Reform of the Audit Market in the EU – Implications For Borrowers and Loan Documentation

A legislative package for the reform of the audit market in the EU has this month been approved by the EU Parliament and adopted by the Council of the European Union. Listed companies will need to change the firms that audit their accounts at prescribed intervals and the EU audit services market will be opened up to audit firms other than the four dominant ones. "Big Four only" clauses in loan agreements will be null and void.

The financial crisis of recent years drew attention to the need for reform to the audit services market. Public confidence in the annual and consolidated financial statements of public-interest entities (PIEs) (such as listed companies, banks and insurance entities) dipped and needed restoring. The recently agreed EU reform package is aimed, among other things, at addressing this lack in confidence. In addition it aims to increase transparency of audit firms and to open up the audit services market (which is currently dominated by the "Big Four" firms) to mid-tier audit firms. The new legislation will also have an impact on borrowers and the documentation governing their loan facilities.

The legislative package is made up of:

- a regulation (the "**Regulation**") on specific requirements regarding the statutory audit of PIEs in particular; and
- a directive (the "**Directive**") amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts of all types of audited entities (including PIEs).

The reform package will enter into force following publication in the Official Journal. This is expected at the end of the second quarter of 2014. Member States are obliged to adopt and publish measures necessary to comply with the Directive by a date falling two years after the entry into force of the Directive. The Regulation is directly applicable (and so does not require national adoption measures) but most of its provisions shall apply from a date falling two years after its entry into force. There are also transitional provisions, as noted below.

The reform package includes the following main features:

1. *Mandatory rotation of audit firms of PIEs* – The reform package specifies that PIEs are required to change their auditors every ten years. By way of derogation from this rule, Member States may provide that this period be extended to 20 years where a public tendering process is conducted, and 24 years where two or more firms are simultaneously engaged. Member States may also provide for a maximum duration of less than ten years.

   With respect to mandatory rotation of audit firms of PIEs, the Regulation specifically provides for transitional arrangements. If, when the Regulation comes into force later this year, an audit firm has been providing audit services to a PIE for 20 or more consecutive years, the PIE will have six years to select another audit firm. If, however, the audit firm has been providing audit services to a PIE for 11 or more years but less than 20 consecutive years at the date of entry into force of the Regulation, the audit firm will have nine years to select another audit firm. Audit engagements that were entered into before the entry into force of the Regulation but which are still in place two years later may remain applicable until

the end of the ten year maximum period specified above (or 20 years where the engagement has been renewed).

2. *Prohibition of the provision of non-audit services by an audit firm to PIEs* – The provision of certain non-audit services such as specific tax, consultancy and advisory services to the audited entity will be prohibited. The aim of the prohibition is to avoid audit firms compromising their independence when providing non-audit services. There will also be a cap on fees for permitted non-audit services of 70% of the average of the statutory audit fees paid for three or more consecutive financial years.
3. *Reinforced role of the audit committee of PIEs in the selection of a new audit firm* – In order to enable the general meeting of shareholders or members of the audited entity to make a more informed decision regarding the selection of the audit firm, the Regulation seeks to enhance the role of the audit committee in the selection of the audit firm. It provides that an audit committee recommendation should contain at least two choices for the audit engagement and a justified preference for one of them. The audit committee will be responsible for the selection procedure and the audited entity should not restrict audit firms with a low market share from presenting proposals for the engagement.
4. *Prohibition of "Big Four only" clauses* – As part of a measure to open up the audit services market to small and mid-tier firms, the legislative package provides that contractual clauses restricting the choice by the general meeting of shareholders or members of the audited entity "*to certain categories or lists of statutory auditors or audit firms as regards the appointment of a particular statutory auditor or audit firm to carry out the statutory audit of that entity*" are prohibited and will be null and void. The prohibition in the Directive applies to contracts involving all types of audited entities and the Regulation applies to contracts between PIEs and third parties only.

   Any "Big Four only" clauses in existing loan agreements requiring that the audit be done by one of the "Big Four" firms (Deloitte, KPMG, PwC or Ernst & Young) will be null and void when the reform package takes effect (by 2016 in the case of the Directive and, in the case of the Regulation, Article 16(6) containing the prohibition will take effect in the second quarter of 2017). Borrowers and lenders may wish to consider amending any such existing clauses to avoid uncertainty under the relevant loan documentation arising from their unenforceability. For future transactions, parties will need to consider to what extent a borrowers choice of audit firms may be contractually limited without violating the new legislation.

   Lenders are generally concerned about the size and capabilities of auditors and want to ensure that the auditing standards, particularly in the case of sub-investment grade loans, are of a high quality. To address, this concern, the LMA standard form leveraged finance multicurrency syndicated loan agreement contains a "Big Four only" clause. Going forward, parties will need to omit or revise this clause and lenders might seek to require borrowers to appoint a particular audit firm rather than rely on a contractual clause referring to "categories" or "lists" of auditors. However borrowers will be reluctant to reduce their flexibility in this manner and a restriction of this kind may also be prohibited under the terms of the legislative package.

   Lenders might also seek to include a provision requiring the borrower to obtain prior approval by the lenders of the selection of the audit firm. Technically, one may take the view that the lender is not limiting the borrower's choice to any list or category of audit firm. However, a clause that seeks to restrict the choice of audit firm in such a manner may similarly violate the new legislation and its aim of breaking down the barriers for small and mid-tier firms to access the audit services market. It is unclear whether

the reference in the prohibition to "certain categories" will catch any attempt by lenders to narrow the borrower's choice of audit firm.

The Regulation includes additional requirements for borrowers that are PIEs, specifying that a PIE must inform the competent authorities without delay of any attempt by a third party "*to impose such a contractual clause or to otherwise improperly influence the decision of the general meeting of shareholders or members on the selection of a statutory auditor or an audit firm*." This is an onerous provision and could potentially deter a lender from seeking to restrict a borrower PIE's choice of audit firm. However, the Regulation and Directive are generally less of a concern for listed companies and other PIEs because the loan agreement will usually be based on the LMA Investment Grade documentation, which does not include a "Big Four only" clause.

The LMA has stated that it has been engaged in dialogue with the European Commission and various stakeholders regarding the proposed prohibition on "Big Four only" clauses in loan documentation, however it has not, as yet, amended its template documentation.

5. *Cooperation of audit oversight bodies* – The supervision of the system under the reform package will be carried out within the framework of the Committee of European Auditing Oversight Bodies (CEAOB). The European Securities and Markets Authority (ESMA) will assist with external relations and co-operation within the structure of the CEAOB.

The UK Competition Commission (now the Competition and Markets Authority) conducted its own Market Investigation into Statutory Audit Service in October 2013. It produced a report and commenced a consultation with respect to audit services. However, in January 2014, it announced that it would wait to give consideration to the implications of the EU proposals. The Competition and Markets Authority expects to redraft the Orders in light of the finalised EU legislative package and conduct another consultation in the second and third quarters of 2014.

If you would like to learn more about the issues in this alert, please contact your usual Ropes & Gray attorney, or any of the attorneys listed below.

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