

**Long Association—Issues Paper****How the Project Serves the Public Interest**

The project serves the public interest as long association of personnel on an audit engagement with an audit client or audit team can impact objectivity and professional skepticism, which in turn are important contributors to audit quality. The independent auditor constitutes the principal external check on the integrity of financial statements. Hence, the length of the auditor's relationship with the audit client becomes a very visible factor when evaluating the auditor's independence of mind and in appearance. It is acknowledged that a perception issue exists with respect to the long association, particularly as the length of time an individual may serve an audit client in a KAP role may be 14 out of a total of 16 years. It is therefore important, and in the public interest, for the Board to consider whether the provisions remain appropriate for addressing the threats arising from long association.

The issues involved are complex and interwoven. The factors that give rise to threats to independence may also be factors that contribute to audit quality. These could include knowledge of the audit client and knowledge of the audit client's operations and continuity of personnel. In addition, while some stakeholders call for mandatory requirements to be strengthened, it is also recognized that arbitrary requirements can create unintended hardship on companies when rotations are forced to occur at times of change or transition.

**I. Background**

1. Since the initiation of the Long Association project, the Task Force (TF) has presented proposals to the Board at its September and December 2013 and April 2014 meetings. As a result of these meetings, the Board reached tentative agreement on the following:
  - Mandatory tendering and firm rotation developments should be closely monitored as any provisions developed by the TF should provide a reasonable and robust alternative to those proposals.
  - The overall framework and general principles currently contained in paragraph 290.150<sup>1</sup> that apply to all audit engagements should be strengthened.
  - The time-on period of seven years remains appropriate for all KAPs.
  - The cooling-off period should be extended to five years for engagement partners (LAEPs) on audits of public interest entities (PIEs) after any time served as LAEP, with a two-year cooling-off period for other key audit partners (KAPs).
  - Mandatory rotation under the Code should not be extended to audits of entities that are not PIEs.
  - Concurrence should be sought from those charged with governance (TCWG) with respect to the application of certain provisions.
  - Certain activities should be prohibited during the cooling-off period. However, a LAEP who is cooling-off for a five-year period could, after two of those five years have been completed, be consulted on issues, transactions or events that were not previously considered by that individual in

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<sup>1</sup> Section 290, *Independence – Audit and Review Engagements*

the course of acting as engagement partner.

2. At the April 2014 meeting, the Board asked the TF to further reflect on whether a KAP may participate in the provision of other services to the audit client during cooling-off.
3. The TF has proposed corresponding changes to Section 291<sup>2</sup> of the Code which concerns independence for other assurance engagements.

## II. Significant Issues

### A. COOLING-OFF PERIOD FOR KAPS ON AUDITS OF PIES

#### *CAG Representatives' Comments*

4. At the March 2014 CAG meeting, CAG Representatives were requested to provide their views on the options of a uniform cooling-off period for all KAPs or a bifurcation of cooling-off periods for different roles. Representatives who expressed a view all indicated a preference for a uniform cooling-off period of three years for all KAPs, noting that a bifurcation would create unnecessary complexity. Representatives still maintained this preference even once informed that a cooling-off period of three years would affect all jurisdictions that have adopted or are adopting the Code, or are on a process of eliminating differences with the Code.
5. In addition, Representatives were requested to provide their views on the ideal length of the cooling-off period. Those who expressed views acknowledged that a cooling-off period of more than two years was preferable. However, no views were expressed on what would be an ideal cooling-off period for all KAPs.

#### *All PIEs or Listed entities*

6. The TF had formed the view that if the LAEP were to be subject to a longer cooling-off period, the requirement should apply only to LAEPs on the audit of listed entities.
7. While it is acknowledged that all PIEs are entities of public interest, the TF considered that a five-year cooling-off period for all LAEPs on all PIEs would have too high an implementation impact considering the increased complexity of overlaying these requirements on local legislation (many jurisdictions have local legislation that is stricter than the Code only in respect of listed entities). The TF also considered the greater stakeholder interest, public interest and regulatory oversight associated with listed companies which may warrant longer cooling-off requirements to apply only at a listed company level.

#### *Comments made at the April Board meeting*

8. At the IESBA meeting in April 2014, while recognizing the views of CAG representatives outlined above, the majority of the Board agreed with the TF's proposal that after a seven-year period of service, the cooling-off period be extended to five years for the LAEP serving on the audit client rather three years. However, the view of the majority of the Board was that there was little or no justification for distinguishing listed companies from PIEs and the longer cooling-off period should apply to the LAEP for the audits of all PIEs rather for just audits of listed entities.

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<sup>2</sup> Section 291, *Independence – Other Assurance Engagements*

9. The TF has deliberated on the comments from the Board and made further amendments to the proposals attached in Agenda Item A-2 to extend the five-year cooling-off period to the engagement partner for the audit of PIEs. These proposals will be presented to the Board at its July 2014 meeting.

*Comments from the IFAC Small and Medium Practices Committee (SMPC)*

10. In commenting on the IESBA's April 2014 agenda material, the SMPC indicated that it did not support the cooling-off period for the LAEP being extended to five or three years. It added, that if it had to make a choice, then it would prefer the initial proposal of three years. Amongst other things, the reasons for the SMPC's lack of support included:
- Revision of the cooling-off period should be based on robust evidence in support of change and there is no concrete evidence to suggest that the current provisions for audit partner rotation have not worked satisfactorily.
  - The proposals would place unreasonable constraints on and present practical challenges to specialist partner resources which are required for PIE audits and could have a disproportionate impact on SMPs.
  - The proposals could further exacerbate market dominance of the largest accountancy firms and lead to a further erosion of choice in the PIE audit market.
  - There are other equally effective alternatives to the proposals which are in place as safeguards, for example, requirements in ISQC 1<sup>3</sup>.
  - The complexity of the bifurcated approach may prove detrimental to the Code's acceptance and adoption in certain jurisdictions and could have a disproportionate impact on SMPs.

*National Standard Setters' (NSS) Comments*

11. At the May 2014 IESBA-NSS meeting, NSS participants were asked if they supported the Board's proposal that the current maximum time-on period of seven years remains appropriate and should not be changed, but that the cooling-off period of two years should be extended to five years for LAEPs on audits of PIEs after any time served as LAEP, with a two-year cooling-off period for other KAPs. Participants who expressed a view were generally supportive of the increase in the cooling-off period for LAEPs to five years on audits of PIEs. However, participants considered that it should also apply to engagement quality control reviewers (EQCRs) in view of the importance of their role. Several participants expressed the view that there should be adequate justification of the change to the five-year period because of the effect on firm resources

*TF Proposals*

12. With respect to the comments regarding applying the same five-year cooling-off period to the EQCR, the TF noted that it and the Board have considered this matter previously. The majority of the Board recommended leaving the cooling-off period for other KAPs, including the EQCR, at the current two years. This was based on the view that the LAEP and the EQCR are distinctly different roles, the LAEP having much more familiarity with the client than the EQCR who provides an objective evaluation of the

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<sup>3</sup> ISQC1 International Standard on Quality Control 1

significant judgments the engagement team has made and the conclusions it reached on formulating the audit report.

**Matter for Consideration**

1. Do CAG Representatives support the TF proposal with respect to the five-year cooling-off period applying only to the LAEPs on the audits of all PIEs?

B. PERMISSIBLE ACTIVITIES DURING THE COOLING-OFF PERIOD

*CAG Representatives' Comments*

13. Representatives who expressed an opinion agreed that a rotated partner should not be able to directly influence the outcome of the audit. However, doubts were raised as to whether a requirement for absolutely no interaction was a practical option. The following situations where interaction with the rotated partner could possibly be necessary to maintain audit quality or was unavoidable were noted:

- Social interactions between the rotated partner and the audit team or the audit client.
- When the incoming partner needs to discuss issues from the previous year's audit with the rotated partner.
- When the rotated partner takes the role of managing partner of the audit firm during the cooling-off period.
- In smaller firms, where limitations on resources could result in the need to consult the rotated partner, notably on specialist issues.

It was noted by the TF chair that the TF's proposals were not intended to prohibit all interactions. Indeed, these proposals allowed for the range of circumstances mentioned.

14. A Representative questioned whether the meaning of "limited" was clear in "limited discussions with the engagement team," and "directly" as related to "directly influence the audit engagement." The TF notes that the draft provisions have been clarified as a response to the first comment. While "directly influence the audit engagement" has been taken verbatim from the definition of "audit team" in the Code, the draft provisions have been clarified to refer to "exerting influence on the outcome of the audit engagement."
15. In addition, a Representative expressed a view that should a LAEP be required to serve a five-year rotation period, there should not be a relaxation on permissible activities part way through the cooling-off. The Representative was of the view that if an activity was deemed not permissible during the initial part of the cooling-off, it would appear counter-intuitive that it would then become permissible after a proportion of the cooling-off period had expired.

*Board Comments at its April 2014 Meeting*

16. The Board discussed whether restrictions on all non-audit services should be imposed during cooling-off, whether the restrictions should apply to services provided to all related entities of the audit client, and what types of services could be permitted, if any. The Board also discussed whether, if a restriction on non-audit services during cooling-off was imposed for all KAPs, there should be a relaxation of the prohibition after a period of two years for the LAEP. There was no consensus reached on these provisions as a whole:

- Some Board Members expressed support for there being no relaxation to the restrictions on activities during the five-year cooling-off period. They believed that it would be difficult to justify proposing the five-year cooling-off provision on the one hand and then allowing exceptions after two years of cooling-off.
  - Other Board members agreed with the proposal for the provision of certain services being acceptable after a two-year period because they felt that the two-year period was sufficient to provide an appropriate balance with the need to not unnecessarily restrict access to resources for the remainder of the cooling-off period. During the discussion, some Board Members expressed the view that the two-year period could be acceptable in relation to non-client specific services.
  - One Board member supported a restriction on activities without exception for the five-year cooling-off period only if the LAEP was returning to the audit engagement after the expiry of that period, but supported some work being undertaken after two years if the LAEP was not going to return to the audit engagement.
17. After confirming that the proposed restriction on non-audit services during cooling-off was a stricter provision than currently exists in any jurisdiction, the Board agreed that time should be taken to consider the matter further.

#### *TF Deliberations*

18. The TF took into consideration the Board's comments including comments from one Board member that the provisions taken as a whole could still allow an individual to influence the audit even if that individual's interaction with management was in a "limited and social context" as outlined in the draft proposals. The TF evaluated three options:
- (a) Removing the restriction altogether in relation to other services;
  - (b) Leaving the provisions as proposed and/or removing the ability for the engagement partner to provide services after two years; or
  - (c) Seeking some middle ground and reconsidering the approach more generally.
19. The TF reconsidered the objective of the provisions and also discussed the feedback from the CAG. The TF did not believe removing the provision altogether was the correct response. It did, however, recognize that the restriction as proposed could be seen as excessive if the objective was to ensure the rotated individual could not be in a position to influence the outcome of the audit engagement or continue to interact closely and frequently with senior management or TCWG.
20. Whilst the TF considered that allowing a two-year cooling-off period for a LAEP who was not going to return to the engagement had merit, it believed that this would add further complexity to the position.
21. The TF noted the Board's concern on the complexity of the provisions and felt that it could add more clarity to the existing provisions by going back to the principles that the provisions are trying to address. The TF felt that the essence of the issue hinges on whether an individual exerts influence on the outcome of the audit engagement or has significant or ongoing contact with client management.
22. The TF proposes for all KAPs that an individual be restricted from undertaking any roles or activities with respect to the audit client which would result in the individual having ongoing or frequent interaction with senior management or TCWG, or being able to exert influence, including through the provision of

other services, on the outcome of the audit engagement. The TF considers this proposal addresses the concerns of the Board and the comments of the CAG.

*Board Comments at its April 2014 Teleconference*

23. The majority of IESBA members supported the TF's revised proposal that there not be an overall prohibition but rather a principle about the activities that should be restricted only if they impact the audit. Some IESBA members also made the following comments and suggestions for the TF's further deliberations:
- Whether the wording of the provision in relation to exerting influence on the audit be adjusted so that it could not be construed as prohibiting the LAEP or KAP from becoming the managing partner of the firm during cooling-off.
  - Whether the wording of the provisions regarding consultation during the cooling-off period appeared to be inconsistent with the proposed principle, given that by being permitted to consult after a two-year period has elapsed, the LAEP would be in a role where they could influence the audit.
  - Whether in the proposals the term LAEP might be used instead of engagement partner.
  - Whether the term "other services" was intended to include non-audit services.
24. Mr. Koktvedgaard commented that the proposals were a simpler solution but questioned whether the right balance had been struck. He indicated a continuing concern about the LAEP having any involvement with the audit team during the cooling-off period.
25. The TF has deliberated on the comments from the Board and made further amendments to the proposals attached in Agenda Item A-2. These proposals will be presented to the Board at its July 2014 meeting.

*National Standard Setters' (NSS) Comments*

26. NSS participants were asked whether they supported the proposals for restricting roles and activities related to the audit client during the cooling-off period. Some participants expressed the view that there should be no permissible activities or interaction between the LAEP and the audit client at all during the cooling-off period.

**Matter for Consideration**

2. Do CAG representatives support the revised proposals describing the roles and activities related to the audit client that can and cannot be undertaken during the cooling-off period?

C. CORRESPONDING CHANGES TO SECTION 291.139

27. The IESBA has made corresponding changes to Section 291.139 which concerns independence for other assurance engagements. In response to comments at the April Teleconference regarding the nature of assurance engagements, the TF has recommended adding wording to set out that familiarity and self-interest threats may be created with respect to assurance engagements of a "recurring nature." This wording is included in Agenda Item A-4.

**Matter for Consideration**

3. Do CAG Representatives have any comments or suggestions on the corresponding changes to Section 291?