

18 November 2014

Mr Ken Siong  
Technical Director  
International Ethics Standards Board for Accountants (IESBA)  
International Federation of Accountants (IFAC)  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, New York 10017 USA  
By email: kensiong@ethicsboard.org

Dear Mr Siong,

**RE: IESBA's Exposure Draft *Proposed Changes to Certain Provisions of the Code Addressing the Long Association of Personnel with an Audit or Assurance Client***

Accounting Professional & Ethical Standards Board Limited (APESB) welcomes the opportunity to make a submission on IESBA's Exposure Draft *Proposed Changes to Certain Provisions of the Code Addressing the Long Association of Personnel with an Audit or Assurance Client* (Exposure Draft). APESB commends IESBA's efforts to enhance audit quality by addressing familiarity and self-interest threats created by the long association of personnel on an audit or assurance engagement.

However, APESB is concerned with some aspects of the proposals in the Exposure Draft and in particular the proposal to extend the cooling-off period to five years for the Engagement Partner where the audit client is a Public Interest Entity (PIE). We understand that this proposal is based to an extent on some stakeholders' perceptions regarding familiarity and self-interest threats to independence and we are concerned that these perceptions are not supported by evidence from fact-based research (i.e. audit failures directly linked to the existing two-year cooling-off period).

In developing APESB's responses to the Exposure Draft, we have taken into consideration submissions received from Australian stakeholders as well as stakeholders' feedback from two roundtable discussions conducted by APESB in Melbourne and Sydney in October 2014.

***Recommendations***

APESB's key recommendations for IESBA's consideration are:

- As evidence from fact-based research has not been provided in the Explanatory Memorandum to the Exposure Draft to support the proposed five-year cooling-off period for the Engagement Partner of a PIE, APESB believes that the existing two-year period remains appropriate. Furthermore under the existing arrangements, the audit regulator or National Standards Setter (NSS) of any local jurisdiction can determine whether a longer cooling-off period is required taking into consideration jurisdictional specific issues;

- If IESBA believes, despite there being no evidence from fact-based research, that it needs to address the perceptions of important stakeholders, then APESB would support increasing the cooling-off period from two years to three years for the Engagement Partner of a PIE. This approach will allow flexibility for the audit regulator or NSS of local jurisdictions to determine whether a longer cooling-off period (i.e. four or five years) is required taking into consideration jurisdictional specific issues;
- APESB is of the view that the cooling-off period for the Engagement Partner and Engagement Quality Control Reviewer (EQCR) for a PIE should be the same and that they should not be allowed to perform any other function (i.e. limited consultation role) during the cooling-off period;
- In order to trigger the maximum cooling-off period applicable to a Key Audit Partner (KAP) who has served time as an Engagement Partner for a PIE, we believe that the KAP should serve at least three years out of a seven-year period as the Engagement Partner rather than the one year as proposed; and
- We suggest that IESBA define the term '*senior personnel*' to include personnel who are involved in audit **management** and limit the application of the long association provisions to these '*senior personnel*'.

### Specific Comments

APESB's responses to the specific questions raised by the IESBA in the Exposure Draft are as follows:

### General Provisions

1. **Do the proposed enhancements to the general provisions in paragraph 290.148 provide more useful guidance for identifying and evaluating familiarity and self-interest threats created by long association? Are there any other safeguards that should be considered?**

APESB supports IESBA's proposal to enhance the general provisions in paragraph 290.148 by providing guidance to identify, consider and evaluate familiarity and self-interests threats created by long association. However, we believe that guidance should clarify that the significance of these threats increases with the seniority of the audit engagement team member as it is unlikely that a junior team member is able to influence the outcome of an audit engagement merely by reason of long association at a junior level.

2. **Should the General Provisions apply to the evaluation of potential threats created by the long association of all individuals on the audit team (not just senior personnel)?**

APESB is of the view that familiarity and self-interest threats posed by junior personnel are not as significant as senior personnel and that the proposed general provisions should not be extended to all individuals on the audit team. The key decision makers on an audit engagement are the senior personnel who are responsible for the management of the audit engagement. The proposed requirements are likely to introduce an

unnecessary level of complexity in monitoring the tenure of all individuals on the audit team.

In addition, any potential threats caused by long association of junior personnel are reduced through the planning, monitoring and review processes undertaken by senior personnel on the audit engagement. The existing Code refers to threats created by 'senior personnel', which is not a defined term and in practice the focus has been on KAPs.

Accordingly, we propose the following for your consideration:

- Define the term '*senior personnel*' as those who exert significant influence on the outcome of the audit engagement (i.e. audit managers, senior managers, directors and KAPs). This will provide greater clarity to ensure that the general provisions are applied to all senior personnel and are not limited to KAPs.

The above change will mean that the 'time clock' will commence when individuals become audit managers and not when they are in junior roles. Furthermore due to high staff turnover in most audit firms, a significant proportion of junior personnel will leave before becoming audit managers and thus the effort of monitoring and tracking the audit engagements' junior personnel served on will be wasted. APESB's proposal will be less onerous and is likely to be more effective from a cost benefit perspective.

**3. If a firm decides that rotation of an individual is a necessary safeguard, do respondents agree that the firm should be required to determine an appropriate time-out period?**

APESB agrees that the firm should determine the policies and prescribe an appropriate cooling-off period for **senior personnel** (excluding KAPs).

#### **Rotation of KAPs on PIEs**

**4. Do respondents agree with the time-on period remaining at seven years for KAPs on the audit of PIEs?**

APESB concurs with IEBSA's view that the time-on period for a KAP of a PIE should remain as seven years. We note that the existing provisions in the *Australian Corporations Act 2001* (Corporations Act) allow the Engagement Partner to serve a five-year time-on period in respect of a listed entity which can be extended by two years with the approval of the entity's audit committee (i.e. it is legislatively possible for listed entities in Australia to extend the time-on period to seven years). However, to date this has rarely occurred in practice.

**5. Do respondents agree with the proposal to extend the cooling-off period to five years for the engagement partner on the audit of PIEs? If not, why not, and what alternatives, if any, could be considered?**

APESB is not supportive of IESBA's proposal to globally extend the cooling-off period from two years to five years for the Engagement Partner of a PIE, as in our opinion there is a lack of evidence from fact-based research (i.e. audit failures directly linked to the existing two-year cooling-off period) to support such a significant change.

### Major concerns in moving to a five-year cooling-off period

As far as APESB is aware, the five-year cooling-off period is the maximum period stipulated by a few major jurisdictions where this decision was made by the respective audit regulator or NSS of that jurisdiction taking into consideration specific circumstances that existed in those jurisdictions at the time.

In addition to the lack of evidence from fact-based research, our other major concerns in respect of moving to a five-year cooling-off period are:

- the jurisdictions (i.e. USA and UK) that moved to the five-year cooling-off period around 2003/04 were in relative terms badly impacted by the 2007/8 Global Financial Crisis (GFC), suggesting the benefits of moving to the five-year cooling-off period in terms of audit quality is not clear;
- we are not aware of evidence from fact-based research which indicates that the existing two-year cooling-off period required under the Corporations Act for the Engagement Partner has given rise to audit failures in Australia;
- different cooling-off periods under the proposed amendment to the IESBA Code and the existing Corporations Act, when they are currently aligned will add to complexity and give rise to the patchwork of regulations that need to be adhered to. This will add to regulatory burden with uncertain benefits;
- over time the proposal is likely to reduce the number of Engagement Partners with specialised industry knowledge (e.g. mining, agriculture, financial services) as the ability of rotating partners to retain and develop their specialist skills in a five-year cooling-off period will be exacerbated;
- the dwindling supply of Registered Company Auditors (RCAs) in Australia will also be exacerbated by a five-year cooling off period, which may lead to a de facto audit firm rotation particularly in regional areas. In 2006 there were over 6,000 RCAs and in 2013 this number had declined to under 5,000;
- we believe that a likely unintended consequence of the proposal will be to drive PIE audits to the largest firms which will lead to reduced competition in the audit services market. We do not believe such an outcome will be in the public interest;
- Firms and RCAs who operate in regional areas of Australia will find difficulties in assigning replacement Engagement Partners to serve clients which may be detrimental to audit quality; and
- Replaced Engagement Partners will spend more time in business development activities and tender proposals to secure audit and assurance clients as opposed to maintaining and developing audit quality.

### US experience in respect of the five-year cooling-off period

We note that the United States (US) moved to a five-year time-on and five-year cooling-off period for the Engagement Partner and EQCR due to the enactment of the Sarbanes-Oxley Act (SOX) in 2002. A subsequent study published by the American Accounting Association, '*Mandatory Audit Partner Rotation: Perceptions of Audit Quality Consequences*'<sup>1</sup> explores a '*Model of Direct and Indirect Effects of Mandatory Rotation on Audit Quality*' (Model). The study examines how the more stringent Engagement Partner rotation rules mandated by SOX may have negatively impacted audit quality.

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<sup>1</sup> Daugherty, B. E., D. Dickins, R. C. Hatfield, and J. L. Higgs. 2013. Mandatory Audit Partner Rotation: Perceptions of Audit Quality Consequences. American Accounting Association: Current Issues in Auditing: Volume 7, Issue 1, 2013 Page 32.

The model predicts that Engagement Partner rotation has a direct and negative effect on client-specific knowledge, and that client-specific knowledge has a direct and positive effect on audit quality. The study notes that the Engagement Partner rotation provisions create unintended consequences and has an indirect and negative impact on audit quality.

The Engagement Partners who were surveyed for this study did not view the acceleration of rotation, or extension of cooling-off periods, required by SOX and the implementation of U.S. Securities and Exchange Commission (SEC) rules as improving auditor independence in fact. They believed that accelerated rotation is perceived to enhance independence in appearance, but extended cooling-off periods may not have a significant effect on perceived independence.<sup>2</sup>

In 2008, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession (ACAP)<sup>3</sup> heard testimony on auditor rotation, including arguments that the SOX-imposed auditor rotation revisions negatively impacted Engagement Partners' quality of life and, in turn, was detrimental to overall audit quality. Some of the testimony documented difficulties with reassignments caused by more frequent Engagement Partner rotation, particularly in remote geographic regions and in small-practice offices; a growing concern about the profession's ability to attract and retain high-calibre Engagement Partners and detrimental effects on technical and sector experience that results in diminished audit quality.

#### *The significance of Engagement Partner rotation requirements and its impact on audit quality*

We have also performed an assessment of the significance of the auditor rotation requirements and their impact on audit quality by reviewing the following frameworks or studies.

IAASB's 'A Framework for Audit Quality'<sup>4</sup> (February 2014) states that a quality audit is likely to have been achieved by an audit engagement team that:

- exhibited appropriate values, ethics and attitudes;
- was sufficiently knowledgeable, skilled, and experienced and allocated to perform the audit work;
- applied a rigorous audit process and quality control procedures that complied with law, regulation and applicable standards;
- provided useful and timely reports; and
- interacted appropriately with relevant stakeholders.

IAASB's *Framework* identifies elements that impact on audit quality. The independence standards will have an impact as one of the input factors to the audit process and will also be part of Audit regulation which is one of ten contextual factors that impact on the audit quality framework. We note that whilst the *Framework* refers to Engagement Partner rotation, a significant emphasis is not placed on auditor rotation requirements.

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<sup>2</sup> Daugherty, B. E., D. Dickins, R. C. Hatfield, and J. L. Higgs. 2013. Mandatory Audit Partner Rotation: Perceptions of Audit Quality Consequences. American Accounting Association: Current Issues in Auditing: Volume 7, Issue 1, 2013 Page 33.

<sup>3</sup> Daugherty, B. E., D. Dickins, R. C. Hatfield, and J. L. Higgs. 2013. Mandatory Audit Partner Rotation: Perceptions of Audit Quality Consequences. American Accounting Association: Current Issues in Auditing: Volume 7, Issue 1, 2013 Page 31.

<sup>4</sup> IAASB. February 2014. A Framework for Audit Quality: Key elements that create an environment for audit quality: Page 5.

The U.S. based *Centre for Audit Quality*<sup>5</sup> (April 2014) has identified the following thematic elements of Audit Quality as the most relevant for an audit committee to consider when evaluating their external auditor:

- audit Firm's leadership and tone at the top,
- engagement team's knowledge, experience and workload,
- monitoring, and
- auditor reporting.

The two frameworks noted above do not indicate that there are significant causal links between Engagement Partner rotation and audit quality.

APESB notes that there has not been any systematic or material independence weakness identified in Australia since the Australian Treasury undertook a review and published *Audit Quality in Australia - A Strategic Review*<sup>6</sup> in 2010. The findings indicated that Australia has a robust audit framework and the existing framework and regulations were working well. Subsequent to the issue of this report, the Australian Government also enacted legislation to allow an additional two-year time-on period for the Engagement Partner subject to the approval of the audit committee of the entity. In practice, audit firms have rarely taken advantage of this extension. Treasury also noted in this study that the skills and personal qualities of Engagement Partners and staff are important key drivers of audit quality as auditing is a knowledge-based service where the primary input is the expertise of the individual auditors and their staff.

From the above frameworks and studies, it is clear that many factors have an impact on audit quality and that auditor rotation requirements is one of the many factors that impact on audit quality, and is not necessarily the most significant factor.

#### APESB's alternative proposal

We acknowledge that the two-year cooling-off period for the Engagement Partner of a PIE might be perceived as inadequate by some stakeholders and respectfully propose that IESBA consider adopting a three-year cooling-off period for the global Code and then allow the audit regulator or the NSS of each local jurisdiction to determine whether they wish to adopt a longer cooling-off period (i.e. four or five years) by taking into consideration jurisdictional specific issues. We note that IESBA adopted a similar approach in respect of the definition of PIE in the existing Code.

If this alternative is adopted, the three-year cooling-off period will also be consistent with the European Union's recently amended Engagement Partner rotation rules in respect of the cooling-off period. We favourably note that IESBA's global research of 82 jurisdictions also indicates that the two or three-year cooling-off period was supported by Those Charged with Governance (TCWG), regulators and NSS, for the Engagement Partner (56.5%) and EQCR (58.2%).

APESB understands and supports IESBA's efforts to ensure that the outgoing Engagement Partner is away from the audit engagement long enough for the incoming Partner to provide a 'fresh look' at the audit. However, we believe that IESBA should provide evidence from fact-based research to justify **all** jurisdictions moving from the existing two-year cooling-off period to a five-year cooling-off period.

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<sup>5</sup> Centre For Audit Quality. April 2014. CAQ Approach to Audit Quality Indicators: Page 3.

<sup>6</sup> The Treasury. March 2010. Audit Quality in Australia: A Strategic Review, Pages 7-13.

We note that the five-year cooling-off period has been adopted by a number of advanced economies with large populations and resources. These economies do not face the same challenges as Australia which is impacted by a relatively small population and a vast geography.

As the global standard setter, we strongly believe that IESBA should adopt a minimum acceptable cooling-off period, two or potentially three years and provide flexibility for each jurisdiction to determine if they need to adopt a longer cooling-off period taking into consideration specific jurisdictional circumstances which IESBA may not be aware of.

We believe that in principle this is what has occurred with the time-on period for Engagement Partners of listed entities in jurisdictions such as USA, UK, Canada, Australia and New Zealand, which have adopted time-on periods that are shorter than those allowed under IESBA's Code.

*Flexibility to reduce cooling-off period with concurrence of TCWG*

If, after considering all submissions, IESBA does determine to adopt a five-year cooling-off period for the Engagement Partner of a PIE, then we believe that there should be some flexibility to reduce the cooling-off period in exceptional circumstances with the concurrence of TCWG where the five-year cooling-off period will have a significant impact on audit quality. In principle this would be similar to the extension of the time-on period with the concurrence of TCWG in paragraphs 290.151-290.152.

**6. If the cooling-off period is extended to five years for the engagement partner, do respondents agree that the requirement should apply to the audits of all PIEs?**

Subject to APESB's responses to Engagement Partner rotation, APESB is of the view that all PIEs should be treated in a similar manner as there is public interest in these entities.

**7. Do respondents agree with the cooling-off period remaining at two years for the EQCR and other KAPs on the audit of PIEs? If not, do respondents consider that the longer cooling-off period (or a different cooling-off period) should also apply to the EQCR and/or other KAPs?**

We propose that the same cooling-off period should be applied to both the Engagement Partner and EQCR, similar to the same time-on period for both individuals. Under the Corporations Act, the EQCR for a listed entity is subject to the same rotation requirements as the Engagement Partner in terms of time-on and cooling-off periods. If the same cooling-off period is not applied to the EQCR, the level of independence of the audit team may be impacted, as it is quite common that the EQCR is known to the audit client. Legislation in Australia and some major jurisdictions treat the Engagement Partner and the EQCR in the same manner in respect of the time-on and cooling-off periods.

APESB favourably notes that based on IESBA's global research on this project, that the majority of TCWG, regulators and NSS (i.e. approximately 57%) were supportive of the same cooling-off period applying to both the Engagement Partner and EQCR.

APESB agrees with the cooling-off period of two years for other KAPs.

- 8. Do respondents agree with the proposal that the engagement partner be required to cool-off for five years if he or she has served any time as the engagement partner during the seven year period as a KAP?**

Subject to our response to specific question 5, APESB is of the view that in order to trigger a maximum cooling-off period, the KAP should serve in the capacity of an Engagement Partner for at least three years out of their seven-year period as a KAP.

- 9. Are the new provisions contained in 290.150C and 290.150D helpful for reminding the firm that the principles in the General Provisions must always be applied, in addition to the specific requirements for KAPs on the audits of PIEs?**

APESB is supportive of these provisions subject to our response in specific question 2.

- 10. After two years of the five-year cooling-off period has elapsed, should an engagement partner be permitted to undertake a limited consultation role with the audit team and audit client?**

If IESBA determines that the cooling-off period for an Engagement Partner should be five years, then APESB is supportive of the Engagement Partner performing a limited consultation role on new issues after a two-year cooling-off period.

However, if IESBA determines that the cooling-off period should be less than five years, then APESB is of the view that the Engagement Partner should cool-off for the entire period and not undertake any other role in respect of the audit client.

- 11. Do respondents agree with the additional restrictions placed on activities that can be performed by a KAP during the cooling-off period? If not, what interaction between the former KAP and the audit team or audit client should be permitted and why?**

APESB agrees with IESBA's proposals in paragraph 290.150B in respect of the activities a KAP cannot perform during the cooling-off period.

- 12. Do respondents agree that the firm should not apply the provisions in paragraphs 290.151 and 290.152 without the concurrence of TCWG?**

APESB is supportive of IESBA's proposals in paragraphs 290.151 and 290.152 that the exceptions to the Engagement Partner rotation rules in the Code are only enacted with the concurrence of TCWG of the audit client.



## Section 291

### **13. Do respondents agree with the corresponding changes to Section 291? In particular, do respondents agree that given the differences between audit and other assurance engagements, the provisions should be limited to assurance engagements “of a recurring nature”?**

APESB agrees with IESBA’s proposal that the corresponding changes in section 291 should only impact assurance engagements of a recurring nature. We suggest however that it would be useful if the Code provides guidance on the type of assurance engagements which will be considered as ‘recurring engagements’ and thus be subject to these provisions.

APESB has provided guidance in respect of recurring engagements in its Standard APES 305 *Terms of Engagement*, which includes the following features of a recurring engagement for your consideration:

- *unchanged terms of engagement under which the Professional Services are provided;*
- *the same or similar Professional Service provided by the Professional Accountant in Public Practice in each period;*
- *defined or identifiable commencement and completion dates each time the engagement is performed; and*
- *performance of the engagement is on a regular basis as agreed with the Client, for example annually.*

## Impact Analysis

### **14. Do respondents agree with the analysis of the impact of the proposed changes? In the light of the analysis, are there any other operational or implementation costs that the IESBA should consider?**

APESB has some concerns in respect of IESBA’s impact analysis and believes that the matters raised in APESB’s response to specific question 5 will have significant unintended consequences in certain jurisdictions, which IESBA’s impact analysis does not take into account. The proposed amendments will significantly impact audit firms resulting in increased operational, administrative and compliance costs associated with implementing and complying with the proposed changes. As no objective evidence has been provided that the proposed changes will lead to increased audit quality, in our view the uncertainty of the likely benefits do not justify these additional costs.

## General Comments

APESB’s responses to the general matters raised by the IESBA are as follows:

### *(a) Impact on SMPs*

IESBA’s proposals in the Exposure Draft may have a significant adverse impact on SMPs and may lead to unintended consequences such as forced audit firm rotation, the inability of Engagement Partners to maintain specific industry knowledge and reduced competition in the audit services market.

*(b) Impact on Preparers (including SMEs), and users (including regulators)*

SMEs account for the vast majority of businesses in Australia and globally. Those SMEs which are PIEs are likely to be unfavourably impacted due to the impact the proposals have on their audit firms.

From a preparer and SME's perspective, compared to auditor rotation, they place more importance on matters such as:

- calibre and quality of the Engagement Partner and the audit team;
- receiving a professional service from the Engagement Partner best suited for the Engagement;
- continuity of the Engagement Partner and the audit team; and
- changes which benefit the audit or assurance client i.e. a 'fresh set of eyes' that reduces the likelihood of complacency.

*(c) Developing Nations – Not applicable*

*(d) Translations – Not applicable*

*(e) Effective Date*

APESB is of the view that IESBA's proposals in the Exposure Draft will require firms to make significant changes to their systems and processes to enable them to properly implement the requirements. Subject to IESBA's final conclusions in respect of the cooling-off period, IESBA will have to perform an assessment whether the proposed effective date will provide sufficient time for firms to make the necessary changes.

### **Concluding comments**

APESB acknowledges IESBA's significant efforts in conducting surveys and stakeholder outreach in respect of this Exposure Draft. APESB's key concern is in respect of the proposal to increase the cooling-off period from two years to five years for the Engagement Partner of a PIE, in the absence of evidence from fact-based research that this change will lead to improved audit quality.

We trust you find these comments useful in your final deliberations. Should you require any additional information, please contact APESB's Technical Director Channa Wijesinghe at [channa.wijesinghe@apesb.org.au](mailto:channa.wijesinghe@apesb.org.au).

Yours sincerely



The Hon. Nicola Roxon  
**Chairman**