

## Employment “Cooling off” Period

### Background

A threat to independence may be created where a member of an audit engagement team joins the audit client in a position to exert significant influence over the preparation of subsequent financial statements and/or otherwise exert influence over the conduct or outcome of the audit. Such circumstances may create self-interest, familiarity and intimidation threats.

A safeguard commonly adopted by regulators and professional bodies is a requirement for a ‘cooling-off’ period between the individual leaving the firm, or the engagement team, and joining the client in such a position. The safeguard is typically phrased such that if an individual does join the client during the period, the firm is deemed not to be independent and is required to resign.

The existing Code approaches this issue on a threats and safeguards approach and does not specify a required ‘cooling-off’ period. The Board has concluded, particularly in the light of the position taken by regulators generally, that it is appropriate to consider and to specify a requirement in the case of the audits of listed entities.

### Key Questions Considered

- Who should be covered by the ‘cooling-off’ period?
  - ✓ Engagement partner
  - ✓ Other audit partners (e.g material subsidiaries)
  - ✓ Other members of the audit engagement team
  - ✓ Chain of Command
  
- How long should the period be?
  - ✓ 365 days
  - ✓ One complete/clean audit cycle
  - ✓ Two years
  
- When does the period commence?
  - ✓ Filing of the last audit report
  - ✓ Date of AGM
  - ✓ Date individual truly has no further involvement in the audit (i.e. completely steps down)
  - ✓ Date of leaving the firm
  
- What employment position is relevant?
  - ✓ Financial oversight role
  - ✓ Director and officer
  - ✓ Other

- Are any exceptions appropriate?

### Comparative Positions

Details of the positions taken by 5 key regulators are provided in the Appendix.

This may be summarised as:

	<b>SEC</b>	<b>8<sup>TH</sup> Directive</b>	<b>Australia</b>	<b>UK</b>	<b>Canada</b>
<b>Who</b>	Audit engagement team member	Statutory auditor or key audit partner (s)	Professional member of the audit team	Engagement partner, independent partner, key audit partner, or Chain of Command	As SEC
<b>How Long</b>	One year	Two years	Two years	Two years	As SEC
<b>When Started</b>	From date of filing annual report to date files its next annual report	Resignation as statutory auditor or key audit partner	Cessation of employment by firm	Cessation of employment by firm	As SEC
<b>Employment position</b>	Financial reporting oversight role	Management position	Officer	Director or key management position	As SEC

There is no clear consistency in the requirements, in terms of length, start point or role.

## **Discussion**

### *Individuals covered by cooling off period*

There is no consensus among the regulatory positions – however all the above referenced rules extend beyond the engagement partner. The Task Force concluded that the restriction should extend only to the engagement partner. This is where the greatest threat exists.

Only the UK rules extend to dealing with the Chain of Command. There seems no strong reason to extend a rule to such persons.

The Task Force recognises that threats can be created where other members of the audit engagement team join the client, but is of a view that consistent with the principles-based approach, it is reasonable to deal with other members of the engagement team (being other professionals participating in the assurance engagement, key partners at a material subsidiary and the Chain of Command) on a threats and safeguards approach that the existing Code adopts (¶290.144).

This approach also recognises that under Employment Law it is often difficult or illegal to impose restrictions on the ability of employees to seek employment elsewhere. Partners on the other hand can be restricted, if they concur, via a Firm's Partnership Agreement.

### ***Action requested***

Members are asked to consider the Task Force recommendation that the specific restriction apply to the engagement partner and other individuals will be addressed through the general threats and safeguards approach.

### *Length of cooling-off period*

Again, there is no consensus in the regulatory position but a majority (3/5) have a two-year rule and application of the US/Canada rule can result in a period extending towards two years.

There appears to be a not unreasonable view that the individual leaving to join the client should not be in a position to influence the following year's audit. The question is how best to capture this?

Based on a limited population expressing a view at the Forum, a 'simple' 365-day formula did not appear to find favour, as this may not result in a one-year clean audit period between leaving and joining.

A two-year period would generally cover this but would have the disadvantage of generally extending beyond the SEC requirement and would cause difficulties in application for practitioners. For this reason this seems inappropriate.

Application of the SEC wording internationally causes some difficulty as the term “filing” does not necessarily mean the same thing elsewhere.

This question needs to be addressed in conjunction with the following:

*Start of period*

There is a variety of regulatory opinion on this.

Reference to “cessation of employment by the firm” does not seem an appropriate reference point as this could be some time after the individual steps down from the engagement team.

Reference to a date when the individual steps down (e.g. as engagement partner) has the potential for inconsistent application (eg if the partner has some involvement in the next year’s audit planning).

The Board wishes to adopt a position that is clear and workable. Reference to a defined period appears to have some merit.

The Task Force concluded, and recommends, that for the engagement partner there should be a clean audit year before joining the client and that during this period that the partner should not fulfil the role of the individual responsible for the engagement quality control review.

Without reference to the engagement quality control reviewer, the engagement partner could step down after one year, perform the QC role for the next year and then join the client at the beginning of year 3. Given the position of influence and knowledge that this individual has, this does not seem appropriate.

*Employment role at client*

There is a variety of regulatory opinion on this.

The existing Code focuses on ‘a director, officer or an employee in a position to exert significant influence over the financial statements’.

A ‘Financial Reporting Oversight role’ (not a term used by the Code) is defined by the PCAOB as:

“A “financial reporting oversight role” means a role in which a person in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.”

The Task Force recommends that reference should be to employment ‘as a director, an officer, or an employee who is in a position to exert significant influence over the financial statements of the client (the subject matter information). Note- the comma after “officer” clarifies the intent of the sentence and makes it clear that the “in a position to exert significant influence” modifies only the employee – not the director or officer.

The Task Force is of a view that this would cover the roles and positions included in the term “financial reporting oversight role”.

The Task Force believes that the requirement for the audit engagement partner, and threats and safeguards approach for others, should be limited in the case of employees to those who are in a position to exert significant influence over the SMI, as opposed to subject matter. In this situation, subject matter is more remote, and there is likely to be no threat if a member of the audit team joins the client in a position of no proximity to the financial statements.

In the light of the above, the following wording is proposed:

*“If a former engagement partner joins a financial statement audit client that is a listed entity as a director, an officer, or an employee who is in a position to exert significant influence over the financial statements of the client (the subject matter information) before the audited annual financial statements, for which the partner was not a member of the engagement team or the individual responsible for the engagement quality control review, has been filed (or local equivalent\*) with the registrar or other appropriate authority, the self-interest, familiarity and intimidation threats created would be so significant no safeguard could reduce the threat to an acceptable level”*

*\* to be defined by each jurisdiction/member body.*

#### *Exemptions*

In relation to the audit engagement partner, the Task Force considers whether any exemptions were appropriate. The Task Force is of the view that it would be appropriate to have an exemption if because of a result of a merger the former partner was in a position to exert significant influence over the financial statements. (the SEC has such an exemption).

The Task Force considered whether it was appropriate to provide an exemption for emergency situations provide the audit committee agreed it was in the best interests of the shareholders. The Task Force concluded that such an exemption was necessary. The restriction is limited to only the engagement partner and, therefore, it is highly unlikely that in an emergency situation the former engagement partner would be the only person who could fill the role at the client.

***Action requested***

Members are asked to consider the recommendation of the Task Force and the illustrative wording.

## **Illustrative Wording**

### **Employment with Assurance Clients**

290.143 A firm or a member of the assurance team's independence may be threatened if a director, an officer, or an employee of the assurance client who is in a position to exert significant influence over the subject matter information of the assurance engagement has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team's independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future.

290.144 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

- (a) The position the individual has taken at the assurance client.
- (b) The amount of any involvement the individual will have with the assurance team.
- (c) The length of time that has passed since the individual was a member of the assurance team or firm.
- (d) The former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary; or
- Quality control review of the assurance engagement.

In all cases, all of the following safeguards are necessary to reduce the threat to an acceptable level:

- (a) The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence.
- (b) The individual does not continue to participate or appear to participate in the firm's business or professional activities.

290.145 A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:

- (a) Policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client.
- (b) Removal of the individual from the assurance engagement.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

*Financial Statement Audit Clients That are Listed Entities*

290.146 If a former engagement partner joins a financial statement audit client that is a listed entity as a director, an officer, or an employee who is in a position to exert significant influence over the financial statements of the client (the subject matter information) before the audited annual financial statements, for which the partner was not a member of the engagement team or the individual responsible for the engagement quality control review, has been filed (or local equivalent\*) with the registrar or other appropriate authority, the self-interest, familiarity and intimidation threats created would be so significant no safeguard could reduce the threat to an acceptable level.

\* to be defined by each jurisdiction/member body.

290.147 *If a former engagement partner joins a financial statement audit client before [such period has expired] as a result of a business combination between the listed entity and the acquiree, the position is not considered to create an unacceptable threat provided that the employment was not in contemplation of the business combination and, where necessary, appropriate safeguards are applied to reduce any threat to independence to an acceptable level. Such*

*safeguards might include those in paragraph 290.144 and discussion of the matter with the client's audit committee.*

## **Appendix**

### **Comparative positions – for information only**

#### **SEC**

The ‘cooling-off’ period requirement prohibits an accounting firm from auditing an SEC issuer’s financial statements if an employee of the issuer is in a financial reporting oversight role of the issuer and was an audit engagement team member at any point during the annual reporting period preceding the commencement of the period under audit. For these purposes, an audit engagement team member is considered to be the lead or concurring partner or any professional who provided ten or more hours of audit, review or attest services during the annual audit period of the issuer, which includes all entities within the consolidated financial statements. To be in compliance with these rules, an audit engagement team member should have a one-year ‘cooling-off’ period (see below) prior to employment by an SEC issuer in a financial reporting oversight role.

The one-year ‘cooling-off’ period is not based on the one-year anniversary of when an audit engagement team member stopped providing service. Instead, the one-year ‘cooling-off’ period starts on the first day after the SEC issuer audit client files its periodic annual report and ends when the SEC issuer audit client files its next annual report. For example, if an audit engagement team member provides services in 2003 for an issuer’s December 31, 2002, fiscal year-end audit, and provides no services after the issuer’s 2002 periodic annual report is filed with the SEC, the ‘cooling-off’ period would end in 2004 when the company files its annual period report for 2003. However, if the audit engagement team member provided services in conjunction with the issuer’s 2003 annual reporting period (for example, the first quarter review), the ‘cooling-off’ period would end in 2005 one day after the company files its annual report for 2004.

#### Exceptions to the ‘cooling-off’ period

The SEC rule provides three exemptions to the mandatory ‘cooling off’ period:

- An audit engagement team member, other than the lead partner or concurring partner, who provided ten or fewer hours of audit, review, or attest services during the engagement period, would not need to adhere to the ‘cooling-off’ period requirement.
- An audit engagement team member employed by the SEC issuer in a financial reporting oversight role as a result of a business combination between the issuer and the acquiree would not impair independence, provided the employment was not in contemplation of the business combination and the audit committee of the successor issuer is aware the person previously was a member of the audit engagement team; and

- An audit engagement team member employed by the SEC issuer audit client in a financial reporting oversight role due to an emergency or other unusual situation would not impair independence, provided the audit committee determines that the relationship is in the best interest of investors.

### **European Commission 8<sup>th</sup> Directive**

“The statutory auditor or the key audit partner who carries out the statutory audit on behalf of an audit firm shall not be allowed to take up a key management position in the audited entity before a period of at least two years elapsed since he or she resigned as a statutory auditor or key audit partner from the audit engagement.”

“Statutory auditor” means a natural person who is approved in accordance with the provisions of this Directive by the competent authority of a Member State to carry out statutory audits.

“Key audit partner(s)” means:

- a. 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 behalf of the audit firm; or
- b. 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
- c. the statutory auditor(s) who sign(s) the audit report.

**Comment:** The starting point for the 2-year period is not entirely clear as to what this means in practice.

### **Australia (Companies Act)**

2 year ‘cooling-off’ period for a ‘professional member of the audit team for the audit, commencing from the departure time (the time when the individual ceases to be a member of the audit firm) before becoming an ‘officer’ of the audit body. If the audit body is a listed entity, this extends to a related entity.

## **UK (APB)**

“Where a partner leaves the firm and is appointed as a director (including as a non-executive director) or to a key management position with an audit client, having acted as audit engagement partner (or as an independent partner, key audit partner or a partner in the Chain of Command) at any time in the two years prior to this appointment, the firm should resign as auditors. The firm should not accept re-appointment as auditors until a two-year period, commencing when the former partner ceased to act for the client, has elapsed or the former partner ceases employment with the former client, whichever is the sooner.

Where a former member of the engagement team (other than an audit engagement partner, a key audit partner or a partner in the chain of command) leaves the audit firm and, within two years of ceasing to hold that position, joins the audit client as a director (including a non-executive director) or in a key management position, the audit firm should consider whether the composition of the audit team is appropriate.”

Key management position – Any position at the audit client which involves the responsibility for fundamental management decisions at the audit client (e.g. as a CEO or CFO), including an ability to influence the accounting policies and the preparation of the financial statement of the audit client. A key management position also arises where there are contractual and factual arrangement which in substance allow an individual to participate in exercising such a management function in a different way (e.g. via a consulting contract).

## **Canada**

One-year ‘cooling-off’ period for a member of the audit engagement team accepting employment in a financial reporting oversight role from the date when the financial statements were filed with the relevant securities regulator or Stock Exchange.