Agenda Item 8-F

Long Association—Response to PIOB

A. Overarching Comments

The IESBA believes that the revised proposals to address the threats arising from Long Association constitute a major contribution to the Code and, by raising the bar, result in a net public interest benefit.

Before addressing the specific points raised by the PIOB, there are certain matters that the IESBA believes that it is essential to have in mind when assessing the revised provisions addressing the familiarity and self-interest threats arising from Long Association.

1. Principal factors that the IESBA had regard to when developing provisions applicable to the audits of public interest entities (PIEs) to address the threats arising from Long Association

(a) **Threats to audits of PIEs cannot be addressed by principles-based standards alone**.

Many G20 and other jurisdictions have concluded that specific rules or regulations are required and those are invariably incorporated into law or regulation.

The IESBA has adopted the same approach.

(b) There is no consensus on an optimal approach.

Fundamentally different approaches have been adopted from jurisdiction to jurisdiction:

(i) Different countries have elected different time-on and cooling-off periods – for example, 5+5; 7+5; or 7+3.

(ii) Some countries have addressed all members of the audit team; others have not.

(iii) Some have allowed exemptions (non-PIEs; SMPs; special situations etc.); others have not.

(iv) The EU, whilst adopting a time-on/cooling-off framework, has introduced additional considerations – re-tendering, joint audits and mandatory firm rotation.

(c) <u>The Code cannot ignore the differing approaches adopted by major jurisdictions.</u>

The Code requires firms to comply with whichever is the stricter of the provisions in the Code or the provisions laid down by law or regulation. This requirement, which is fundamental to the conceptual structure of the Code, had the potential to give rise to two problems:

(i) Combining the provisions laid down by law or regulation with those required by the Code would give rise to considerable complexity (and uncertainty as to how related, but not identical requirements should be implemented); and

(ii) The combined effect might be regarded as unduly harsh with the result that firms (and member organizations) might decide not to comply with or adopt the Code.

To remove these risks – of undue complexity and/or non-compliance – the IESBA developed the so-called 'jurisdiction clause'. That allows firms to comply with an alternative cooling-off regime for engagement partners **<u>provided</u>** that that alternative regime has been authorized by law or regulation **<u>and</u>** that certain other minimum requirements are met.

(d) <u>That the IESBA should focus on developing provisions that would be operable on a global basis.</u>

Given that many of the G20 countries have taken steps to address the threats from Long Association, the IESBA's primary responsibility in the public interest is to develop provisions for implementation in those jurisdictions that currently have no, or no acceptable provisions.

It would not, therefore, be in the public interest for the IESBA to adopt an approach that has been taken in one G20 country that would not be acceptable or operable throughout the world, let alone in other G20 countries.

With the benefit of extensive consultation, the IESBA believes it has achieved provisions that raise the bar significantly for the globe, including in several respects even among the G20.

In developing provisions for implementation generally, the IESBA has enhanced the current provisions by:

(i) Moving to 7+5;

(ii) Addressing the positions of engagement partners (EPs), engagement quality control reviewers (EQCRs) and key audit partners (KAPs);

(iii) Being clear about what 'cooling-off' requires.

2. <u>The IESBA addressed risks to the effectiveness of the Code whilst recognizing the dangers of undue complexity.</u>

(a) <u>The revised provisions identify three risks to the effectiveness of the Code</u>,

(i) That the Code would not be adopted in those jurisdictions where alternative provisions have been adopted by law or regulation – see 1 (c) above.

(ii) That an individual might avoid the intended cooling-off period by holding different positions in an audit team within a 7 year period.

(iii) That the provisions might adversely affected audit quality.

(b) <u>The IESBA has addressed these risks in the simplest way possible.</u>

(i) The jurisdictional clause involves a two-element test – (i) the regime must have been implemented by law or regulation; (ii) there must be an inspection regime that is independent of the profession.

(ii) The cooling-off period to be observed if an individual holds different positions in an audit team in a seven-year period is determined by one criterion – namely the period applicable to the position held for the longest period within that seven-year period. The Code also addresses the situation where an individual might circumvent the requirements by breaking the continuity of the seven-year period.

(iii) The revised provisions permit access to an individual observing a cooling-off period who has specialist expertise – but only on a tightly controlled basis.

(c) <u>Previous complexity has been removed.</u>

(i) The distinction between listed and unlisted PIEs has been removed.

(ii) The provision based on the position held by an individual in an audit team during two of the last three years has been removed.

3. The two factors that the IESBA had regard to when developing provisions applicable to the audits of non-PIEs to address the threats arising from Long Association.

(a) The need to enhance the provisions which auditors of non-PIEs must observe.

The IESBA has strengthened the principles-based framework to comprehensively address long association threats in relation to audits of all non-PIEs. That framework addresses:

(i) All members of the audit team, and is not limited to KAPs. As a result, any individual on the team could be required to rotate;

(ii) The familiarity threat that could arise with respect to the financial information itself, and not only with respect to the entity or management;

(iii) Guidance regarding the threats and factors to be considered has been extended and is now much more comprehensive; and

(iv) Examples of safeguards.

(This framework of general principles applies also to audits of PIEs.)

(b) The need to avoid any actual or potential adverse consequences for audit quality.

(i) Familiarity threats will vary depending on the roles of individual KAPs on the audit engagement and their levels of interaction with management.

(ii) it is important to recognize the practical reality that in many jurisdictions, even among the G20, the pool of available talent (e.g., individuals suitably qualified and experienced to act as EQCRs, or individuals who are specialists in particular fields) is limited, and especially so among SMPs.

Accordingly, it would not be in the public interest to impose requirements that would incentivize or otherwise compel firms to make compromises on audit quality or that could create potential unintended consequences for audit quality.

(iii) Many regulators have given careful consideration to the potential adverse consequences for audit quality when revising their rules to address long association.

For example, in developing certain exemptions from its partner rotation requirements in 2002-2003, the U.S. Securities and Exchange Commission (SEC) noted that it had endeavored to achieve *"an appropriate balance between the need for a fresh look with*

the difficulties encountered in certain locations where the pool of available talent is limited."[1]

4. The scope of the project

(a) **The Long Association project proposal was considered and approved in accordance with normal due process.**

That involved consultation with stakeholders and consideration by and advice from the CAG.

(b) **The project proposal did not include a reconsideration of the definition of a PIE**.

Any changes to that definition would have significant implications across the Code that would not be limited to the Long Association project.

(c) **The project proposal did not extend to mandatory firm rotation (MFR).**

The IESBA concluded (at its June 2012 meeting) that there was insufficient evidence of the effect of MFR for it to have a formal position on MFR.

In addition, it is important to note that MFR is primarily directed at a different issue – namely enhancing competition in the PIE audit market and thereby possibly increasing the number of market participants.

(d) **Re-opening the scope of the project to address these matters would trigger due process requirements**.

Re-opening the scope of the project to introduce revised provisions would require extensive consultation (given the complexity and controversial nature of these matters). This would result in the implementation of the revised provisions being delayed by at least two years.

[1] Exemptions from the partner rotation requirement under U.S. SEC independence rules include: audit partners serving on subsidiaries which constitute less than 20% of the consolidated assets and revenues of the issuer; and audit partners on subsidiaries above the 20% threshold other than the engagement partner on those subsidiaries (see Section II(C)(2) of U.S. SEC final rule 17 CFR Parts 210, 240, 249 and 274). (By contrast, the IESBA Code imposes rotation requirements on all audit partners on PIE audits who meet the KAP definition.)

(e) **Looking forward**

In addition to monitoring the effectiveness of the revised provisions, the IESBA has already:

(i) Identified the definition of a PIE (and the interaction with the definition of listed entity) as an area requiring reconsideration. The IESBA will consider including an appropriate project on this topic in its upcoming consultation on its Strategic Plan for 2019-2023; and

(ii) Committed to monitor the implementation of MFR and re-tendering in different jurisdictions with a view to considering whether those matters should be addressed in the Code.

5. Due Process

(a) **The Long Association provisions have been the subject of extensive consultation.**

(i) There have been two exposure drafts resulting in 115 responses in aggregate;

(ii) The proposals have been considered at meetings with IOSCO Committee 1, the IFIAR Standards Coordination Working Group, the European Audit Inspection Group, the IESBA's National Standard Setters liaison group and others; and

(iii) All of the issues have been discussed extensively with the CAG – which supports the final provisions.

(b) **The IESBA has accepted the points raised by IOSCO Committee 1.**

Subject to the points it raised, IOSCO Committee 1 expressed broad support for the revised provisions (see its letter dated July 8, 2016.)

(c) The IESBA has responded to comments raised by PIOB observers

The IESBA has:

(i) Extended the provisions to the financial information of the audit client.

(ii) Simplified the final provisions in response to PIOB concerns about complexity.

(d) PIOB observers have commented favorably on the quality of the debate, the commitment to the public interest and the outcome.

Certainly no indication was given that the PIOB would not support the revised provisions.

(e) **The IESBA has already unanimously approved all the revised provisions**.

The only outstanding item to be finalized is the effective date and proposed transitional provisions, for which an IESBA teleconference has been scheduled for November 16, 2016.

The fact that such provisions have been approved is already in the public domain, the full text of the close-off document being available on the IESBA website as part of the agenda material for the November 16th IESBA teleconference.

(f) The IESBA does not consider that it has the ability to reopen those provisions that it has approved.

(i) Against the background of extensive consultation,

(ii) The support of the CAG; and

(iii) Full observance of due process:

(g) Further re-exposure would materially delay the adoption and implementation of the revised provisions

(i) The IESBA would have to re-expose most, if not all, of the revised provisions to address the points raised at this late stage by the PIOB.

(ii) That would leave the current, out-of-date provisions in effect – an outcome that would not, in the IESBA's view, be in the public interest.

B. Responses to Specific Matters Raised by the PIOB

#	PIOB Comments/Questions	Response and Why Revised Provisions are in Public Interest
Complexity		
1.	The complexity of the proposed regime makes it very difficult to understand and will make implementation and monitoring extremely difficult. The Staff Q&A Paper is an indicator of such complexity. Can it be made simpler?	This is an area where complexity is unavoidable given that we are dealing with an already complex situation across jurisdictions. • The Board has recognized that, in the case of PIEs, an approach to a familiarity threat that is "principles" based would not command confidence – primarily because it would allow subjective judgment by individual firms and partners. • The Board has also recognized that, within an audit team, there are individuals performing different functions (e.g. EP, EQCR and other KAP) giving rise to familiarity threats of differing significance and, therefore, requiring differing provisions. • As a result, the section establishes rules that prescribe maximum periods that a professional accountant can hold a particular position combined with minimum periods for 'cooling-off'. • Were this regime to be limited to individuals holding only one position, this approach would not be complex. • However, individuals may hold different positions within an audit team and may do so for varying periods consecutively. • The need to address the situation where individuals hold differing positions has been recognized by respondents to both Exposure Drafts, by the IESBA CAG and by the PIOB – as has the inevitable complexity that this gives rise to. To reduce complexity, the Board eliminated provisions that had a compounding effect:

#	PIOB Comments/Questions	Response and Why Revised Provisions are in Public Interest
		• By removing the distinction between listed and non-listed PIEs when determining the cooling-off period for EQCRs. • By providing that the period that an individual should cool off after having served in a combination of roles should be determined by just one factor – the role the individual held for the majority of the time-on period. The Board does not believe that the regime will be difficult to implement, monitor or enforce for the following reasons: • Firms already deal with complex independence requirements that differ from jurisdiction to jurisdiction. • As a result, firms manage compliance with rotation requirements centrally. • Firms only need to implement the new provisions into their systems and processes once. • The Q&As have been developed to provide helpful guidance to facilitate understanding and application. The rationale for and the implications of the "jurisdictional safeguards" are considered under 5 below.
2.	Does par. 290.160 add any substantial condition? Could this paragraph be eliminated?	No. This paragraph is required to ensure that an individual who has: • Acted as a KAP for 3 years, an EP for three years, and an EQCR for 1 year is required to complete a cooling-off period that reflects the importance of his/her role – namely 5 years. • Acted as a KAP for 3 years, an EP for 1 year and an EQCR for 3 years is required to complete a cooling-off period that reflects the importance of his/her role – namely 3 years.

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		Without paragraph 290.160, the requisite cooling-off period in each instance would be only 2 years (as the requirements of paragraphs 290.158 and 159 would not be triggered).
Scope		
3.	The proposed regime for the non-PIEs is very weak and essentially based on assessment of the threats and safeguards: could it be made stricter?	The Board's approach, which has been supported throughout the consultation process, has been that there is no public interest in adopting a rules-based approach for non-PIEs and, further, that to do so would present considerable difficulties to the SME and SMP constituencies and potentially adversely affect audit quality. The Board therefore developed revised principles-based provisions that establish a more robust framework than existed before: (a) They cover all members of the audit team, and are not limited to KAPs. As a result, any individual on the team could be required to rotate; (b) They recognize that the familiarity threat could arise with respect to the financial information itself, and not only with respect to the entity or management (a point specifically raised by the PIOB observer); (c) The guidance regarding the threats and factors to be considered is now much more comprehensive; (d) They contain additional examples of safeguards; and (e) If rotation of an individual is necessary, they now require the firm to have the individual cool off for a sufficient duration to eliminate the threats or reduce them to an acceptable level. Any material changes would require exposure

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4.	Can the definition of the PIE be adapted to include all larger entities such as, e.g., large unlisted public entities?	• A review of the PIE definition is outside the scope of this project (and any proposals would require exposure). • It would also require more general consideration of implications throughout the Code. • However, because the definition is becoming of increasing significance, a revision of the definition will be included in the IESBA strategy consultation next year.
Exceptions to Cooling-off		
5.	The jurisdictional safeguards proposed seem unnecessary and weaken the proposed regime (i.e. reducing the cooling-off period). Stricter rules in domestic legislation (i.e. mandatory firm rotation) prevail and apply. Could these exceptions (par. 290.163) be eliminated?	Under the Code, a professional accountant is required to comply with whichever is the stricter of the provisions in the Code or the provisions laid down by law or regulation. As a result of this fundamental provision of the Code, a problem arises where a jurisdiction implements a different approach to an issue to that adopted in the Code. This has not been a problem historically. However, the completely different approach taken by the EC (which provides for a 3 year cooling-off period for EPs), MFR, joint audits and re-tendering, and which does not address the position of an EQCR) could be interpreted to mean that a firm would have to comply, in effect, with the provisions of the Code AND the requirements of the EU Regulation. Respondents pointed out that this situation could have serious consequences to the adoption of the Code in EU jurisdictions (which might decide NOT to adopt the Code in order to avoid the complexity and to avoid having to adopt the stricter provisions on top of MFR). Clearly that would be damaging to the credibility of the Code globally.

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		The Board therefore concluded that the Code should respect legal or regulatory regimes that had been brought into effect by governments or agencies independent of the profession – provided that an independent regulatory inspection regime was also in place. The jurisdictional provision, therefore, appropriately acknowledges existing jurisdictional diversity in approaches to addressing threats created by long association, while using the enhanced provisions in the Code to *raise ethical standards in an area where cooling off is not required , e.g. EQCRs in the EU, and in jurisdictions that have not implemented such regulatory requirements*.
6.	Can a professional standard reduce the cooling-off years when the regulator has determined what cooling off will apply and under which conditions?	The Code cannot alter requirements established in law or regulation. • Para 290.163 is addressing the cooling-off period *specified in the Code*, not in legislation. • As explained above, auditors need to apply the stricter of the Code or legal or regulatory requirements. So, if a particular jurisdiction already requires a 5-year cooling-off period for EPs (e.g. the UK), that will still apply and cannot be reduced by the jurisdictional provision in the Code.
7.	Is the provision relating to mandatory rotation an effective solution?	• This provision recognizes one of the alternative approaches that jurisdictions (such as the EU) have adopted to address threats created by long association (see above).
8.	Is the exception in para. 290.168 needed? Is it not a decision of the regulator?	• Para 290.168 is not an exception. It merely recognizes that in some jurisdictions, the local regulator may (a) grant an exemption from the partner rotation requirements, and (b) specify appropriate conditions for such exemption.

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Exceptions to Prohibition to Consult During Cooling-off Period		
9.	In principle, consulting with an EP or an EQCR is prohibited during their cooling-off period. However, after only two years of cooling-off, they can be consulted in specific circumstances (par. 290.164). Consultation should be limited to cases where the firm has no technical or industry-specific auditors and such consultation should be limited only to one year and to work undertaken or conclusions reached in the last year, after which the firm should be able to consult a specialist in the market. Could provisions in par. 290.164 (b) be simplified to establish this simple principle, eliminating (b) (i), (ii), (iii)?	• The Board recognized the need to strike the right balance between (a) addressing threats to independence (through the increased cooling-off period for EPs and EQCRs and the stricter restrictions on the types of activities they could undertake during that period), and (b) safeguarding audit quality by making these individuals available given that specialist resources are often in short supply. • The final provisions contain strict conditions under which the rotated individual could be consulted in a technical specialist capacity after two years. Those conditions include: (a) That there be no other partner within the firm with the expertise to provide the advice (this is to promote consultation with other experts first if available); (b) That the consultation be in respect of a particular *issue, transaction or event*, as opposed to various issues (this is to emphasize that the provision is intended to be used in limited circumstances); and (c) That such consultation only be with the engagement team and not involve contact with the client. • The PIOB proposal does not address the issue because: (a) The suggestion does not address the familiarity threat from long association; nor does it take appropriate account of the potential adverse implications to audit quality. It is primarily relevant to the structure of the audit and assurance market. (b) The suggestion that any consultation should be limited to work undertaken or conclusions reached in the last year would mean that the individual would be re-considering

#	PIOB Comments/Questions	Response and Why Revised Provisions are in Public Interest
		his/her own work – precisely what the revised provisions are trying to avoid. (c) The suggestion that after one year the firm should consult a specialist in the market involves significant issues – client consent, confidentiality, availability of that expertise etc.
Transitional Provisions		
10.	EPs and EQCRs on audits of PIEs who have served their seven cumulative years of service and have started their cooling off at the time the LA provisions become effective (December 15, 2018) must cool off for two years (extant provisions in the Code). In all other circumstances, the cooling-off periods introduced with the revised LA provisions (5 years for EP, 3 years for EQCR) will be applied. Is there a need of transitional provisions? If so, why do they allow the application of the old regime (extant Code)?	A transitional provision is required to address the position where an individual has already held a position (e.g. as EP) and is part way through the cooling-off period required under the extant Code. Theoretically, an individual could 'game' the new provisions by acting as EP for less than the maximum period required by the extant Code (i.e. 7 years) so that he/she could complete a cooling-off period of two years then argue that he/she could begin a new 7-year period. The transitional provision is designed to ensure that the only individuals to which a cooling-off period of 2 years can apply are those who have already completed a 7-year period as EP before the effective date. The alternative would be to have no transitional provision. The present view of the Task Force is that that would present particular difficulties for smaller firms where specialist resources are in short supply, particularly with respect to EQCRs. Therefore, given the extent of the changes, the Task Force has concluded that: • It would be in the public interest to allow for a transition to enable individuals and firms to manage the changeover to the new requirements without undermining their ability to perform robust quality audits.

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		• Even with the lead time for implementation, there may be risks to audit quality as not all firms may be fully ready to apply the new provisions from the date they become effective. In particular, it would be important to minimize risks that firms would feel pressured to assign individuals to EQCR roles without the appropriate skills and experience just to comply with the new provisions. • Other standard-setting bodies and regulators that promulgate independence standards also have determined it important to address transition issues when they released new or revised requirements. This has been the case, for example, with the US SEC when it issued strengthened auditor independence requirements (including partner rotation requirements) that became effective on May 6, 2003.
11.	Why is the effective date established in two years (December 2018)?	• The extension of the effective date by an additional year from the proposal originally set out in the August 2014 Exposure Draft (i.e., December, 15, 2017) reflects the fact that the Board issued a subsequent re-Exposure Draft in February 2016, which effectively deferred finalization of the provisions by almost a year. • In addition, the Board concluded that the revised provisions should not become effective until after they have been restructured. This was to avoid the introduction of new requirements (that would need to be translated and implemented through due process) that would then need be replaced shortly thereafter. • The Board is aiming to complete the restructuring of the Code by Q4 2017. Assuming PIOB approval in March 2018, the restructured Code (including the restructured LA provisions) would only be issued at the end of March 2018 or in early April 2018.

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		• In these circumstances, the Board believes that December 2018 is the earliest possible date when the new provisions could be implemented. • As an illustration of the time it can take to implement changes in rules given the need for translation, due process and other implementation activities, when the new EU audit legislation became effective on June 17, 2016 (a little over two years after the European Parliament and Council adopted it in April 2014), a number of EU Member States had still not completed their implementation of the new rules by the deadline (as noted in a June 17, 2016 Fédération des Experts Comptables Européens press release).

B. Concerns Raised by PIOB Observers at IESBA and CAG meetings in 2015

#	Public Interest Issues	Response and Why Revised Provisions are in Public Interest
1.	<u>IESBA January 2015 meeting</u> **Scope does not include audit firm rotation** No reference is made to firm rotation. At least some mention should be made, allowing for firm rotation in jurisdictions where this is mandatory or accepted practice.	• The Board explicitly scoped out firm rotation given the extensive discussion it had on the topic in 2012 when it determined that the evidence concerning the benefit of MFR to independence was inconclusive. • The final provisions acknowledge that some jurisdictions may have established MFR as one approach to address threats created by long association. The final provisions allow firms to take into account such requirement in implementing the cooling-off requirement for EPs. • The Board has agreed that it will continue to monitor international developments regarding firm rotation.
2.	<u>IESBA June 2015 meeting</u> **Cooling-off period of EPs and EQCRs in LA provisions should be aligned** The regime has now been strengthened for EPs (five-year cooling-off period). Rotation of the other leading auditors should not be more lax as that may be detrimental to audit quality.	• The Board set out a "bridge proposal" in the February 2016 re-ED whereby EQCRs on listed PIEs would be required to cool off for 5 years, and EQCRs on non-listed PIEs for 3 years. • Respondents across the entire spectrum of stakeholders raised strong concerns about the proposal, including lack of proportionality, potential unintended consequences, additional complexity and impact on SMPs given that EQCRs are a scarce resource. • The Board's rationale for concluding on 3 years vs 5 years for EQCRs is as follows: o Some G20 jurisdictions already require 5 years, in particular US, Canada, UK, and Japan (which tend to have largest numbers of listed entities).

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		o In other G20 jurisdictions, there is no consensus approach (e.g. US exemptions for SMPs; Canada exclusion of small listeds from PIEs; 2 years for SMPs in Japan; no cooling-off required in EU). o The public interest lies in facilitating development of EQCR approach more widely. o The EQCR cooling-off regime will fill a gap in the EU legislation. o This approach achieves a better balance, recognizing the different roles EPs and EQCRs play, and the scarcity of EQCR resources. • The Board will keep the provision under future review.
3.	IESBA June 2015 meeting **Weakness of LA provisions** The overall weakness of the new regime may affect audit quality and influence the structure of the profession and its attitude toward effective oversight of companies' accounting systems. The regime should be extended to a wider range of PIEs, including (in addition to listed companies) financial institutions and large companies such as government-owned entities, where the need for reliable accounting is significant.	• See response above re definition of PIE.
	Also, the consultancy activity of the EP in the cooling-off period should be described more clearly and limited to specific services for which few or no alternatives are available on the market.	• See response above re allowance for limited specialist consultation.
	Therefore, the IAASB also needs to strengthen the PIE regime.	• This is a matter for IAASB to address.

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4.	<u>IESBA October 2015 teleconference and CAG September 2015 meeting</u> **Complexity of LA provisions** The proposal is quite complex and difficult to analyze. The added level of complexity to the code risks taking the focus off the key independence principles and making understanding, acceptance, application, compliance, and convergence more difficult.	• See response above re complexity.