Partner Rotation and Key Audit Partner

Background

Partner Rotation

Existing Section 290 recognizes that using the same senior personnel on an audit engagement over a long period of time may create a familiarity threat. The existing section further provides that for the audits of listed entities, the engagement partner and the individual responsible for the engagement quality control review should be rotated after a pre-defined period, normally no more than seven years, and should not participate in the audit engagement until a further period of time, usually two years, has elapsed. The existing section also provides that when a firm has only a few people with the necessary knowledge and experience to serve as the engagement partner, or the individual responsible for the engagement quality control review, rotation may not be an appropriate safeguard. In these circumstances, the existing section provides that firms should apply other safeguards to address the threat.

In reviewing section 290, the IESBA considered this guidance and in particular, the need to strike a balance between addressing the familiarity threat by bringing a fresh look to the audit and the need to maintain continuity and audit quality. The IESBA recognized that in larger engagements, key audit partners, other than the engagement partner and the individual responsible for the engagement quality control review, may play a significant role in the performance of the audit and maintaining ongoing relationships with client management. The Exposure Draft, therefore, addressed the familiarity threat by extending the partner rotation requirements to all key audit partners on an audit of an entities of significant public interest.

The IESBA considered the length of time after which rotation should be required and the length of time before the individual may return to the audit team. The IESBA was conscious that in some jurisdictions a limited number of individuals have the knowledge and competencies to be a key audit partner on entities of significant public interest. The IESBA was, therefore, of the view that the existing requirement of seven years on the team and two years off strikes an appropriate balance between requiring the necessary fresh look and the need for continuity and competence.

The IESBA considered whether it was appropriate to maintain the existing position that alternative safeguards may be applied by firms with only a few people with the necessary knowledge and experience to serve as key audit partners ("the limited resource flexibility"). The IESBA was of the view that on balance, such flexibility should not be provided. The IESBA considered whether alternative safeguards, including an external review by a regulator, were available to appropriately address the familiarity threat. The IESBA concluded that such safeguards were not adequate to address the threat, noting that a review by a regulator is performed after issuance of the audit report and may be several years after issuance. The IESBA was also mindful that if there was insufficient depth within the firm to rotate the required partners this could have implications for audit quality. The proposed revised Section 290 therefore requires rotation of key audit partners on all audits of entities of significant public interest.

Key Audit Partner

The IESBA proposed the following definition for the new term “key audit partner”:

> “The engagement partner, the individual responsible for the engagement quality control review, and other audit partners on the engagement team, such as lead partners on significant subsidiaries or divisions, who are responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.”

The term is used not only in the provision on partner rotation, but also with respect to employment relationships and compensation, where the IESBA concluded that such provisions should apply to additional audit partners. The definition of key audit partner focuses on whether a partner is responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion. For example, in the case of an audit of consolidated financial statements, if the audit partner of a significant subsidiary is responsible for key decisions or judgments on significant matters with respect to the consolidated financial statements, that individual would be considered to be a key audit partner.

Discussion

Comments Received - Partner Rotation

53 respondents commented specifically on the partner rotation proposals, of whom 39 opposed the proposals directly or queried whether they were entirely in the public interest. (See Summary of Responses attached.) All accounting firms and practitioners commenting on the proposals were opposed to the Exposure Draft. Of the 14 respondents who supported the proposals, 8 were from Europe/Africa and 6 were from Asia or Australasia, being mainly regulators and member bodies. All respondents from the Americas opposed the proposals. Many respondents also wrote at considerable length in voicing their opposition to the proposals, advancing many arguments as to why the proposals were ill-judged and detrimental to audit quality.

Of all respondents, only two (both in Australasia) proposed a tightening of the proposals (one with respect to the period of rotation and one with respect to activities in the time off period).

The overwhelming reason given for objecting to the Exposure Draft was the practical impact of removing the limited resource flexibility.

Objections were also made to the extension of the rotation requirements beyond the lead engagement partner and the individual responsible for the engagement quality control review to all key audit partners. Often the objection to this proposal was linked to concerns about the ability of small firms to undertake audits of unlisted entities of significant public interest, when taken together with the removal of the limited resource flexibility.

A significant number of respondents also linked their concerns about the removal of the limited resource flexibility with the definition of entities of significant public interest. Indeed, the three elements of (1) extending partner rotation to key audit partners, (2) extension to entities of significant public interest, and (3) the removal of the limited resource flexibility, when taken together, were often seen as likely to result effectively in small firm rotation, severe resource constraints, particularly for audits of specialized industry companies and in certain territories, and a loss of expertise on audits impacted by the proposals leading to a reduction in audit quality.

There were very few objections raised to the mandatory rotation period (seven years) and the two year time off period, although one member body (ICPAI) recommended that in small practices, or in special cases in firms, the period for listed entities could be prolonged to nine years. There was some positive endorsement of the proposal compared for example with the five year mandatory rotation for the audit engagement partner and five year time off period required in the UK. ACAG (Australia) was the only respondent to argue for a shortened rotation period to five years for key audit partners.

Comments Received – Key Audit Partner

The Task Force noted that most of the comments on the definition of key audit partner were made in the context of partner rotation. Although some respondents argued that the definition of key audit partner should be modified, the respondents did not suggest that the group of partners covered by the key audit partner definition differed depending on its application. The Task Force is of the view that conceptually, a partner should not be determined to be a key audit partner for one purpose but not another. As a result, the Task Force concluded to focus on the definition without regard to the particular provisions where the definition was relevant (i.e., partner rotation, employment relationships and compensation). However, the Task Force also concluded this topic should be covered as part of the partner rotation discussion given its relevance to the comments in this area.

Concerns about the proposed definition of “key audit partner” contained in the Exposure Draft were expressed by 17 respondents. Several agreed with the proposed definition as drafted (CGA-Canada, NIVRA, IRBA) and others suggested some edits to the proposed definition without substantially changing the meaning (FEE, ICANZ, MIA, KPMG, E&Y), but many respondents were of the view that the definition of key audit partner should be clarified. The changes to the proposed definition generally could be characterized as follows:

- Key audit partners should only include those audit partners who are responsible for key decisions or judgments on significant matters *at the group level*. (ICAEW, ICAS, ACCA, CCAB, CARB, FAR, E&Y, GT)
- The definition should be conformed to the definition in the EC Statutory Audit Directive. (ICAEW, FAR, DnR, CEBS) Key audit partner means, under that definition:
  - the statutory auditor(s) designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on the behalf of the audit firm; or
  - in the case of a group audit, at least the statutory auditor(s) designated by an audit firm as being primarily responsible for carrying out the statutory audit at the level of the group and the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries; or
  - the statutory auditor(s) who sign(s) the audit report.
- Because "audit partner" is not defined, the definition should be clarified to exclude specialty partners, such as tax partners, actuaries, and "National Office" audit partners, who consult on engagements. (E&Y, PwC, DTT, CoCPA, GT)

Although the last point was raised largely by firms, the other points were shared by member bodies, firms and regulators without preponderance by any one group.

Concerns that the language of the Exposure Draft failed to convey the concept of responsibility at the group level, i.e., at the level of the group financial statements, may reflect a lack of understanding as to the meaning of the term "financial statements on which the firm will express an opinion." In the context of the audit of an entity of significant public interest, the term was intended to mean the financial statements of the entity itself (which might be consolidated in the case of a group) and not all the individual financial statements of entities forming part of the entity's group.

Discussion – Removal of the limited resource flexibility

By far the majority of comments received on the partner rotation proposals related to the removal of the limited resource flexibility.
Again, particular concerns were expressed about the impact of this proposal when taken together with the definition of entities of significant public interest and the extension of the rotation requirement to key audit partners. A significant number of respondents were prepared to accept the removal of the limited resource flexibility for audits of listed entities but not for audits of other entities of significant public interest.

US respondents frequently pointed to US studies not supporting audit firm rotation, arguing that this is tantamount to how the proposal would operate for certain SMPs in their audits of entities of significant public interest. A typical response from a small US accounting firm was as follows:

> "*audit firm rotation has significant costs that far outweigh the potential benefits, as governmental agencies (including the Securities and Exchange Commission and the Government Accountability Office), private organizations and members of academia in the United States previously have concluded. Those costs include an increase in audit failures, start-up costs and difficulties in timely reporting, loss of institutional knowledge and reduced incentives to improve efficiency and audit quality.*"

A number of respondents also referred to the SEC exemption for small firms and argued that a similar exemption should be provided in the Code. Others referred to the FDIC exemption and also pointed to the EU Statutory Audit Directive (see discussion below).

A number of respondents drew attention to the fact that although often thought of as a small firm exemption, the limited resource flexibility should apply to any situation where, for example due to the specialist nature of the audit client or due to the undeveloped or developing state of the local economy, there are in fact few audit partners available to perform the audit work such that rotation would impose severe difficulties on the ability of a firm to continue to undertake the audit. A particularly strongly worded objection to the proposal was received in a single submission on behalf of the IFAC SMP Committee and the IFAC Developing Nations Committee. The principal arguments expressed were:

- Combined with expanded definition of key audit partners it will for many SMPs and SMP networks amount to firm rotation;
- Could be reviewed as discriminatory, anti-competitive and even a restraint of trade;
- Will restrict the choice of auditors open to entities of significant public interest;
- From the perspective of an external stakeholder is not visible, so how does partner rotation improve independence in appearance?
- Cost outweighs the benefit in terms of enhanced audit quality.

Many respondents argued that a principles-based approach should be applied, in particular, in addressing any threats created by long service of auditors of unlisted entities of significant public interest. Safeguards typically mentioned in this context included:

- Involving an independent quality control reviewer either from within the firm or externally, possibly with the approval of the audit regulator;
- Monitoring of the engagement by external assessors, typically the audit regulator in a particular country;
- Undertaking an enhanced quality control review focusing on independence and competence of the engagement partner;
- Discussing the matter with the audit regulator;
- Discussing the matter with those responsible for governance;

- Encouraging joint audit arrangements to enable partner rotation to be scheduled with less disruption to the audit.

Some respondents argued that the familiarity threat from long service should be analyzed with reference to the particular facts and circumstances, in particular the extent to which management of the client has changed over the period.

There do not appear to be any arguments emerging from the responses that the IESBA did not consider in the course of developing its proposals. Nevertheless, the Task Force is of the view that the strength of the opposition to the proposals does warrant careful reconsideration, particularly given that the opposition is coming not just from small firms, but also from some larger firms (arguing that there would be a decrease in audit quality because their resources do not extend to being able to rotate key audit partners on all entities of significant public interest, particularly in specialist areas) and also from a very significant number of IFAC member bodies. However, it is also noteworthy that all the independent audit oversight bodies that responded were in favor of the Exposure Draft position to eliminate the flexibility.

The Task Force believes that it is appropriate to reconsider the positions taken by other independent regulators and has reviewed the SEC requirements that exempt small firms from the SEC rotation provisions. The SEC rules provide as follows:

> "Any accounting firm with less than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 …. and less than ten partners shall be exempt from paragraph (c)(6)(i) of this section *[ie the rotation requirement*] provided the Public Company Oversight Board conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under this paragraph."….

The Task Force does not know how many firms have availed themselves of this facility in the SEC rules or whether the arrangements for a triennial review are in fact operating as envisaged in the rules.

Although it could be said that an ex-post review of the files by an independent regulator will not identify any weaknesses in the audit process until it is too late to remedy them for that year's audit, it does nevertheless provide a significant incentive to the audit partner to take whatever steps he or she can to ensure the quality of the audit work.

The Task Force has further considered the requirements of the EU Statutory Audit Directive. The Directive requires the rotation of key audit partners for all entities of significant public interest after seven years (consistent with the ED). It does include a provision for member states to exempt statutory audits of public interest entities (other than listed entities) from certain provisions of the Directive (including the partner rotation requirements). It is not, however, known whether member states will choose to avail themselves of this provision when implementing the Directive into national law.

The Task Force has also considered the arrangements for quality assurance of statutory audits of public interest entities in the Directive. Article 29 requires all statutory auditors and audit firms to be subject to a system of quality assurance organized in such a manner that it is independent of the reviewed statutory auditors and audit firms and subject to public oversight. Article 43 requires the quality assurance review to be carried out at least every three years for statutory auditors or audit firms that carry out statutory audits of public interest entities. It is likely, therefore, that member states could in theory offer a three year independent review similar to that required by the SEC, although whether the resources would be available to conduct a review of each audit engagement where key audit partners have not been rotated is not yet possible to determine.

The Task Force does not have evidence to determine whether a quality control review of the audit work by an independent firm would be a practical solution, but has a concern that it may be impracticable for a firm to arrange such a review except possibly under reciprocal arrangements that would in turn compromise the independence of the reviews. Some respondents advanced the argument that additional internal reviews should provide an adequate safeguard, without explaining how a firm could have sufficient people available to perform internal reviews but lack the resources available to provide for partner rotation.

Discussion – Extension of partner rotation to key audit partners

Nine respondents commented specifically that partner rotation should not be extended to key audit partners or otherwise queried the definition of key audit partner in this context. A typical example of a comment on the key audit partner extension is from the Australian Member Bodies:

> "*Whilst we agree that the lead partner bears the responsibility for key decisions or judgments on significant matters, we do not agree that an "other audit partner" bears a similar responsibility. We therefore do not support the extension of the definition of "key audit partner" to be used in the provisions on employment relationships, partner rotation and compensation.*"

A response from Mazars along similar lines reads:

> "*We believe that persons designated by the firm without final responsibility for the engagement and the audit opinion provided at group level, should not be required to rotate other than in specific circumstances to be determined on a case by case basis.*"

DTT commented:

> "*As for the proposed expansion of the scope of partners covered by the proposed rotation requirements, we are concerned that regardless of the size of the entity or*

> *size of the firm, the risk that audit quality will be negatively impacted is such that we do not believe it is appropriate to mandate partner rotation beyond the engagement partner and engagement quality control reviewer. The threats associated with other key audit partners serving a client over a long period of time should be dealt on a factors and circumstances basis using the principles-based approach.*"

Some of those who sought to justify an alternative proposal that only the engagement and quality control review partner should rotate generally did so on the grounds of responsibility, arguing that only the engagement partner on the audit of the entity is actually responsible. Respondents suggesting that "key audit partner" should be defined as those "at the group level" may have been arguing, in effect, that by limiting the application of the rotation requirements to those at the group level, only the engagement partner and engagement quality control reviewer would be impacted by the requirement.

The Task Force noted that it believed that the definition of key audit partner was intended to cover those partners who are responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements of the entity of significant public interest. However, the Task Force noted that the language was not clear.

The Task Force considered two scenarios, which had previously been considered by the IESBA. In the first case, the audit client's operations reside in two divisions and there is a lead audit partner with responsibility for signing the audit report on the financial statements and two additional audit partners assigned to the engagement, one on each division. In the second scenario, the audit client has established two subsidiaries rather than divisions. Three audit partners also serve, one as the lead and one on each of the subsidiaries. The lead partner has responsibility for signing the audit report on the group's financial statements.

The Task Force was of the view that the answer as to which partners should be required to rotate should be the same in the two scenarios. As a result, the Task Force did not agree with those respondents who argued that key audit partner should only include those at the group level. The Task Force also did not agree with those favoring conformity with the EC Directive. If, for example, there were no significant judgments or key decisions required to be made by the audit partner on one of the subsidiaries, the partner should not be required to rotate merely because the subsidiary was material. Rotation may be appropriate for partners on significant subsidiaries and divisions, but only if there are key decisions at those subsidiaries and divisions, such partners have responsibility for those decisions and those decisions affect the financial statements of the entity of significant public interest. The Exposure Draft does not state this clearly.

The Task Force also considered whether any clarification was needed to specifically exclude tax or specialty partners from being included in the definition. The Task Force was of the view that both the term itself referencing "audit" and the definition that refers to "other audit partners" adequately address the concerns raised.

In summary, the concern that extension of the rotation requirement to all key audit partners would result in a shortage of sufficiently qualified partner resource and would therefore impair audit quality (as well as reduce the career opportunities available to auditors) should not, in the view of the Task Force, be lightly dismissed. However, the Task Force believes that the recommendations to address concerns about the definition of entities of significant public interest (see Agenda Paper 3-F) providing some limited resource flexibility (see below), and proposed changes to the key audit partner definition, (see below), should alleviate much of the concern.

Alternative solutions considered by the Task Force

Despite the sheer volume of comments, the Task Force does not believe that any arguments have been advanced in favor of retaining some flexibility in this area that have not already been considered by the IESBA. However, given the strength of the opposition to the proposal to remove the limited resource flexibility and the concern of a resultant decrease in audit quality, the Task Force recommends that the IESBA give serious consideration to whether the proposal is appropriate or whether a pragmatic solution is warranted.

The Task Force requests that the IESBA consider retaining some form of limited resource flexibility within the partner rotation section of the Code. The greater weight of objection expressed in the responses appears to relate to the introduction of mandatory key audit partner rotation for entities of significant public interest other than listed entities with no flexibility where resources are limited. This could therefore be the area where any relief is targeted. However, this would be an exception from the general position taken in the ED that all types of entities of significant public interest be subject to the same provisions.

Options available if some form of limited resource flexibility is to be permitted include:

- Provide some form of flexibility for entities of significant public interest other than listed entities. This might be applied as follows:
    - Broad relief to include safeguards such as enhanced internal quality control review, external review by a firm, member body or independent regulator (“broad relief”);
    - Narrow relief, for example requiring the audit firm to agree with its independent regulator that the audit files shall be subject to a quality assurance review by the regulator at least every three years (“narrow relief”). Whilst this has the attraction of being similar to the relief permitted by the SEC for listed entities, it is unclear, however, that this would lead to consistent implementation worldwide as many jurisdictions may not have a facility to offer independent review by a regulator, particularly for entities other than listed entities.

- Provide some form of flexibility for all entities of significant public interest, including listed entities. This might be applied as follows:
    - Broad relief for all entities;
    - Narrow relief for all entities;
    - Narrow relief for listed entities with broad relief for other entities of significant public interest.

A further consideration in evaluating the merits of a narrow relief would be whether the relief should be limited to only those firms that meet certain specified criteria, such as number of partners or number of audits of entities of significant public interest (for example, as applied by the SEC). On balance the Task Force would not recommend that any narrow relief be limited to firms of certain size only, particularly given that it would be designed to address situations where there is legitimate scarcity of resource of appropriate specialist expertise and not merely where a firm comprises a few partners only.

With respect to the definition of key audit partner, the Task Force recommends that key audit partner be defined as follows:

> The engagement partner, the individual responsible for the engagement quality control review, and other audit partners, if any, on the engagement team who make key decisions or judgments on significant matters with respect to the audit of the financial statements of the entity of significant public interest. Depending on the circumstances, the structure of the group audit, and the role of the individuals on the group audit, this may include, for example, audit partners responsible for significant subsidiaries or divisions.

Action requested
Members are asked to consider the recommendations of the Task Force and provide feedback to the Task Force.

Appendix 1
Summary of Comments Received

	Member bodies	**Firms/Practitioners**	**Regulators**	**Other**
Support elimination of flexibility from rotation	ICPAS, KICPA, ICAS*, ICANZ*, ICAEW, NIVRA, ICAP, FSR, CNCC, ACAG		IRBA, PAOC	APB, CEBS
Object to extension to key audit partners	Australia, MIA, CNCC, NRF, FACPE, FAP	Mazars, DTT, EY		
Object to removal of limited resource flexibility	CGA – Canada, AICPA, CoCPA, HKICPA, SCAA, Australia, ICAIndia, ACCA, SAICA, CNCC, FAP, FACPE, CACPA, CSOEC, IDW, WpK	Wolf&Co, AC, BDO, Mazars, Blieden, GT, DTT, KPMG, PwC, HRH-CR, HRH - DH		APESB, CGA Alberta, KyCPA, FEE, EFAA, SMP/DNC
Other	ICPAI	Maresca		
* subject to some additional tightening of the proposal				