



EU Public Interest Entity – Audit Committee Briefing

Nottingham City Council

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Contents (title only)

	Page
Background	2
European Union (EU) audit legislation	2
PIE: Definition and scope	2
Implications for the Council	3
- Mandatory firm rotation	3
- Prohibited non-audit services	3
- The role of the Audit Committee	4
- Auditors' responsibilities	4

EU Public Interest Entity – Draft discussion document/Audit Committee Briefing

Background

Nottingham City Council (the Council) has around £0.6 million of listed debt on the London Stock Exchange (LSE). Officers have provided a breakdown of the various elements of the total.

The Council's understanding is that in practice the stock issue is not actively traded on the LSE. The Council manage the administration of the stock in house including changes in ownership, interest payments and the reporting of those payments to HMRC. However, if the Bond is traded the process of changes in ownership and interest payments is normally dealt with by a third party "registrar" on the Council's behalf. The third party processes all changes of ownership, update the register of stock holders, and apply all relevant tax requirements when interest is paid and apply relevant financial law, for example, in relation to money laundering legislation. The largest stock holder is HSBC Global Holdings Nominee who manage on this behalf of an individual client(s). In this instant for example HSBC is deemed to be the registrar.

European Union (EU) audit legislation

New European Union (EU) audit legislation came into effect on 17 June 2016 and applies from the first financial year starting on or after 17 June 2016. The legislation has two components, a directive and a regulation.

The directive contains a series of requirements governing every statutory audit in the EU and amends previous existing statutory audit directives.

Crucially, in relation to the Council the regulation contains a series of additional requirements that relate only to the statutory audits of Public Interest Entities (PIEs). These additional requirements include changes to:

- Mandatory firm rotation; and
- Prohibited non-audit services;

Additionally the change in legislation has implications for the

- Role of the Audit Committee; and
- Auditors' responsibilities

PIE: Definition and scope

The definition of a PIE was include in the Statutory Audit Directive (2006) and has now been amended by the new legislation with effect from 17 June 2016. The new PIE definition includes:

- Organisations with transferable securities listed on EU regulated markets and governed by the law of an EU member state;
- Credit institutions authorised by EU member states authorities
- Insurance undertaking authorised by EU member states' authorities; and
- Other entities a member state may choose to designate as a PIE

The Council has around £0.6 m of listed debt on the LSE and therefore conforms to the definition of a PIE under the first of these requirements as it has transferable securities listed on an EU regulated market.

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Implications for the Council

There are four areas to consider and taking each in turn:

Mandatory firm rotation

Under the new legislation the initial engagement period for a statutory auditor or audit firm should not be less than one year but not exceed 10 years. Tenure is counted from the start of the first accounting period audited and only during the period when the entity was considered to be a PIE.

Member states may adopt a rotation term of less than 10 years or extend the rotation period up to a maximum of 20 years in the case of tendering or 24 years in the case of joint audit. The United Kingdom has opted for Mandatory Firm Rotation after a period of 20 years in the case of tendering with a required four year cooling off period.

At the individual level 'key audit partners' are required to rotate after a period of seven years with a three year cooling off period.

For Nottingham City Council the 2017/18 audit will be the first audit under EU PIE regulations and the last year in which KPMG provides the service for at least a period of five years as a consequence of the recent tender exercise that the Council took part in. The 2017/18 audit is Tony Crawley's third year as your 'key audit partner'. Therefore, the regulations in respect of Mandatory Firm Rotation have no immediate impact on your audit.

Prohibited non-audit services

The legislation includes a detailed list of non-audit services that audit firms and members of their networks may not provide to a PIE statutory audit client, its EU parent, or its EU controlled undertakings (subsidiaries). Generally, these include:

- Provision of tax services;
- Services that involve playing a part in management or decision making;
- Payroll services
- Designing and implementing internal control or risk management procedures;
- Valuation services;
- Legal services;
- Services related to the clients internal audit function;
- Services linked to financing
- Promoting, dealing in or underwriting shares in the audited body;
- Human resource services
- Structuring the organisation design and
- Cost control

Fees for permissible non-audit services should not exceed 70% of the average audit fees paid in the past three consecutive financial years.

KPMG has not undertaken, and is not engaged to undertake any of the listed prohibited non-audit services at the Council. During the current financial year we have undertaken four pieces of permissible non-audit work with a total value of £25,250 which is approximately 15% of the average statutory audit fee for the previous three years. This work is:

- Pension work for Nottingham City Transport
- Certification of the SFA sub-contracting return
- Certification of the Pooling of Housing Capital Receipts Return; and
- Certification of the Teachers Pensions Agency Return.

Note that our work for Midlands Engine, procured via the Council (£30k) does not count towards the threshold, as agreed with the PSAA.

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The role of the Audit Committee

The legislation includes several provisions designed to strengthen the audit committees of EU organisations and to provide more transparency into the activities of the committee and the statutory audit.

Each PIE must have an audit committee composed of non-executive members and:

- At least one members of the audit committee must have competence in accounting and/or auditing
- The committee members as a whole should have competence relevant to the company's business sector

A PIE is required to have a tender process with the close involvement of the audit committee when considering either the selection of a new auditor or the reappointment of an existing auditor.

All permitted non-audit services provided by the audit firm or a member of the network to the PIE, its parent undertaking, or its controlled undertakings require audit committee approval.

Audit committees must monitor auditor independence and review a non-public report prepared by auditors specifically for the audit committee that includes:

- More detailed information on the results of the audit.
- Disclosure of quantitative level of materiality applied to perform the statutory audit, materiality level(s) for particular classes of transactions and account balances or disclosures, and qualitative factors used to determine materiality.
- Reporting and explaining judgments about events or conditions identified during the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty and providing a summary of all measures that have been taken into account when making a going-concern assessment.

We are currently seeking clarity on the extent to which these requirements extend to a public sector entity, such as the City Council.

Auditors' responsibilities

The legislation relating to auditor reporting includes a series of requirements that should enhance understanding of the audit process, including critical judgements made during the audit. The legislation contains detailed provisions affecting statutory audits and the way they are conducted. The new auditor reporting requirements will apply for financial year ends on or after 30 June 2017:

- Auditors will be required to carry out statutory audits in compliance with the international auditing standards (ISAs),
- Audit report for statutory audits must provide a statement on any material uncertainty related to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern.
- The audit report must provide a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, summary of auditor's response to those risks, and key observations arising with respect to those risks.
- Audit firms may perform audits in another member state provided that the key audit partner carrying out the audit has been duly approved as a statutory auditor in that other member state.
- The legislation also establishes new non-public reporting requirements from the auditor to the audit committee of the audited PIE.

Our audits already comply with the requirements of international auditing standards (ISA's) and we are currently seeking clarity on the extent to which the rest of these requirements extend to a public sector entity, particularly the second, third and fifth bullets listed above. We believe that in all likelihood these requirements will apply to our audit of the Council's 2017/18 financial statements.



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