

# Briefing Paper

*Standing for trust and integrity*

August 2014



## THE APPOINTMENT OF THE AUDITOR AND THE DURATION OF THE AUDIT ENGAGEMENT: Striving for a Workable Single Market in the EU

### Introduction

FEE seeks to provide an overview of the changes included in the updated European Union (EU) requirements regarding the appointment of the auditor and the duration of the audit engagement.

These requirements introduce a number of Member State options<sup>1</sup> relating to this topic and FEE is committed to informing the choice of Member States with the objective of creating a workable single market in this respect and enhancing consistency of application throughout the EU as far as possible.

Whilst primarily targeted at the auditing profession in the EU, the audit legislation also imposes requirements on businesses, i.e. on Public Interest Entities (PIEs) and their audit committees. Therefore, it is preferable to help promote the consistency of the regulatory framework governing statutory audit across the EU and to ensure that any additional burden on business is minimised given the cost implications that may result for them. EU Member States have a one-time opportunity to get this right and should keep the burden on business in mind when transposing, applying and implementing this legislation in their jurisdictions.

### Background

Provisions related to this topic are included in:

- The **Directive 2014/56/EU**<sup>2</sup> amending the Directive 2006/43/EC<sup>3</sup> (2006 SAD) on every statutory audit in the EU (hereafter referred to as “the Directive”), but which includes provisions on the responsibilities of the audit committee applicable to PIEs only; and
- The **Regulation (EU) No 537/2014**<sup>4</sup> containing requirements that relate specifically to statutory audits of Public Interest Entities (PIEs) (hereafter referred to as “the Regulation”).

Both the Directive and the Regulation were published in the Official Journal of the EU on 27 May 2014 and came into force 20 days later on 16 June 2014.

The Directive needs to be transposed by the respective individual Member States into their national legislation in order to become effective. Member states have two years to adopt and publish the provisions to comply with the Directive after its entry into force. The Regulation technically entered into force on 16 June 2014, but most provisions will be applicable as of 17 June 2016 onwards, which ties in with the transposition deadline of the Directive.

<sup>1</sup> FEE has prepared tables summarising the options available in the Directive and Regulation :  
[http://www.fee.be/images/publications/auditing/Option\\_Table\\_-\\_Audit\\_Directive\\_2014.pdf](http://www.fee.be/images/publications/auditing/Option_Table_-_Audit_Directive_2014.pdf)  
[http://www.fee.be/images/publications/auditing/Option\\_Table\\_-\\_Audit\\_Regulation\\_2014.pdf](http://www.fee.be/images/publications/auditing/Option_Table_-_Audit_Regulation_2014.pdf)

<sup>2</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0056&from=EN>

<sup>3</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0043:20080321:EN:PDF>

<sup>4</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN>

## General provisions applicable to all entities

The Directive requires the auditor to be formally appointed by the general meeting of shareholders or members of the audited entity. Member States may also allow alternative systems of appointment that ensure the independence of the auditor from the executive members of the administrative or managerial body of the audited entity, for instance via a nominating committee.

Regarding dismissal, the Directive states that the auditor may only be dismissed when there are proper grounds. Divergence of opinions on accounting treatments or audit procedures shall not constitute proper grounds for dismissal.

The independence of the auditor remains one of the key matters to be considered before appointment. In accordance with the Directive, the statutory auditor has to assess and document compliance with the conditions of independence<sup>5</sup> prior to accepting any audit engagement.

Furthermore, the Directive prohibits any contractual clauses which could by any means restrict the choice of auditors to

certain categories or lists of audit firms. If existing, any such clause is null or void<sup>6</sup>.

**A significant change in the Directive is the prohibition of contractual clauses restricting the choice of auditors. FEE believes in free competition and therefore supports the prohibition of such clauses.**

Whilst the above applies to every audit, the following sections deal with the selection of the auditor and the duration of the audit engagement for PIEs as defined in the SAD 2006 and the EU Accounting Directive<sup>7</sup>. These provisions are included:

- In the Directive to the extent that they relate to the responsibilities of the audit committee with respect to the auditor selection and supervision of the audit; and
- In the Regulation that provides detailed requirements with respect to the auditor selection process, the audit tenure and reporting requirements by the audit committee to the general meeting.

## Selection procedure of a new auditor for Public Interest Entities

### Role of the audit committee<sup>8</sup>

The audit committee of a PIE has an important role to play in the appointment of the auditor of the PIE. As part of its responsibilities stated in Article 39 (6) of the Directive, the audit committee is responsible for the procedure of selection of the auditor and the recommendation to the general meeting. Since this approach will be new in some Member States, additional guidance for audit committee members might be necessary to help them perform their duties.

According to the Regulation, the audit committee has to make a reasoned recommendation for the appointment of the auditor following a prescribed selection process and submit that

recommendation to the administrative or supervisory body of the audited entity. The recommendation has to contain at least two auditors and the justified preference for one of them<sup>9</sup>.

**The audit committee of a PIE is charged with the responsibility for selecting the auditor for the PIE via a formal process. FEE welcomes the enhanced involvement and increased transparency in the way in which the audit committee operates in many areas including the auditor selection process. This rationale has been supported in earlier FEE publications:**

- **A Discussion Paper on the Functioning of the Audit Committees<sup>10</sup>, as well as related follow-up events<sup>11</sup>; and**
- **A Paper on the auditor selection process, 'Auditor Selection – Towards Best Practices'<sup>12</sup>.**

<sup>5</sup> Directive, Article 22b

<sup>6</sup> Directive, Article 37

<sup>7</sup> Article 2 of the 2013 Accounting Directive accessible at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:182:0019:0076:EN:PDF>

<sup>8</sup> Exemptions from the obligation to have an audit committee may be granted to PIEs with a body performing equivalent functions to an audit committee in accordance with legal provisions in the Member State or, for reasons of proportionality, to a small or medium-sized undertaking where the functions of the audit committee are performed by an administrative or supervisory body.

<sup>9</sup> Regulation, Article 16 (2)

<sup>10</sup> [http://www.fee.be/images/Discussion\\_Paper\\_on\\_Audit\\_Committees\\_120615.pdf](http://www.fee.be/images/Discussion_Paper_on_Audit_Committees_120615.pdf)

<sup>11</sup> [http://www.fee.be/index.php?option=com\\_content&view=article&id=1295&Itemid=106&lang=en](http://www.fee.be/index.php?option=com_content&view=article&id=1295&Itemid=106&lang=en)

<sup>12</sup> [http://www.fee.be/images/Auditor\\_selection\\_Towards\\_best\\_practices\\_1310.pdf](http://www.fee.be/images/Auditor_selection_Towards_best_practices_1310.pdf)

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## Selection procedure

The Regulation requires the audited entity to organise a thorough selection process for the auditor.

This selection procedure is to be conducted under the responsibility of the audit committee of the audited entity and has to meet the following conditions<sup>13</sup>:

- In general, the audited entity is free to invite any audit firm to participate in a tender for the audit, with a process that does not preclude audit firms that received less than 15 % of their total audit fees from PIEs in the Member State concerned in the previous calendar year. The auditor that has to rotate off (according to the rules as set in Article 16 of the Regulation) cannot de facto be invited to tender for a cooling off period of four years;
- Invited auditors should be provided with tender documents, which provide a basic understanding of the entity and clearly set out the selection criteria. The Regulation clarifies that, within this process, the audited entity is free to enter into negotiations with the tenderers. Tender documents shall contain transparent and non-discriminatory selection criteria to be used by the audited entity to evaluate the proposals received;
- The report on the conclusions of the selection procedure should be based on the criteria stated in the tender documents and has to be validated by the audit committee;

- If any, published findings or conclusions of inspections conducted by the appropriate audit regulator on the auditors proposed for the audit engagement should be taken into consideration; and
- The entity to be audited must be able to demonstrate to the competent authority that the selection procedure was conducted in a fair manner.

Small and medium-sized PIEs and companies with lower market capitalisation are exempted from the requirement to organise a selection procedure as per the criteria laid down above<sup>14</sup>. In practical terms, there might be different scenarios possible for the selection of the auditor of PIEs that are subsidiary undertakings given the fact that this type of PIE is exempted from the requirement to have an audit committee when an audit committee is established at the group level.

**As part of FEE's commitment to contributing towards preserving auditor independence and enhancing corporate governance, in 2013 FEE took the initiative to reflect on the auditor selection process: a pan-European stakeholders' survey and the work of an expert task force resulted in a publication outlining best practices for entities seeking guidance on how to manage this process. The FEE Paper on the auditor selection process 'Auditor Selection – Towards Best Practices' examines the governance aspects around the selection of the auditor, the phases of the process, and provides an appropriate list of criteria to be assessed when selecting an auditor.**

## Duration of the audit engagement applicable to Public Interest Entities

As per the Regulation, PIEs need to appoint their auditor or audit firm **for a minimum of one year and a maximum of ten years**, although, as discussed below, Member States can extend the maximum duration period in specified circumstances. Member States are provided with an option regarding both of these deadlines<sup>15</sup>:

- Member States are allowed to set the minimum duration to **longer than one year**; and
- Member States are allowed to set the maximum duration to **shorter than ten years**.

### Minimum and maximum duration of the audit engagement and their interaction

The minimum duration<sup>16</sup> of the audit engagement is currently set higher than one year in several EU Member States, for example Belgium and France. This minimum duration will now need to be considered in the context of the maximum duration of ten years as set by the new EU audit Regulation.

<sup>13</sup> Regulation, Article 16 (3)

<sup>14</sup> Regulation, Article 16 (4)

<sup>15</sup> Reaulation, Article 17 (2)

<sup>16</sup> The minimum duration of the audit engagement as referred to in this paper stands for the minimum number of years for which the auditor is initially appointed.

|  | Minimum duration<br>6 years | Minimum duration<br>5 years | Minimum duration<br>3 years | Minimum duration<br>1 year |
|--|-----------------------------|-----------------------------|-----------------------------|----------------------------|
| Possible renewed periods of initial appointment  | 1 period                    | 2 periods                   | 3 periods                   | 10 periods                 |
| Maximum duration possible to comply with the ten-year maximum duration set by the Regulation | 6 years                     | 10 years                    | 9 years                     | 10 years                   |

That being said, regulations at Member State level setting a minimum duration of three or more years and/or preventing early resignation might need to be fine-tuned such that the duration of the combined minimum periods coincides with the maximum duration. The above table is intended to illustrate how minimum duration and maximum duration will interact.

Currently, in some Member States such as Italy, the Netherlands and Portugal, a maximum duration of the initial audit engagement is already set at national level for a period shorter than the maximum period permitted by the Regulation. However, in the Netherlands the maximum duration is expected to be changed from eight to ten years to comply with the EU Regulation. If not reconsidered by all other relevant parties, the interaction between different maximum durations of audit engagements within the EU could be a significant issue for cross-border businesses and their auditors.

It would be in the interests of businesses across the EU to promote a level playing field as far as possible – without limiting the choice and flexibility for businesses – keeping in mind that many EU PIEs are operating cross-border. Divergence in the choices of Member State options would increase complexity and costs on business while the performance of the audit will not always be as smooth as it could be. In addition, because auditors of subsidiaries might have to change at different times, the group auditor may face additional procedures and inefficiencies in the coordination of the audit. These could be avoided if transition timings were harmonised throughout the EU.

**FEE understands that the different minimum durations of the audit engagement across Member States are carried forward from a long tradition of a variety of local corporate governance laws and regulations. In addition, in some Member States, a maximum duration of the audit engagement is already set at national level for a period shorter than the maximum period permitted by the Regulation.**

**Providing flexibility to businesses within the EU to allow PIEs to set the same rotation rules at group level for the entire entity would be beneficial to those businesses operating cross-border. Specifically, this flexibility permits parent companies and their subsidiaries in different EU Member States to more easily achieve compliance with one another's respective national maximum duration requirements based on Article 17 of the Regulation. Disruption due to different rotation timeframes could lead to additional audit procedures and inefficiencies in the coordination of audits with potential effects on the quality and cost of audits.**

## Extending the duration of the audit engagement - maximum duration of renewed engagement

Member States are also given two separate options to extend the maximum duration of the initial audit engagement to the total maximum duration of a renewed audit engagement – by imposing “tendering” or “joint audit”. By enabling one of these options, the same auditor may stay in place<sup>17</sup>:

<sup>17</sup> Regulation, Article 17 (4)

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- **A total period of maximum 20 years**, but only if a tender<sup>18</sup> takes effect upon the expiry of the first ten-year period (or a shorter period decided by the Member State) and the engagement is renewed. The tender should be organised under the conditions for a transparent selection process as described above;
- **A total period of maximum 24 years**, but only if upon the expiry of the first ten-year period, “more than one auditor is simultaneously appointed, provided that the audit results in the presentation of the joint report” (hereafter referred to as a “joint audit”). It shall be noted that, according to the legal text, it is also possible to jointly appoint two auditors who have to present a joint report for the entire 24-year period, in which case no interim tender is required.

A PIE may request that the competent authority grant an extension to re-appoint the auditor for a maximum of **two years** after the expiry of the maximum duration of the engagement<sup>19</sup>. However this provision is to be used on a strictly exceptional basis.

## Via a tendering process

Assuming that a Member State would implement the option to prolong the audit engagement to the maximum of 20 years as set out in the Regulation, the duration of renewed engagement<sup>19</sup> would be as follows:

| Possible duration of audit engagement renewed by tendering |           |
|--|-----------|
| Initial maximum duration of audit engagement               | 10 years* |

Tendering process

|  |           |
|--|-----------|
| Duration of renewed engagement by tender | 10 years* |
|--|-----------|

Tendering process (incumbent auditor cannot participate)

\* Unused years from the initial audit engagement cannot be transferred to the engagement renewed by tender.

## Via a joint audit

Having more than one statutory auditor was already an option that EU Member States and entities could adopt under the 2006 SAD.

Whilst this has only been adopted in a limited number of Member States, for example in France, and a very small minority of companies have chosen to do so voluntarily, it is recognised that certain jurisdictions see merit in this approach. However, there are still significant factors which should be considered such as how the concept of joint audit works in practice when two audit firms jointly carry out an audit at national, European and international level, or how to act in situations where the audit firm rotation mechanisms are different between subsidiaries of the PIE. The effect these factors could have on audit quality should also be considered.

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.

Where the Member State chooses to implement the option to allow or mandate joint audit, the audit engagement may be renewed without the execution of a tender up to the total maximum of 24 years. The different scenarios, applying joint audit – in full or part – or not, are illustrated in the following table:

| Audit conducted by one statutory auditor | More than one auditor (“joint audit”) | Combination of tendering and joint audit  |
|--|---------------------------------------|---|
| 10 years                                 | 24 years with an automatic renewal    | 10 years audited by one statutory auditor |
| Possible renewal by tender               |                                       | Possible renewal by tender                |
| 10 years                                 |                                       | 14 years with joint audit                 |
| <b>20 years total maximum</b>            | <b>24 years total maximum</b>         | <b>24 years total maximum</b>             |

<sup>18</sup> Article 17 refers to “public” tender, but the conditions under which it should be organised are set in Article 16 where “public” is not mentioned. This procedure should therefore not be considered as public.

<sup>19</sup> Regulation, Article 4 (2)

As Member States are given two options where they may allow companies to prolong the initial maximum duration of an audit engagement, via “tendering” or “joint audit”, although it is not realistic to expect all Member States to adopt the same approach, FEE would like to point out that Member States which do not take up these duration extension options will significantly limit the options and flexibility for businesses, their audit committees, boards and shareholders.

## Other related provisions

### Cooling-off period

The “cooling-off” period, during which the statutory auditor, audit firm or any member of their network shall not undertake the statutory audit of the same PIE after expiration of the total maximum duration of a renewed engagement, is **four years as from the end of the engagement**.

### Rotation of key audit partners and senior personnel

The key audit partner must rotate at least every seven years with a cooling off period of three years; the Member State may decide to make this rotation period shorter.

As an addition to the rotation of the key audit partner that was already required under the 2006 SAD, the Regulation also requires the auditor to establish an effective gradual rotation system for senior personnel<sup>20</sup>, meaning engagement team members with long term audit experience and at least all those who are registered as auditors. The rotation should be executed individually.

## Summary of rotation deadlines

The summary of rotation deadlines is illustrated in the following table:

| Mandatory audit firm or statutory auditor rotation                      |                                       |          |
|---|---------------------------------------|----------|
| Minimum duration of audit engagement                                    |                                       | 1 year   |
| Initial maximum duration of audit engagement                            |                                       | 10 years |
| Maximum duration of renewed audit engagement via options                | Tendering process                     | 20 years |
|   | More than one auditor (“joint audit”) | 24 years |
| Exceptional extension (subject to competent authority’s approval)       |                                       | 2 years  |
| Cooling-off period  |                                       | 4 years  |
| Key audit partner rotation  |                                       |          |
| Rotate every  |                                       | 7 years  |
| Cooling-off period  |                                       | 3 years  |
| Senior personnel rotation   |                                       |          |
| Rotate when appropriate based on the scale and complexity of activities |                                       |          |

**Although mandatory rotation of audit firms is considered by regulators as a contributor to more independence and objectivity of the auditor and a possible means to decrease audit market concentration, the effect of disruption due to different rotation timeframes and deadlines across the EU should not be underestimated. EU Member States have a one-time opportunity to deal with this.**

## Transitional arrangements

The deadline by which PIEs will have to change their auditors depends on the length of the audit appointment at the date the new legislation came into force, namely on 16 June 2014:

- If the auditor of a PIE has been in place for **20 years or more**, the PIE cannot enter into or renew the engagement after six years of the entry into force, namely:

|  |              |
|--|--------------|
| Publication in the Official Journal  | 27 May 2014  |
| Entry into force   | 16 June 2014 |
| Deadline preventing a PIE from entering into or renewing an audit engagement with an incumbent auditor | 16 June 2020 |

<sup>20</sup> Regulation, Article 17 (7)

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- If the auditor or audit firm of a PIE has been in place for between **11 and 20 years**, the PIE cannot enter into or renew the engagement after nine years of the entry into force, namely:

|  |              |
|--|--------------|
| Publication in the Official Journal  | 27 May 2014  |
| Entry into force   | 16 June 2014 |
| Deadline preventing a PIE from entering into or renewing an audit engagement with an incumbent auditor | 16 June 2023 |

- Otherwise, the new regime will start to apply to the engagements that were entered into before the date of entry into force of the legislation and that are still in place on the legislation implementation date, which FEE interprets as follows:

|  |              |
|--|--------------|
| Publication in the Official Journal  | 27 May 2014  |
| Entry into force   | 16 June 2014 |
| Deadline for first rotation (depending on when the engagement started, to reappoint the auditor or audit firm or to appoint a new auditor) | 16 June 2026 |

There is a need for appropriate clarification for the third case detailed above where the auditor has been in place for less than eleven years. Assuming that the maximum duration is set at ten years, there are two possible interpretations:

- A first restrictive interpretation for those audit engagements that have reached at least ten years when the Regulation applies (i.e. on 17 June 2016, two years after entry into force), the PIE would have to change auditor by 17 June 2016 and for those that have not yet reached ten years, the PIE would have to change auditor at the latest when the ten-year mark is reached. This would mean that PIEs with audit relationships started between 17 June 2003 and 16

June 2006 would have to change auditor at the latest on 16 June 2016, well before PIEs with longer-running audit engagements which may continue until mid 2020 or 2023. Since this approach would lead to a “cliff effect” (i.e. a sudden and abrupt change, with virtually no transitional period) and is at odds with the logic of the transitional arrangements, FEE does not support this interpretation.

- Another interpretation whereby the maximum period only starts to run as from when the Regulation actually applies (i.e. a prospective application) seems more logical to stakeholders in this debate, including FEE. For PIE audit engagements that start in the period between 17 June 2003 and the date of entry into force of the Regulation and that are still running on the day the Regulation becomes applicable, the incumbent auditor would not be permitted to be reappointed after 16 June 2026, which is compatible with longer audit engagements not being permitted to be renewed after, respectively, 16 June 2020 and 16 June 2023. This interpretation is supported by FEE and is illustrated in the table below.

| Auditor in place for                           | 20 or more years    | Between 11 and 20 years               | Less than 11 years                    |
|--|---------------------|---------------------------------------|---------------------------------------|
| Original appointment                           | Before 17 June 1994 | Between 17 June 1994 and 16 June 2003 | Between 17 June 2003 and 16 June 2014 |
| Entry into force                               | 16 June 2014        |                                       |                                       |
| Transitional period                            | 6 years             | 9 years                               | n/a                                   |
| Deadline for entry into or renew an engagement | 16 June 2020        | 16 June 2023                          | 16 June 2026                          |

**Transitional arrangements have been set in the Regulation with regard to the application of the mandatory rotation requirement for long-lasting existing engagements between PIEs and statutory auditors. The laudable objective is to avoid a “cliff effect” on the audit market when these rules will effectively apply.**

**Nevertheless, these transitional arrangements still need to be clarified, especially for the cases whereby the PIEs anticipated the need to change auditors in the past few years and will reach at least ten years when the Regulation applies (i.e. on 16 June 2016, two years after entry into force).**

## Conclusion

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As detailed above, the new requirements placed upon the appointment of the auditor and the duration of the audit engagement and the way in which individual Member States exercise the options available to them will have significant impact on the business environment within the EU. Diverging minimum and maximum durations of audit engagement in different Member States will generate practical difficulties, potentially increasing costs, especially for businesses operating cross-border.

The use of a Regulation should have resulted in a more certain and harmonised EU audit regulatory environment. However,

due to the number of options available to Member States, the extent to which these are exercised will significantly impact regulatory convergence. The risk is that an unnecessarily complex regulatory environment will be created which will affect the EU's growth agenda for business.

FEE strongly recommends that Member States act to mitigate this risk and consider carefully the implications of utilising or not utilising those options in order to promote a workable single market as much as possible. FEE calls for the maximum choice and as much flexibility as possible for businesses, their audit committees and shareholders.

## About FEE

**FEE (Fédération des Experts-comptables Européens – Federation of European Accountants) is an international non-profit organisation based in Brussels that represents 47 institutes of professional accountants and auditors from 36 European countries, including all of the 28 EU member states.**

FEE has a combined membership of more than 800,000 professional accountants, working in different capacities in public practice, small and large accountancy firms, businesses of all sizes, government and education – all of whom contribute to a more efficient, transparent and sustainable European economy.

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