Mandatory Audit Firm Rotation

Discussion Paper: Considering Mandatory Audit Firm Rotation (MAFR) (and other Related Measures) as Possible Means of Enhancing Auditor Independence
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A MESSAGE FROM SAICA

“SAICA supports the stated objectives of the IRBA and believes that these should be addressed in the public interest in the South African context. However, the measures adopted to achieve these objectives deserve careful consideration. Any potential measures adopted will have a significant impact on, among others, companies, the profession, investors, regulators and other stakeholders. The measures adopted should also be fit for purpose and the unintended consequences should be considered carefully.”

Watch Dr. Terence M Nombembe, SAICA CEO discuss the (MAFR) Paper

A MESSAGE FROM IRBA

“The IRBA’s primary objective is to protect the investing public. It does so by regulating auditors through setting, monitoring and enforcing high quality auditing standards and ethical behaviour. Furthermore, the IRBA’s mandate includes issuing a Code of Professional Conduct for auditors which addresses, inter alia, the independence of auditors from their clients. Given the importance of responding to the need to strengthen auditor independence the IRBA Board must consider further measures necessary to:

- strengthen auditor independence
- address market concentration of audit services and create a more competitive environment
- promote transformation by creating more opportunities for small and mid-tier audit firms.”

Watch Bernard Agulhas, IRBA CEO discuss the (MAFR) Paper
OBJECTIVE AND SCOPE

Should MAFR (and other related measures) be considered in South Africa as possible means of further enhancing auditor independence and audit quality (as well as contributing to the achievement of objectives related to market concentration and transformation)?

This discussion paper aims to provide an overview of SAICA’s interpretation and perspectives around mandatory audit firm rotation in the context of it being a possible means of further enhancing auditor independence in South Africa. It is aimed at informing SAICA members from all constituencies, at stimulating discussion and further input around the topic, and at providing a basis for members to form and provide their views and comments.

This discussion paper is written in the context of referring to the mandatory rotation, after a specified period, of the appointed external audit firm of an entity in terms of the auditor’s engagement to perform the annual audit of the entity’s financial statements in accordance with International Standards on Auditing (ISAs).

Mandatory audit firm rotation (MAFR) is distinct from individual audit partner rotation. The latter refers to the rotation, after a specified period, of key audit partners, which include the audit engagement partner on a particular audit engagement within the same audit firm, i.e. the audit firm retains the client, but the key audit partners within the firm rotates. MAFR refers to the rotation of the audit firm, i.e. a different audit firm is appointed after the prescribed rotation period and the new firm designates the new key audit partners, including the engagement partner, for the audit.

Mandatory Audit Tendering (MAT) and Mandatory Joint Audits (MJAs) are also often referred to or considered together with, or as alternatives to MAFR in further strengthening auditor independence.

It is certainly true that business failures occur and although it is very important to make the point that a business failure does not necessarily equal an audit failure, audit failures also occur (e.g. what has been observed in relation to various financial institutions internationally and a number of large corporates in South Africa). Such failures appropriately lead to the question “Why?” and focus attention on key matters such as auditor independence, sufficient levels of professional scepticism,
the sufficiency of the auditor’s evidence-gathering process, quality monitoring, other oversight mechanisms, etc.

In response to the above occurrences and questions, the robustness of current/existing measures and requirements should be evaluated and, where possible, strengthened, and new and more robust measures could emerge and be implemented. One such measure that has been implemented in the European Union and in some other jurisdictions is MAFR (as well as, in certain instances, other related measures such as MAT and MJAs).

The Independent Regulatory Board for Auditors (the IRBA), the audit regulator and standard-setter in South Africa, has indicated that in terms of its mandate to protect the financial interests of shareholders and investors, it has a responsibility to respond to the current global debates and recent legislative measures which have been implemented in respect of strengthening auditor independence. The IRBA’s consideration of these matters is also broader, taking into account the specific circumstances in South Africa. The IRBA has described the main reasons why they are considering further measures as follows:

**It will strengthen auditor independence to protect the public and investors, which is part of the IRBA’s mandate and current strategy;**

**It will address market concentration of audit services and create a more competitive environment, which will positively influence audit quality; and**

**It will promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets, provided they are competent to audit in those markets.**
There can be little doubt regarding the importance of auditor independence in contributing to overall audit quality, which in turn is essential for the continued relevance and value of the external audit in enhancing the credibility of financial reporting and the stability of financial markets.

One of the foundations, if not the cornerstone, that enables the provision of assurance to users of the assured/audited information is the independence of the assurance provider. The auditor’s opinion has value and is accepted as credible because it is performed by an independent assurance provider.

The auditor’s interest in carrying out his/her professional duties as the appointed auditor is to be neutral and objective, and to express an opinion on the entity’s financial statements in the interest of the primary users of the reported information (the shareholders of the entity), as well as in the broader public interest. The financial statements, in essence, represent the outcome of the directors’ measurement and evaluation of the entity’s financial position, financial performance and cash flow information in accordance with the requirements of an applicable financial reporting framework (e.g. IFRS or IFRS for SMEs).

The auditor and the audit firm have a commercial interest in the audit, and charges an audit fee as part of running his/her/its business as a registered auditor in public practice. All of these interests are required to be appropriately balanced.

Audit quality and the highest standard of professional ethics and conduct must always trump any other interests, since these directly relate to investor protection, the protection of the public interest and the continued relevance and value of the external audit. Hence, the auditing profession has gone to great lengths to introduce codes of conduct, quality control standards and professional engagement standards, which are further supplemented, in certain instances and for certain types of entities, by requirements of laws and regulations.

Independence is entrenched in the auditing profession’s Code of Professional Conduct in South Africa, namely the IRBA Code of Professional Conduct for Registered Auditors (IRBA Code), which
is consistent with the International Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (Parts A and B). The IRBA Code applies a conceptual approach that requires the auditor to identify threats to independence, to evaluate the significance of the threats identified, and to apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level. The code also specifies that in some situations no number of safeguards can reduce a threat to an acceptable level. Detailed guidance on various circumstances that create threats to independence is provided in section 290 of the IRBA Code.

In South Africa certain laws and regulations add to auditor independence requirements. For example, section 90(2) of the Companies Act, 71 of 2008 (the Companies Act) provides additional requirements that prohibit certain relationships and the provision of certain non-audit services by an entity’s auditor.

Section 92 of the Companies Act requires the rotation of the individual auditor or designated auditor (i.e. the audit engagement partner) after tenure of five consecutive financial years for companies that are required by the Companies Act or the Companies Regulations to have their annual financial statements audited, or who have incorporated the audit requirement in their Memorandums of Incorporation. The above individual audit partner rotation requirement for companies is more onerous than the requirement in the IRBA Code, which calls for rotation of key audit partners after seven years. Public interest entities (as defined in the IRBA Code) other than companies are subject to the seven-year key audit partner rotation rule.
Section 94 of the Companies Act requires the appointment of an independent audit committee for every public entity, state-owned entity and any other entity that requires the appointment of an audit committee in terms of its Memorandum of Incorporation. The duties of the audit committee include, amongst others:

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<td>on an annual basis, an auditor for appointment who in the opinion of the audit committee is independent of the entity.</td>
<td>subject to the provisions of the Companies Act, any non-audit services that the auditor may provide, as well as those that the auditor must not provide, and to pre-approve any proposed agreement to provide non-audit services to the entity.</td>
<td>an audit committee report to be included in the entity’s annual financial statements that includes, amongst others, stating whether the audit committee is satisfied that the auditor was independent from the entity.</td>
<td>and deal with any concerns or complaints relating to the content or auditing of the entity’s financial statements.</td>
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Section 94(8) provides further requirements in terms of how the audit committee determines whether the auditor is independent of the entity.

For listed entities, the JSE Limited Listings Requirements require that every entity appoint an audit committee in compliance with the King Code on Corporate Governance.

The Draft King IV Report on Corporate Governance (which will replace the current King III report when finalised) (the King IV Report) discusses auditor independence as part of the foundational concepts of corporate governance and specifically states that “auditor independence remains a vital pillar of corporate governance.” In essence, the full value of the independent audit cannot be realised without auditor independence. The King IV Report links this very strongly to the roles and responsibilities of the audit committee, which amplifies an important principle, namely that although the auditor is responsible for the performance of the audit (and audit quality), those charged with governance, including the audit committee, also have an important role to play in overseeing the audit.

Recommended practice in terms of the King IV Report includes that the role of the audit committee should be to provide independent oversight of:
Furthermore, the King IV Report recommends, among other things, that the audit committee meet periodically with the auditor, without management being present, and to include in its report disclosure on whether it is satisfied that the auditor is independent of the entity; any significant matters that the audit committee considered in relation to the external audit and how these were addressed by the committee. In relation to the auditor’s independence, the disclosure should make reference to the nature and extent of non-audit services rendered, audit firm tenure, audit partner rotation and significant management changes during the course of audit firm tenure.

In the case of companies in South Africa, the audit committee nominates an auditor for appointment, but the shareholders actually appoint the auditor (refer to section 90(1) of the Companies Act). The shareholders ultimately have the power to appoint the entity’s auditor on an annual basis, although the appointment of an auditor other than one nominated by the audit committee will only be valid if the audit committee is satisfied that the shareholder-proposed auditor is independent of the entity (refer to section 94(9) of the Companies Act). The appointment or re-appointment of the auditor occurs on an annual basis.

The most recent addition to measures that have been implemented to strengthen auditor independence is the Audit Tenure Rule that was issued by the IRBA in December 2015. In accordance with this rule, the auditor’s report on the financial statements of any public entity as defined in the Companies Act and that meets the definition of a public interest entity in terms of the IRBA Code, is required to disclose the audit tenure, in number of years, of the incumbent auditor (effective
for auditor’s reports relating to financial periods ending on or after 31 December 2015). The Audit Tenure Rule results in increased transparency about the auditor-client relationship and enables the consideration by users of the audited financial statements (specifically the shareholders), and by the audit committee, of any threats relating to long association between the audit firm and the entity.

As is evident from the above discussion, the matter of auditor independence has rightfully received considerable attention, both from the perspective of the auditor maintaining his/her independence and from the perspective of those charged with governance, ensuring that the auditor is independent from the specific audit client, and overseeing the external audit and its outcomes.

Auditor independence cannot be considered in isolation, since the ultimate measure against which all the codes, rules, standards should be measured is their contribution to ensuring high and sustainable audit quality in the public interest.

Various quality control measures are encapsulated in the auditing profession’s quality control and engagement standards. Engagement quality control reviews, firm monitoring procedures, and external inspections have relevance in terms of providing a safeguard or a level of defence to ensure compliance with certain audit fundamentals, including independence and other ethical requirements, the exercise of appropriate professional judgement, the exercise of sufficient levels of professional scepticism, sufficient appropriate audit evidence and proper audit documentation.

Auditors of listed entities or other large and complex public interest entities may also be subject to additional accreditation requirements that take account of the technical and professional demands on the auditor, including matters of auditor independence and audit quality. Examples are the accreditation requirements applicable to audit firms, individual auditors and “reporting accountants” in terms of the JSE Limited Listings Requirements. Certain specialised industries in South Africa may also follow the route of introducing auditor accreditation/authorisation.

Again, it is important to add the perspective that auditor independence and audit quality are enhanced within an environment of strong corporate governance, including strong audit committees and transparency of audit committee oversight (i.e. the important role of other participants in the financial reporting supply chain in providing audit quality oversight overall).
To summarise, the following measures already exist in relation to ensuring adequate levels of auditor independence (and audit quality):

- The **independence requirements of the IRBA Code**, which provide for a conceptual approach to identify and respond to independence threats and address various specific circumstances which the auditor should be alert to and how these should be addressed by the auditor.

- **Legislated independence requirements** prohibiting certain relationships and non-audit services (e.g. the Companies Act).

- **Mandatory audit partner rotation** required by legislation for certain entities. For example the Companies Act requires a five-year rotation period (which is more onerous than the seven years prescribed by the IRBA Code).

- Legislation and regulations that require the appointment of an **independent audit committee** for certain entities (e.g. the Companies Act and the JSE Limited Listings Requirements). Audit committees have specific responsibilities with respect to ensuring the independence of the auditor and audit quality oversight.

- Requirements relating to **audit committee reporting** with respect to auditor independence and any significant matters in relation to the external audit (e.g. the Companies Act, read together with the King IV Report).

- **Shareholders of a entity** have the ultimate right (and responsibility) to appoint an auditor for the entity (i.e. they are the primary users of the financial statements and derive the most benefit from the performance of a high quality audit).

- The **appointment or re-appointment** of the external auditor of an entity in South Africa occurs on an annual basis (i.e. nomination by the audit committee and approval by the shareholders). The audit committee and the shareholders have an annual opportunity to replace the incumbent auditor should they believe that the best interests of the entity and its stakeholders are not being served.

- The **IRBA Audit Tenure Rule** in terms of which the audit firm’s number of years of tenure must be disclosed in the auditor’s report for public companies that meet the definition of public interest entities.
The performance of objective engagement quality control reviews (EQCRs) for certain qualifying entities.

Internal audit firm monitoring reviews during the course of engagements, as well as compulsory post-issuance reviews.

External inspections performed at audit firm level and at individual engagement level by a strong, authoritative and independent audit regulator (i.e. the IRBA), coupled with requirements relating to a root cause analysis and a remedial action plan with respect to inspection findings.

Auditor accreditation requirements for auditors of listed entities and some other specialised industries add another layer of regulation that reinforces auditor independence and audit quality. For auditors of multinational companies this may extend across borders, where accreditation may also be required with regulators in other jurisdictions.

It is reasonable and fair to consider whether the existing measures with respect to ensuring auditor independence (and audit quality), as identified above, are indeed meeting their objectives. i.e. are they effective?

External inspections findings indicate deficiencies/issues regarding compliance with ethical requirements, including auditor independence, as reported by the IRBA in South Africa (refer to the IRBA Public Inspections Report 2014/2015), as well as internationally (e.g., as is evident from the IFIAR 2015 Survey of Inspections Findings). Similarly, inspections findings indicate deficiencies in relation to some quality control matters, such as EQCRs and firm monitoring procedures.

Reported inspections findings, as above, appropriately lead to regulators and other stakeholders in the financial reporting supply chain (most notably shareholders, investors and analysts) asking “Why?” Why are some auditors not getting it right with respect to certain matters and what could be done to minimise deficiencies and, thereby, the likelihood of a decline in audit quality and users’ perceptions thereof? One can understand why regulators may be looking at more robust measures which will further enhance auditor independence and audit quality.

By extension, inspections findings that are particularly related to breaches of auditor independence requirements may also raise questions around the
effectiveness of the audit committee concerned in terms of their consideration of the auditor’s independence (for those audited entities that require an audit committee).

Audits are conducted in an evolving business environment and therefore matters linked to the auditor’s work, including auditor independence requirements and auditing and quality control standards, are not static. While it is recognised that requirements, standards and codes must also adapt, it is equally important to properly comprehend the impact (and unintended consequences) of proposed possible measures, including measures such as MAFR, MAT and MJAs (both for auditors and the users of audit services).

The next two sections of this discussion paper provide an overview of some of the potential **benefits or advantages**, as well as **challenges or concerns or disadvantages** of MAFR, that have been observed through research, information-gathering, experience in certain jurisdictions and by audit firms and users of audit services. These should be considered collectively, since there are often an advantage(s) and a disadvantage(s) around the same theme.
(Reference is also made to MAT, as may be appropriate)

MAFR may enhance audit quality and users’ perceptions thereof. There exists research that indicates that long-term auditor tenure leads to a reduction of audit quality over time, as well as indications that the likelihood of issuing a qualified audit opinion decreases over the length of the auditor-client relationship.

Furthermore, there is research that indicates that MAFR may have a positive impact on auditor independence in appearance. Section 280.2 of the IRBA Code states, amongs other things, that independence of mind and in appearance is necessary to enable the registered auditor to express a conclusion, and be seen to express a conclusion, without bias, conflict of interest, or undue influence of others.

MAFR creates a sense of advancement of the public interest, because the requirements are legislated and apply to everyone equally.

MAFR could be seen as enhancing checks and balances around concerns that those charged with governance may not always properly balance, or achieve an appropriate balance between the interests of the entity and the public interest.

MAFR is seen as an additional safeguard against familiarity and self-interest threats that are associated with long auditor-client association that could lead to auditor bias or to complacency which, amongs other things, detract from the proper exercise of professional scepticism by the auditor.

MAFR results in the audit being performed through “a new pair of eyes”. It results in a “fresh look” and renewed focus on the entity and its business, renewed evaluation and interrogation of management judgements, systems and processes, data, assumptions, etc.
It is seen as an opportunity to strengthen the exercise of professional scepticism and as a defence against static audit programmes and an over-reliance on prior year knowledge.

The involvement of a new audit firm also refocuses the attention of management and those charged with governance, e.g. the new auditor may again ask questions that the previous auditor has not done recently, and the new auditor would inevitably also bring different perspectives and approaches (i.e. everybody rethinks and refocuses their efforts).

Knowing that tenure with respect to a specific audit client is limited, and that another auditor will be evaluating or reviewing the auditor’s work once the client rotates, may result in greater objectivity, enhanced levels of professional scepticism and an overall increased focus on foundation matters such as proper audit documentation and sufficient appropriate audit evidence.

MAFR may create an environment where there are more opportunities for more audit firms to tender for audits. This stimulates competition and may also serve to reduce market concentration and enhance transformation initiatives.

MAFR may create more opportunities for more auditors to develop the knowledge and skills that are required to be proficient in auditing large complex public interest entities and develop a wider range of industry specialists.

MAFR could create an incentive for smaller or mid-tier audit firms and even other established firms to invest (or invest more) in expanding their staff and resources if they perceive that there are viable opportunities available to obtain “new business” owing to other audit firms having to rotate off of certain engagements.

Owing to increased competition for audits (i.e. increase in supply), increases in audit fees may be kept in check and audit costs may even reduce. However, reductions in audit fees should never come at the expense of audit quality and therefore there should be sufficient monitoring of compliance with the Code of Professional Conduct as it relates to professional fees.
There is research that suggests that audit quality could be most vulnerable early on in the auditor-client relationship (i.e. in the first number of years), including the risk of audit failures. MAFR would increase the frequency of establishing and maturing new auditor-client relationships.

MAFR can have the effect (in appearance and in fact) of disempowering those charged with governance by diluting the responsibilities of the audit committee to take entity-specific decisions relating to the appointment of the auditor and audit quality oversight. Such decisions require careful consideration of a wide range of factors specific to the entity’s environment and what this means for auditor demands relating to specialisation, geographic reach and industry knowledge. All relevant factors should be considered in the circumstances and the audit committee for a specific entity should arrive at a decision that is in the best interests of that entity and its stakeholders.

Further to the previous point, shareholders’ rights may be adversely affected, because ultimately it is the shareholders of the entity who appoint or reappoint the auditor on an annual basis. In accordance with principles of good corporate governance it is for the shareholders to decide if and when to appoint a new auditor.

MAFR has been linked as a factor that may increase audit market concentration. This can be attributable, amongst other things, to large corporations tending to choose audit firms they perceive to be of the stature and possessing the competence to match the demands of their corporations and therefore they choose from a specific pool of audit firms.
Although MAFR creates more opportunities for more audit firms to tender for audits, the audit firms that are eventually appointed may very well still be from the bigger/larger firm constituency. This is as a result of the demands of these audits, as well as legislated requirements that only accredited audit firms may be considered and/or, in multinational group scenarios, the group’s requirement to select an audit firm that can service all or most of the components of the group, which may be spread over a number of jurisdictions. Therefore MAFR could actually have a negligible effect on creating real opportunities for smaller or mid-tier audit firms or for reducing market concentration.

When there are a limited number of audit firms that are of critical size, capacity and capability to perform audits of large and complex public interest entities, MAFR coupled with the effect of independence rules prohibiting the provision of non-audit services and introducing related cooling-off periods, may cause a situation where an entity has a limited choice of firms, resulting in appointing who is available and not who the entity wants to appoint in the best interests of the entity and its stakeholders.

The choice of available audit firms may be inhibited further in South Africa in the context of the effects of section 90(2) of the Companies Act that has introduced strict prohibitions on the provision of certain non-audit services, including an effective five-year “cooling-off” period. In an environment where audited entities also use audit firms for various other services, a number of firms will simply be disqualified from participating in the audit tendering process at a particular point in time.
A MAFR environment could stifle the development of smaller or mid-tier audit firms in terms of them not being willing to (and in some instances not being able to) make the necessary investment in staff and other resources to reach critical size, capacity and capability to perform audits of large and complex public interest entities (including attaining accreditation where this may be required), knowing firm tenure will be limited. The firm will, however, still be able to participate in other tenders owing to other companies having to rotate their auditors.

In the current environment, without MAFR, a change in auditors by a large listed entity or public interest entity is normally an event that attracts considerable investor and broader public attention, with a focus on understanding the underlying reasons for such change. In essence any change could be initiated by the audit firm (which could raise questions why the firm wishes to disassociate with the audit client), or by the audit client (which could raise questions around the audit firm’s performance or changes at the audit client or even that the audit client is opting for a new auditor that may be more “willing to meet” management’s demands). When changes in auditors become a norm in a MAFR environment, these matters may not be interrogated to the same extent.
A change of audit firm is coupled with a loss of accumulated knowledge about the client and its environment. Although changes in audit firms occur as a normal market phenomenon, the frequency of these changes would increase in a MAFR environment. Accumulated knowledge and understanding of the audit client are embedded in the audit firm through the key audit partners (even though there may have been partner rotation within the firm) and engagement staff who are involved in the audit over a number of years. Research suggests that audit quality may benefit from client knowledge that has been accumulated over a number of years.

A change in auditors places onerous demands on the entity being audited – its investment (or re-investment) in time and resources to facilitate the auditor’s understanding of the entity and its environment. This process is made more challenging, because it often requires the time and investment of senior members of the audit committee and management of the entity.

Increased audit tendering activities increase costs for the companies affected. The companies and their investors will be asked to carry additional expenses associated with the tendering process, including costs passed through by the audit firms and the cost for the entity to manage and administer the tender process. However, if objectives linked to increased auditor independence and audit quality are achieved, the costs may be justified.
MAFR creates challenges for multinational companies, as well as other large group audits where the companies’ policies and procedures require consistency of auditors within the group, requiring the same audit firm to serve all or most of the components in the group, across various jurisdictions. MAFR could increase the complexity to coordinate the appointment of auditors across a large multinational entity.

Companies have in the first instance introduced the concept of a single group auditor to address concerns around audit costs, as well as enhancing audit quality in the interest of investor protection; they have been implemented to address some of the risks and inefficiencies involved in placing reliance on auditors that are not part of the same firm or network of firms.

MAFR coupled with MAT, or just increased tendering opportunities because of MAFR, increase the cost of doing business for audit firms.

Tendering is an expense exercise, especially for those firms that participate and are unsuccessful in the tendering process.

Audit firms may not always be able to pass these additional costs on to the client and therefore they have to be absorbed internally, which could reduce the firm’s investment capacity (and have possible unintended consequences for transformation).

Owing to increased competition for audits in a MAFR environment, audit fees may reduce, but this could be at the cost of audit quality, since fees could be discounted in order to secure the client. This would not be sustainable for audit firms.

MAFR could have possible negative consequences for audit quality overall if one considers that the demands that are placed on resources of an audit firm in an environment of more rotations and more tenders have to be balanced within the
context of each firm’s overall audit portfolio. The additional time and resources required to manage rotations and tenders may reduce the time and resources available to perform existing audit engagements.

MAFR may cause disruptions in terms of an audit firm’s professional staff complement and may even lead to loss of staff, owing to the fact that a specific client that leaves because of rotation is not necessarily replaced by an “equal” client rotating from another audit firm, or owing to the fact that senior or specialist staff may leave to join another firm (i.e. “following clients” within a specific industry from one firm to the next). Although, in theory, new opportunities should then exist at another audit firm, these moves from one firm to another cause disruption for both the individuals involved and the audit firms.
A joint audit (JA) is where two or more audit firms (but usually two) are jointly appointed as the auditors of an entity. The joint auditors share the responsibility for the audit and a single auditor’s report is issued by the joint auditors. Mandatory joint audits (MJAs) refer to a situation where the appointment of joint auditors is required in terms of law or regulation.

Until now joint audits (JAs) have not been considered as a measure to further strengthen auditor independence by the International Ethics Standards Board for Accountants in its Code of Ethics for Professional Accountants. Nevertheless, JAs are a reality in practice (internationally and in South Africa), although mandatory MJAs are less common (although France has had MJAs since 1966).

If used, JAs will normally be found in the case of financial institutions and very large multinational companies or groups where, due to size, location, scope and complexity, the demands on the auditor are such that it is believed that they can best be achieved by involving more than one audit firm. This is often motivated by the lack of capacity of a single firm to meet the demands of such audit clients during a particular audit cycle.

MJAs should firstly be viewed in the context of the potential benefits or advantages and the potential challenges or concerns or disadvantages that have already been discussed with respect to MAFR (and MAT) above. Some additional matters (for and against) are listed below (these should be considered collectively, since there are often an advantage(s) and a disadvantage(s) around the same theme).

**Additional matters to consider in terms of potential benefits or advantages:**
MJAs could be considered as an additional safeguard against familiarity and self-interest threats that may be created by long association of audit staff with an audit client, together with possible added advantages relating to enhanced audit quality.

Shared knowledge of the client and the fact that the work performed by each auditor is reviewed by the other auditor could improve the likelihood of an effective audit (i.e. linked to the saying “two pairs of eyes are better than one”). Audit work in relation to certain areas of the audit, in particular at group level, may be performed by both the joint auditors.
CONSIDERATIONS PERTAINING TO MANDATORY JOINT AUDITS (MJAS)

The joint responsibility that comes with a JA, in terms of one also being held responsible for the work of the other, may contribute to higher levels of diligence by each auditor in the performance of the audit work and increased levels of professional scepticism.

In a JA, certain tasks are performed jointly (e.g. audit planning), which harnesses the joint views, knowledge and skills of the joint auditors. The audit work per audit area is allocated between the firms, but are also periodically rotated with the advantage of a “fresh approach” and a “new look” when a different auditor performs that work. This could serve as a safeguard against over-familiarity.

JAs could potentially address the concern of a loss of accumulated client knowledge that has been linked to MAFR, if one considers that the knowledge of the client is retained between the joint auditors, provided that the joint auditors do not resign or rotate simultaneously.

The joint auditors have access to a larger pool of support and other specialised resources (i.e. their combined support and resources). However, firms of sufficient size and capacity may argue that, because of the expansion of networks and additional investment in resources owing to existing demands pertaining to professional conduct and audit quality, they would in any event already have sufficient access to support and other specialised resources.

Additional matters to consider in terms of potential challenges, concerns or disadvantages:

There could be concerns that in certain instances there is not sufficient sharing of responsibilities on the audit, in the sense of joint responsibility, accountability and risk, especially if the joint auditors are firms that differ in terms of their capacity, skills and capability.

The splitting of work with respect to different audit areas (i.e. allocation of work to the various joint auditors) could increase the risk of material misstatements or significant deficiencies not being detected, in the context that firm methodologies differ and proper communication and coordination are more difficult (and sometimes more complex) than when dealing with audit staff that are all from the same firm. Conversely, the fact that each of the joint auditors focus on their allocated sections does not increase the chance of misstatements or deficiencies being identified by the other.
Auditor/joint-auditor communication with those charged with governance, including the audit committee, could be more complicated in terms of coordinating communications and a common message (i.e. an effective communication mechanism). This includes situations where management and those charged with governance may communicate significant matters with one of the joint auditors without informing the other.

There is duplication of audit work effort in JAs, in particular in relation to senior staff involvement by both firms on certain areas of the audit (e.g. audit planning, communication with management and those charged with governance, the group consolidation, forming the audit opinion and reporting) and the review of audit work by both firms. However, it is important to also consider whether this results in a commensurate increase in audit quality.

MJAs increase the cost for business, owing to more than one firm being involved, which results in more senior audit staff, more consultations and specialists being involved, more review of work between the joint auditors, duplication of work effort, etc. In essence, a JA costs more than the same audit being performed by a single audit firm.

If JAs are combined with other measures such as MAFR or MAT, it could complicate the coordination of the appointment of auditors, especially coordination across multinational entities and other large groups.
Means to an end

On the balance of the information that has been presented in the preceding sections of this discussion paper, the primary consideration is whether or not there are net benefits for adopting MAFR (and/or MAT and MJAs) in South Africa, with the main objectives of further strengthening auditor independence and enhancing audit quality.

If “yes”, one has to consider what will be the best model for South Africa in order to maximise any potential benefits and minimise any risks or concerns.

If “no”, one has to consider what the alternatives are and how to address the need to demonstrate that there are sufficiently robust measures in place to meet expectations related to ensuring auditor independence and consistent high audit quality.

As stated at the beginning of this discussion paper, there are also other objectives, namely addressing market concentration by creating a more competitive environment and promoting transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets. Transformation in particular is a legitimate pursuit and essential in South Africa – a pursuit that the profession, including SAICA, the IRBA and audit firms have taken seriously (but there is always more that can be done). The consideration is whether measures such as MAFR, MAT and/or MJAs could also contribute to these objectives.

What has happened in other jurisdictions?

There are instances where certain jurisdictions have considered the introduction of MAFR, but have decided not to proceed, for example the USA, UK, Australia, New Zealand, Japan and Germany.

In the USA, more than 90% of respondents to the PCAOB’s Concept Release in August 2011 that addressed possible ways to enhance auditor independence, objectivity and professional scepticism opposed MAFR. Comments were received from a wide range of constituencies, including audit committee members, preparers of financial statements and audit firms.
There are also examples of MAFR being introduced and then subsequently having to be repealed owing to negative and unintended consequences for both the auditing profession and the users of audit services. Affected countries include Argentina, Canada, South Korea, Singapore and Spain.

Then again, there are countries that have implemented MAFR and where it is still in operation, e.g. Italy, China, Brazil and India. Portugal has implemented MAFR on a “comply or explain” basis.

The European Union (EU) has recently introduced MAFR as part of the EU Regulatory Framework for Statutory Audit. The following salient features are relevant:

- The regulations are effective for the first financial year starting on or after 17 June 2016, except in the case of MAFR which effectively applies retrospectively, subject to certain transitional arrangements (these are outside the ambit of this discussion paper).
- The MAFR requirement only applies to public interest entities (as defined) in the EU.
- The MAFR period is 10 years.
- If after the initial period of 10 years, the audit engagement is put out on public tender, the incumbent auditor may be appointed for a further 10 years.
- Subject to the above, firm rotation will have to take place after a maximum of 20 years if the same audit firm was appointed after the initial period of 10 years.
- Any EU member state may adopt a shorter term of rotation (with respect to the initial 10 years or the maximum of 20 years).
- An EU member state regulator/supervisory authority may on application by an audited entity, and in exceptional circumstances, extend a particular rotation period once for a further two years.
The EU reforms focus on MAFR, but combines it with audit tendering (refer to previous section). Furthermore it is also linked to JAs – JAs are not mandatory, but could serve to extend the firm rotation period: the initial 10 year rotation period can, subject to a tendering process, be extended for a further 14 years (not the normal 10 years) if the audited entity concerned appoints joint auditors.

The EU requirements as stated above are only now becoming effective and therefore there is no empirical evidence yet regarding their impact and consequences (whether positive or negative).

The study does not show why the legislators in the EU and US decided on two different approaches, only that the decision by the legislators in the EU did not agree with the investors’ point of view.

In those instances where MAFR have been implemented, as in the case of the EU, it only applies to listed entities and other entities that are classified as public interest entities. This is a sensible approach in the context of protecting the financial interests of investors and the public interest pertaining to those types or classes of entities that would normally be expected to have the most significant impact in this regard.

It is clear that there has not been universal acceptance or rejection of MAFR, and that there are different models for its application, should it be considered an option. Furthermore, the potential benefits or advantages and potential challenges or concerns or disadvantages (as presented earlier in this discussion paper) will have to be weighted up carefully.
What can be done to harness the full benefits and intended objectives of existing auditor independence requirements and quality control measures, implemented within a strong corporate governance environment?

In this section we return our focus to what exists already and whether this could be enhanced or expanded in order to address the need to further strengthen auditor independence and enhance audit quality.

Regulatory Oversight
A strong audit regulator that applies a robust external inspections process remains a very effective measure in contributing to create an environment which maximises the likelihood that quality audits are performed on a consistent basis (refer to the IAASB’s Framework for Audit Quality, 2014). In South Africa we are fortunate that we have such a regulator in the IRBA, who has already incorporated as part of its inspection process requirements for audit firms to perform proper root cause analysis of inspections’ findings and implement appropriate remedial action plans.

Audit Commitees
Further strengthening best practice for audit committees in discharging their responsibilities relating to auditor independence and audit quality oversight will also contribute to more transparency and consistency in practice. Developments relating to the King IV Report will contribute significantly in this regard and can be supplemented by additional awareness and guidance initiatives by representative member organisations (e.g. the Institute of Directors) and professional accountancy organisations (e.g. SAICA). Some other measures relating to audit committees are elaborated on below.

Ensure strong and capable audit committees, with members that have the requisite competencies (contributing to efficiency and, most importantly, effectiveness).

If audit committees are properly empowered to consider auditor independence in all its aspects, it is expected of them to properly discharge their responsibilities relating to the external auditor. This truly allows the entity to take entity-specific decisions in the best interests of the entity, its owners and investors and other stakeholders; with a much needed public interest consciousness in the case of public interest entities.

Audit committees could also be encouraged, as part of their normal decision-making process around the appointment or reappointment of auditors, to consider firm rotation or audit tendering or the appointment of joint auditors.
Additional measures to strengthen transparency in terms of reporting/disclosing audit quality indicators should be pursued. The following audit quality indicators should be pursued:

- The outcome of quality monitoring activities – the firm’s internal review activities and the results of external inspections by the regulator
- Compliance with independence requirements
- Engagement team knowledge, experience and workload
- Investment in staff and other resources (e.g. methodology, technology, etc.) that support quality
- Audit results (the auditor’s opinion, financial statement restatements, communications with those charged with governance, etc.)

Strengthening transparency, as discussed, is linked to the principle that if audit committees are well informed they should be better able to take decisions in the best interests of the entity and its stakeholders, and normal market forces will dictate when and what changes may be required within a particular cycle.

Introducing measures to enhance audit committee reporting. Recommended practice in this regard is already being advanced in the King IV Report, but could be expanded further.

In addition, recent enhancements to the auditor reporting standards that are expected to result in a new and improved (long-form) auditor’s report that provides more transparency about the audit that has been performed (including, for certain entities, the reporting of key audit matters), will in the normal course of the audit and auditor-audit client interactions bring benefits such as the following:

- More robust, more transparent, more frequent and more in-depth communications between the auditor and those charged with governance, in particular the audit committee.

Although not explicitly required in terms of the Companies Act, the audit committee will feel obliged to provide the users of the financial statements with the “full picture”, including their assessment and perspectives on key audit matters reported by the auditor. Furthermore they would be inclined to provide more information regarding their role in monitoring auditor independence, assessing audit quality and overseeing the audit process.

Users of audit services (including shareholders and investors who are the primary users of the financial statements and the auditor’s report thereon) gain
insight into the audited entity “through the eyes of the auditor” – increased transparency and enhanced informative value, because of receiving more relevant; entity-specific and audit-specific information. Overall, this means better informed users who are empowered to take better informed decisions.

The new and revised auditor reporting standards require, among other things, that the auditor makes an explicit statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit. The auditor’s responsibility to ethics in the auditor’s report has been elevated and this is expected to lead to greater awareness in audit firms about issues surrounding their policies and procedures with respect to ethical requirements so that these statements can continue to be made authoritatively and with confidence.

**Partner Rotation**
We should consider if the intended benefits of MAFR relating to “a new pair of eyes”, a “fresh look at”, a “new / fresh approach” may not already be achieved by mandatory individual audit partner rotation. Individual audit partner rotation, which occurs within an audit firm, provides the benefits referred to as well as retaining the accumulated knowledge about the client and its environment. Furthermore, individual audit partner rotation results in continuity in the audit; the interaction with the audit committee and is less disruptive from a cost and efficiency point of view.

**Professional Scepticism**
Strengthening the exercise of professional scepticism by auditors. If one can succeed to positively influence auditor behaviour in terms of the exercise of professional scepticism by applying a more neutral and challenging mind-set, instead of an overly collaboration mentality, the effects on audit quality may be profound. Research suggests that scepticism may benefit from a longer term auditor-client relationship.

Professional scepticism and the further enhancement thereof is one of the IAASB’s priority projects and was included in the IAASB’s recent Invitation to Comment on...
Enhancing Audit Quality in the Public Interest (December 2015). Efforts are focused on exploring ways to strengthen the exercise of professional scepticism through, among other things, a common understanding of the concept, influencing auditor behaviour, evaluation of sufficient levels of professional scepticism during an audit and more clearly documenting the application of professional scepticism. The IAASB has already started to incorporate the work of its Professional Skepticism Work Group in current projects to update specific auditing standards, such as ISA 540 that addresses the auditing of accounting estimates.

**Some additional considerations if MAFR is considered for adoption**

It would appear that, if adopted, MAFR is normally considered in the context of an additional safeguard against the potential threats associated with very long auditor-client relationships and providing for a sufficient intervening period during which normal market forces within an environment of strong corporate governance would take care of any changes that may be required in the circumstances of a specific entity.

If it is to be adopted, MAFR would probably only make sense as an additional safeguard to ensure auditor independence in the context of protecting the public interest. Therefore it should apply to public interest entities (as defined in the IRBA Code).

As is evident from the discussions in this discussion paper, if MAFR is adopted it could be implemented in combination with other measures, such as MAT and JAs. Additional options that could also be considered include:

The audit committee could have discretion to extend any mandatory rotation period on good grounds shown that this would be in the best interests of the entity and its stakeholders (e.g., during a critical period of transition or change or crisis when it is especially important to maintain stability).

An entity, through its audit committee, could apply to an appropriate authority to extend the rotation period, for example taking into account the audit firm’s commitment to and demonstrated audit quality as reflected in identified audit quality indicators, and the entity’s circumstances and ability to take entity-specific decisions in the best interests of the entity and its stakeholders.
In an environment where individual audit partner rotation is already mandatory, it may be an option to implement firm rotation on a ‘comply or explain’ basis, or to introduce audit tendering. This results in the audit committee and, ultimately the shareholders, deciding what are in the best interests of the entity and its stakeholders, but at the same time it ensures that there is a proper and focused application of minds to the circumstances.

Another option that could be considered is to require the audit committee to perform a periodic formal assessment of the external auditor and the audit outcomes, based on identified audit quality and related indicators (over and above the annual auditor appointment process). This should be coupled with strengthening best practice in audit committee reporting in terms of its assessment process and its recommendation to retain or replace the auditor and, if applicable, the audit committee’s decision to, or not to put the audit out on tender, its evaluation of tenders, its monitoring of auditor independence, its monitoring of the outcomes of the external audit (and audit quality), etc.

Apart from models considering MAFR together with MAT (as in the EU), MAT could also be considered as an alternative to MAFR that “gives the power back” to the entity and to those charged with governance to take entity-specific decisions in the best interests of the entity and its stakeholders (again, properly balanced with considerations relating to the public interest). The entity still chooses, but after having had the opportunity to refocus on and reconfirm its demands; whether those demands have been met in an efficient and effective manner, and evaluating what is available in the market. The period of MAT would also have to be considered carefully in order to appropriately balance potential benefits and potential consequences or concerns.

When MAFR was reconsidered in Canada in 2012/2013, they instead opted for a comprehensive review of auditor effectiveness by the audit committee every five years, with a recommendation to either retain or replace the audit firm. In the UK, the Competition and Markets Authority has also advocated the regular reassessment of the auditor and the audit market by the audit committee.
The auditing profession and the users of audit services should continuously challenge the status quo in the interest of investor protection, the protection of the public interest and ensuring the best possible quality and value of the external audit.

The further enhancement of existing codes of conduct, quality control standards and audit and assurance engagement standards, and requirements of laws and regulations should also be on the agenda, alongside considerations related to the strengthening of corporate governance oversight mechanisms (e.g. audit committees). There is always room for improvement, with a measured approach that includes the careful consideration of potential benefits and potential risks and unintended consequences.

The consideration of broader objectives linked to the realities of the environment in South Africa, such as reducing market concentration and promoting transformation, deserve close scrutiny of existing measures and activities may be expanded to achieve improved results, identifying and addressing any obstacles that could be inhibiting the achievement of these objectives and considering whether additional or other measures or activities may have to be implemented/undertaken. These matters all contribute to the bigger impact on, and influence and contribution by the auditing (and broader accountancy) profession.

SAICA agrees with the objectives stated by the IRBA and believes that these should be addressed in the South African context. To this end, it is important that the profession, business leaders and other stakeholders initiate discussions on how these objectives will be best achieved. SAICA will engage with its members, across the broad range of constituents, to contribute to the discussion.

It is in the interests of SAICA members, the business fraternity, and the South African economy at large that you peruse this document carefully and provide us with input relating to the implications contained therein.

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