12 November 2014

Mr Ken Siong
IESBA Technical Director
By email: kensiong@ethicsboard.org

Exposure Draft: *Proposed Changed to Certain Provisions of the Code Addressing the Long Association of Personnel with an Audit or Assurance Client*

Thank you for the opportunity to provide comments on the proposed changes to the Code of Ethics for Professional Accountants ("the Code"). This submission provides an SMP perspective and is based on:

(i) my previous experience as the Technical Standards Partner for a large mid-tier firm in Australia, with responsibility for Independence and Quality Control for more than a decade; and
(ii) my previous experience as chair of a group of technical representatives from ten large national networks in Australia over a period of approximately six years; and
(iii) my continuing experience acting as a consultant to firms in a large international network of firms; and
(iv) my role as an independent audit committee member; and
(v) my former experience as a senior audit manager in the first part of my career, with a then Big 6 firm.

1. General Comments

1.1 The Code is fundamental to audit quality as it sets out the prerequisite conditions that demonstrate auditor independence. The Code is principles-based, but also includes certain prescriptive audit rotation requirements.

1.2 A current major failing in the practical application of the Code is its "one-size-fits-all" approach regarding listed company audits. Entities listed on global capital markets vary enormously in the nature, extent and complexity of their operations. The audits of the relatively few multinational enterprises in global markets require significant audit firm resources to be committed over prolonged periods. The audit partners involved in the audit of multinational enterprises will spend a significant proportion of their chargeable time on their one major client. Further audit fees generated from that major client are likely to comprise a high proportion of the audit partner's fee income, and retention of the audit client is likely to be a key factor in assessment of the partner's remuneration. In contrast, the fee income generated from an individual audit client for an SMP (whether a listed audit client or a PIE) will not often be a significant proportion of a partners' total fees, and further the remuneration model may follow a "whole of firm" contribution model rather than fee income being a key determinant

1.3 In Australia there are approximately 2,000 listed entities of which only 30 might be considered multinational. The audit of a single multinational corporation is likely to require a significant proportion of the annual chargeable working hours of the audit partners and audit team members assigned to the audit. In my experience as a

former senior audit manager of a regional component of a multinational group, the audit team spent approximately 4-6 months of the year on one audit client. In contrast, the audit of smaller listed entities will often require less than 1-2 weeks of chargeable time for a year end audit (for example consider the small Australian exploration companies). Applying the same prescriptive rotation requirements to all senior audit team members is unduly onerous, with spurious benefit, for these smaller audit clients.

1.4 The Australian listed market has clear size differentials and entities outside the top 300 are significantly smaller than those in the top 300, with approx. 97% of the market capitalisation of the top 300 companies audited by Big 4 firms. Approximately half of all Australian listed companies (by number) are audited by Big 4 firms and half are audited by non-Big 4 firms, and therefore audit concentration is not a significant issue in Australia.

1.5 While the rotation requirements are accepted for listed entities, they necessitate onerous scheduling of audit personnel in mid-tier firms over periods extending to 10-15 years, as audit partners will often rotate back onto an audit client. In addition, mid-tier practices may retain long-term senior staff at the manager and director level, who potentially could also remain on audit clients for lengthy periods. Whether or not auditor independence is compromised by long associations needs to be considered in the context for provision of those services. The time an audit partner, director or manager from mid-tier firms spends on any individual audit client is likely to be a very small proportion of their total chargeable time, when their client portfolio comprises relatively smaller entities. This means that the experience and events in-between individual audits are likely to be more diverse in these situations, such that auditors coming back to the audit in subsequent periods will have a continually evolving perspective on client activity. The 'familiarity' of the long-serving audit team member is compensated by the range of experiences that individual obtains, and the supervision and review of work done by an engagement partner and EQCR who are required to rotate in accordance with the Code.

1.6 In order to promote and support audit quality, auditor independence needs to be evaluated in the context in which those services are provided. Rather than requiring prescriptive rotation rules to be followed, auditor independence of senior audit team members should be evaluated by reference to a matrix of criteria, which includes consideration of long association. For example:

(i) size and complexity of the audit client to the audit firm
(ii) size and complexity of the audit client to the individual audit team member (whether an audit partner or senior staff member)
(iii) time spent on the audit each year by the individual audit team member
(iv) the number of consecutive years spent by the audit team member on the same audit client
(v) the nature and extent of audit and other experience the audit team member has obtained in-between audits of the audit client being considered
(vi) the significance of fee income earned and its impact on the audit team member's remuneration
(vii) changes in audit critical employees at the audit client
(viii) the development of personal relationships (beyond professional relationships) with the audit client and audit critical employees

(ix) the nature and composition of the audit client's board, including rotation of independent directors and alumni of the audit firm, and their interaction with the auditor
(x) the audit client's audit committee monitoring of the external auditor
(xi) quality control practices within the audit firm
(xii) external reviews of quality control practices of the audit firm

1.7 I consider that the arbitrary requirement to rotate all senior personnel, without due consideration of these significant other factors, will undermine audit quality.

1.8 In addition, my understanding of the Big 4 practice models is that an audit partner will rarely rotate back onto an audit client. Also Big 4 firms rarely retain long-term senior staff in audit and therefore long-association of staff below partner level is extremely unlikely. The provisions for addressing long associations replicate and validate the existing Big 4 practice model and will therefore reinforce Big 4 audit market domination. Further, the impact of unconscious bias of audit firm alumni within the director community, regarding audit firm competencies, has not been considered by the IESBA.

1.9 The table showing an "Illustration For a Partner Who Has served as a KAP" on page 15 0f the exposure draft illustrates the complexity in scheduling audit partners for ***just one audit client***. The majority of listed audit clients in mid-tier firms are likely to be relatively less complex and are therefore unlikely to have more than 3 partners involved in the audit. However, this scheduling becomes considerably more complex when the number of listed audit clients for a firm increases to (say) 50 clients with a limited number (say less than 10) audit partners available. Given the relatively lower size and complexity of listed audit clients of mid-tier firms, a mid-tier audit partner is likely to have responsibility for many more listed audit clients (by number) than a Big 4 audit partner.

2. Comments on General Provisions

2.1 The guidance for identifying and evaluating familiarity and self-interest threats created by long association is useful but needs to be expanded to consider the external safeguards that may also exist. For example, the expertise of the audit client's board of directors and audit committee, and the rotation of independent directors, will impact the effectiveness of the audit client in monitoring auditor independence (refer 1.6 above). Also, the threats to independence arising from the presence of audit firm alumni on the boards of audit clients, has not been given any consideration. During the course of audit training in the early years of career development, the audit firm brand value is reinforced and remains many years later as unconscious bias in alumni. Even now, 25+ years after leaving the Big 4 firm with whom I trained, I have become aware of positive bias towards that firm, which shaped my thinking during formative years of career development.

2.2 The general provisions need to be considered in context. Refer paragraphs 1.3 and 1.4 above. In some cases a threat to independence may exist but in many cases, other circumstances will mitigate that threat. In particular, when an individual has extensive and varied experience in-between each audit engagement, their approach and perspective will continue to evolve each year they return to the audit client. The strength in this potential 'familiarity' of one team member will be mitigated by the

firm's quality control processes and more particularly by the review and supervision by audit partners subject to the rotation provisions.

2.3 I concur with the view that the firm should be required to determine an appropriate time-out period. This will allow a range of relevant factors to influence the appropriate time-out period.

3. Rotation of KAPs on PIEs

3.4 Agreed

3.5 As discussed above, the nature, size and complexity of a listed audit entity, or any other PIE can vary considerably. In many instances a 5-year cooling off period will be unduly onerous (refer 1.2 to 1.9 above). Prescriptive unduly onerous requirements are likely to see many smaller audit firms exit the audit market for PIEs, even though the familiarity threats are already adequately mitigated by practice management over a wide range of smaller and diverse clients. Audit concentration is unlikely to support an objective of improving audit quality.

3.6 An extension to a prescriptive 5-year cooling off period is not agreed for any entities, ***except*** where audit partners and other audit team members spend a significant proportion (say 40-50%) of their chargeable time on one client.

3.7 I concur with the cooling-off period remaining at two years *for all rotations*, unless exceptional circumstances exist. In my view, exceptional circumstances exist when audit partners (including the engagement partners, EQCR and KAPs) spend a significant proportion (say 40-50%) of their chargeable time on one audit client. In these circumstances a 5-year cooling off period may be more appropriate.

3.8 The arbitrary allocation of cooling-off periods to roles is not appropriate. The cooling off period should be related to the nature, size and complexity of the client and the significance of that client to the firm and individuals involved in the audit. In any instance where the engagement partner, EQCR, KAP or individual involved in the audit has spent a significant proportion of their annual chargeable time on one audit client, they will have a lack of diversity and experience in other circumstances, and familiarity risks will increase. In many instances a two year cooling off period for all parties will be sufficient. In exceptional circumstances (refer 3.7 above) a five year cooling off period may be appropriate for all those involved in the audit. The role and cooling off period should be considered in the context of the client domination to the firm and the individual.

3.9 The guidance in paragraphs 290.150C and 290.150D is helpful for all engagements. However, the requirements in 290.150B need to be considered in context, rather than one-size requirements.

3.10 The familiarity threat should be considered in context, rather than a one-size approach. Refer discussion above regarding exceptional circumstances (refer 1.2, 1.3, 2.1, 2.2, 3.7 and 3.8 above).

3.11 Refer 3.10 above. A one-size approach will not promote audit quality.

3.12 The role of TCWG is integral to mitigating familiarity threats, and particularly where there is undue influence through alumni connections on the board of directors or with other audit critical employees. External safeguards are considered in paragraph 2.1 above. Threats to auditor independence arising through relationships and familiarity need to be monitored and agreed by both the audit firm and TCWG to ensure transparency in the process, and to improve awareness in the director community of the relationships which introduce threats.

4. Section 291

4.13There are significant differences between audit and other assurance engagements and the arbitrary allocation of the same prescriptive requirements to assurance engagements is not agreed, and in particular, **not** agreed for recurring engagements. For example, for review engagements familiarity with the client circumstances is a necessity and a benefit. Analytical review procedures need an understanding of past events and circumstances to be able to conduct appropriate analysis. Further, explanations received from management should be considered in the light of previous discussions and explanations received in past periods. The ability to deliberately or inadvertently manipulate analysis and explanation increases where there is limited familiarity with the client. The quality of a review engagement will increase with client familiarity and rotation is not appropriate.

4.14 The analysis of the overall impact of proposed changes is generally not agreed. The IESBA has taken a “one-size-fits-all” approach to considering familiarity risk applied to the extremely broad range of circumstances in which both listed entities and PIEs operate. The rigor of the proposed changes may be appropriate for sophisticated multinational corporations, with mature governance and internal control processes, and which dominate both an audit firm and audit individual’s time and gathering of experience. However, they are unduly onerous for a majority of both listed entities and PIEs in Australia, where there has been insufficient consideration by IESBA of the contextual differences arising through their size, nature and complexity of operations. Further, there are external safeguards such as composition and expertise of the board and audit committee, including rotation of independent directors, which have not been adequately considered. In addition, the threats arising through the unconscious bias of audit firm alumni engaged by the client (whether on the board, or as audit critical employees) has not been considered at all. In my view, if the proposals are adopted as presented in this exposure draft, they will contribute to diminishing audit quality and result in further audit market concentration.

Please feel free to contact me to discuss further any matters arising from this submission.

Dianne Azoor Hughes
Consultant – Governance, Risk & Audit
azoorhughes@gmail.com