



Department
for Business
Innovation & Skills

**AUDITOR REGULATION –
SUPPLEMENTARY INFORMATION**

The implications of the EU and
wider reforms

MARCH 2015

Contents

Contents	2
AUDITOR REGULATION - SUPPLEMENTARY INFORMATION	4
... on the implications of the EU and wider reforms	4
Questions and Answers	6
Transitional provisions under Article 41 of the new Audit Regulation (and the effect of the first subparagraph of Article 17(8))	6
1. Which Public Interest Entities (PIEs) do the first two transitional provisions at Article 41(1) and (2) apply to?	6
2. What is the effect of the transitional provisions?	6
3. When is an audit engagement to be understood to have begun and ended for the purposes of the Regulation?	6
4. Can an audit engagement for the last financial year beginning before the 17 June 2020 or 2023 dates under the transitional provisions be completed?	7
5. Doesn't this contradict the two bullet points at the bottom of page 30 of the discussion document?	7
6. Which PIEs does the third transitional provision, at Article 41(3), apply to?	8
7. What is the effect of the third transitional provision?	8
8. Given the Government's proposals on the options under the framework for tendering in the Regulation, when would the audit normally be required to be put out to tender?	8
9. The first and second transitional provisions each specify a date after which auditor engagements are affected. Is there a date after which audit engagements under the third transitional provision will be affected?	9
10. Is this also true for those audit engagements covered by the third transitional provision that, on the application date, have reached 11, 12 or even 13 years' duration?	9
11. Doesn't this contradict the bullet point at the top of page 31 of the discussion document?	9
12. What are the minimum requirements for a tender during the audit engagement period to be effective for the purpose of allowing the extension of the maximum duration?	10

13. Where a tender during the audit engagement period results in the reappointment of the auditor for a financial year beginning before the 17 June 2016 application date, would the maximum duration of the audit engagement be extended beyond ten years?	10
14. What are the minimum requirements for a tender during the audit engagement period resulting in the reappointment of the auditor for a financial year beginning before 17 June 2016 to be effective for the purpose of allowing the extension of the maximum duration?	11
15. What would the allowable extension of the maximum duration be following a tender?	11
Determination of the date to be treated as the beginning of the audit engagement (and the effect of the third subparagraph of Article 17(8))	11
16. How does the first subparagraph of Article 17(8) relate to the second and third subparagraphs?	11
17. How are the rotation and tendering requirements of Article 17 of the new Audit Regulation intended to apply when a PIE undergoes a group reconstruction, resulting in the creation of a new PIE as the holding company of the group?	12
18. Would the auditor’s engagement period be regarded as having started when they were appointed to audit the new PIE in a group reconstruction or, if the new PIE is effectively the same as the old one, should the period be regarded as having started when the auditor was first appointed to the old PIE?	12
19. Where the auditor has held office for a continuous period beginning before the client met the applicable conditions for it to qualify as a PIE, should the audit engagement be viewed as having begun when those conditions were met or when the auditor was originally appointed?	13
20. So does the competent authority have absolute discretion to determine the “relevant” start date of an audit engagement in cases where this is not clear?	13
21. Will it be possible for the competent authority to issue guidance on how it would assess cases under the third sub-paragraph of article 17(8)?	13
The sanctions to be applied for breaches of the audit tendering and auditor rotation framework	14
22. What sanctions will be applicable for breaches of the framework?	14

AUDITOR REGULATION - SUPPLEMENTARY INFORMATION

... on the implications of the EU and wider reforms

This document supports the discussion document on the UK Implementation of the new EU Audit Directive and Regulation launched on 17 December 2014¹. The closing date for responses to the discussion document is 19 March 2015.

The supplementary information in this document mostly concerns the framework for auditor tendering and rotation in the Audit Regulation². It provides answers to questions raised following the launch of the discussion document. At the invitation of the Department for Business Innovation and Skills (BIS), this document has been developed in collaboration with:

- **the Competition and Markets Authority (CMA)**, which has already issued an Order requiring competitive tendering of auditor appointments³, applying to companies listed on the FTSE 350, and also has enforcement powers in relation to the Order; and,
- **the Financial Reporting Council (FRC)**, which is the independent audit regulator with specific responsibilities in relation to audits of listed companies. The FRC corporate governance code already includes “comply or explain” requirements on audit tendering, applying to companies listed on the FTSE 350.

BIS, the CMA and the FRC are agreed that, in so far as possible, the CMA Order and the requirements of the Regulation should be applied consistently with one another.

The information provided in this document is intended:

- to assist those preparing responses to the discussion document to do so on an informed basis; and,

¹ The discussion document is available at www.gov.uk/government/consultations/auditor-regulation-effects-of-the-eu-and-wider-reforms.

² The Regulation is available at http://ec.europa.eu/finance/auditing/directives/index_en.htm.

³ The Statutory Audit Services for Large Companies (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 see <https://www.gov.uk/cma-cases/statutory-audit-services-market-investigation#orders>.

- to assist those preparing for application of the requirements of the new Audit Regulation as from the application date on 17 June 2016.

Decisions as to the legislative provision to be made for the application of the Regulation will be taken in the light of responses to the discussion document and to a further planned Government consultation on draft regulations in summer 2015.

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Questions and Answers

Transitional provisions under Article 41 of the new Audit Regulation (and the effect of the first subparagraph of Article 17(8))

1. Which Public Interest Entities (PIEs) do the first two transitional provisions at Article 41(1)⁴ and (2)⁵ apply to?

This is set out on page 30 of the BIS discussion document. These provisions apply to PIEs that have engaged the same auditor:

- for 20 years or longer on 16 June 2014 for the first transitional provision; and,
- For 11 years or longer, but less than 20 years, on 16 June 2014 for the second transitional provision.

2. What is the effect of the transitional provisions?

As set out on page 30 of the discussion document, the provisions state that such a PIE cannot “enter into or renew an audit engagement” with that statutory auditor “as from” the following dates:

- 17 June 2020 for PIEs that have engaged the same auditor for 20 years or longer on 16 June 2014; and,
- 17 June 2023 for PIEs that have engaged the same auditor for 11 years or longer but less than 20 years on 16 June 2014.

3. When is an audit engagement to be understood to have begun and ended for the purposes of the Regulation?

The first subparagraph of Article 17(8) makes clear that for the purposes of that Article “the audit engagement should be calculated as from the first financial year covered in the audit engagement letter”. We (and the Commission) consider this should be understood also to

⁴ “As from 17 June 2020, a public-interest entity shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that public-interest entity for 20 and more consecutive years at the date of entry into force of this Regulation.”

⁵ “As from 17 June 2023, a public-interest entity shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that public-interest entity for 11 and more but less than 20 consecutive years at the date of entry into force of this Regulation.”

apply to the calculation of the duration (both the beginning and end) of the audit engagement for the purpose of Article 41.

So for example the audit engagement in relation to the calendar accounting years beginning on 1 January 2000 and ending on 31 December 2023 should be understood to have begun and ended on those dates even though, after the end of the final year, the auditor will have to continue to work to complete the audit of the accounts for that year.

4. Can an audit engagement for the last financial year beginning before the 17 June 2020 or 2023 dates under the transitional provisions be completed?

Yes. The effect of Article 17(8) is to allow the auditor of accounts for the last financial year beginning before the relevant date for the engagement (17 June 2020 or 2023 as the case may be – see the answer to Q2 above) to complete the audit of those accounts. However they could not be reappointed to audit the accounts for the following financial year. This is irrespective of whether such reappointment or any previous reappointment has been on the basis of a tender of the auditor appointment.

5. Doesn't this contradict the two bullet points at the bottom of page 30 of the discussion document⁶?

These two bullet points explained our understanding of the transitional provisions at Article 41(1) and (2) but those provisions need to be read with the first subparagraph of Article 17(8) of the Regulation. In the light of further consideration and discussions with the Commission since the discussion document was written, including the emphasis placed on Article 17(8) in the Commission's own published statements, we think it is appropriate to clarify and explain this point. Decisions on the UK's interpretation of the Regulation will be taken in the light of responses to the discussion document.

The relevant text on page 30 of the discussion document might better have been expressed as:

“As a result, when the start of the first financial year of the audit engagement is:

- On or before 16 June 1994: a PIE cannot renew or enter into an audit engagement with the auditor **in relation to a financial year beginning on or after 17 June 2020**;
- Between 17 June 1994 and 16 June 2003: a PIE cannot renew or enter into an audit engagement **in relation to a financial year beginning on or after 17 June 2023**;

⁶ This text reads “As a result, when the start of the first financial year of the audit engagement is:

- On or before 16 June 1994: a PIE cannot renew or enter into an audit engagement with the auditor that extends beyond 16 June 2020;
- Between 17 June 1994 and 16 June 2003: a PIE cannot renew or enter into an audit engagement with the auditor that extends beyond 16 June 2023;”

6. Which PIEs does the third transitional provision, at Article 41(3)⁷, apply to?

As stated in the discussion document (page 30 again) the provision applies to PIEs that have engaged the same auditor for less than 11 years on 16 June 2014 where that engagement continues so that the auditor is still in place on 16 June 2016.

However, as we did for the first and second transitional provisions, we must apply the first subparagraph of Article 17(8) to the wording of the provision. This means that the provision applies to audit engagements for financial years beginning between 17 June 2003 and 16 June 2014 which are still in place for the financial year that includes 16 June 2016.

7. What is the effect of the third transitional provision?

The provision states that these audit engagements “...may remain applicable until the end of the maximum duration...”.

It then states that the Member State options in Article 17(4) of the Regulation to allow the extension of this maximum duration may apply.

The relevant maximum duration is 10 years or Member States can opt for a shorter maximum duration if they prefer. In the UK the Government is proposing:

- (i) to provide that maximum duration should be 10 years; and,
- (ii) to take up the option to provide for the extension of this maximum duration on the basis of a tendering exercise, up to a maximum duration of the engagement of up to 20 years.

8. Given the Government’s proposals on the options under the framework for tendering in the Regulation, when would the audit normally be required to be put out to tender?

This is explained at the top of page 29 of the discussion document, but Article 17(8) is also relevant here. As from the date when an audit engagement has continued for a duration of 10 years from the start of the financial year for which the auditor was first appointed, the auditor could not be reappointed to audit the accounts for the next financial year, other than on the basis of a tender.

However, as with the answer to Q3 above, the effect of Article 17(8) of the Regulation is that the auditor of the accounts for the last financial year beginning before that date may complete the audit of those accounts.

⁷ “Without prejudice to paragraphs 1 and 2, the audit engagements that were entered into before 16 June 2014 but which are still in place as at 17 June 2016 may remain applicable until the end of the maximum duration referred to in the second subparagraph of Article 17(1) or in point (b) of Article 17(2). Article 17(4) shall apply.”

9. The first and second transitional provisions each specify a date after which auditor engagements are affected. Is there a date after which audit engagements under the third transitional provision will be affected?

The third transitional provision doesn't specify a date, which means that the requirement applies from the normal application date for the Regulation ie 17 June 2016.

At the start of each financial year beginning on or after 17 June 2016, when an audit engagement reaches a duration of 10 years from the start of the financial year for which the auditor was first appointed, the auditor could not be reappointed to audit the accounts for the next financial year, other than on the basis of a tender.

10. Is this also true for those audit engagements covered by the third transitional provision that, on the application date, have reached 11, 12 or even 13 years' duration?

It is true that on 17 June 2016, some audit engagements under the third transitional provision will be of more than 10 years' duration, and up to 13 years' duration. This is because the transitional provision covers audit engagements for financial years that began on or after 17 June 2003. This will be the case for all audit engagements for which the first financial year began between that date and 16 June 2006.

For these audit engagements, we consider that the auditor of the accounts for the financial year beginning before 17 June 2016 is still able to complete the audit of those accounts. However at the start of the first financial year beginning after that date, the auditor could not be reappointed to audit the accounts for that year other than on the basis of a tender.

11. Doesn't this contradict the bullet point at the top of page 31 of the discussion document⁸?

As with Article 41(1) and (2), Article 41(3) needs to be read with the first subparagraph of Article 17(8) of the Regulation.

In the light of further consideration and discussions with the Commission since the discussion document was written, including the emphasis placed on Article 17(8) of the Regulation in the Commission's own published statements, we think it is appropriate to clarify and explain this

⁸ This text reads "[As a result, when the start of the first financial year of the audit engagement is:]

- Between 17 June 2003 and 16 June 2006: PIEs will need to conduct a tender and either reappoint the existing auditors or appoint new auditors so that the new audit engagement takes effect on or before 16 June 2016, ie by the date of application of the Regulation.

point. Final decisions on the UK's interpretation will be taken in the light of responses to the discussion document and further consultation later in 2015.

This text might better have been expressed as:

“[As a result, when the start of the first financial year of the audit engagement is:]

- Between 17 June 2003 and 16 June 2006: PIEs will need to conduct a tender and reappoint the existing auditors or appoint new auditors so that the new audit engagement takes effect **in relation to the next financial year beginning after 16 June 2016**”.

12. What are the minimum requirements for a tender during the audit engagement period to be effective for the purpose of allowing the extension of the maximum duration?

For an audit engagement for a financial year beginning after the application date for the Regulation, the tendering exercise will need to be conducted in accordance with the Regulation.

However, as is explained on page 32 of the discussion document, we are also considering whether, in order to be effective for the purpose of extending the maximum duration, a tender for a financial year beginning before the expiry of the initial maximum duration of 10 years, should be required to be notified in advance.

As explained on page 34 of the discussion document, this notification would take the form of a disclosure by the audit committee in the directors' report stating the next financial year in relation to which the PIE intends that the auditor appointment would be based on a tender. For the tender to be effective for the purpose of extending the maximum duration, it would need to be notified in the directors' report accompanying the accounts for the financial year two years before the financial year for which the auditor appointment would be the result of the tender.

13. Where a tender during the audit engagement period results in the reappointment of the auditor for a financial year beginning before the 17 June 2016 application date, would the maximum duration of the audit engagement be extended beyond ten years?

We are considering whether the maximum duration of the audit engagement should be extended to longer than 10 years where a tender resulted in the reappointment of the auditor for a financial year beginning before the application date. This would be consistent with the approach taken in the CMA Order and any provision would also need to be consistent with Article 41(3) of the Regulation.

We recognise that there may well be tenders that have resulted in the reappointment of the auditor, or will do so, for financial years beginning before the application date.

We would appreciate responses to the discussion document on this issue.

14. What are the minimum requirements for a tender during the audit engagement period resulting in the reappointment of the auditor for a financial year beginning before 17 June 2016 to be effective for the purpose of allowing the extension of the maximum duration?

Though the CMA Order applies to FTSE 350 companies only, it defines a “competitive tender process” as being:

“a process by which a Company invites and evaluates bids for the provision of Statutory Audit Services from two or more Auditors”.

This applies whether the tender results in the appointment of the auditor for a financial year beginning before or after 17 June 2016.

We are considering the extent to which this would be sufficient in cases of a tender by any PIE, which resulted in the reappointment of the auditor for a financial year beginning before the 17 June 2016 application date for the Regulation.

15. What would the allowable extension of the maximum duration be following a tender?

The discussion document (page 32) considers how the maximum duration of the audit engagement should be extended following a tender. It also considers (on page 33) how an extension of the maximum duration to less than 20 years might be followed by a further tender to allow a further extension to the final maximum duration of 20 years that is permitted by the Regulation.

We are considering the extent to which the options discussed on page 32 of the discussion document also apply in cases where the tender resulted in a reappointment of the auditor for a financial year beginning before the 17 June 2016 application date.

Determination of the date to be treated as the beginning of the audit engagement (and the effect of the third subparagraph of Article 17(8))

16. How does the first subparagraph of Article 17(8) relate to the second and third subparagraphs?

As discussed above, the first subparagraph of Article 17(8) sets out when the audit engagement begins for the purposes of Article 17. This is:

“the first financial year covered in the audit engagement letter in which the statutory auditor or the audit firm has been appointed for the first time for the carrying-out of consecutive statutory audits for the same public-interest entity”.

The second subparagraph of Article 17(8) then states that for the purposes of Article 17, the audit firm includes other firms acquired by or merged with the firm. (So, if audit firm A acquires audit firm B, A’s audit work for PIE X cannot be passed on to B as a way of getting round the maximum engagement duration requirements).

The third sub-paragraph in Article 17(8) addresses cases of uncertainty about the date on which an auditor or audit firm begins “carrying out consecutive statutory audits”. This subparagraph notes that such uncertainty could occur because of firm mergers, acquisitions or changes in ownership structure but the words “for example” show that this is not meant to be an exhaustive list of the causes of uncertainty about the start date.

17. How are the rotation and tendering requirements of Article 17 of the new Audit Regulation intended to apply when a PIE undergoes a group reconstruction, resulting in the creation of a new PIE as the holding company of the group?

The third subparagraph of Article 17(8) appears primarily aimed at cases where there are changes in the structure etc of the auditor rather than changes in the structure etc of the audited entity.

However, the list given in that subparagraph is not an exhaustive list – the main intention is to cover cases of uncertainty about the date. The Government takes the view that this could also cover cases where mergers, divisions, takeovers or other forms of acquisition or change in ownership structure create uncertainty about the date on which the auditor or firm begins carrying out audits.

18. Would the auditor’s engagement period be regarded as having started when they were appointed to audit the new PIE in a group reconstruction or, if the new PIE is effectively the same as the old one, should the period be regarded as having started when the auditor was first appointed to the old PIE?

Advice on individual cases will be a matter for the competent authority, once it is concluded which body should be responsible for oversight of compliance with the appointment and tendering framework.

However, we consider the Regulation allows the competent authority to put greater emphasis on whether there has been any substantive effect resulting from the change in the ownership structure of the group in question.

In the example given, it would appear that, in substance, the ownership of the PIE (ie its shareholders) and its business are unchanged. In a case like this where there has been no substantive effect, we would expect the audit engagement period to be regarded as having started when the auditor was first appointed to the old PIE.

19. Where the auditor has held office for a continuous period beginning before the client met the applicable conditions for it to qualify as a PIE, should the audit engagement be viewed as having begun when those conditions were met or when the auditor was originally appointed?

The Regulation is not applicable to non-PIEs. So, following the application date for the Regulation, the start of an audit engagement for a newly qualifying PIE will be the first date of the first financial year for which the entity must prepare audited accounts as a PIE.

We consider the same applies in relation to the calculation of the start date for an audit engagement where the client became a PIE before the application date for the Regulation.

For example where an auditor was originally appointed in 1991 and the client met the applicable conditions to qualify as a PIE in 2001, the engagement will be subject to the transitional provision at Article 41(2) as the audit engagement with the PIE should be understood to have begun at the start of the 2001 calendar accounting year.

However, we recognise that to establish whether or not the conditions were met for an entity to qualify as a PIE before the conditions were applicable may prove difficult for some PIEs. This is another area where the competent authority may be required to make a determination under the third subparagraph of Article 17(8).

20. So does the competent authority have absolute discretion to determine the “relevant” start date of an audit engagement in cases where this is not clear?

The discretion of the competent authority under article 17(8) is limited to determining “the date on which [the auditor] began carrying out consecutive audits for the public interest entity” and then only where there is “uncertainty as to the date” and the audit firm has reported that uncertainty to the competent authority. In addition the competent authority would need to make a determination that is consistent with the Regulation and UK company law and apply the principles of administrative law and of EU law in making its determinations. It would be susceptible to judicial review if, for example, it did not follow proper processes.

21. Will it be possible for the competent authority to issue guidance on how it would assess cases under the third sub-paragraph of article 17(8)?

This is not precluded by the Regulation. It will be a matter for the competent authority, once it is concluded which body should be responsible.

The sanctions to be applied for breaches of the audit tendering and auditor rotation framework

22. What sanctions will be applicable for breaches of the framework?

This matter will be determined in the light of the responses to the discussion document, in particular to Question 33, which is at the end of Chapter 4.4. We do not consider it would generally be appropriate for an audit report to be invalidated by such a breach, once the report had been accepted at an annual general meeting.

We consider the kinds of sanctions envisaged by the CMA Order to be more appropriate than this. Section 167 of the Enterprise Act 2002 provides that the CMA can bring civil proceedings to enforce an Order. There is a duty on persons to whom the Order applies to comply with it. This duty is owed to persons who are affected by a contravention of the Order. Persons who suffer loss or damage as a result of a breach can also bring an action (although it is a defence to show that all reasonable steps were taken and all due diligence exercised to avoid contravening the Order). Where there is a doubt as to the interpretation of a provision or a gap in the Order, the CMA is able to enter into a dialogue with the party concerned.

Where compliance was difficult due to a difficulty in interpreting the Order or meeting its provisions, or otherwise an “inadvertent breach” had occurred, CMA would usually seek to inform the relevant parties of what it is prepared to accept by way of compliance (but bearing in mind that, technically, the Order may still be breached and that third parties could still take action).

However, the Government is also ready to consider other solutions. We would appreciate the views of respondents to the discussion document on this issue.



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