



New audit legislation for Public Interest Entities (PIE's) – Key issues for the Audit Committee (AC)

The purpose of this guide is to highlight the key issues for the AC and present DI's general recommendations. DI strongly recommend that the AC discuss the implications of the new legislation and put in place appropriate procedures based on the specific needs of the company.

Key areas of the new legislation

New regulation governing selected parts of the audit of PIE's effective from financial years starting 17th June, 2016 or later:

- ⊕ Mandatory audit firm rotation
- ⊕ Stricter independence regime with 70% CAP on non-audit services and a list of prohibited services
- ⊕ Increased reporting in the Auditors Report – Key Audit Matters to be included

Changes in Audit Directive implemented in local legislation. Effective date differs, but generally same effective date as the regulation:

- ⊕ New requirements on the composition of the Audit Committee (AC)
- ⊕ Mandated responsibility of AC for ensuring Auditor independence especially regarding non-audit services and for over-seeing the tendering process for auditors
- ⊕ Increased sanctions regime

Implementation in Danish Legislation (Revisorloven or RL) has taken advantage of most of the member state options.

PIE-definition

The definition of PIE's has been limited to listed entities, credit institutions and insurance undertakings. Large, unlisted entities are no longer considered PIE's.

Composition of the Audit Committee

The rules are laid out in RL § 31 and are effective from the first general assembly after 31st December 2016.

For PIE's the Supervisory Board (Board) has to decide whether

- 1) The full board should assume all the responsibilities of the AC.
Requirement: No executive directors may be members of the Board. Also possible for small PIE's
- 2) The AC should be a subset of the Board, or Requirements:
 - a) One member shall have competence in accounting and/or auditing (unchanged) ...
 - b) The AC as a whole shall have competence relevant to the sector in which the company is operating
- 3) The AC should include members elected directly at the general assembly and not part of the Board.
Requirements: Same as option 2 plus a majority of the AC including the AC chair shall be independent.

Stricter independence regime – The AC needs to make their own assessment of auditor’s independence

Three layers of independence

	Level I: 70% CAP	Level II: Prohibited services “The Black List”	Level III: General independence
Coverage on auditor side	Auditor + Audit firm	Auditor + Audit firm Audit network	Auditor + Audit firm Audit network Their integrated business partners
Coverage on company side	PIE entity It’s parent undertaking It’s subsidiaries GLOBAL	PIE entity It’s parent undertaking It’s subsidiaries BUT ONLY IN THE EU	PIE entity It’s parent undertaking It’s subsidiaries GLOBAL
Rules:	Non-audit services (NAS) may not exceed 70% of the average audit fees for the past three years provided to the above companies (including the audit of the group financial statement). NAS required by EU or local legislation is excluded from the 70% limit calculation.	No provision of the prohibited services allowed (no de-minimis) directly or indirectly in the period between the beginning of the period audited and the issuing of the audit report. Assuming management responsibility and designing/implementing internal control or risk management procedures is never acceptable and requires one extra year of cooling-in. DK allows certain valuation and tax services, but not the calculation of direct/indirect tax.	For services provided outside the EU, the AC needs to access whether this will endanger the independence of the auditors. Decision should respect general Danish independence requirements as well as local independence requirements. Independence is always breached by providing services related to bookkeeping and preparing accounting records and financial statements as well as the services subject to the extra year of cooling-in. There are no safeguards available.
AC responsibility	The AC is formally responsible for approving all non-audit services provided by the auditor, to ensure compliance to the 70% CAP and also to assess threats to auditor independence. Violations at subsidiary or parent level impact independence of group/PIE-auditor.		

Recommendation 1: DI recommends option 2 and option 1 for less complicated entities.

DI’s key concern on option 3 is the issue around the responsibility of the supervisory board and ensuring full transparency between the Board and its subcommittees. In our view the solution in RL § 31, 2 does not resolve the issue.

Prohibited services allowed by Denmark

Guidance on the details of the list is expected to be published by the authorities later this year. The services can be provided if

- i) the principles of independence are complied with by the audit firm; and

- ii) the service has no direct or has an immaterial effect, separately or in the aggregate, on the audited financial Statements.

The estimation of the effect on the audited financial statements has to be comprehensively documented and explained in the additional report to the audit committee. The AC can make use of the principles in ISA 320 (audit standard) when evaluating materiality.

Deliveries from the auditor

The statutory auditor shall confirm annually in writing, to the AC that the statutory auditor, the audit firm and partners, senior managers and managers conducting the statutory audit are independent from the audited entity.

Recommendation 2: The AC should require the auditor to provide at least bi-annually fee estimates for non-audit services, including expected/started services, from all audit firms potentially qualified for conducting the audit. Services should be specified in accordance with the list of prohibited services. (Needed also for the tendering process)

Recommendation 3: The AC should require the statutory auditor to provide a list of services the statutory auditor believes is acceptable under the country specific implementation of the regulation and does not endanger independence.

Note that the lists differ in the detail from audit firm to audit firm, so the AC needs to make their own assessment.

For services provided to non-PIE's and third country subsidiaries/parent, the PIE-auditor needs to justify that such provision of services does not affect the professional judgement and the audit report and inform the AC about their assessment.

Monitoring independence

Recommendation 4: AC should formulate an approval policy, delegating decisions within a threshold to the management (catering for the 70% CAP). The approval policy should cover both the statutory auditor (prohibitions) and other auditors as certain non-audit services may endanger independence at the time of tendering. A review of the engagement letter should only be needed for bigger assignments.

Recommendation 5: The AC secretariat or Group Accounting should make an in-house assessment of the Group auditor and their international network in all areas, preparing the AC for their assessment.

Recommendation 6: The PIE entity should track non-audit services provided from ALL audit firms potentially qualifying for the group audit in order to continuously assess the independence of the auditors according to the guidelines set-out by the AC. The tracking should include the PIE and its subsidiaries. Parent entity should also report to the PIE. The entity may not limit focus to Big 4 by automation. Ongoing monitoring is needed to ensure flexibility.

Recommendation 7: Reporting to AC should be at least bi-annual. Reporting should include the 70% CAP and more frequent reporting may be needed if close to the 70% CAP.

For level III independence the AC needs to approve the assessment made by management, especially for

services prohibited in Europe. The IESBA Code of Ethics can be used as an international benchmark, but is not directly mandated in the law.

Mandatory Firm Rotation

No audit firm can audit the same PIE for more than 20 years (provided a tender has been conducted after 10 years). For joint audits the period can be extended to 24 years. The 10 years are calculated from auditors first appointment for the PIE (periods as non-PIE doesn't count against this period). The rules concerning Audit partner rotation after 7 years with 3 years cooling off still apply.

AC is responsible for the tendering procedure. Detailed rules are laid out in the regulation art 16 and should involve the choice of at least two audit firms.

For extension/renewal between the 10-years' brackets, a simplified evaluation and re-approval procedure can be followed. For the extension there is no need for a second option.

The tendering / extension procedure can be illustrated like this:

Timeline	Requirement
Year 0 – Appointment of auditor	Appointment = Tendering
Year 1 – 9- Extension of audit engagement (partner rotation after max 7 years)	Extension = Simplified evaluation and reapproval
Year 10 – Appointment/Re-appointment of auditor	Appointment/Reappointment = Tendering
Year 11 – 19 Extension of audit engagement (partner rotation after max 7 years)	Extension = Simplified evaluation and reapproval
Year 20 – Appointment of auditor	Appointment = Tendering

Recommendation 8: The AC should ensure keeping appropriate flexibility when tendering. It is therefore important to consider which audit firms should be independent before meeting the tendering requirement.

Recommendation 9: The AC should reflect on whether they need to be able to disengage quickly from non-audit services with another audit firm, if urgent need for a change in statutory auditors arises. Continuous monitoring of services in recommendation 6 supports this.

Increased reporting in the Auditors' Report

First mandatory reports expected in 2nd half of 2017 (Companies with financial years starting 1/7-16), but the bulk is expected in first quarter 2018.

The major change is a new section entitled "Key Audit Matters" to be included. This section should describe the most significant assessed risk of material misstatement, including risks due to fraud; summarize the auditor's response; and where relevant, provide key observations arising with respect to those risks. UK experience shows an impact on management commentary.

Even though the Audit Opinion (including Key Audit Matters) is in principle the responsibility of the auditor, the AC should question audit reports with an excess amount of Key Audit Matters. Tentative discussions at the IAASB Board during their discussions on the International Standard on Auditing introducing a similar requirement indicated that 2–10 Key Audit Matters would be the normal interval. Note that the auditor is not expected to give conclusions on each item.

Recommendation 10: AC should require the auditor to deliver a draft audit report this year in order for the AC to be able to discuss and understand the implications.

Sanctions

The sanctions regime for AC's has been strengthened significantly.

In case of misconduct or violation of the set requirements, members of the AC can be

- ⇒ Fined with a fine of up to 300.000 DKK and/or
- ⇒ Have the ability to serve as management, member of the Board or member of the Audit Committee of a PIE withdrawn for up to 3 years.

The Disciplinary Tribunal for Auditors is deciding these sanctions, and as a consequence two experts with personal experience as management, member of the Board or member of the AC of a PIE will be nominated to the Disciplinary Tribunal.

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