



EU Audit Legislation in Germany



April 2016



From June 2016 onwards important changes driven by EU Audit legislation will start to come into effect impacting audit firms and public interest entities (PIEs). This document summarizes a number of key EU baseline measures and how these have been incorporated into German law. Please note this does not cover all aspects of the EU [Directive](#) or the [Regulation](#).

Should you have any questions, please consult your usual KPMG contact.



A reminder of the key EU baseline provisions

The key changes introduced by the EU Audit legislation are:

- **Mandatory Audit Firm Rotation (MFR):** A requirement for auditors of a PIE to rotate every ten years with a Member State option to extend audit firm tenure for either a tender or joint audit arrangement.
- **Non-Audit Services Prohibitions (NAS):** A list of prohibitions that apply to services provided by the statutory auditor and its network, in respect of services provided to the audited entity, its parent undertaking or controlled entities, based in the EU. The NAS provisions do not apply to sister entities of the EU PIE unless they themselves are EU PIEs.
- **NAS Fee Caps:** The introduction of a 70% cap on NAS fees as a percentage of the average of the audit fees for the previous three years.
- **Auditor reporting:** Introduces additional reporting requirements for the statutory auditor of EU PIEs covering the statutory audit report, audit committee reporting and reporting to supervisory bodies of PIEs.



Germany– recent developments



- There have been two legislative initiatives to implement EU audit reform legislation in Germany as follows:
 1. The reform of the auditor oversight system and professional law – voted in German Parliament in December 2015 and published in the Official Gazette on 5 April 2016; and
 2. The implementation of all other aspects of the EU audit legislation, including member state options on MFR and on the permissibility of tax and valuation services – voted in the German Parliament in mid March 2016.

The vote in the German Parliament usually marks the end of the debate on the contents of the legislation. Once the second legislative initiative has also been signed by the German President and published in the official gazette, this part of the legislations will be final. This is expected to take place before the application date of the EU audit legislation, 17 June 2016.

Germany has taken a two tier approach to MFR meaning that:

- Banks and insurance companies are only granted a ten year rotation period without the option to extend.
- All other PIEs can apply the option to extend* by means of a tender or joint audit.
- Regarding the prohibited list of non-audit services, Germany grants all tax services and valuation services permissible under Art. 5 of the Regulation. However, there is a specific provision in German law that defines the materiality of tax services with the aim to ban aggressive tax planning services.
- Both German legislative texts are due to come into force on 17 June 2016.

*: *As permitted under Article 17, paragraph 4 of the Regulation*



 EU Baseline	 Germany	What does this mean in practice?
<p>The EU PIE definition is unchanged from the 2006 Statutory Audit Directive (the 8th Directive) however, the practical impact of being a PIE is broader than previously. The EU new directive defines a PIE as any entity incorporated in an EU Member State with:</p> <ol style="list-style-type: none"> 1. debt or shares admitted to trading on an EU regulated market; or 2. credit institutions (e.g. non-listed and licenced under regulation to take deposits in the EU); or 3. insurance undertakings (e.g. non-listed regulated insurance activities, irrespective of whether they are life, non-life or reinsurance undertakings); or 4. entities designated by local Member States to be of public interest. 	<p>The German legislation implements the EU baseline definition of PIEs.</p> <p>Please note however, that there is no central definition of a PIE in the German legislation, and the legal definition is spread over a number of individual provisions in various laws.</p> <p>In Germany, a change of scope results from the inclusion of non-listed banks and insurance companies, which were not previously subject to PIE requirements. This change is triggered by the deletion of the member state option in article 39 of the old 2006 EU audit directive.</p>	<p>Due to the inclusion of non-listed banks and insurance companies, it is estimated that the number of PIEs in Germany will increase from approx. 770 entities to 1,600 entities.</p>
<p>Statutory auditors of a PIE are required to:</p> <ul style="list-style-type: none"> ➤ Rotate at least every 10 years (subject to a Member State option); ➤ With a Member State option to extend audit firm tenure to: <ul style="list-style-type: none"> - a maximum of 20 years (subject to a public tender process being held after 10 years); or - a maximum of 24 years (subject to a joint audit arrangement). 	<p>Germany has taken a two tier approach to MFR meaning that:</p> <ul style="list-style-type: none"> ➤ The standard MFR period for all PIEs will be 10 years. ➤ Banks and insurance companies cannot extend audit firm tenures beyond the initial 10 years. ➤ All other PIEs are granted the option to extend for a further 10 years via a tender or a further 14 years for a joint audit. 	<p>The shorter rotation period for banks and insurance companies are likely to result into more frequent changes of audit firms in the financial sector. It may also have effects on industry groups which have banks and insurance companies as subsidiaries.</p>
<p>When the start of the first financial year of the audit engagement is:</p> <ul style="list-style-type: none"> ➤ On or before 16 June 1994, a PIE cannot renew or enter into an audit engagement with the auditor for the financial year beginning on or after 17 June 2020. ➤ Between 17 June 1994 and 16 June 2003, a PIE cannot renew or enter into an audit engagement for the financial year beginning on or after 17 June 2023. ➤ Between 17 June 2003 and 16 June 2006: PIEs need to conduct a tender and reappoint the existing auditors or appoint new auditors so that the new audit engagement takes effect for the next financial year beginning after 16 June 2016. Member States will determine whether an audit straddling 17 June 2016 could be completed. ➤ For audits commencing 17 June 2006 onwards, when an audit engagement reaches a maximum duration of 10 years since first appointed, the auditor can not be reappointed other than on the basis of a tender or joint audit. 	<ul style="list-style-type: none"> ➤ The MFR transition periods are aligned with the EU baseline. ➤ In German legislation, there is a specific transitory provision to address auditors who were appointed in the period between 17 June 2003 and 16 June 2006, and are still auditors as at June 2016. It reconfirms the earlier EC interpretation that tendering is needed for the financial year starting on or after 17 June 2016. ➤ An accompanying report of the legal affairs committee of the German Parliament explicitly states that the total engagement period cannot exceed 20/24 years (following conduct of a tender/appointment of joint auditor, respectively). 	<p>If the audit mandate straddles the 17 June 2016 application date then the auditor can complete that year end – but will need to rotate at the end of this period if the maximum duration has been reached. So for example, a 31 December 2016 audit would be the last for an audit firm with 10+ years tenure.</p>
<p>Requires KAPs to rotate after a maximum of seven years, followed by a three-year cooling-off period. Member States have the option to elect shorter KAP rotation periods.</p>	<p>Germany retains a seven year rotation cycle for KAPs. There are no transitory provisions in German law to address changes, in particular the extended cooling-off period. This is subject to discussion in the German profession.</p>	<p>No particular impact expected.</p>

To which entities do the new rules apply – PIE definition?

Audit Firm Rotation – what are the MFR rules?

What are the MFR transition rules – including the short runner issue?

Key audit partner rotation (KAP) – new rules?

 EU Baseline	 Germany	What does this mean in practice?
<p>The list of NAS which statutory auditors and members of their network are prohibited from providing to their PIE statutory audit clients is included in Appendix 1. Member States have the option to add to this list.</p> <p>The audit firm may NOT provide such NAS during the time between the beginning of the period audited and the issuing of the audit report. There is also a ‘clean period’ required from the financial year preceding the start of the year to be audited for; <i>‘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’</i>.</p> <p>Valuation and certain tax services (with the exception of customs taxes and payroll tax) are subject to Member State derogation (Appendix 1) meaning they could be permitted. In the event of such a derogation the audit committee must conclude and document that the services in question have no direct or have an immaterial effect on the financial statements and do not compromise the auditor’s independence.</p>	<p>Germany follows the EU baseline. It fully uses the member state derogations regarding tax and valuation services.</p> <p>However, the German law contains a provision to define materiality of tax services with the aim of banning ‘aggressive tax planning’ services by the statutory auditor.</p> <p>There is no further clarification of the term ‘legal services’ in the German legislation. So far, only the German profession (IDW) has released a position paper on EU audit legislation including an interpretation of ‘legal services’ which associates it with the position of a General Counsellor.</p>	<p>As the German legislative process has not resulted into further clarifications regarding the black list requirements, there are still debates about the exact meaning of certain prohibited services. So far, only the German profession has stepped in with a position paper containing interpretations.</p>
<p>Fees earned by the auditor of the PIE for permissible NAS are capped at 70% - though Member States have the option to establish stricter rules on the NAS fee cap, including a lower %.</p> <p>Any NAS that is not explicitly prohibited to the audited PIE, its parent undertaking or its controlled undertakings is permissible.</p> <p>Approval by the Audit Committee is needed following an assessment of the threats to independence and the safeguards.</p> <p>Member States may introduce a list of permitted services.</p>	<p>Germany follows the EU baseline with no changes to the cap itself.</p> <p>There is one deviation from the EU baseline to note. Under the EU baseline, the audit regulator may exempt the application of the cap for two years. Under the German legislation, this period has been shortened to one year and the cap is in this case limited to 140 percent.</p> <p>German law particularly introduces a pre-approval requirement for tax services as it has been considered not be covered by art. 5 par. 4 of the Regulation.</p> <p>There is no list of permitted services in German law.</p>	<p>Many German companies will need to introduce in 2016 pre-approval processes for non-audit services and over time develop audit tender procedures taking into account EU requirements.</p> <p>For further guidance on the role of the Audit Committee see the KPMG Audit Committee Institute handbook and, in particular, local guidance from the German member firm.</p>
<p>The EU requirements largely align with the new ISA requirements, although there are still some additional unique EU disclosures such as an independence declaration and an indication of the length of the audit/client relationship. In addition:</p> <p>For PIEs, the audit report will need to provide:</p> <ul style="list-style-type: none"> ➤ a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud; ➤ a summary of the auditor’s response to those risks; and ➤ where relevant, key observations arising with respect to those risks. <p>For ALL statutory audits in the EU the audit report will need to:</p> <ul style="list-style-type: none"> • ‘provide a statement on any material uncertainty relating to events or conditions that may cast significant doubt about the entity’s ability to continue as a going concern’. 	<p>German legislation follows the EU baseline.</p> <p>Discussions in the German profession on how to best respond to new EU and ISA requirements are ongoing.</p>	<p>Increased transparency – the audit report will include a description of the risks identified by the auditor and the procedures performed.</p>

Prohibited NAS

Permissible services - what is the cap on fees?

Auditor reporting – what’s new?

Appendix 1

Prohibited Non-Audit Services as per Art 5 (1) of the Regulation

1. A statutory auditor or an audit firm carrying out the statutory audit of a public-interest entity, or any member of the network to which the statutory auditor or the audit firm belongs, shall not directly or indirectly provide to the audited entity, to its parent undertaking or to its controlled undertakings within the Union any prohibited non-audit services in:
 - a. the period between the beginning of the period audited and the issuing of the audit report; and
 - b. the financial year immediately preceding the period referred to in point (a) in relation to the services listed in point (e) of the second subparagraph.

For the purposes of this Article, prohibited non-audit services shall mean:

- a. Tax Services relating to:
 - i. *preparation of tax forms**;
 - ii. payroll tax;
 - iii. customs duties;
 - iv. *identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law**;
 - v. *support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspection is required by law**;
 - vi. *calculation of direct and indirect tax and deferred tax**;
 - vii. *provision of tax advice**;
- 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. *Valuation services, including valuations performed in connection with actuarial services or litigation support services**;
- g. Legal services, with respect to:
 - i. the provision of general counsel;
 - ii. negotiating on behalf of the audited entity; and
 - iii. acting in an advocacy role in the resolution of litigation
- h. Services related to the audited entity's internal audit function;
- i. 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;
- j. Promoting, dealing in, or underwriting shares in the audited entity;
- k. 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.

* *Services subject to the Member State derogation*