Audit firm rotation

Accounting reform in the European Union (EU) will require public-interest entities to change their auditor periodically from 2016. How will these changes affect your business?

What is the European legislation?
There is a new European audit regulation regarding the statutory audit of Public-Interest Entities (PIEs).

A regulation has binding legal force throughout every EU member state, and will override national law where there is a conflict.

Who will be affected?
The requirements of the regulation are applicable to PIEs, and to audit firms only insofar as they carry out statutory audits of PIEs.

A PIE is defined as:
- entities governed by the law of an EU member state whose securities are admitted to trading on a regulated market of an EU member state;
- credit institutions (as defined);
- insurance undertakings (as defined); and
- other entities which are designated by member states as PIEs, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.

When will the changes come into effect?
The regulation is applicable to PIEs for accounting periods commencing on or after 17 June 2016.

What are the headlines?
The key elements of the legislation are outlined below.

Headlines covered in this factsheet:
- PIEs will be required to change their statutory auditor at least every ten years, although member states can extend this up to 20 years where a company conducts a public tendering process for the audit, or up to 24 years if a company uses more than one auditor (joint audit); and
- new rules are introduced regarding auditor appointment and auditor selection procedures.

Headlines covered in other factsheets:
- the provision of certain non-audit services to a PIE by its auditor is prohibited;
- there is a cap of 70% of the audit fee, averaged over three years, on the level of [allowable] non-audit services which a PIE’s auditor is able to provide to the company;
- new reporting requirements by the auditor to shareholders and to the audit committee are introduced; and
- audit committee responsibilities are expanded.

What are the rules on changing auditor?
The regulation mandates periodic changes of auditor by PIEs. There will be a maximum tenure for auditors of PIEs of ten years, although individual EU member states may set a maximum duration of less than ten years.
Further, member states may extend the maximum duration by up to a further:
• ten years if a company conducts a public tender for the audit; and
• 14 years if a company uses joint audit for that 14 year period (a public tender is not required in this case).

Where a company takes advantage of the extension, it must be approved by shareholder vote.

After the expiry of the above periods, neither the statutory auditor nor any members of their network within the EU shall be able to undertake the audit of the company within the following four-year period.

In exceptional circumstances, the PIE may request that the competent authority in the member state grant an extension to re-appoint the statutory auditor for a further engagement of no more than two years. However, we expect that such an extension will be extraordinarily rare.

The requirements for rotation of the audit partner will remain at seven years and, additionally, audit firms will be required to introduce an appropriate “gradual rotation mechanism” for all other senior personnel involved in the statutory audit which is otherwise undefined in the law and practice will likely emerge.

Are there transitional provisions for changing auditor?
Transitional provisions for audit appointments in place at 17 June 2016 are established in the regulation as follows:
• PIEs which have had the same auditor at 17 June 2014 for 20 and more years must change their auditor within six years of the law coming into force (i.e. 2020);
• PIEs which have had the same auditor at 17 June 2014 for 11 and more but less than 20 years must change their auditor within nine years of the law coming into force (i.e. 2023); and
• if an audit engagement was entered into before 17 June 2014, but is still in force by 17 June 2016, then the auditor may remain in place until the end of the maximum duration. If the maximum duration has already been reached then rotation rules apply for the first accounting period commencing on or after 17 June 2016.

The final clause captures entities whose auditor has been in place at 17 June 2014 for less than 11 years, and effectively drives the tender period where member states allow an extension beyond ten years. However if the member state maximum duration has been reached prior to 17 June 2016 then unless the member state allows for extension the company will need to change auditor for the financial period commencing on or after 17 June 2016.

The law refers to the period in which the auditor has been “providing audit services to a public interest entity”. For companies that qualified as a public-interest entity after the date on which the incumbent auditor was first appointed, the European Commission has confirmed that “the calculation of the duration starts from the moment that the company becomes a PIE”.

What about the auditor appointment process?
New requirements are introduced for an audit committee when appointing a statutory auditor of a PIE. In particular, an audit committee is required to:
• submit a recommendation to the board for the appointment of a statutory auditor. The recommendation, unless it is the renewal of an audit engagement, must be justified by the audit committee and contain at least two choices for the audit engagement with a duly justified preference for one of them; and
• state that its recommendation is free from influence by a third party and that its choice of auditor has not been restricted.

Where the proposal of the board to the general meeting of shareholders, for the appointment of an auditor, departs from the preference of the audit committee, the reasons shall be justified. In any case, the auditor recommended to the shareholders must have participated in the selection procedure.

Is the auditor selection procedure prescribed?
An audit committee for a PIE is required to organise a selection procedure to support their recommendation for auditor appointment. The selection procedure must follow certain minimum criteria, the audited entity shall:
• be free to invite any audit firms to submit proposals for the provision of the statutory audit service on the condition that he organisation of the tender process does not in any way preclude the participation of [audit] firms who received less than 15% of the total audit fees from PIEs in the member state concerned in the previous calendar year”. A list of those audit firms who received less than 15% of the total audit fees from PIEs in the member state must be produced by the competent authority and updated on an annual basis;
• prepare tender documents for the attention of the invited audit firms which allow them to understand the business of the audited entity and the type of statutory audit that is to be carried out. The tender documents shall contain transparent and non-discriminatory selection criteria that shall be used by the audited entity to evaluate the proposals made;
• be free to define the selection procedure and may conduct direct negotiations with interested audit firms in the course of the procedure;
• where, in accordance with national or EU law, the competent authorities require audit firms to comply with certain quality standards, those standards shall be included in the tender documents;
• evaluate the proposals in accordance with the selection criteria predefined in the tender documents [and] prepare a report on the conclusions…which shall be validated by the audit committee. The audited entity and the audit committee shall take into consideration any findings or conclusions of any inspection report on the applicant audit firms published by the competent authority; and
• the audited entity shall be able to demonstrate, upon request, to the competent authority that the selection procedure was conducted in a fair manner.

PIEs which qualify as small or medium-sized enterprises and which have a reduced market capitalisation will be exempt from the above procedure.

We recommend that audit committees and companies effectively prepare for the introduction of the new requirements by:
• planning ahead for the year in which the audit firm will change to avoid, where possible, significant business or senior management changes in the same period;
• drafting and agreeing tender documents, including the transparent and non-discriminatory selection criteria to be used, in advance of the date at which invitations will be sent out to invited audit firms; and
• seeking investor views on which audit firms should be invited to tender for the statutory audit and building relationships with a range of audit firms prior to the year of auditor change.

Restrictions on choice of auditor
Any contractual clause (including a clause in an existing agreement) which restricts the choice of shareholders of an audited entity (including non-PIEs) to certain categories or lists of statutory auditors regarding the appointment of a particular auditor to carry out the statutory audit of that entity shall be null and void with effect from 17 June 2017.

A PIE will be required to inform its national competent authority directly and without delay of any attempt by a third party to impose such a contractual clause or to otherwise improperly influence the decision of the shareholders on the selection of auditor.

Any questions?
This factsheet serves as an introduction to some of the issues raised by the expected changes to EU accounting law. Further factsheets are available on other aspects of the law and can be obtained from your usual Grant Thornton representative, including:
• audit committee responsibilities;
• the provision of non-audit services by the auditor; and
• auditor reporting to shareholders and the audit committee.

The impact of these changes will vary from entity to entity. If you wish to discuss this further, then please contact a member of our team to discuss how we can help you assess the implications of this legislation.

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