Proposed changes to certain provisions of the Code addressing the long association of personnel with an audit or assurance client

A consultation issued by the International Ethics Standards Board for Accountants

Comments from ACCA

11 November 2014

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ACCA

ACCA welcomes the opportunity to comment on the proposals issued by the International Ethics Standards Board for Accountants (the IESBA).

OVERALL COMMENTS

According to page 6 of the consultation, '[t]he IESBA recognizes that the issues are finely balanced and that any change must be seen by stakeholders as being substantive', and we would completely agree with this assertion. In addition, any substantive change must improve clarity, and it may be difficult to achieve this given the need to overlay the proposals with local jurisdictional rules. The need to achieve clarity is particularly relevant to small and medium practices (SMPs), not only because they have more limited resources when a need to rotate staff arises, but also because they may lack the in-house technical resources needed to fully comprehend the detailed and ever-changing requirements of the Code. With this in mind, the merits of focusing on the conceptual framework for recognising and addressing threats to objectivity are clear.

We are surprised by the statement on page 7 of the consultation that developments in the area of audit firm rotation are 'outside the scope of this project'. If, as suggested, such developments indicate a lack of confidence in the effectiveness of partner rotation, then surely it must be worth exploring, at this stage, whether firm rotation should, in fact, be the area of focus. While ACCA would not advocate a prescriptive approach within the Code to audit firm rotation, a 'comply or explain' approach to the rotation of the audit firm would be a proportionate response to the issue currently being addressed. This would still leave scope for the rotation of audit (or assurance) personnel to feature in the firm's (and its client's) explanation of why it should continue to act (together with other factors unique to the particular assignment). Our comments below are set against our position that we are not in favour of the mandatory rotation of audit personnel.

We welcome the proposal that the changes to the Code should include appropriate guidance on evaluating the threats and possible safeguards arising through long association. This is particularly relevant to SMPs – a group which, we fear, might have been under-represented in the IESBA's consultations. However, we have set out below how the proposed guidance might be greatly improved.

In respect of public interest entities (PIEs), the proposed changes go a long way towards addressing the threats arising out of familiarity at key audit partner (KAP) level. However, there is a deeper issue at firm level. This concerns the

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firm's strategy for obtaining and retaining clients, and the emphasis that firms place on relationship-building to support this endeavour.

SPECIFIC ISSUES

In this section of our response, we answer the 14 questions set out in the exposure draft section *Request for Specific Comments*.

GENERAL PROVISIONS

Question 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?

ACCA supports the provision of guidance within paragraph 290.148, as the identification of threats and appropriate safeguards is fundamental to objectivity and audit quality. However, in the interests of clarity, we propose the following:

- The wrong impression may be given by stating that threats may be created by 'using the same personnel', and we suggest that paragraph 290.148A should refer to 'using some of the same personnel'.

- It is not explained why a familiarity threat is created by an individual's long association with the client's financial statements or the financial information on which those financial statements are based. If the rationale is that familiarity with those records may give rise to a degree of complacency, we suggest that this is far outweighed by the advantages to audit quality that emanate from familiarity with the firm's financial reporting systems. Therefore, we believe that this point in proposed paragraph 290.148A would be likely to give rise to confusion, and the changes to the Code should focus on the relationships between personnel.

- Relating long association to concern about losing a client is also confusing. This paragraph should be concerned only with personal relationships. Concern about losing a particular client is usually born out of the level of fees or prestige derived from that client; whereas long association with a client may, in fact, strengthen the relationship. This paragraph should not be confused with audit firm rotation, but should focus on the self-interest that may arise out of close personal relationships.

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- The relevance of the distinction, in paragraph 290.148B, between factors relating to an individual within the firm and those relating to the audit client is unclear. There might equally be factors relating to an individual within the audit client or relating to the structure of the audit team. More important than drawing such distinctions is an acknowledgement that each audit client and each audit firm will have unique characteristics, which may make an analysis of threats and safeguards complex.

- In our opinion, there is too much focus on relationships with senior management and those charged with governance. Particularly in smaller organisations, the work of more junior staff could have a significant impact on the financial statements, and familiarity between such staff and audit personnel would be likely to give rise to threats over time.

In respect of assurance engagements, many of the points raised here are also relevant to paragraph 291.137. In addition, we do not agree that a threat to objectivity may arise only in respect of a recurring assurance engagement. The threat arises because an individual has worked closely with a particular client for a period of time prior to the assurance engagement.

The means by which threats may be reduced to an acceptable level are complicated. Paragraphs 290.149B and 291.137D suggest that an individual rotated off the engagement should not be able to exert influence on the outcome of the engagement for an appropriate period. However, this alone will not ensure that the threat to objectivity is sufficiently low at the end of that period. In order to do so, there should be no contact between the individual and the relevant client staff in respect of whom familiarity was deemed to have been a threat.

We note that it is proposed to replace the word 'management' with 'senior management' in the guidance. In practice, auditing issues are often discussed between members of the audit team and staff in the client's finance department who are not considered to be senior management. Therefore, the recognition and evaluation of threats created by long association should include consideration of the audit client's staff within the finance department, and not be limited to senior management. A change in the client's accountant or finance manager, who may not be considered to be senior management, may also reduce the level of familiarity threat. The consideration of such individuals will also be consistent with the extension of the independence requirements to all members of the audit team instead of just senior personnel.

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Question 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)?

Yes, we agree that the evaluation of potential threats should be applied to all members of the audit team, and not just senior personnel. Any member of the audit team could be associated with audit client staff long enough to create threats to independence. However, the varying natures of these types of relationship make it important that a principles-based approach is adopted, subject of course to due regard for the perception of appropriate independence.

Question 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?

Yes, we agree that the firm should be required to determine an appropriate time-out period. The necessary length of the time-out period (and so its effectiveness) is directly related to the length and nature of involvement of the individual concerned, and the threat arising from that level of familiarity. Therefore, firms require flexibility in determining the appropriate time-out period in each situation. Our response to question 5 below is also relevant to this question.

ROTATION OF KAPS ON PIES

Question 4: Do respondents agree with the time-on period remaining at seven years for KAPs on the audit of PIEs?

ACCA agrees with the proposal that the 'time-on period' should remain at seven years. We feel that the benchmarking evidence and stakeholder feedback set out on page 9 of the consultation effectively support this proposal. Furthermore, we believe that the most effective way to strengthen the Code, and to make the maximum time-on period more meaningful, is to focus on the length and nature of the cooling-off period.

Achieving an appropriate balance between independence and the drivers of audit quality requires the consideration of many factors (including the perception of stakeholders). Therefore, ACCA believes that the appropriate time-on period in a particular case can only be assessed on a principles basis. The prescription of a maximum period in respect of PIEs should only serve as a limitation in situations in which the assessment of threats and safeguards would not satisfy a PIE's stakeholders.

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Question 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?

In many respects, the length of the cooling-off period is more important than the period for which a KAP is permitted to act. A short cooling-off period may simply be regarded as a brief hiatus in the audit appointment – a costly breach of continuity only. A meaningful cooling-off period will address the familiarity threat more effectively, but also allow (and encourage) the new KAP during that period to gain a better understanding of the client’s business.

However, a cooling-off period of five years would appear to many to be a long time in the context of new mandatory audit firm rotation requirements that have been legislated or are currently being implemented in some jurisdictions. Also, in some jurisdictions, the time-on period for engagement partners of listed companies is limited to a period of less than seven years. In these jurisdictions, an extension of the cooling-off period required under the Code could not easily be accompanied by a corresponding extension of the time-on period for the engagement partner. In view of this, and the complexities of establishing appropriate safeguards that fit all PIEs, ACCA recommends that the Code should provide greater emphasis on principles in respect of all audit entities, including PIEs.

Question 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?

We believe that, if a five-year cooling-off period were to form part of the Code’s requirements in respect of PIEs, that requirement should apply to the audits of all PIEs in the interests of clarity and consistency. However, the five-year cooling-off period should be regarded as a default, whereby it would nevertheless be possible for the auditor (together with those charged with governance) to justify an alternative approach according to the specific threats presented and the safeguards available. Therefore, it is important that guidance in respect of the conceptual framework approach is highly visible within the Code. In the case of some PIEs, more stringent safeguards may, in fact, be appropriate.

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Question 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 that the familiarity threat that the extension of the cooling-off period to five years is intended to address is most clearly evident in the case of the engagement partner. Although having the same cooling-off periods for KAPs and EQCRs would aid consistency and clarity, in many cases, this would be unnecessarily restrictive (especially in the case of smaller practices). However, to simply retain the existing two-year cooling-off period for KAPs and EQCRs would represent a failure to acknowledge the variety of threats that might exist. We believe that, while a presumption may exist that the appropriate cooling-off period is two years (or five years), an assessment of the specific threats and safeguards might indicate that an alternative period would be more appropriate.

In our opinion, the pertinent question is whether the default cooling-off period for KAPs and EQCRs should be two or five years. Although the rationale for a distinction between the different types of partner is well-explained in the consultation, we believe that any changes to the Code at this stage provide an opportunity to achieve much greater clarity (which comes, largely, from greater consistency). Applying only minor changes to the Code risks the costs of change exceeding the benefits. We believe that clarity and transparency are enhanced by convergence of the default cooling-off periods. The inclusion of appropriate transitional provisions within the Code will ensure that it would never be necessary for the whole engagement team to rotate off the engagement at the same time, irrespective of the assessment of threats.

Question 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?

This question demonstrates the problems of having a Code that is not truly principles-based. What is proposed in the exposure draft is a provision in the Code that is driven by the need for greater simplification, rather than its effectiveness. In contrast, if our suggestion of a default cooling-off period of five years for all audit partners in conjunction with a risk-based approach was accepted, the significance of this question would be diminished.

In our view, although the specific proposal referred to in the question is intended to result in easier implementation of the rotation requirements, the underlying principle appears to be in conflict with that underlying the proposal not to extend the cooling-off period to the EQCR and other KAPs, ie that the extent to which familiarity threats arise from long association is usually lower

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for EQCRs and other KAPs. For example, if the individual served as the engagement partner for just one year and as other KAP for another six years, it would seem unreasonable to require a mandatory cooling-off period of five years – the same as if the individual had served as the engagement partner for seven years.

Question 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 believe, in fact, that the provisions contained in 290.150C and 290.150D (or similar emphases) are essential in demonstrating that the Code remains principles-based. We would also strongly support a similar approach in respect of the appropriate cooling-off periods.

Question 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?

An increased number of prohibitions and specified exemptions within the Code inevitably represents a detrimental move away from an effective threats and safeguards approach. As well as undermining the professional accountant's ability to consider threats and appropriate safeguards, it gives rise to complicated and inaccessible drafting, as exemplified by 290.150B. It proves to be impractical to attempt to permit or prohibit activities such that the provisions are appropriate to any situation.

In practice, a limited consultation role for the rotated partner might be acceptable from the start of the cooling-off period. The objective would be to enhance audit quality, and allowing a certain amount of flexibility might encourage a sufficiently long cooling-off period. At the same time, any involvement of the rotated partner must not impede the judgement or control of the incumbent engagement partner. A fresh view of the audit must be allowed to flourish. (If audit quality is to be maintained, then firms with adequate resources will usually plan for a new audit engagement partner to remain in that role for the full seven years.)

However, if any cooling-off period is to be effective for the purpose of retaining independence, and being seen to do so, there must be a fundamental requirement that a partner, during his or her cooling-off period, must not take part in decision-making concerning the audit, nor have any significant contact with the audit client. We recommend that the IESBA focuses on the principles mentioned here. To require a degree of cooling-off in the first two years followed

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by a further three years to a lesser degree is likely to be confusing and appears somewhat arbitrary. It also appears to undermine moves to extend the cooling-off period beyond the current two year requirement.

Question 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 refer the reader to our answers to questions 5 and 10 above.

In our view, the restriction on overseeing the firm's relationship with the audit client (ie acting as relationship partner) is an example of a provision that is excessively prescriptive, potentially damaging to the reputation of the firm, and unnecessary. The purpose of a cooling-off period is to allow an individual to demonstrate independence on returning to a senior role in an audit or assurance engagement. If, for a period after being rotated off the audit, a partner acts as relationship partner, a 'threats and safeguards approach' might determine that the cooling-off period should simply be extended accordingly.

Question 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 or 290.152 without the concurrence of TCWG. However, we also agree with the observation within the consultation that TCWG have the option to change the auditor, and so it would be more appropriate to view this in terms of communication with TCWG, which would make it clear that decision-making in respect of the auditor's independence must rest with the auditor. A requirement for communication with TCWG would help to remove the potential for misuse of the provisions, which may arise out of subjective terms such as 'unforeseen circumstances outside the firm's control'. Appropriate communication is also a valuable process within an assessment of threats and safeguards.

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SECTION 291

Question 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"?

The answers provided above also apply in respect of section 291 to the extent that the questions raised are relevant to assurance engagements. A lack of independence would undermine both types of engagement. However, as stated within our response to question 1, we do not agree that a threat to objectivity may arise only in respect of a recurring assurance engagement. The familiarity threat arises out of the long association of individuals, and their relationships with the audit client personnel. The threat does not directly depend upon the nature of the assignment.

IMPACT ANALYSIS

Question 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?

The positive outcomes intended from the proposed changes are enhanced value of the audit derived from increased independence, and the public perception of increased independence. The opposing costs include those associated with compliance (particularly for smaller firms), continuity and audit quality, and clarity of the Code. We are concerned that the impact analysis is incomplete without due regard for audit firm rotation – a requirement in many jurisdictions, including throughout the European Economic Area. The costs associated with 'layering' personnel requirements over the requirements for audit firm rotation are difficult to anticipate. We suggest that, before doing so, the benefits of audit firm rotation are awaited and evaluated.

The impact analysis set out within the consultation acknowledges the complexity of the proposed changes. This will significantly restrict the benefits, as smaller firms will find it disproportionately difficult to translate the requirements to their own situations. A regrettable cost of the proposed changes might be the exit of some firms from the PIE audit market. This would certainly not be in the public interest.

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GENERAL COMMENTS

In this section of our response, we address some of the matters identified in the section of the exposure draft *Request for General Comments*. ACCA has developed this response following an internal due process involving preparers and users, those in developing nations, and those who will use the Code in translation. This input, such as from our Global Forum for Ethics, has informed the whole of this response. However, we would make the following specific observations.

SMPs

This consultation response is provided with focus on the public interest. However, we should emphasise that the IAESB should consider the operational aspects for SMPs – particularly those that audit PIEs. Resource limitations within such firms would frustrate their ability to interpret the detailed requirements, as well as implement them using personnel of the required knowledge and experience.

There are also costs associated with tracking the independence requirements. The independence records relating to specific partners, audit staff and PIEs would result in higher costs and complicated planning procedures, and these problems would be exacerbated by variances in the rotation requirements of different jurisdictions and the IESBA Code. In addition to our concerns that complicated provisions within the Code will give rise to inadvertence breaches, we are also concerned about further concentration in the PIE audit market due to SMPs no longer having the resources to ensure compliance with the Code.

Effective Date

Despite our view that the proposed changes to the Code would diminish its clarity and transparency, we believe that the proposed effective date of 15 December 2017 should allow those firms with adequate resources sufficient time to review their rotation requirements and plan accordingly.

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