

Commissioner Michel Barnier  
DG Internal Market and Services  
European Commission

via email: [Michel.Barnier@ec.europa.eu](mailto:Michel.Barnier@ec.europa.eu)

cc: [Ugo.Bassi@ec.europa.eu](mailto:Ugo.Bassi@ec.europa.eu)  
[Nathalie.Berger@ec.europa.eu](mailto:Nathalie.Berger@ec.europa.eu)

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Dear Commissioner,

**Re: Joint Associations Letter - Audit firm rotation & transitional provisions**

Transitional arrangements for mandatory audit firm rotation

The new European regulation on statutory audits of public interest entities (PIEs), due to be published soon, brings in a new requirement to change auditor after a maximum period of 10 years, which Member States have the option to extend up to 20 or 24 years respectively in case of a tender or joint audit. Member States are also entitled to set a maximum duration of less than 10 years which further complicates matters. In what follows, the assumption is made that the maximum duration is set at 10 years.

A recent stakeholder meeting on the audit regulation organised by the Commission highlighted differences in view as to how the transitional arrangements for this new requirement are to work for audit engagements in place for less than 11 years at entry into force of the regulation.

The regime outlined for audit engagements that have been in place for 20 or more years or between 11 and 20 years at entry into force of the regulation<sup>1</sup> appears clear (Article 41 (1) and (2) of the regulation): they may not be renewed as from respectively 6 or 9 years after entry into force of the regulation. This means that assuming the regulation enters into force on 15 June 2014, where the auditor/public interest entity relationship is at least 20 years long or between 11 and 20 years long on 15 June 2014, the entity cannot re-appoint its incumbent auditor after respectively 15 June 2020 (i.e., six years later) or 15 June 2023 (i.e., nine years later). The longer the audit relationship, the shorter the period during which it may continue.

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<sup>1</sup> The regulation will enter into force 20 days after its publication in the Official Journal of the European Union and apply 2 years after entry into force except for transitional measures and certain limited provisions.

However, we have serious concerns about the initial explanation provided by the Commission for audit engagements in place for less than 11 years at entry into force of the regulation (Article 41 (3) and Article 17 of the regulation): for those that have reached at least 10 years when the regulation applies (i.e., on 15 June 2016, 2 years after entry into force), the PIE would have to change auditor by 15 June 2016 and for those that have not yet reached 10 years, the PIE would have to change auditor at the latest when the 10 year mark is reached.

This would mean that PIEs with audit relationships started between 15 June 2003 and 15 June 2006 would have to change auditor at the latest on 15 June 2016, well before PIEs with longer-standing audit engagements which may continue until 2020 or 2023.

An interpretation whereby the maximum period only starts to run as from when the regulation actually applies (i.e. a prospective application) seems more logical. For PIE audit engagements that start in the period between 15 June 2003 and the date of entry into force of the regulation and that are still in force on the day the Regulation becomes applicable, the incumbent auditor would not be permitted to be reappointed after 15 June 2026, which is compatible with longer audit engagements not being permitted to be renewed after, respectively, 15 June 2020 and 15 June 2023.

The reason for the Commission's initial view appears to be their interpretation of a reference to the 10 year maximum duration of successive audit engagements as including the period before the regulation actually applies. Article 41 (3) provides that audit engagements in place for less than 11 years may remain applicable until the end of the maximum duration of ten years (or less if a member state so chooses) referred to in Article 17, as may be extended by a member state. However, Article 41 (3) does not specify when this 10 year maximum starts.

The view of stakeholders is that this interpretation cannot be what was intended when the transitional provision was drawn up.

It appears contrary to the stated aims and logic of the regulation for the following reasons:

- This interpretation would lead to a “cliff effect” (i.e. a sudden and abrupt change, with virtually no transitional period), for a large number of engagements resulting in significant market disruption, whereas the very purpose of the transitional provisions of Article 41 is to allow for a smooth transition to the new system (as noted in Recital 21 of the regulation). This would be in sharp contrast to Commissioner Barnier's press statement of 17 December 2013 stating that “a calibrated transitional period taking into account the duration of the audit engagement is foreseen to avoid a cliff effect following the entry into force of the new rules”;
- It is at odds with the logic of the transitional provisions (i.e., that the longer an audit relationship has already run, the shorter the transitional period should be until rotation is required, and vice versa);
- For the sake of argument, even if it would be accepted that periods of time prior to the application of the regulation may be taken into account in calculating the duration of an audit engagement of relationship for the purposes of Article 17(1), the proposed interpretation still appears inappropriate. If one were to assume that Article 41(3) did not exist, and that no transitional period applied to audit engagements covered by Article 41(3), the maximum period for engagements commencing between 15 June 2003 and 15 June 2006 would also expire on 15 June 2016. This means that the proposed interpretation of Article 41(3) would render it devoid of meaning, which cannot have been what Council and Parliament intended;
- Nothing in the wording of Article 17(1), to which Article 41(3) refers, indicates that the time for which an engagement has already run, at the point in time when Article 17(1) becomes applicable, should be taken into account when calculating the maximum period.

In addition, the interpretation suggested by the European Commission may not be in line with some principles of European law:

- The principle of legal certainty (which guards against non-specific and unjustified retroactivity) implies considering that Article 17(1) (like Article 17 more generally) should be interpreted prospectively. Since Article 17(1) sets the maximum period at 10 years, and since the regulation would only become applicable on 15 June 2016, absent any clear provisions to the contrary, the starting point should be that the obligation to consider a change of auditors could only apply at 15 June 2026 at the earliest;
- It may result in a breach of the principle of proportionality. The transitional provision envisages that the familiarity threat for audit relationships of more than 11 years can be addressed by allowing periods of 6 and 9 years. The familiarity threat is less for audit relationships which have less than 11 years, so longer transitional periods are appropriate; and
- It is a breach of the principle of non-discrimination in that it would result in imposing the burden and cost of rotation on those undertakings with shorter-term relationships long before those with longer-term relationships. The former would be discriminated against and punished for having anticipated the legislation.

To summarise, the Commission's initial interpretation would represent significant additional costs for European PIEs and be disruptive for the market which would only have a short time to prepare itself. There could be a very significant cliff effect as a result of the Commission's interpretation and a significant proportion of PIEs in the EU would be affected by the rotation requirements in 2016.

The stakeholders undersigning this paper represent a large section of the EU economy that will be affected by the proposed interpretation. We support the phased approach for transition in Article 41 (1) and 41 (2) as approved by the European Parliament and Council of Ministers. We understand that other European associations representing stakeholders using auditor's services that participated in the EC stakeholders' meeting share the same concerns and are considering expressing similar views. We therefore call upon the Commission to reconsider its initial view on the interpretation of Article 41 (3).

Yours sincerely,



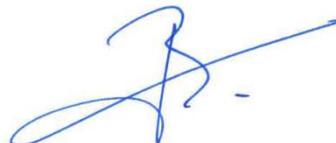
Richard Middleton, MD, Tax & Accounting Policy  
Association for Financial Markets in Europe (AFME)



Guido Ravoet, CEO  
European Banking Federation (EBF)



Susannah Haan, Secretary General  
EuropeanIssuers



Olivier Boutellis-Taft, CEO  
Federation of European Accountants (FEE)