threats to independence and the safeguards to mitigate or eliminate those threats.

Additionally, the legislation requires a cap on permissible NAS of 70% of the average fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertakings, its controlled undertakings and of the consolidated financial statements of that group of undertakings. The fee cap applies, however, only to the audit firm in Luxembourg and not to its network firms.

NAS and the related fee cap will have to be monitored by the AC and the NAS will have to be disclosed in the audit report if not done in either the Management Report or the financial statement.

New requirements regarding reporting by the statutory auditor

The auditor's opinion on the financial statements will change from a standardised opinion to a new audit report for PIEs that will provide more transparency and insight on key judgments taken during the audit. It will also provide additional information on the independence of the audit firm.

Auditors will also have to issue an additional report to the AC with comprehensive disclosure on the result of the statutory audit. This report will have to be issued at the latest at the date of the audit report.

Reinforcement of the supervision of the CSSF

The Law introduces a new obligation for the CSSF to monitor developments in the PIE audit market and among others the performance of audit committees and the market concentration levels. A report should be prepared by the CSSF at least every three years.

Sanctions

The CSSF can impose administrative fines and other sanctions to the auditor but also to the members of the Audit Committee and to the Directors of a PIE. The sanctions could be up to EUR 1,000,000 or 5% of the annual turnover for corporates and up to EUR 500,000 for individuals. In addition, the sanction would be published on the CSSF website including in principle the names of the sanctioned persons.

Date of application

The new Law will be effective with an application to the first financial year starting on or after 17 June 2016, except for the mandatory audit firm rotation which is subject to transitional arrangements.

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