

Partner Rotation Requirements

Background

Paragraph 290.154 of the Code of Ethics for Professional Accountants (the “Code of Ethics”) provides that for listed entities that are financial statement audit clients, the engagement partner and the individual responsible for the engagement quality control review should be rotated after having served for seven years and upon rotating off the engagement should not participate in the audit until two years has elapsed.

In addition to the partner rotation requirements in the Code of Ethics, several other jurisdictions have requirements relating to partners on listed entity audit engagements to rotate off of those engagements after a period of time. Some of those jurisdictions and their requirements are listed in the table that appears at the end of this paper.

This paper analyzes the following broad issues:

- The nature of the threat to independence from prolonged service on the audit engagement team
- To whom the rotation requirements should apply
- What should be the mandatory “time-out” period and at what point in the service period it should apply
- Whether small firms should be provided with relief from the rotation requirements

Threat to Independence

The main threat to independence that the rotation requirement is intended to address is a familiarity threat. Paragraph 290.154 of the Code of Ethics acknowledges this, stating that “using the same engagement partner or the same individual responsible for the engagement quality control review on a financial statement audit over a prolonged period may create a familiarity threat.” Paragraph 100.10 of the Code of Ethics defines a familiarity threat as one that “may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others.”

The familiarity threat appears to be the basis for the rotation requirements of other bodies. For example, the SEC notes that rotation brings a “fresh look” to the engagement. The SEC also notes that rotation “must strike a balance between the need to achieve a fresh look ... and a need for the audit engagement team to be composed of competent accountants” and concluded that such a balancing should include rotation of the lead partner and the concurring partner. The SEC’s rules also require other partners to rotate depending on their roles on the audit engagement. (Refer to the table later in this paper.)

The Task Force agrees that prolonged service on the audit engagement could create a familiarity threat. The Task Force recognizes that self-interest and self-review threats also could arise from prolonged service; however, the main threat appears to be a familiarity threat. These threats can arise because of familiarity with client management and client accounting and reporting issues. The latter seems particularly relevant for the individual responsible for engagement quality review, who more often would deal with accounting and reporting issues rather than client management. These threats are also particularly relevant in the context of the financial statement audit of a listed entity and the Task Force agrees that it is appropriate for the Code to address the threat in that context through a rotation requirement.

The Task Force is of the view that the Code of Ethics should continue to acknowledge that prolonged service on the audit engagement team may create a familiarity threat but also should indicate that it may create self-interest and self-review threats in varying degrees. The Code also should indicate that these threats can arise because of familiarity with client management and client accounting and reporting issues. A rotation requirement should be the primary means of addressing these threats and it is appropriate to continue to apply it only with respect to the financial statement audits of listed entities. The general provisions of paragraph 290.153 continue to be applicable for all other assurance engagements.

Action requested

Members are asked to consider whether they agree with the recommendation of the Task Force.

Application of rotation requirements – who, how long, nature of time-out period

The current Code rotation requirement applies with respect to the audit of the financial statements of a listed entity and applies to the lead audit partner and the individual responsible for the engagement quality control review. Those individuals are required to rotate off the engagement generally after seven years of service and remain off the engagement generally for two years.

The requirements of other jurisdictions (cited in the table later in this paper) cover the lead partner and other partners, and in some circumstances non-partners to the extent they are “senior personnel on the engagement.” The rotation and time-out requirements vary as well.

The Task Force considered the following matters in addressing this area.

Who should be required to rotate?

In addition to requiring the lead audit engagement partner to rotate, the SEC and CICA require rotation of quality review partners, and both the SEC and CICA subject other audit partners to rotation requirements. By going beyond the lead and quality review partners, those requirements look beyond the chief decision-maker on the audit (i.e., the lead partner) and beyond the partner who would typically check his or her audit decisions (i.e., the quality review partner) and reach partners who make decisions on significant matters that affect the financial statements or who maintain regular contact with client management.

The Task Force is of the view that it is appropriate to direct the requirement to rotate to the individuals who are the final decision makers on the financial statement audit engagement of a listed entity. Those individuals are the lead audit engagement partner and the individual responsible for the engagement quality control review. Focusing the rotation requirement on those two individuals strikes the right balance between bringing a fresh look on the audit and the need to maintain continuity and audit quality. For example, it recognizes the importance of maintaining the continuity of certain personnel on the engagement to achieving and maintaining audit quality and the difficult challenges that mandatory partner rotation could have in certain parts of the world where there may be a limited pool of available talent. The Task Force believes that all other personnel on the audit team can be adequately dealt with under the general provisions of paragraph 290.153 and any threats addressed on a facts and circumstances basis.

The Task Force also considered an issue which was raised at the Forum in Brussels – whether the threat eliminated if a new management team is installed at the client, and as a result the audit partner begins dealing with new people in key decision-making levels within the client's organization, or whether the threat eliminated if the nature or complexity of the accounting and reporting issues has changed.

Although there is merit to considering the effect that a change in management or a change in the nature or complexity of the issues would have on the familiarity threat, the Task Force believes neither should be used to overcome a rotation requirement applicable to the lead audit engagement partner and the individual responsible for engagement quality control review. First, since a familiarity threat is acknowledged above as relating to both client management and accounting and reporting issues, the task force is not convinced that a change in both would occur simultaneously and to a sufficient degree to eliminate the threat with respect to a listed entity audit client. Second, if such changes did occur, the lead engagement partner and the individual responsible for engagement quality control review could, in theory, remain on the engagement twice as long as the normally allowed time period absent such changes. The Task Force was not comfortable with that result for a listed entity audit client. Accordingly, the Task Force recommends that for listed entities the no exemption from rotation is permitted due on management turnover or changes in the nature or complexity of relevant accounting and reporting issues.

However, the Task Force is of the view that for non-listed entities such factors are relevant in evaluating the significance of the threat. Accordingly, paragraph 290.153 of the Code of Ethics should be revised to acknowledge that such changes are factors to consider in evaluating the threat created by long service of senior personnel.

Action requested

Members are asked to consider whether they agree with the recommendation that the requirements to rotate should address only the engagement partner and the individual responsible for the engagement quality control review. Members are also asked to consider whether they agree that paragraph 290.153 dealing with the significance of the threat be amended as suggested.

Rotation period

As the table in this paper illustrates, some jurisdictions (SEC, CICA and New Zealand) call for rotation after five years on the audit rather than after seven years, depending on the partner involved. The EU requires rotation after 7 years. Other jurisdictions (ICAEW and Ireland) do not appear to specify a time period after which rotation should occur. The Task Force considered this issue by assessing at what point during the period of service the threat identified would rise to a level that a time-out should be required.

The Task Force is of the view that rotation after seven years continues to be appropriate for the lead audit engagement partner and the individual responsible for engagement quality control review with respect to the financial statement audit of a listed entity. That period of time seems to provide the right balance between the need for qualified accountants to serve as lead audit engagement partners and individuals responsible for engagement quality control review and the need for a periodic fresh look on the audit. This seems particularly appropriate in today's environment where a limited supply of qualified professionals may exist in certain parts of the world, particularly in emerging markets, and there are increasingly complex accounting and reporting issues and an increasing number of global accounting and reporting standards.

Action requested

Members are asked to consider whether they agree with the Task Force recommendation that the rotation period be seven years.

Time-out period

The SEC, CICA and APB require a five year time-out period for the lead partner and the quality review partner. For other partners a two-year time-out period is required. The EU requires a two-year time-out period, while others have an unstated period. An unstated period would seem to leave room for judgment based on facts and circumstances. For example, if during the time-out period the client management team turns over and the nature of the accounting and reporting issues changes, it may be unnecessary to continue to preclude the former lead audit partner from returning to the engagement.

The Task Force considered a situation in which a lead audit engagement partner might complete his or her service after seven years, but during the time-out period engages in certain activities with respect to the audit client such that he or she has contact with client management or the engagement team after rotating off the engagement. For example, a the partner might have come off the engagement as the lead partner upon completing seven years of service, but undertakes transitioning activities with a new lead partner at the beginning of year eight. In that situation, depending on the nature of the transitioning activities, the time-out period could be considered to be less than two years if the partner returned to the lead partner role at the beginning of year ten. Accordingly, the Task Force considered whether the two-year time-out period should be extended to three years to ensure that where such activities occur, a full two-year time-out period occurs.

The Task Force is of the view that two years is a sufficient time-out period and the Code should continue to reflect that. However, paragraph 290.154(b) should clarify that during the time-out period the former lead audit engagement partner and the individual formerly responsible for engagement quality control review should not engage in any meaningful activity with respect to the listed entity audit client. That paragraph should further clarify that if such activity occurs it would need to be completed promptly and the time-out period would begin only upon completion of that activity. A meaningful activity would generally not include wrapping up minor administrative details associated with the engagement.

Action requested

Members are asked to consider whether they agree with the Task Force recommendation that the time-out period be two years and with the additional guidance proposed in the illustrative wording with respect to activities that can be performed during the time-out period.

Limited relief from rotation requirement

The Code, in paragraph 290.156, currently states that some degree of flexibility of timing of rotation may be necessary in certain circumstances. The two examples provided are:

- Situations when the person's continuity is especially important to the financial statement audit client, for example, when there will be major changes to the audit client's structure that would otherwise coincide with the rotation of the person's, and
- Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.

The Task Force is of the view that the situation of small firms, if addressed (see discussion below), should be in a separate paragraph. With respect to changes in client structure, the Task Force is of the view that the flexibility should only be provided in rare circumstances when a person's continuity is especially important to the quality of the financial statement audit. In addition to changes in client structure changes in client management might also necessitate some limited degree of flexibility. Illustrative wording to reflect these changes is presented at the end of this agenda paper.

Action requested

Members are asked to consider with the recommendation of the Task Force.

Small firms

The Code currently provides relief from the rotation requirement if a firm has only a few people with the necessary knowledge and experience to serve as the lead engagement partner or the individual responsible for engagement quality control review on the financial statement audit of a listed entity. In such a situation, paragraph 290.157 provides that "rotation may not be an appropriate safeguard" and other safeguards should be applied to reduce the threat to an acceptable level, including involving an additional professional accountant who was not otherwise associated with the audit team to review the work done or advise as necessary.

The SEC's rules also contain limited relief from partner rotation if firms have fewer than five audit clients that file financial statements with the SEC and fewer than ten partners. Those firms can choose to have the Public Company Accounting Oversight Board (PCAOB) conduct a review of the audit engagement, focused on audit quality and the independence and competence of key personnel on the engagement team, at least once every three years in lieu of partner rotation. The PCAOB inspection cycle is three years for firms with fewer than 100 SEC registrants not every audit will be inspected. If a firm takes advantage of the SEC relief from rotation, the PCAOB will inspect that particular audit at least once every three years.

The CICA also, in effect, provides relief because its rotation requirements only apply with respect to listed entities that have over \$10 million in market capitalization or total assets.

Questions the task force considered in addressing this were:

- What are some arguments for and against providing relief from the rotation requirements for small firms?

Some participants at the Forum suggested that small firms should have the same rotation requirement as all other firms. Their view was that if a small firm is going to practice in the listed entity arena, it should be required to follow all of the same standards that any other firm that practices in that arena must follow. Some Task Force members see merit in that argument. They are also concerned that if a firm does not have sufficient personnel to meet the rotation requirements, there can be a question of whether it has sufficient personnel and expertise to conduct an audit of a listed entity. Those Task Force members consider rotation to be the most effective means of safeguarding independence in this situation.

Other Task Force members believe that measures other than rotation can be effective in safeguarding independence in these situations. For example, some Task Force members believe that a subsequent review of the audit engagement can serve as an incentive for audit engagement teams, particularly the lead audit engagement partner and the individual responsible for engagement quality control review, to ensure that a quality audit is conducted. They note that this is the notion inherent in the SEC's exception under which a review is conducted at least once every three years by the PCAOB after the audit has been completed and the audit report has been issued.

However, most Task Force members who supported engagement reviews as a form of safeguard believe that the safeguard should be equivalent to rotation in its effectiveness, and accordingly such a review would need to take place before the audit report is issued. In that regard, they would be willing to accept an engagement quality review conducted by a third party unrelated to the firm if it is conducted prior to the issuance of the audit report following prescribed guidelines, such as those set out in ISQC 1 (The ISQC has been provided as Agenda Paper 2-D as part of the Network Form agenda item - engagement quality control is addressed in ¶60-73). This would be different than the safeguard described in paragraph 290.157, which provides that a safeguard "[c]ould include involving an additional professional accountant who was not otherwise associated with the assurance team to review the work done . . ." because that provision permits the additional professional accountant to come from within the firm. Further, Task Force members who supported safeguards in lieu of rotation requirements for small firms noted that this would be consistent with the SEC's exception.

All Task Force members generally agreed that a joint audit would not be an effective safeguard in lieu of rotation. In addition, the Task Force questioned the effectiveness of the safeguard described in paragraph 290.157 under which the additional professional accountant who was not otherwise associated with the assurance team could "... advise as necessary."

- If rotation is considered an appropriate safeguard under the Code, can it be described as inappropriate just because the firm has only a few people in it?

Rotation interrupts the prolonged interaction between client management and the lead audit engagement partner and the individual responsible for engagement quality control review. If this safeguard is considered effective, it would seem to be equally effective for all firms regardless of size. If one accepts this, to say it "may not be an appropriate safeguard" for some firms could be viewed as ignoring the conceptual merit of rotation.

- If small firms should be afforded relief, should that relief extend to small offices of larger firms where cultural, licensing, social, language, and regulatory barriers make partner rotation equally challenging?

Most observers likely believe that large firms with multiple offices across the globe have plenty of audit partners who could be called upon to replace rotating partners in a particular part of the world. The reality is, however, that the issues described in the question above can serve as significant impediments to achieving this within a large firm.

Action requested

Members are asked to consider the differing views of the Task Force and provide direction on a way forward.

Jurisdiction	Partners required to rotate	Rotate after	Time-out period	Comments
U.S. SEC	<ul style="list-style-type: none"> Lead partner QC partner Other partners who provide more than 10 hours of audit, attest, or review services in connection with the annual or interim consolidated f/s Lead partners at material subs 	5 years 5 years 7 years 7 years	5 years 5 years 2 years 2 years	<p>Applies to listed entities</p> <p>Other partners exclude partners who consult with others on the audit engagement team during the audit regarding technical or industry-specific issues, transactions, or events, but includes "relationship" partners.</p> <p>Material subsidiary constitutes 20% or more of the assets or revenues of the listed entity.</p>
EU	<ul style="list-style-type: none"> Key audit partner 	7 years	2 years	<p>Applies to audits of public interest entities. Key audit partner is the statutory auditor(s) who is/are 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 in the case of a group audit at least the statutory auditor(s) who is/are 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) who is/are designated as being primarily responsible at the level of material subsidiaries; or the statutory auditor(s) who sign(s) the audit report.</p>
APB	<ul style="list-style-type: none"> Lead partner Independence partner Key audit partner 	5 years 5 years 7 years	5 years 5 years 2 years	<p>Applies to listed entities</p> <p>A partner or other persons performing the function of a partner who is not a member of the audit team. The experience required of the independence partner is determined by the nature of the audit engagement and the seniority and experience of the audit engagement partner.</p> <p>An audit partner, or other person performing the function of an audit partner, of the engagement team (other than the audit engagement partner) who is involved at the group level and is responsible for key decisions or judgments on significant matters, such as on significant subsidiaries or divisions of the audit client, or on significant risk factors that relate to the audit of that client.</p>

Jurisdiction	Partners required to rotate	Rotate after	Time-out period	Comments
ICAEW	Senior personnel may need to rotate	Unstated	Unstated	Applies only to non-audit assurance engagements (APB establishes ethical standards for audits) Consistent with 290.153 which contains the general provisions for all assurance engagements.
Ireland	Senior personnel should be rotated	Unstated	Unstated	Applies only to non-audit assurance engagements (APB establishes ethical standards for audits) Consistent with 290.153 which contains the general provisions for all assurance engagements.
CICA	<ul style="list-style-type: none"> • Lead partner • QC partner • Other audit partners 	5	5	Applies to listed entities Partners who provide 10 hours of assurance services re: the f/s or serve as the partner on a material subsidiary
		5	5	
		7	2	
Japan	All engagement partners	7	Prescribed by cabinet order	
New Zealand	Lead partner	5	Unstated	Alternatively, the firm itself would rotate after 5 years

Illustrative Wording

Long Association of Senior Personnel with Assurance Clients

General Provisions

290.153 Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity, self-review, or self-interest threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team;
- The role of the individual on the assurance team;
- The structure of the firm; ~~and~~
- The nature of the assurance engagement;~~:-~~
- Whether a new management team has been installed at the assurance client; and
- Whether there has been a change in the nature or complexity of the assurance client's accounting and reporting issues.

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

- Rotating the senior personnel off the assurance team;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- Independent internal quality reviews.

Financial Statement Audit Clients That are Listed Entities²

290.154 Using the same engagement partner or the same individual responsible for the **engagement quality control review**^{*} on a financial statement audit over a prolonged period may create a familiarity, self-review, or self-interest threat. ~~Th~~~~o~~~~s~~~~e~~ threats ~~are~~~~i~~~~s~~ particularly relevant in the context of the financial statement audit of a listed entity and safeguards should be applied in such situations to reduce such threats~~s~~ to an acceptable level. ~~Accordingly~~ in respect of the financial statement audit of listed entities:

- (a) The engagement partner and the individual responsible for the engagement quality control review should be rotated after serving in either capacity, or

² See also Interpretation 2003-02 on page 73.

^{*} See Definitions.

a combination thereof, for a pre-defined period, normally no more than seven years; and

- (b) Such an individual rotating after a pre-defined period should not participate in the audit engagement until a further period of time (a “time-out period”), normally two years, has elapsed. During the time-out period, the individual should not engage in meaningful activities with respect to the financial statement audit of the listed entity. If such activities occur, they would need to be completed promptly and the time-out period would begin only upon completion of the activities. A meaningful activity would not include wrapping up minor administrative details associated with the audit engagement.

290.155 When a financial statement audit client becomes a listed entity, the length of time the engagement partner or the individual responsible for the engagement quality control review has served the audit client in that capacity should be considered in determining when the individual should be rotated. However, the person may continue to serve as the engagement partner or as the individual responsible for the engagement quality control review for two additional years before rotating off the engagement.

290.156 While the engagement partner and the individual responsible for the engagement quality control review should be rotated after such a pre-defined period, in rare circumstances when a person’s continuity is especially important to the quality of the financial statement audit a limited ~~some~~ degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include: ~~For example~~

- ~~Situations when the person’s continuity is especially important to the financial statement audit client, for example,~~ when there will be major changes to the audit client’s management or structure that would otherwise coincide with the rotation of the person’s; ~~and~~
- ~~Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.~~

In all such circumstances when the person is not rotated after such a pre-defined period equivalent safeguards should be applied to reduce any threats to an acceptable level.

290.157 When a firm has only a few people with the necessary knowledge and experience to serve as engagement partner or individual responsible for the engagement quality control review on a financial statement audit client that is a listed entity, rotation may not be practicable ~~an appropriate safeguard~~. In these circumstances the firm should apply other safeguards to reduce the threat to an acceptable level. Such safeguards would include involving an additional professional accountant who was not otherwise associated with the assurance

team to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or someone within the firm who was not otherwise associated with the assurance team.