

Briefing Paper

Standing for trust and integrity

June 2011



Appointment of the Auditor

FEE believes that the independent external audit is fundamental to the efficiency of the global economy. The financial crisis has raised questions regarding the auditing profession and in particular, some commentators have raised concerns around the independence of the auditor and the length of the appointment of the auditor. FEE supports a global debate towards an even more valuable audit, meeting the needs of stakeholders.

The appointment of the auditor encompasses considerations for companies regarding the process of how the auditor is selected prior to commencing the audit work, how many auditors a company selects and how often the company would appoint and/or reappoint its auditor. These matters are further discussed in this FEE Briefing Paper.

The independence of the auditor is a fundamental prerequisite to the effectiveness of the audit, but independence alone cannot deliver a quality audit. It is therefore important to ensure that the quality of the audit is the paramount consideration in any decision to change the rules on auditor appointment.

Selection process for appointment of the auditor

The auditor is formally appointed by the shareholders of a company, usually on the recommendation of the board or the audit committee. While many audit firms do remain appointed for long periods of time due to having been reappointed a number of times, the audit appointment is subject to approval upon each reappointment, which in some countries takes place annually, but in other countries is done less frequently. The auditor is bound by ethical standards governing independence and, while the audit firm can remain appointed for some time, the key audit partners of public interest entities responsible for the audit engagement are already required at European level to rotate after a maximum period of seven years and cannot be reappointed again until two years later.

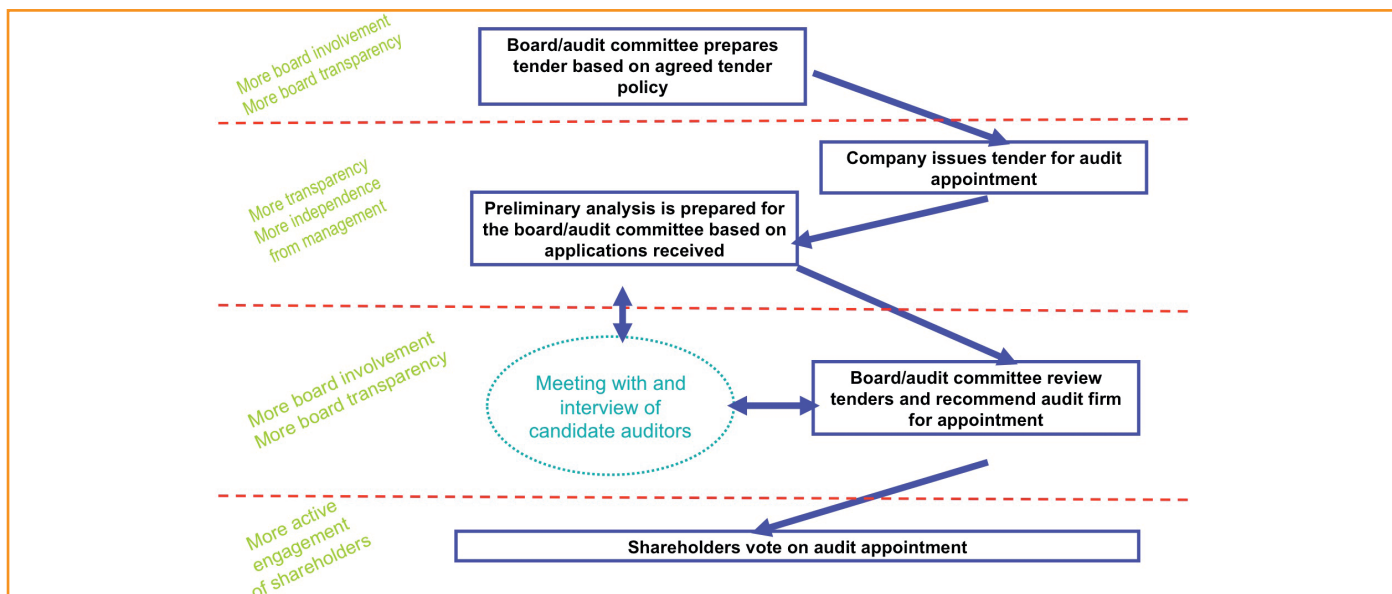
Different measures may be needed for companies of differing natures and sizes. In general, the process for selection and appointment of the auditor should be independent of management and the decision-making for auditor appointment should be with the governing bodies of the entity.

For *non-public interest entities*, the main parties involved in the appointment of the auditor are the board and the shareholders. Non-public interest entities are not a homogenous group. More involvement of independent members of the board, or the audit committee if so required at national level, could be relevant for entities where being independent of management would also be important. However, for smaller unlisted companies, including small and medium-sized entities (SMEs) and companies with an owner-manager structure, the current practice continues to appear appropriate.

In order to take account of some of the concerns expressed regarding the appointment of the auditor in *public interest entities* and having further harmonisation at European level in mind, FEE recommends the improvements as set out below for such entities:

- **Boards:** As is the case in some EU Member States, independent members of the Board, the supervisory board or the audit committee should be more involved in and be responsible for recommending the choice of audit firm. This would ensure that the appointment of the auditor is independent of management of the entity both in appearance and in mind.
- **Transparency:** There should be enhanced disclosure and transparency of the audit appointment process. In particular, the report of the board or the audit committee in the financial statements or annual report should include the rationale for selection of a new audit firm or the renewal of an incumbent audit firm's term.
- **Shareholders:** The board or the audit committee should seek to engage with the shareholders on the selection of the auditors, for instance by involving a "Shareholders Nominating Committee" in the appointment process.

The selection process and the proposed improvements can be explained as follows:



Following the appointment, the auditors engage with the board and/or the audit committee throughout the audit process over the year. In addition, the board and the audit committee review and monitor the effectiveness and the independence of the auditor on an ongoing basis throughout the year.

Appointment of the Auditor and Joint Audit or Audit Consortia

Having more than one statutory auditor is already an option that EU Member States and entities can adopt should they choose to do so. Whilst this is not widely adopted in practice and a minority of companies have chosen voluntarily to do so, it is recognised that certain jurisdictions see merit in this approach as a possible solution to the current levels of concentration in the audit market. How the concept of joint audit works in practice when two audit firms jointly carry out an audit at national and international level as well as the effect it can have on audit quality are to be considered as well.

Only few countries have experience with joint audit, and one example is France, where joint audits are mandatory for the audit of consolidated financial statements of all companies. There are no restrictions on the size of the audit firms which are involved in the joint audit. The auditors are required to take a balanced approach using quantitative as well as qualitative criteria, and to have a proportionate repartition of hours, experience and qualifications of the members of the audit teams. Even with these principles in mind, the concentration in the audit market for large listed entities is still relatively high. However, for smaller listed entities, more audits are carried out as a joint audit between a small and a large audit firm.

Another example, which originated from other concerns than the audit market, is Denmark. In Denmark, a mandatory joint audit requirement

was introduced at a time where the audit firms lacked the capacity to carry out audits of very large, complex and global companies. Joint audit was therefore used to ensure the sufficiency of audit resources for such companies. The concept of joint audit was abandoned as of 2005, as it was considered that the administration and financial burden placed on entities did not necessarily result in any tangible benefits for the business from an audit quality perspective. The original concerns with audits of large multinational companies are now addressed through independence requirements, review partner requirements, key audit partner rotation and effective internal and external quality control.

The main objective of using joint audits or audit consortia would be to decrease audit market concentration by building capacity for smaller audit firms in the audit market over a period of time and to enlarge their global reach. This could in due course change the dynamics of the audit market. Making audit consortia work in practice necessitates considering a number of issues like transitional measures in the initial years, how companies can coordinate and cooperate with two instead of one single audit firm, how the audit work can be divided, performed and reviewed, what the cost implications are for the audit firms and for the companies, etc. Further consideration should also be given to how differences of opinion between the auditors involved would be approached and how each signing auditor can take sole responsibility for the audit.

FEE notes that audit consortia could have an impact on helping to change the concentration in the audit market, although its impact on audit quality is unclear. Audit consortia will bring about some practical difficulties compared to having only one auditor carrying out the audit.

Appointment of the Auditor and Audit Firm Rotation

Mandatory or fixed duration audit firm rotation has been experimented with in a number of EU Member States and currently only one Member State (Italy) continues to apply mandatory rotation of audit firms for public interest entities.

The arguments for and against the mandatory rotation of audit firms have been debated by regulatory bodies and other interested parties for a number of years and have not changed much during this time.

Those in favour of mandatory audit firm rotation argue that a long-term relationship between an auditor and an audit client creates a risk of excessive familiarity that might impair the auditor's objectivity and independence.

Against this, those who are not in favour of mandatory audit firm rotation claim it might inadvertently threaten audit quality and that while there will undoubtedly be financial and time costs in making sure the "new" auditors get to know the business, sometimes against the backdrop of pressure on audit fees, the imposition of mandatory rotation has in the past increased market concentration in the larger audit firms.

There are legitimate concerns regarding independence and excessive client familiarity that mandatory audit firm rotation attempts to address. However, it can have the undesired effect of increasing audit market concentration.

Appointment of the Auditor and Retendering

Audit firm rotation has to be balanced with the growing trend in EU Member States for audit committees to opt for voluntary re-tendering of the audit.

Audit committees would seem to be well placed to undertake the task of assessing what the impact on audit quality will be should there be a change in auditor. A mandatory process of audit tendering, which would define a fixed term appointment for the auditor, would detract from the audit committee's ability to take any specific circumstances into account and exercise their judgment on whether the timing is right for such an appointment.

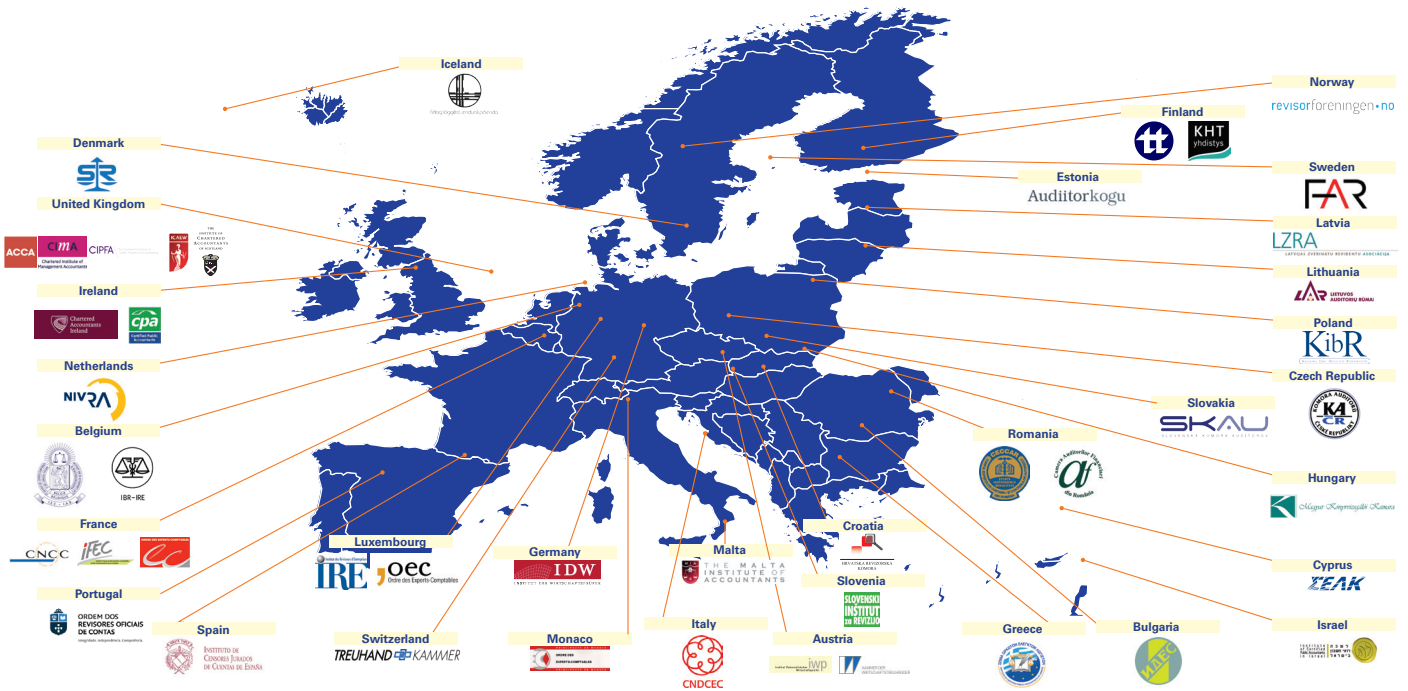
By opting for a system of voluntary retendering, the reappointment process could be effectively and efficiently managed by providing enhanced disclosure of the rationale behind the reappointment, which may be less expensive and disruptive and prove to be more conducive to gradual change in market dynamics. In this context, laws, regulations or general practices should not restrict the choice of an audit firm to a smaller selection of the market and "Big 4 clauses" or "covenants" should therefore be eliminated.

FEE believes that mandatory audit firm tendering will not meet the expectation of reducing concentration and that a move towards a system of voluntary tendering, with the provision of enhanced disclosures on the qualitative aspects of reappointment, would leave the decision in the hands of the audit committee who are ultimately better placed to make such a judgement.

Way Forward

FEE recognises that there is concern over the level of market concentration and independence in relation to the appointment of the auditor of the largest companies. FEE encourages the European Commission, in its deliberations following the Green Paper on Audit Policy, to ensure that any potential solutions do not impair the quality of the audit and we would be happy to assist the Commission in assessing any proposals when these have been formulated. FEE would also encourage policy makers to ensure that it fully engages with all stakeholders in this process and is conscious of what the implications of any proposals will mean in practice for all sizes of European businesses through a robust and transparent impact assessment.

FEE and its Members



About FEE

FEE (Fédération des Experts-comptables Européens - Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all 27 EU Member States. In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 500.000 professional accountants working in different capacities in public practice, small and larger firms, business, public sector and education, who all contribute to a more efficient, transparent, and sustainable European economy. Based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in this public policy debate.