

TO: CHAIR, IESBA
FROM: SMP COMMITTEE
DATE: APRIL 4, 2014
RE: LONG ASSOCIATION

The SMP Committee would like to thank the IESBA for having the opportunity to comment on the Agenda Items on Long Association.

The IESBA Task Force of the SMP Committee has prepared this response. These comments have been circulated and duly approved by the entire SMP Committee (SMPC).

The SMP Committee is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small- and medium-sized entities (SMEs). The constituents of the SMP Committee are small and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members of the SMP Committee have substantial experience within the accounting profession, especially in dealing with issues pertaining to SMEs, and are drawn from IFAC member bodies from 18 countries from all regions of the world.

General Comments

We recognize that some provisions are necessary to deal with the long association issue in the public interest. Indeed, the proposals raised in the Agenda Items are not incompatible with certain existing provisions in particular jurisdictions, such as the UK. However, we are concerned that the current proposals could place unreasonable constraints on SMPs and could have significant unintended consequences, which should be further considered by the IESBA (the Ethics Board).

Agenda Item 6A states that the Ethics Board has agreed that any provisions developed by the task force (TF) should provide a reasonable and robust alternative to proposals on mandatory tendering and firm rotation. In Europe it is anticipated that audit firm rotation will be introduced when the audit policy regulation comes into force. Hence, from a purely European perspective, there is little if any need for the IESBA to proceed in developing such alternatives. In addition, in India the new Companies Act 2013 (applicable with effect from April 1, 2014) has established requirements for the rotation of individual auditors and audit firms. Of course, in other jurisdictions more precise provisions to address significant threats may be needed, but, as often this is a matter for national legislators, we cannot comment on the residual demand for IESBA to work in this area.

The definition of public-interest entities (PIEs) likely varies from country to country. In many jurisdictions relatively small entities may fall within the definition of PIE: listed entities may also be relatively small in some cases. Many such entities are audited by SMPs, who, by definition, will have a far more limited capacity to rotate partners and personnel than larger audit firms. We therefore believe that IESBA needs to bear this in mind in developing proposals specifically for PIEs and listed entities, especially where there

is a trade-off between the quality of the audit work and the need to safeguard objectivity. There are also practical issues which we note in responding to the questions.

In this respect, the SMPC feels that regulators and policy makers (including IESBA) often appear to pay little regard to the fact that rotation of key personnel (partners, senior managers etc.) inevitably results in a loss of knowledge of a particular client/ industry etc. with a consequential adverse impact on audit quality, thereby having the opposite effect to that intended. In addition, irrespective of the impact on audit quality alone, introducing new auditor personnel at any level will reduce efficiency and/ or increased recourse to audit client resources, simply because they are new and do not know the client and its systems and will need to rely more on client staff for answers. These considerations may be particularly acute in an SMP environment and we would urge the Ethics Board to allow some degree of flexibility to take into account the individual circumstances.

These proposals appear to represent a trend to increasingly detailed regulation. We are not aware of any concrete evidence to suggest that the current provisions for audit partner tenure for a maximum of seven year and a two year cooling off period in the EU have not worked satisfactorily. These provisions were only introduced into the Code recently, and as such there has not been opportunity to properly assess their effect in the market. We note that the Agenda papers refer to the latter as “being seen” as too short, but no evidence that this is the case has been cited. A particular time frame for audit tenure and for cooling off periods will always be arbitrary, as the varied responses of the Ethics Board at its December meeting indicate.

Specific Comments

Our specific comments below are in response to the questions (**in bold**) raised in Agenda Item 6-A.

1. **Do SMP members support:**

- (a) **The TF’s initial proposal of a three year cooling-off period for all KAPs; or**
- (b) **The TF recommendation of a five year cooling-off period for LAEPs on audits of listed companies, a two year cooling-off for other KAPs (and two years for all KAPs on non-listed PIEs); or**
- (c) **Neither of the above options. If so, why not, and what would be an appropriate alternative proposal and why?**

Overall, we believe that it is too early to determine whether the recently introduced two year period is inappropriate. We therefore do not support the Task Force’s (TF) initial proposal of a three year cooling-off period for all Key Audit Partners (KAP) on all PIEs, or the TF recommendation of a five year cooling-off period for the Lead Audit Engagement Partner (LAEP) on listed entities with two years off for all other KAPs and LAEPs on other PIEs. In this context, we agree with the cautions expressed in paragraph 9 of Agenda Item 6-A that overlaid rules based on the Code will complicate application in practice, and may even be detrimental to its acceptance and adoption in some jurisdictions. Furthermore we recognize that many jurisdictions, having so recently implemented the new requirements, may be reluctant to introduce further requirements this soon.

Nevertheless, we accept the rationale for the proposed differentiation between KAP and LAEP, based on the fact that the more influential a partner is, the more critically his or her objectivity will be viewed. That said, we do not view the proposed differences in the cooling off period as appropriate (2 years versus 5 years). In particular, a five year period appears excessive and would pose considerable difficulties for many SMPs that audit listed entities as they have a smaller number of partners to rotate amongst.

We consider that these proposals would place unreasonable constraints on and present practical challenges to SMPs in relation to specialists and partners resources, which are required for publicly listed entities audits. By their nature SMPs have a limited number of partners and often lack in-house technical resources. Research indicates that in many, if not most jurisdictions, SMPs are sole practitioners or two partner practices. Indeed, even medium-sized practices, especially those in smaller jurisdictions, will have technical review departments comprising just one partner. This makes the rotation of the KAP particularly difficult. Small and medium-sized firms may not be able to comply with the more stringent requirements of the cooling off periods under either proposal and as a result will not be able to serve publicly listed entities.

Anecdotal evidence also suggests that the consequences of adopting longer cooling-off periods has forced several small and medium sized companies to be audited only by the largest audit firms in certain jurisdictions (for example, Brazil). This is primarily because SMPs do not have the necessary infrastructure to accommodate the requirements of the cooling off period.

It is well-known that the 'Big Four' accounting firms audit the majority of publicly listed entities worldwide. We believe that the proposals could further exacerbate the market dominance of the largest accounting firms and lead to further erosion of choice in the audit market for publicly listed entities. A competitive audit market is in the public interest and the current proposals may directly impact the concentration of firms servicing these entities and could assist the 'big four' to capture an even larger share of the market. This would result in an even greater risk of the threat of a potential collapse of any one of the big accounting firms, which could seriously destabilize financial markets on a global scale. We believe the Ethics Board must recognize the potential unintended consequences of its proposals.

We believe that any revision to the current cooling-off period should be based on robust evidence in support of change. We agree with the acknowledgements made in Agenda Item 6-A that research indicates there is no specific concern with the current two year cooling-off period and that in practice the rotated LAEP does not normally return to a client in the audit role as soon as the cooling-off period ends (paragraph 11), thus undermining the case for a longer cooling-off period. We recognize that there is perhaps pressure from stakeholders external to the accountancy profession for action in this area, but any changes must not be made without due consideration of any unintended consequences and the possible disproportionate impact of such changes on SMPs.

We believe that there are other equally effective, if not more appropriate, alternatives to the proposals which are in place as safeguards rather than having to sacrifice the knowledge and experience accumulated over time. For example, the requirements in ISQC 1¹ which require an engagement quality

¹ ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.*

control review (EQCR) for all audits of financial statements of listed entities, the firm's quality control system, detailed file review by another professional colleague prior to issuance of the audit report, and so forth. These measures are in addition to obtaining written agreement on an annual basis to continue the engagement having held a full discussion with the client as to the issues of independence. We believe that objectivity should not be achieved at the expense of forgoing knowledge of a client and the in-depth understanding of the risks for an audit. We note that service history promotes auditors' understanding and knowledge of a client, which in turn enhance audit quality. We consider the TF should take such benefit into due consideration when reviewing the appropriateness of safeguards in the project of Long Association.

2. **If (b) is the preferred option, do SMP members agree with the TF recommendation that a KAP serving only part of a seven-year time-on period as the LAEP should still cool off for five years, regardless of the amount of time served as the LAEP?**

Please see our response above to question 1. On balance while we do not support either option we would prefer the TF's initial proposal of a three year cooling-off period for all KAPs. We acknowledge that the TF recommendation to apply model 2 and consider any time served as an LAEP during a seven year period does appear more logical and easier to apply compared to the proposals in model 1.

3. **Do you agree with the revised proposals for restricting activities during the cooling-off period?**

We do not agree that prescribing further restrictions would enhance audit quality. A complete ban on certain activities seems inappropriate in certain areas, especially where it might be possible to introduce other safeguards. In particular, we question whether precluding the provision of non-audit services is excessive, or whether this issue could not also be addressed by additional safeguards, especially for smaller firms. For example, from an SMP perspective we believe that it might be counterproductive to preclude consulting with the engagement team regarding technical or industry-specific issues as is proposed. In such cases not only would banning recourse to valuable technical or industry-specific expertise not seem sensible from an audit quality perspective, the individual may over time lose the expertise or fail to keep up to date with developments. In contrast, larger firms with recourse to technical departments may not face these issues to the same extent. Also introducing a blanket ban on services to related entities might not be necessary or appropriate in all conceivable individual circumstances. We would suggest that the IESBA consider whether it would be more appropriate to introduce safeguards instead in some cases (e.g. quality control reviewer must consider consultation on significant technical matters).

The proposals to limit discussions with the engagement team in the new proposal for 290.152 "(other than discussions with the engagement team limited to work undertaken or conclusions reached in the previous year where this remains relevant to the audit)" and the restriction to only "interact with senior management or those charged with governance other in a limited and social context" during the cooling-off period are not only impractical but the costs of implementing such proposals will likely outweigh the benefits.

4. **If the Board were to proceed with a five year cooling-off period for the LAEP, do SMP members agree with the tentative conclusions above regarding certain activities that may be undertaken after two years?**

The rationale behind the proposal of relaxing certain non-permissible activities that the LAEP may undertake after 2 years is unclear. Indeed, it could be argued that this relaxation is not consistent with the TF recommendation for a five year cooling off period. We therefore do not support the tentative conclusions and agree with the comment made that it could be considered counter intuitive for an activity to be deemed permissible after a period of the two year cooling-off period had expired, but was not allowed in the initial years (paragraph 37 Agenda Item 6-A). In our opinion, the proposals are overly complex and thereby seem to demonstrate that a period of five years is unjustified and excessive.

5. **Do you agree with the proposed revised framework?**

In general we agree with the proposed revised framework and the suggested enhancements. However, we believe that the second paragraph of 290.150 is inappropriately phrased. As a minimum it ought to indicate that there may be a trade-off between familiarity threats and the depth of knowledge and experience gained by audit partners, which has a consequential impact on audit quality. As it is currently drafted this section appears to imply that the familiarity threat is the primary concern and audit quality secondary. This could also be a factor to bear in mind in evaluating the significance of a threat in the particular engagement (paragraph 290.151).

6. **Do SMP Members agree with the TFs proposals that the concurrence of TCWG should be obtained with respect to the application of the requirements of paragraphs 290.152 and 290.154?**

Overall the majority of SMPC members support the task forces proposals that the concurrence of those charged with governance should be obtained. We note that SMEs often do not have a true separation of governance and management.