International Federation of Accountants

529 Fifth Avenue, 6th Floor, New York, NY 10017
T + 1 (212) 286-9344 F +1 (212) 286-9570
www.ifac.org

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# IFAC Small and Medium Practices (SMP) Committee Response to the International Ethics Standards Board for Accountants (IESBA) Exposure Draft *Proposed Changes to Certain Provisions of the Code Addressing the Long Association of Personnel with an Audit or Assurance Client*

## INTRODUCTION

The SMP Committee is pleased to respond to the IESBA (the Board) on this Exposure Draft (ED).

The SMP Committee is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small-and medium-sized entities (SMEs). The constituents of the SMP Committee are small-and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members of the SMP Committee have substantial experience within the accounting profession, especially in dealing with issues pertaining to SMEs, and are drawn from IFAC member bodies from 18 countries from all regions of the world.

## GENERAL COMMENTS

We have been grateful for the opportunity to provide comments on the Long Association project in advance of the IESBA Board's meetings and welcomed the inclusion of some of our points as part of one of the Agenda Items for the IESBA July 2014 board meeting. The ED states that the IESBA has "listened to the concerns" of the effects of the proposed amendments on SMPs. We appreciate that the comments we previously raised have been carefully considered. However, as the Board's proposals are unchanged, we wish to reiterate these points and add further comment in this response to the ED.

We are concerned that some of the current proposals may place unreasonable constraints on SMPs and have significant unintended consequences. Hence, we encourage the IESBA to reconsider certain proposals. In particular, we do not support the following proposals: to extend the general provisions to all members of the audit team; to extend the cooling-off period to five years for the engagement partner on the audits of Public Interest Entities (PIEs); and to place additional restrictions on activities that can be performed by a Key Audit Partner (KAP) during the cooling-off period.

Due to their often limited resources SMPs may not be aware of the ongoing activities of international standard setters like the IESBA and thus generally do not submit comment letters or otherwise engage in the standard setting consultation process. We strongly encourage the Board to recognize this fact when analyzing the responses to the ED. We expect that the IESBA would receive similar concerns from the wider SMP constituency. We also encourage the IESBA to consider the number of PIEs which are currently audited by SMPs worldwide, so as to obtain an understanding of the number of firms that would potentially find some of the current proposals problematic.

In many jurisdictions PIEs include quite small entities, which are audited by SMPs, for example small charities. These SMPs are therefore disproportionately affected by any proposals that relate solely to this sector group. More stringent requirements may also impact the market concentration and could ultimately force some SMPs out of the PIE audit market.

In our opinion, the developments globally with respect to mandatory firm rotation should also be factored into the assessment of long association. For example, the European Regulation on Statutory Audit of Public Interest Entities and the new Companies Act 2013 in India have both recently established requirements for the rotation of individual auditors and audit firms. We agree that any changes proposed by the IESBA should provide both a reasonable and robust response to regulatory changes and acknowledge that there is reference in the ED that these developments would be considered outside the scope of the project. We also recognize that it is not possible for the *IESBA Code of Ethics for Professional Accountants* (the Code) to address all the developments, complexities and practicalities in each jurisdiction and the IESBA should focus on setting standards with an appropriate balance at the global level. It is therefore essential that the Code is sufficiently principles-based to allow it to work in conjunction with national requirements.

The rationale for many of the changes explained in the ED is to strengthen the perception of independence and for the Code to be revised so as to better serve the public interest. From a public interest perspective, the premise for making any change should be to improve the quality of audit and other assurance engagements. The cost of change arising from adapting to new or revised standards should be outweighed by delivering a tangible benefit to the public by way of improved audit and assurance quality. The public perception of a linkage between audit partner tenure and audit quality should not drive rational decision making when there also exists an equally strong perception that audit quality actually improves as the audit partner gains knowledge of the client and the industry in which the client operates.

In our view, global convergence could also be seen to be in the public interest. We believe that the proposed changes to the Code of layering bifurcated requirements for different partner roles over local regulation will complicate application in practice, and may even be detrimental to its acceptance and adoption in some jurisdictions. Furthermore, we recognize that many jurisdictions, having so recently implemented the new requirements, may be reluctant to introduce further requirements this soon. Additional changes can be problematic - not only from an implementation perspective, including translation, but also a member body communication perspective.

As this is often a matter for national legislators, it is important the proposals do not impose undue complexity and that any changes to the Code are clearly justified, based on a thorough impact analysis and are supported by robust evidence and research. The potential benefits must outweigh the costs, in particular, the high cost of their implementation in many jurisdictions. We are not convinced that many of the significant proposals in the ED meet these important criteria.

**SPECIFIC COMMENTS**

We have outlined our responses to each question (*in italics*) in the ED below.

**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?*

The proposed enhancements to the general provisions should provide more useful guidance for identifying and evaluating familiarity and self-interest threats created by long association.

However, as drafted, this section appears to imply that the familiarity threat is the sole concern without regard to the impact of certain measures on audit quality. In our view, this section should also indicate that there may be a trade-off between measures aimed at safeguarding familiarity threats and the depth of knowledge and experience gained by audit personnel, including audit partners, which directly impact audit quality.

Alternative safeguards such as external rotation or tendering ought to feature in a firm's assessment of the need to rotate individuals.

*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)?*

We disagree with the proposal that the General Provisions should apply to all individuals on the audit team. There is a lack of evidence in support of the need to extend the application of these sections. In our opinion, it is unnecessary to have general provisions beyond senior personnel. We encourage the IESBA to retain the current distinction between senior and other personnel, but adopt a risk based approach to non-senior staff that can take individual engagement circumstances into account i.e., mirroring ISQC 1[1].22 (b) and (c) on an "when the firm becomes aware" basis, rather than designing rules to be applied by all.

In practice, junior team members will not be exposed to areas involving significant decisions or judgment and their work is subject to full review by more senior team members. They will therefore have very little opportunity to be in a position to influence an audit opinion (or exert direct influence on the outcome of an audit). If the proposals were adopted, firms would need to consider the potential for familiarity and self-interest threats from all personnel. This could lead to calls for firms to document, at regular intervals, considerations regarding each member of an audit team in order to justify why the individual should not rotate from the audit engagement, particularly when external inspection is involved. The time involved in complying with such requirements would likely significantly outweigh any perceived benefits of such a proposal as the propensity of less senior personnel to influence the audit outcome is generally limited. In addition, many SMPs may not have sufficient resources to fully comply with the proposals and it may adversely impact audit quality were an SMP is unable to assign the most appropriate staff person(s) to an assignment.

[1] ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

We also have some concerns with the new wording proposed to the General Provisions section, specifically para.290.148A. The term "familiarity threat" is defined in section 100.12 (d) as "the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work". The proposed changes to para.290.148A specify an individual's long association with the financial statements on which the firm expresses an audit opinion, or the underlying financial information, as one of the three factors that may create a familiarity threat. In our opinion, this is not compatible with the afore-mentioned definition of familiarity threat, since that definition refers solely to relationships between individuals. In addition, it is questionable whether familiarity with financial statements and information could, alone, create a threat to an auditor's compliance with the fundamental principle of objectivity, i.e. independence as addressed in Section 290 (the word "or" in 290.148A and 291.137A means it could).

*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?*

We agree that the firm should be required to determine an appropriate time-out period. Documentation of the determination within the working paper file, including the rationale for the length of the time-out would be appropriate.

**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?*

We agree with the time-on period remaining at seven years for KAPs on the audit of PIEs.

*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?*

We disagree with the proposal to extend the cooling-off period to five years for the engagement partner on the audit of PIEs. In our opinion, this time period appears excessive and together with the new requirement in the second bullet point in paragraph 290.150A ("any other key audit partner shall not be a member of the engagement team or provide quality control for the engagement team for two years") could pose considerable difficulties for many SMPs that audit PIEs as they have a smaller number of partners to rotate amongst. We are concerned this may also result in SMPs having to retire from smaller PIE audits, and as a result the client loses valuable knowledge and experience accumulated over time, which may have a corresponding negative impact on audit quality and could drive the audit costs higher for certain PIEs.

In our opinion, the revision of the cooling-off period should be based on robust evidence in support of change. The current partner rotation requirements in the Code were only effective for the audit of financial statements for years beginning on or after December 15, 2011. There is no evidence to suggest that the current provisions for audit partner tenure for a maximum of seven years on and a two year cooling off period have not been working effectively in practice. We therefore believe that it is too early to determine whether the two year cooling off period is inappropriate. In addition, we believe that in considering the

proposed extension of the cooling off period the IESBA should also take due account of the proposed reduction in activities during the cooling off period. We encourage the Board to consider that the combined impact of these two proposals may, for some SMPs, force a denial of access to technical expertise detrimental to audit quality. We recognize the proposals may assist certain stakeholders to feel more confident about independence and familiarity of auditors, but there may be other – more principles based- measures, such as greater communication of the existing safeguards, which could be equally as effective in this regard.

We believe that any changes must not be made without due consideration of any unintended consequences and the possible disproportionate impact of such changes on SMPs. Anecdotal evidence suggests that the consequences of adopting longer cooling-off periods has forced several small and medium sized companies to be audited only by the largest audit firms in certain jurisdictions (for example, Brazil). This is primarily because SMPs do not have the necessary infrastructure to accommodate the requirements of the cooling off period.

It is well-known that the 'big four' accounting firms audit the majority of publicly listed entities worldwide. We believe that the proposals could further exacerbate the market dominance of the largest accounting firms and lead to further erosion of choice in the audit market for publicly listed entities. A competitive audit market is in the public interest and the current proposals may directly impact the concentration of firms servicing these entities and could assist the 'big four' to capture an even larger share of the market. It may also result in higher costs for smaller PIEs if those larger firms do not adjust their charging structures. For example, it would not be in the public interest if the provisions effectively forced a small PIE in the charity sector to spend a disproportionate amount of its income on administration rather than on charitable activities. We believe the Board must recognize the potential unintended consequences of its proposals.

There are other equally effective, if not more appropriate, alternatives to the proposals which are in place as safeguards rather than having to sacrifice the knowledge and experience accumulated over time. For example, the requirements in ISQC 1 which require an engagement quality control review (EQCR) for all audits of financial statements of listed entities, the firm's quality control system, detailed file review by another professional colleague prior to issuance of the audit report, and so forth. These measures are in addition to obtaining written agreement on an annual basis to continue the engagement having held a full discussion with the client as to the issues of independence.

We believe that the IESBA could consider alternative safeguards in particular circumstances, rather than taking a one-size-fits all approach to address this issue. This would take into consideration the impact of the proposals on smaller PIEs and SMPs.

It is also worth noting that in respect to mandatory firm rotation as part of the European Regulation on Statutory Audit of Public Interest Entities, there is a Member State Option, whereby Member States can allow PIEs to extend the audit engagement tenure by an additional 10 years upon tender or by an additional 14 years in the case of joint audits. However, this EU Audit Policy legislation does not change internal partner rotation. By allowing for an extension of audit firm tenure in the case of joint audit or upon tender, the legislation recognizes other possible safeguards to auditor independence that require

intervention of the audit committee (or equivalent) of the entity subject to audit. IESBA might wish to reflect on this.

*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?*

If the cooling-off period is extended to five years for the engagement partner, we do not believe that the requirements should apply to the audits of all PIEs, as it is excessive for the smallest PIEs. The conclusion in the ED that "there was little justification for making the distinction between listed companies and other PIEs.." seems to fail to take account of the fact that the definition of a PIE varies from country to country and an entity may be a PIE because of the nature of its operations, its size or the number of its employees. The Federation of European Accountants (FEE) recently published a survey *Definition of Public Interest Entities (PIEs) in Europe*[2] which demonstrates the wide diversity of definitions of PIEs applicable across European Countries.

In many jurisdictions relatively small entities may fall within the definition of a PIE and many are audited by SMPs, who, by definition, will have a far more limited capacity to rotate partners and personnel than larger audit firms. This may result in SMPs being unable to compete in the PIE market space, which would be detrimental to the value, quality and price that they are able to offer smaller PIEs.

The Code's extant definition of PIE is also dependent on local regulation, which in turn is subject to change over time and may mean that extending provisions beyond listed entities means that jurisdictions definitions of PIEs are not comparable. The IESBA should consider how many SMPs will be affected by its proposals each time they propose changes to affect PIEs, as this may vary.

Should the Board, contrary to our views, decide to extend the cooling-off period for the engagement partner to five years, then we believe that such requirement should only apply to listed entities. Indeed, as the ED notes the majority of jurisdictions that have longer cooling-off periods than the extant Code have them for the audits of listed companies, and we see no evidence that more restricted application is called for.. Furthermore, the Code needs to be suitable for application worldwide. As noted above, the definition of PIEs may vary considerably from one jurisdiction to another, and thus, in our view, it is national legislators who are in a position to determine whether such provisions should apply to PIE entities beyond those that are listed entities, as applicable to the circumstances of their jurisdiction, not IESBA.

We believe that the IESBA needs to give this further consideration.

*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 agree with the cooling-off period remaining at two years for the EQCR and other KAPs on the audit of PIEs for the reasons outlined in the ED. The independence and familiarity threats created by the long

[2] http://www.fee.be/images/publications/auditing/PIE_definition_survey_outcome_141015.pdf

association is less for these individuals, so we believe it is important there is the distinction as proposed by the Board.

Section 290.150A deals with cooling off periods in the context of an audit of a public interest entity for both the single individual who was "engagement partner" and "any other key audit partner", proposing periods of 5 and 2 years respectively. For the purposes of this section, we believe there is a need for further clarification beyond the extant definition. The Code's definition of "key audit partner" clarifies that audit partners responsible for significant subsidiaries or divisions are not necessarily "key audit partners", but may be included as such.

In our view, determining which individual audit partners are subject to the provisions of the Code for the audit of a PIE and which audit partners are not is likely to be challenging in practice, and may be very difficult for individual firms that are not the auditor of the holding entity or PIE – although it is the individual firms that will need to manage their compliance. This determination can only be made at consolidation level, since this will involve a retrospective assessment of and determination as to which decisions were key, and which judgments related to significant matters from a group perspective. Indeed, to ensure consistent application by audit firms and a common understanding between auditors and oversight bodies, robust criteria will be needed in this regard too. We suspect that uncertainty arising from a lack of clarity in this matter may lead firms seeking to "stay on the safe side", leading to rotation and cooling off of individuals, which might be unnecessary from a group audit perspective. The impact on audit quality resulting from the loss of expertise and need to build up client-specific knowledge anew is also a factor that needs to be considered in this context.

*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?*

As stated in our response to question 5, we do not support the proposal for the engagement partner to be required to cool-off for five years. In addition, the proposed model to require a KAP who at any time during the seven-year period served as an engagement partner be required to cool off for a period of five years is considered excessive. We believe that a risk-based approach would be more appropriate.

*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?*

We generally agree that the new provisions contained in paragraphs 290.150C and 290.150D are helpful reminders for firms. However, we consider it is unlikely in practice that many firms would opt to rotate a KAP before the mandatory rotation period (whatever the size of the practice) as suggested by paragraph 290.150C.

We are also concerned that the phrase in paragraph 290.150D "significance of any threat created by the long association of a member of the audit team who is not a key audit partner with an audit client" seems too severe a definition compared to the impact and influence of non-key audit partners, and especially

since proper safeguards (and quality control) will be undertaken by the firm. We are concerned that this will lead to annual evaluations of key audit partners and members of the audit team that does not contribute to audit quality. It would be preferable for the provision to be worded on the basis "if anything comes to the firm's attention" instead.

*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 the proposals for a five-year cooling-off period are not re-considered then we would support the engagement partner being permitted to provide limited consultation to the audit team after a period of two years. This would be particularly important for many SMPs who, in comparison with larger firms, have a fewer number of partners with specialist technical expertise in industry-specific areas.

We acknowledge the proposal is in line with some major jurisdictions (e.g., the UK), but believe it does make the Code complex to apply and could also be used to support the view that a period of five years cooling off is unjustified and excessive.

*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?*

We do not agree with the additional restrictions placed on activities that can be performed by a KAP during the cooling-off period. The proposed additional provisions concerning consultation on technical or industry specific issues (para. 290.150B) are likely to be particularly problematic from an SMP perspective. Such measures would potentially give rise to a significant loss of audit quality should "new" engagement partners within SMPs seek to avoid appropriate consultation with their firm's best available experts and ultimately would not be in the best interest of the client In contrast, larger firms with recourse to technical departments may not face these issues to the same extent.

It would be more valid to increase and improve existing safeguards instead of a strict prohibition or severe restriction, especially for smaller firms. We believe a risk based approach should be applied. For example, no consultation at all is excessive in practical terms, especially for matters of relatively low risk and it could also impact audit quality.

The IESBA should acknowledge that certain regulators may choose not to adopt the provisions as articulated in 290.150B because it would be seen to infringe upon the commerce of a firm. This may mean that certain jurisdictions would have unfair advantage over others (i.e. those jurisdictions that use the Code alone would include this provision – those that abide by the rules of another authority would not).

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

We agree that the firm should not apply the provisions in paragraphs 290.151 and 290.152 without the concurrence of TCWG. Any service extension and/or relaxation of professional code requirements should

not be adopted without full transparency - the exchange must be conducted in addition to obtaining written documentation confirming this agreement.

**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"?*

We have the same views as outlined to the other questions in respect of the corresponding changes to Section 291. We agree that the provisions should be limited to assurance engagements of a recurring nature.

**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?*

We do not agree with all of the analysis of the impact of the proposed changes. We note the ED acknowledges that the length of the cooling off period may have a negative impact particularly on smaller audit firms, which have fewer audit personnel available to them. However, as we highlighted in our response to question 5 above, there is no empirical evidence which suggests that a longer cooling-off period would serve to improve audit quality.

The argument that the adverse impact for firms from restrictions on activities during the cooling-off period is outweighed by the anticipated improvement in the perception of independence by stakeholders also appears somewhat dismissive having recognized that there could be an overall adverse impact. In our view, the perception of independence is not a sufficient reason to make the changes and a more thorough impact analysis should be undertaken. This should include the number of SMPs who perform audits of PIEs to assess the potential impact of the proposals and take steps not to disadvantage this faction, giving that there may be other safeguards that could be used beyond internal rotation and cooling-off.

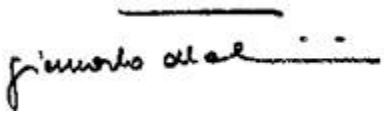
**Effective date**

As we have previously communicated to the IEBSA, keeping up with new regulations and standards has been consistently ranked as one of the top challenges facing SMPs. This supports the need for a stable platform for the Code. We would prefer that the Board do not make piecemeal changes to the Code and give due consideration to whether it would be practical for these revisions to be introduced as part of other significant changes resulting from other current projects. Practitioners need time to understand the changes, assess how they are affected and to put measures in place to enable them to comply. The impact on SMPs resources of this process can be particularly onerous as they do not have the same level of in-house resources available at larger firms.

**CONCLUDING COMMENTS**

We hope the IESBA finds this letter helpful in further developing proposed changes to certain provisions of the Code addressing the long association of personnel with an audit or assurance client. In turn, we are committed to helping the Board in whatever way we can to build upon the results of this ED. Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,



Giancarlo Attolini

Chair, SMP Committee