PREVIEWING SOME POTENTIAL IMPLICATIONS OF NEW EUROPEAN UNION RULES FOR U.S. AUDITORS

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CURRICULUM: Accounting and Auditing

LEVEL: Basic

DESIGNED FOR: CPAs who work for or with entities impacted by European Union (EU) Directive 2014/56/EU

OBJECTIVES: Summarize and provide examples of several key EU provisions, and offer perspective on their potential impact on U.S. entities

KEY TOPICS: Mandatory audit firm rotation; restriction of non-audit services; use of international auditing standards; reporting requirements; and new PIE audit committee and auditor requirements

PREREQUISITES: None

ADVANCED PREPARATION: None

In June 2016, the European Union (EU) amended a Directive (2014/56/EU) to require its member states to change their statutory audit regulations of public interest entities (PIEs). The EU defines a PIE more broadly than a U.S. public company to include: entities listed on regulated markets and subject to EU member state law; listed and unlisted credit institutions that borrow or lend funds to or from the public; life, non-life or reinsurance insurance firms; and member states-designated entities such as PIEs (e.g., due to their size, nature or number of employees).

Member states can go beyond the Directive requirements. Upon summarizing and providing examples of several key EU provisions, we provide some perspective on their potential impact on U.S. entities.

Deloitte (2015) reports that, of the approximately 300,000 EU companies that must have statutory audits, about 30,000 fall within the PIE definition. U.S. companies with EU operations should also evaluate the impact of the new rules, because multinational entities often contain at least one EU PIE and many companies seek to keep one worldwide auditor. Directive 2014/56/EU also impacts European entities with U.S. operations, because their U.S. subsidiaries should understand the parent company's audit requirements.

Brief Summary of the New EU Framework

With their roots in the Sarbanes-Oxley Act (SOX) (2002), the new EU rules (EC, 2016) require all audit firms and statutory auditors to do the following:

- Introduce more robust independence requirements by cultivating higher quality organizational requirements for audit firms and statutory auditors;
- Provide investors with more informative audit reports that outline pertinent information regarding the entity being audited;[1]
- Bolster the powers and competences of the competent authorities [e.g., the equivalents of the U.S. Securities and Exchange Commission (SEC) or Public Company Accounting Oversight Board (PCAOB)] tasked with public oversight of the audit profession; and

- Reaffirm the European Commission's (EC's) ability to adopt ISAs at the EU level.

As summarized in Exhibit 1, Directive 2014/56/EU:
- Transforms the audit role to one of statutory inspection;
- Requires mandatory audit firm rotation or audit tendering (allowing the current auditor to bid for audit renewal) and restricts bidders on becoming the new auditors;
- Limits the auditing firm from providing non-audit services (NAS) to audit clients;
- Mandates applicable international auditing standards; and
- Expands auditor and independent audit committee reporting and other responsibilities.

EU member countries should develop local statutory inspections for PIEs with regulatory sanctions that include imposing restrictions or conditions, assessing regulatory penalties (fines), and suspending or withdrawing audit registration. Below, we analyze how these requirements will apply to auditors both in the EU and around the world and discuss some potential implications for U.S. practitioners.

Mandatory Audit Firm Rotation

Despite different levels of local competition and industry expertise, extended relationships between audit firms and their clients may threaten independence and professional skepticism. Effective June 17, 2017, PIEs must rotate their external audit firm every 10 years, which member states can extend by 10 years if the PIE undertakes a tender (20-year rotation), or by 14 years (24-year rotation) if, upon shareholder approval, the PIE contracts with more than one audit firm (joint audit). A tender refers to a PIE's audit committee-managed public bidding process, with transparent audit firm selection criteria and a clearly articulated nature of the audit. Mandatory audit firm rotation seeks to reduce the negative impact of an extended relationship between an audit firm and its client and thereby improve audit quality (EC, 2016).

Directive 2014/56/EU does not change mandatory audit partner rotation standards – the EU uses an up-to-seven-year rotation, compared to the SEC's current five years. But the amended directive mandates a three-year cooling-off period for audit partners (compared to the SEC's one-year period), increasing the 2006 two-year Federation of European Accountants (FEE) requirements (2014).

Mandatory auditor rotation, coupled with joint audits, tendering and restricting NAS, all seek to broaden

EXHIBIT 1
Comparing New EU and Current U.S. PCAOB Audit Rules

Issue	New EU Rules (2016)	Current PCAOB Rules
Statutory inspection of audit firms	Countries should develop local statutory inspections for PIEs with regulatory sanctions that include imposing restrictions or conditions, assessing regulatory penalties (fines), and suspending or withdrawing audit registration	Publicly listed companies should follow PCAOB regulations
Mandatory audit firm rotation or audit tendering; restriction on who can bid	Audit firms should rotate every 10-20 years, after which the PIE can invite bids from firms that received under 15% of total audit fees from a PIE	Audit firm rotation not required
Restricts audit firm from providing non-audit services (NAS)	Expand list of prohibited NAS and cap fees of such services to 70% of the average of group statutory audit fees over previous three years	Prohibit listed NAS and disclose fees for audit firm-provided NAS
Mandates applicable international auditing standards	Should use International Auditing Standards (IAS) for all audits	Should use PCAOB Auditing Standards
Expanded auditor and independent audit committee reporting and other responsibilities	Auditors should report key risk areas of material misstatements, explain how financial statement irregularities were detected and make other related disclosures	Auditor reports must now disclose critical audit matters and other relevant, material items (Reinstein, Hepp and Weirich, 2018)

the concentrated EU audit market and disrupt the Big Four's domination of the EU audit markets, allowing small and mid-size firms to pursue new audit clients. Opponents of audit firm rotation argue that mandatory rotation could drastically increase audit costs by reducing competition and increasing audit firms' initial investments in such areas as understanding the risks, business processes, IT systems and other aspects of their new, complex audit clients (Arruñada and Paz-Ares, 1997).

Restriction of Non-Audit Services (NAS)

The Statutory Audit Directive of 2006 includes minimum requirements that forbid statutory auditors from providing certain NAS to audit clients, which are intended to promote consistency across member states (EC, 2010). Such prohibited NAS services should promote auditor independence in fact and appearance (Ratzinger-Sakel and Schönberger, 2015).

To reduce threats to auditor independence, the 2016 Directive, similar to SOX, lists forbidden NAS. This "blacklist" includes many tax and valuation services; services that affect any part of the management or decision-making process; services involved in promoting, dealing in or underwriting stock activities; legal services as a client advocate; and internal control design and implementation services connected with financial reporting. Member states can deviate from this blacklist to allow auditors to provide certain immaterial services.

Besides listing forbidden NAS for audit clients, the Directive caps the amount of total NAS fees at 70 percent of the average of group statutory audit fees over the prior three years. The cap does not apply to permissible NAS provided by members of the statutory audit firm's network. The EU fee caps will also likely limit the total NAS that SOX permits U.S. firms to perform in the EU, thus preventing firms from pricing audits as "loss leaders" to earn large non-audit fees (Thakrar, 2015).

The new NAS rules will likely affect large and small firms differently.

Mao, Qi and Xu (2017) found that firms located in regions with more developed credit market and legal environments will more likely hire members of the statutory audit firm's network than nonmembers; also, despite similar audit quality, non-Big Four member-auditors charge 3.9 percent higher fees than nonmember firms. Thus, the new NAS rules will likely affect large and small firms differently, depending largely with the market environment.

Reaffirmation of International Auditing Standards' Usage

Directive 2014/56/EU empowers the EC to mandate using International Standards on Auditing (ISAs) for all EU statutory audits. ISAs now largely converge with the American Institute of CPA's (AICPA's) Clarified Statements on Auditing Standards that govern U.S. nonissuers.[2] The competent authority in each member state should consider an entity's scale and complexity to determine the applicability of ISAs, as in auditing an international company's total pension liabilities.[3] Again, member states may add further audit requirements considering national cultures and legal requirements.

Because ISAs are developed with proper due process, public oversight and transparency, global entities generally accept their results (EC, 2016). The 2016 Directive's new sanctions should increase the accountability of global audit firms, especially because many firms belong to international networks, whose clients often join international groups. To ensure compliance, the Directive (EC, 2016) mandates member states' minimum requirements in developing measures (e.g., sanctions criteria) to punish auditors, audit committees and other violators.

U.S. auditors should also consider the Directive's contents. Then-PCAOB member Franzel (2016, p. 45) urged PCAOB "to require large auditing firms to produce a public annual report incorporating information about firm structure, client lists, independence practices, financial information and the effectiveness of the firm's control systems, similar to what is required by the European Union's Eighth Directive." PCAOB may well issue standards akin to Directive 2014/56/EU and AICPA's ASB may even follow suit for nonissuer audit clients.

Expanded Reporting Requirements

Both Directive 2014/56/EU and the related Regulation (EU) No 537/2014 dictate the audit report's content, distinguishing PIE from non-PIE audit reports. For example, the regulation requires PIE statutory audits to report key risk areas of material misstatement in the consolidated and annual financial statements and explain how they detected financial statement irregularities. Enhancing the information reported should help narrow auditing's "expectation gap" (EC, 2016). Overall, audit firms must now:

- Disclose the entity that retained them;
- Indicate the appointment date and period of uninterrupted engagement, including renewals and reappointments;
- Disclose key assessed fraud and non-fraud risks and responses to assessed risks;
- Confirm that the audit opinion is consistent with the separate required reporting to the audit committee;
- Attest that they performed no prohibited NAS and disclose all permissible NAS performed; and
- Provide an overall audit opinion.

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New PIE Audit Committee and Auditor Requirements

The Statutory Audit Directive (2006/43/EC) required PIEs to have audit committees to minimize compliance, operational and financial risks, and to create more effective systems of internal control. The Directive requires increased levels of communication between the auditor and the audit committee, using a separate report to the audit committee to explain the outcome, overall methodology, significant internal control deficiencies noted and the valuation methods applied throughout the audit. Traditionally, this additional report is not disclosed publicly, but the audit committee can disclose it if prompted by national law (EC, 2016).

> **The Directive requires increased levels of communication between the auditor and the audit committee.**

The EU Directive expanded the audit committee's roles and responsibilities for financial oversight to include monitoring:

- Financial reporting processes;
- Audited financial reports;
- Financial reporting integrity; and
- Effectiveness of internal quality control, risk management systems and the internal audit function.

Specifically, except for certain special investment entities and subsidiaries, PIEs' audit committees should:

- Contain some nonexecutive members with auditing or accounting competence;
- Understand their company's business sector;
- Have most audit committee members be independent of the PIE; and
- Have the committee members or the auditee's supervisory body appoint the chair (Deloitte, 2015).

PIEs' audit committees must follow mandated procedures to select new auditors. These include:

- Inviting bids from audit firms that received below 15 percent of total audit fees from a PIE in the prior calendar year;
- Documenting the negotiation and selection of potential audit firms;
- Checking that bidders comply with the quality standards outlined in tender documents that follow EU or national laws; and
- Showing (upon request) the competent authorities that it completed the selection procedure fairly and unbiasedly (Grant Thornton, 2016).

Auditors must now explain the statutory audit results in a report to the audit committee that:

- Declares their independence from the client;
- Identifies all key audit partners involved;
- Notes the nature, frequency and extent of communication with the committee and management, including all meeting dates;
- Describes the scope and timing of the audit and the methodology used;
- Discloses the quantitative level of materiality applied to financial statement statutory audits and the bases for materiality decisions;
- Reports significant deficiencies in the audited entity's financial statements, actual or suspected noncompliance with laws and regulations, plus assesses the valuation methods applied to various items in the annual financial statements;
- Indicates whether the client provided all requested explanations and documents; and
- Discloses any significant difficulties or other significant matters that arose in performing the audit.

Mandates, Purpose and Questions

The new EU directive mandates audit firm rotation, restricts NAS, prescribes compliance with international auditing standards, expands auditor reporting requirements and requires PIEs to establish independent audit committees with expanded responsibilities. These provisions seek to increase investors' confidence, enhance the public's perception of audit firm independence and improve audit quality.

The Directive raises several questions: What will the implementation costs be? Will larger audit firms compete for audits that smaller firms previously conducted? Will audit firm rotation lead to increased audit fees, with qualified auditors moving to new engagements prior to rotating off an engagement? And, perhaps most importantly for U.S. auditors, will the EU's stricter requirements flow through to the U.S. via PCAOB or AICPA? These questions will only be answered with further experience and research.

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Footnotes

[1] These reports should go beyond the typical standardized financial statement opinions.

[2] https://www.aicpa.org/research/standards/auditattest/sas.html

[3] ISAs are in harmony with the AICPA-issued Clarified Statements on Auditing Standards (https://www.aicpa.org/research/standards/auditattest/clarifiedsas.html), but do not correspond to Auditing Standards issued by PCAOB (https://pcaobus.org/Standards/Auditing/Pages/default.aspx)

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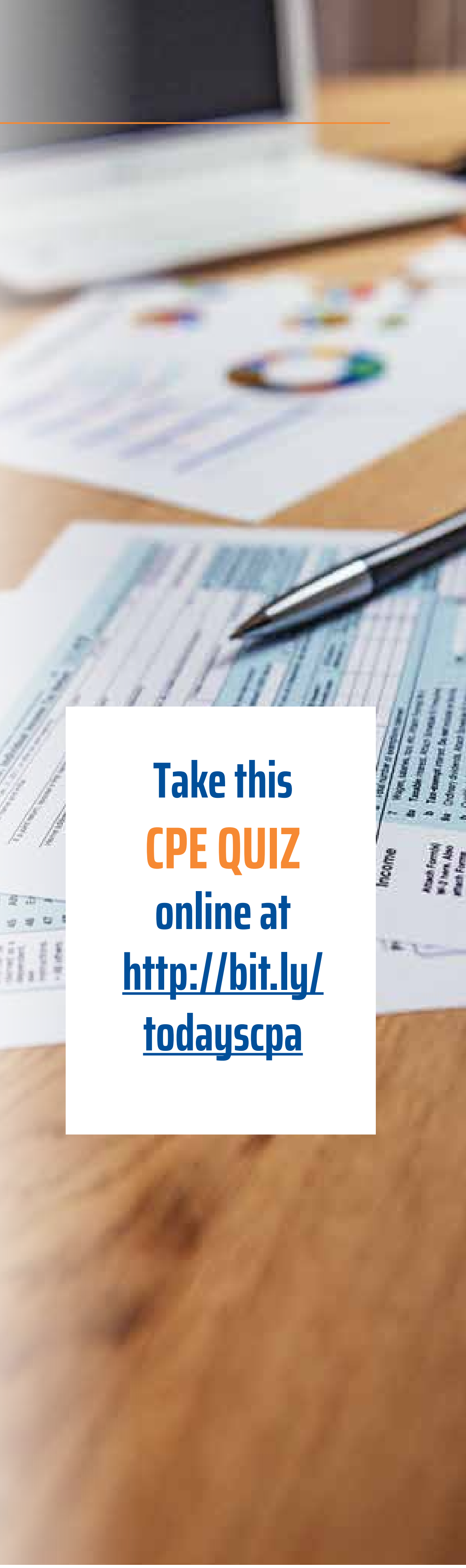

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