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TRANSPARENCY

Auditor–client relationships

The Independent Regulatory Board for Auditors (IRBA) envisage that the disclosure of audit tenure will lead to greater transparency regarding the number of years of the association between audit firms and audit clients, thus strengthening auditor independence in South Africa. By ***Franeli Bredell***

Audit regulators globally aim to protect the interests of investors and other stakeholders of audited entities. Locally, the Independent Regulatory Board for Auditors (IRBA) mandated the disclosure of audit firm tenure in the auditor's reports on Annual Financial Statements of all public companies which also meets the definition of public interest entities. This rule was published in *Government Gazette* No 39475 of 4 December 2015 and is effective for periods ending on or after 31 December 2015. Audit tenure refers to the number of years which the audit firm or sole practitioner has been the auditor of the company.

The requirement hence applies to public companies as defined in the Companies Act of 2008 and which are also considered public entities as defined in the IRBA Code of Professional Conduct for Registered Auditors. Auditors of state-owned companies, private companies with higher-end public interest scores (more than 350) and other types of entities are consequently not required to include audit tenure in their auditor's reports. This requirement is also not applicable to other types of reports issued by the auditor.

THE INDEPENDENCE PICTURE IN SOUTH AFRICA

The Companies Act regulates three important aspects around auditor independence:

- Audit partner rotation is mandatory every five years (section 92). This governs the independence by rotating the individual audit partner and not the firm. It mitigates the familiarity threat to the independence of the individual auditor but reduces start-up investment costs and the steep learning curve that is generally expected when the audit firm is rotated.
- Prohibiting the appointment of a person or firm as an auditor who is a director, a prescribed officer, an employee involved in maintenance of the company's financial records or the preparation of its financial statements, who habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company or has done any of these in the previous five financial years (section 90(2)).
- Audit committees are required to nominate for appointment a registered auditor who, in their opinion, is independent of the company (section 94(7)) and to take responsibility for the appointment, fees, and terms of engagement of the external auditor.

LOOKING THROUGH DIFFERENT LENSES

Disclosing the length of audit firm tenure could have an interesting impact on different stakeholders.

From the perspective of a shareholder or institutional investor

A higher tenure number could result in a concern around familiarity and objectivity of an auditor, where a lower number could result in a concern about knowledge and experience of the auditor related to the company. Both of these could have a negative impact on the perception of audit quality. An acceptable mid-range number could strengthen the perception of assurance and accordingly impact the investing decisions. Having said this, there are multiple elements that impact on an investor's investment decisions and the audit tenure would seldom be the determining factor.

From the perspective of an audit committee

A direct emphasis is now placed on the number of years of the client-auditor relationship. Consequently, in executing the responsibility regarding the assessment of the auditor's independence, the audit committee might reconsider the nomination of the particular auditor. The audit committee has a clear reminder of the length of the current relationship which could impact its assessment of independence. Extended client–auditor relationships could raise questions from other stakeholders on the appropriateness of the nomination of the auditor. Furthermore, this should be balanced with the importance of a detailed, in-depth understanding of the company's business which is often the result of a longer-term relationship. The draft King IV report proposes that the audit committee considers three matters when looking at auditor independence: the length of audit firm tenure, partner rotation, and non-audit services. This emphasises the fact that auditor independence is not a one=dimensional consideration but rather a range of factors that should be considered (that is, one of a range on potential audit quality indicators).

From the perspective of a regulator

The first concern is also related to familiarity and self-interest threats to auditor independence that may be created by long association. Furthermore, longer audit tenure could raise concerns regarding complacency and possible insufficient levels of professional scepticism applied in the audit evidence-gathering process. Longer experience with a client, however, could mean the auditor has a thorough understanding of the company, its systems and processes, and the environment that it operates in.

From the perspective of a trade union and labour force

Trade unions are pivotal stakeholders acting on behalf of their members. The reliability of financial statements disclosures around executive, employee remuneration and share schemes are important and to this degree the objectivity and knowledge of the auditor could be important considerations for these parties.

AUDIT FIRMS CHANGING SHAPES

Where a merger or de-merger of the audit firm has taken place, the number of years would also include the former years of audit when a firm existed in another form, resulting in disclosing the longer period rather than the shorter period of the relationship. The disclosure should be transparent about the actual number of years and not merely the appointment date.

THE GLOBAL PICTURE

On the international front audit tenure and audit firm rotation remain top of mind. The Financial Reporting Council (UK) prescribes the disclosure of audit firm tenure in the audit committee report. Although not yet a requirement, the Public Company Accounting Oversight Board (US) proposed in the Auditor's Reporting Model Proposal, where long form audit report requirements are suggested, the disclosure of audit firm tenure.

Regulators around the world are investigating promotion of auditor independence in the form of mandatory audit firm rotation. The European Union mandates audit firm rotation for public interest entities every ten years, with only a single ten-year extension allowed, subject to public tendering. The US regulatory environment does not mandate audit firm rotation.

Current law in South Africa does not mandate audit firm rotation, but the IRBA are considering various measures, including mandatory firm rotation, to further strengthen auditor independence and audit quality.

Should mandatory audit firm rotation be introduced, it might detract from the importance of the audit firm tenure disclosure currently being required by the IRBA.

CLOSING IN A SNAPSHOT

Disclosing audit tenure introduces more transparency about client-auditor relationships and would play a role in strengthening auditor independence. Stakeholders should however not consider audit tenure in isolation when evaluating auditor independence and quality, but rather consider the combination of tenure, partner rotation and knowledge, experience and scepticism of the auditor at the client.

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