Guidance on Mandatory firm rotation and selection procedures

One of the key requirements of the EU audit legislation is that public interest entities (PIEs) in the EU must change their statutory audit firm after a certain period of time. The legislation started to apply from June 2016 but transitional arrangements have been put in place for audit engagements concluded before June 2014.

In this document you can find a summary of the requirements, and the various member state options to extend or adapt the maximum periods of auditor tenure.

Mandatory audit firm rotation (MFR) for PIEs

<table>
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<tr>
<th>Core MFR requirements</th>
<th>Member state options (to be adopted in national legislation)</th>
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<tbody>
<tr>
<td>a. 10-year MFR for all PIEs in the EU</td>
<td>i. To extend the period once for up to a maximum further:</td>
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<td>• 10 years if a tender is undertaken</td>
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<td>• 14 years if joint audit is adopted</td>
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<td>ii. To adopt a shorter term of rotation</td>
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<td>b. At the request of the audited entity, the national regulators/supervisory authorities can extend the term once for a maximum of two years, in 'exceptional circumstances'. The definition of what these circumstances are remains unclear but is understood to include mergers or where a tender process has been unsuccessful.</td>
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Transitional arrangements

For PIE audit engagements where:

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<th>The auditor has been in place for financial years starting:</th>
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<tr>
<td>• Before 16 June 1994 - no renewal after 17 June 2020</td>
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<tr>
<td>• Between 17 June 1994 to 16 June 2003 - no renewal after 17 June 2023</td>
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<td>• Between 16 June 2003 to 17 June 2006 – rotation on or before 16 June 2016 at the latest, or extension, subject to the adoption of the member state option for tender or joint audit, noting that the audit firm can finalise the audit of the financial year that straddles 17 June 2016</td>
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<td>• After 17 June 2006 - rotation (or extension) when maximum tenure is reached from the first year of engagement (subject to the adoption of the member state option to extend the period).*</td>
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*E.g. if the first year of engagement was FY 2010, the audit firm should retender or rotate off for the audit for FY 2020 (if the maximum engagement period is ten years).

These Guidance/Q&As reflect frequent questions received from audit professionals and from clients. They are designed to help understand and apply the EU audit legislation in a consistent manner, drawing on the European Commission’s Q&As regarding the audit Regulation and Directive. The content is provisional, updated on a regular basis and no representation or warranty (express or implied) is given as to the accuracy or completeness of it. These Guidance/Q&As have been prepared to provide general guidance on matters of interest only, and do not constitute professional advice. You should not act upon the information contained herein without obtaining specific professional advice. To the extent permitted by law, PwC does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this document or for any decision based on it. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see [www.pwc.com/structure] for further details.

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Selection procedure

### Tendering requirements

At the end of the maximum duration of 10 years, a tendering process should be organised by the audited entity. The Regulation lays down requirements for the selection and appointment of the auditor. The audit committee has overall responsibility for the selection procedure.

- The audit committee must submit a recommendation to the administrative or supervisory body which is justified and **contains at least two choices** - the audit committee should express a preference for one of them, giving its reasons. If the board’s final proposal to the AGM differs from the preference of the AC, reasons must be given.

- The audited entity is free to invite any statutory auditors or audit firms to submit proposals for the provision of the statutory audit service on the condition that the tender process does not in any way preclude the participation in the selection procedure of firms which received less than 15% of the total audit fees from PIEs in the member state concerned in the previous calendar year (this list will be drawn up on an annual basis by the competent authority).

- In terms of how a company demonstrates that they have not excluded such firms from the tender process, the audit committee should formally document the various criteria they have considered in deciding which firms to invite to tender.

- The audited entity and the AC shall take into consideration any findings or conclusions of any inspection report issued by the national competent authority.

There is no difference between the selection process at the initial appointment of the auditor and the tender to re-appoint the audit firm (provided that the member state has allowed the option to extend the engagement with a further period of maximum ten years).

### Impact on multinational groups

In the case of groups which have subsidiaries in various EU member states, each EU PIE in the group will have to comply with the MFR rules applicable to the member state in which it is based. There is no requirement for non-PIE entities in the group to rotate their audit firm.

The audit committee of the parent undertaking in the EU is responsible for the selection procedure of the audit firm for the group in the EU. Where subsidiaries of the group which are a PIE in their own right are concerned, the audit committee of the subsidiary could be involved in the selection procedure of the audit firm, in particular if they are based in EU member states with shorter rotation periods than the PIE parent in another member state.
Q&As on MFR and the selection procedure

Q: Assume audit firm A was the auditor of Company X from 1996 to 2002. From 2002 to 2010 the Company was audited by audit firm B. Audit firm A became the auditor again in 2011. Should tenure of audit firm A be calculated from 2011 or 1996?

A: In this scenario, the beginning of the engagement period is 2011.

Q: Audit firm A has been the auditor of company X since 1990. The company listed in July 2008, at which point they became an EU PIE; their financial year equals a calendar year. What is the starting point for calculating the mandatory firm rotation rules?

A: According to the European Commission, if an entity qualifies as a PIE during the course of an audit engagement, the calculation of the duration should start from the first financial year after the entity qualifies as a PIE. In this example the starting point for calculation the mandatory firm rotation rules the financial year that starts 1 January 2009.

Q: Article 17.4 of the Regulation enables member states to extend the maximum 10 year engagement period with a further 14 years in case of joint audit. In order to qualify for the 14 year extension, is a joint audit required throughout the initial 10 year period?

A: No, a PIE does not need to have a joint audit during the first 10 year period in order to qualify for an extension of that engagement up to 24 years.

Q: If during the first ten years the audit was conducted by a single audit firm, and the PIE wants to appoint a second audit firm, does it need to conduct a tender to select the second audit firm?

A: Yes. If a PIE decides to appoint a second audit firm after ten years of appointing a single audit firm, they need to conduct a tender in order to appoint the second audit firm (as joint auditor) according to the rules of article 16.3 of the Regulation.

Q: Does the requirement to conduct a tender at the end of the maximum 10 year also apply if joint audit has been in place since the beginning of the engagement?

A: No, the EC has clarified that there is no obligation to hold a public tender in order to benefit from the extension if firms jointly conducting the audit have been appointed since the start of the audit engagement.

Q: The first financial year audit firm A audited the financial statements of client Y is calendar year 2004. By June 2016 the firm will have been the auditor for 12 years. Will client Y be able to invite audit firm A to participate in a tender and re-appoint the firm for a further ten years?

A: If the member state has allowed the option to extend the duration upon a tender, the incumbent auditor can participate and be re-appointed. However, the maximum duration cannot exceed 20 years and so audit firm A can potentially remain the auditor only until the financial year ending 31 December 2023.
Q: Do all PIEs in the EU have to follow the tendering rules laid down by article 16(3)?

A: Yes they do. However article 16(4) lays down that PIEs which meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC will not be required to apply the more detailed criteria described in Article 16(3) when conducting their selection procedure.

Article 2(1) of Directive 2003/71/EC says:

(f) ‘small and medium-sized enterprises’, i.e. companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria:

· an average number of employees during the financial year of less than 250,
· a total balance sheet not exceeding EUR 43 000 000, and
· an annual net turnover not exceeding EUR 50 000 000.

(t) ‘company with reduced market capitalisation’ i.e. a company listed on a regulated market that had an average market capitalisation of less than EUR 100 000 000 on the basis of end-year quotes for the previous three calendar years.

Q: What is the meaning of the provision requiring the selection procedure ‘not to preclude a firm which received less than 15 % of the total audit fees from PIEs in the member state concerned in the previous calendar year’?

A: It is not clear how this requirement to ‘not preclude’ the participation of smaller audit firms is to be interpreted but the purpose of this requirement is to ensure that smaller audit firms are not routinely excluded from the tender process. The requirement does not impose a duty on the PIE to approach smaller firms actively but means that any requirement imposed by the audited entity in the tender process cannot amount to the exclusion of small and medium sized firms.

In terms of how a company demonstrates that they have not excluded such firms from the tender process, the audit committee should formally document the various criteria they considered (e.g., geographical coverage, industry expertise and if available, audit inspection results) in deciding which firms to invite to tender. The audited entity shall be able to demonstrate, upon request, to the competent authority that the selection procedure was conducted in a fair manner.

Q: What is the meaning of ‘quality standards’ which can be included in the tender documents?

A: Article 16.3(d) allows the competent authority to require statutory auditors and audit firms to comply with certain quality standards, which should be included in the tender documents. Where the regulator does not require such standards we are free to refer to our existing standards (ISQC 1, ISA 220).

Q: Article 17 of the Regulation refers to a ‘public tender’. Does this mean that the company needs to publish a tender in the Official Journal?

A: The notion of ‘public’ remains undefined. We would recommend that the notion of ‘public’ be considered as sufficient where one follows the same process of announcement as followed in the particular member state for the public announcement of official shareholder meetings. This may be publication on the company’s website - however, it may also be more or less than this.
Q: If a PIE would voluntarily choose to rotate its auditors before the end of the transition period, would the provisions of Article 16(3) apply for selecting a new auditor?

A: No, Article 41(4) of the Regulation on MFR transition says that the provisions for auditor selection mentioned in Article 16(3) of the Regulation need only apply to tendering for audit engagements that commence after expiry of the maximum duration period (of 10 years). As such they do not appear to apply to voluntary changes of auditors before the end of the first transition period.

Q: So if a company is due to rotate audit firms in 2019, but decides to organise a voluntary tender before the due date, e.g. in autumn 2016 with a view to change auditors for the FY2017, would they have to organise a tender according to article 16.3 or would article 41.4 apply, as explained above?

A: Article 41.4 applies - this voluntary tender will take place before the end of the transition period, and therefore the company does not need to follow the tendering rules in article 16.3.