



International
Ethics Standards
Board for Accountants

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Meeting: IESBA Consultative Advisory Group
Meeting Location: New York
Meeting Date: September 12, 2012

Agenda Item

E

Strengthening Safeguards Against Familiarity Threats

Objective of Agenda Item

To seek input from CAG member on a proposal to review the provisions in the Code that address partner rotation.

Background

In August 2011 the Public Company Accounting Oversight Board (PCAOB) issued a Concept Release to solicit public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced. One possible approach on which the board sought comment was mandatory audit firm rotation. IESBA submitted comments on relevant matters.

In December 2011 the EC issued proposals for a Directive amending the Directive on statutory annual accounts and consolidated accounts, and also proposals for a Regulation on specific requirements regarding the statutory audit of public-interest entities.

In light of these regulatory developments, at its meeting in February 2012 the IESBA discussed and agreed to a revision to its strategy and activities for 2012. The board believes it is important to have a position on the key regulatory proposals in Europe, the U.S., the Netherlands, and other jurisdictions. For the IESBA to properly exercise its position as a global standard setter of ethics for professional accountants, it should develop a position on the matters under consideration in Europe, the US, and other jurisdictions that are within the board's purview, including whether the Code's partner rotation requirements continue to be appropriate. The board agreed its analysis should be guided by an overarching objective of improving audit quality.

At its June 2012 meeting the IESBA considered information that can assist it in determining its position is on mandatory audit firm rotation (MFR), and other possible safeguards as a means of reducing to an acceptable level the familiarity and self-interest threats that can be created as a result of an auditor's long association with an audit client. The Code presently addresses those threats by requiring rotation of key audit partners on the engagement team when the audit client is a public interest entity.

Matters discussed by the IESBA at its June 2012 meeting

The IESBA considered a working paper to guide the Board's discussions including references to three areas of potential consideration: partner rotation; mandatory audit firm rotation; and mandatory tendering.

Partner rotation

The code addresses the familiarity threat for Public Interest Entity (PIE) audits through partner rotation. There is a requirement for the audit engagement partner and Engagement Quality Control Review partner to rotate off after serving seven years as a key audit partner and observe a two year time-out period. Many jurisdictions use seven or fewer (often five) years as the maximum period, and two or more (often five) years as the time-out period.

In terms of refreshing the Board's view, the key points are the time on and time-out periods, the definitions of the partners covered and the entities covered.

Mandatory Firm Rotation (MFR)

The E.C. proposals include a requirement for mandatory firm rotation after six years (nine if there is a joint audit) with a four year time-out off period, for PIE audits, as well as partner rotation. The USA PCAOB also issued a concept release on the possibility of MFR, as a potential response to concerns about audit skepticism. The academic evidence that exists tends to be against MFR, but is based on little practical experience. The paper noted some of the theoretical arguments for and against MFR:

- The key arguments for MFR are improved perception of independence, no evidence of harm to audit quality, bringing fresh eyes to the audit and possibly lower fees.
- The key arguments against are a greater risk of audit failure in early years, international logistical challenges, possible increase in costs, increased market concentration, the impact on staff recruitment and retention, and impinging on the audit committee role.

Mandatory Tendering

Mandatory tendering is advocated by the E.C. as well as MFR. The E.C. proposal in effect ensures a formal tender process when firms are rotated. The UK Financial Reporting Council is advocating tendering on a comply-or-explain basis. However there is little academic or other evidence in support or against this requirement. The theoretical arguments for and against mandatory tendering noted in the agenda paper are:

- The key arguments for, include reduction of the perception of a familiarity threat, promotion of audit committee judgment about the balance of familiarity and inexperience, and possibly improved competition.
- The key arguments against, include restriction of auditor performance evaluation, a possible increase in market concentration, a possible increase in costs for auditor and company, and a possible effect on audit quality after a change.

Board discussion

The Board reiterated its view from the February meeting that its analysis should be guided by an overarching objective of improving audit quality. The discussion highlighted the complexity of the issue, with the arguments finely balanced. The following additional points were noted:

- While there was a clear rationale for the approach in the extant Code for partner rotation at the time it was approved, circumstances have changed and it might be appropriate to revisit the positions taken on the length of service and time-out periods, and the scope of who is covered by the requirement and the roles of the various partners on an engagement, and whether requirements should cover all senior audit personnel. It was noted that it would be helpful to understand why regulators in different jurisdictions have chosen the periods they have.
- An impact of mandatory firm rotation in Italy has been to increase concentration in the audit market leading to a reduction in auditor choice. It was also noted that the potential quality problem in early years caused by a change in auditors would be likely to be most acute in the largest and most complex companies e.g. banks. In addition the number of alternative auditors for complex companies in some jurisdictions may be very limited, presenting a practical problem in terms of limited choice of auditor. A variety of approaches is adopted by those countries which have MFR and it would be useful to understand the rationale for these differences. The Italian experience of MFR was noted, where it was not perceived as having affected quality overall, but it has resulted in fee pressure. It was also noted that a familiarity threat is not limited to business issues but also includes relationships between people and that the threat may differ depending on staff turnover within the client.
- It was noted that mandatory tendering is being introduced in the UK from 1 October 2012 for the largest 350 listed companies. This may produce useful evidence in a year or two. Anecdotally, audit committees who have undertaken tendering have found it time consuming and costly but informative. The UK's Audit Quality Inspections Annual Report 2011/12 was reported to have cautioned that substantial fee reductions may lead the auditor to reduce valuable audit work and therefore compromise audit quality.
- It was unclear whether the Code could require firm rotation or tendering if the IESBA favored either of these alternatives because these would be regulator or management decisions respectively.
- The issue of mandatory firm rotation arose because of a perception that relationships between auditors and their clients were too close, therefore the matter needs to be addressed. Any review should take into account all of the issues raised and other areas of potential concern and safeguard.
- The Canadian accountancy profession together with the independent audit regulator is reviewing the issues of enhancing audit quality that are being considered by the EU and the PCAOB in its Concept Release of 2011. Rather than requiring mandatory firm rotation or mandatory tendering, the Canadian profession is exploring the merits of a "mandatory comprehensive review" by the audit committees of the auditors on a regular basis e.g. at least every 5 years. This would not replace the annual review of the auditor's work but would involve a much more extensive review at least every 5 years by the audit committee. This would require buy-in from audit committees as well as some degree of educating the audit committees as to what they should be considering as part

of these comprehensive reviews. A discussion paper is expected to be released later in 2012. Progress of this initiative will be followed by IESBA.

Conclusion

The Board's overall tentative conclusion was that at this stage the arguments on MFR and mandatory tendering were too finely balanced and the evidence too insufficient to be taken forward as formal projects leading to including provisions in the code, or for the Board to yet have a formal position on them. The minutes would be a public record of the Board's discussions so far on these matters. The Board agreed to devote some resource to further research and monitoring developments, including the U.K. experience with tendering, the Canadian review, and the wider issues considered in the discussion. The Board wishes to explore what more can be done to promote greater skepticism and independence.

The Board agreed that it was appropriate to review the provisions in the Code that address partner rotation, and requested that a project proposal be prepared to initiate this. This project should address the period that a partner can serve as a key audit partner, the time-out period required, the individuals who should be subject to rotation, and other safeguards that could address the threats created by long association with the client.

Action requested

CAG members are asked to consider whether they agree with the proposal to review the partner rotation provisions in the Code, to strengthen safeguards against familiarity threats.

Material Presented

Agenda Item E	This Agenda Paper
Agenda Item E-1	IESBA agenda paper

Action Requested

CAG members are asked to consider the question raised in this paper.