Long Association of Senior Personnel with an Audit Client

The International Ethics Standards Board for Accountants (IESBA) has commenced a project to consider the provisions in its *Code of Ethics for Professional Accountants* that address the potential threats to independence created by using the same senior personnel on an audit engagement over a long period of time (contained in paragraphs 290.150-155).

The IESBA is interested in obtaining the views of stakeholders and interested parties on whether the current provisions continue to provide robust and appropriate safeguards against familiarity and self-interest threats arising from the long association of senior personnel with an audit client; or whether the provisions can and should be revised to help enhance the independence and skepticism of individuals on an audit team.

Familiarity and self-interest threats (referred to as "the threats" in this survey) are described in the Code as follows:

- Familiarity Threat - The threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work
- Self-interest Threat - The threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior

This survey does not include consideration of any issues relating to Mandatory Firm Rotation or Re-tendering.

The survey should take approximately 15 to 20 minutes to complete. All responses are anonymous.

Thank you for taking the time to complete the survey; we are interested in your opinions.

IESBA Question	Technical staff proposed response
1. Do you think that the longer an individual serves on an audit team, the more the threats to objectivity and independence increase? o No, I don't think any significant threats to independence are created by the long association of individuals on the audit team with the audit client. o Yes	• Yes Long association of senior personnel on an audit team increases threats to objectivity and independence. However, this is offset to a degree through benefits derived from increased audit quality. A long-serving individual is likely to have developed significant knowledge of the client and its systems, the industry in which the client operates, and the key risk areas associated with the audit. This knowledge generally leads to engagement efficiencies (assuming that a significant number of personnel continue from year to year) and the effectiveness of the audit work performed on key audit risks. On the other hand, familiarity with an audit client may increase the risk of failing to critically evaluate management's assumptions and estimates or

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	recognise changes in the risk profile of the client. Other members of the audit team may rotate into and out of the team and while this of itself does not address the issues relating to a long serving individual, it can mitigate the overall issue.
2. On a scale of 1 (very unimportant) to 5 (very important), please indicate how important you think the length of time an audit team member has been associated with an audit engagement is in assessing his/her independence?	• 3 The length of time an audit team member has been associated with an audit engagement is an important consideration.
3. Do you think that the role or seniority an individual has on an audit team impacts the extent of the threats to independence that may arise over a period of time? o No o Yes	• Yes The higher the seniority of an individual, the greater their decision making power in respect of judgements on significant matters associated with the audit. This in turn increases the threat to independence.
4. Assume for a moment that the threats created by an individual who has served on the audit team for a long period of time are assessed as significant. Do you believe in such a case that requiring the individual to rotate off the audit team is a necessary safeguard for reducing significant threats to objectivity and independence? In answering this question, please consider the impact of changes in the audit engagement personnel on audit quality. o No o Yes	• Yes Where the threats to independence are assessed as significant, appropriate action must be taken to reduce such threats to an acceptable level. However, it is important that consideration be given to the impact on audit quality, which is likely to be a greater concern for smaller audit Firms where the number of individuals with the appropriate expertise may be limited. The risk of deterioration in audit quality can be mitigated by having a successor transitioned in over time, particularly in larger Firms.
5. What other safeguards do you think could be effective in reducing the threats to independence created by the long association of audit team personnel to an acceptable level?	*Public Interest Entities (PIEs)* *Proposed Safeguard 1* Putting a time limit in total, say 10 years (or two terms), on how long an individual can serve as a key audit partner on an audit engagement. *Proposed Safeguard 2* Another potential safeguard is where an individual has been in a senior role (Senior Manager equivalent or Partner) on an Audit Engagement for 10 years or more then the Firm should perform a quality assurance review of the significant judgements made on the

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	audit engagement at the end of the 10th year and communicate that this has occurred with Those Charged with Governance of the client. The rotation of partners addresses the familiarity threat. However, another issue is the self-interest threat created by a partner receiving a significant amount of fees from one audit client. *Proposed Safeguard 3* A potential safeguard to address this issue can be where an individual Audit Partner derives more than 25% of his or her fees from one client then the Firm should similarly initiate an independent quality review every 3 - 5 years (i.e. a period less than seven years) in a similar manner to how the Code currently treats circumstances where the Firm receives more than 15% of their total revenue from one client. This current 15% rule in paragraph 290.222 is unlikely to have been an issue for the larger Firms given their diverse portfolios. It may have caused more issues for the mid-tier and SMP markets. However, setting a test at the individual partner level and at a higher threshold (25% vs 15%) will mean that partners in larger Firms will also have to critically evaluate their objectivity and independence at more regular intervals. Partner revenue was a key factor in the case of Enron, where the partner was aware of the key audit issues that subsequently resulted in the collapse of a fortune 500 company. He was however unable to disagree with the client due to the influence of his and the Firm's dependence on nearly $25 million of audit fees and a similar amount in consultancy fees. Other options include Firm rotation and retendering which have been excluded by IESBA for the purposes of this survey. Current safeguards in the Code such as independent reviews of audit work may be effective in reducing the threat

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	to independence for entities that are not public interest entities. However, we have a suggestion in question 15 for the Firm to perform an assessment every 10 years.
6. Do you have any views on whether there is an impact on audit quality in the immediate period following rotation of the audit engagement partner or the quality control review partner? If so, please also include any comments on how this can be addressed. o No o Yes	• Yes There is always a substantially heightened risk in regard to audit quality when the audit engagement partner is rotated off the engagement since the engagement partner possesses significant knowledge of the client that may not readily be handed over to their successor. However, if managed appropriately, the reduction in quality due to rotation of the audit engagement partner can be minimised. Larger Firms are likely to have sufficient capabilities such that there are other partners in the Firm that have specialised knowledge relating to the client's industry. Audit quality can be enhanced by ensuring that the year of rotation for the audit engagement partner does not coincide with that of the quality review partner. Further, consistency of other senior members in the audit team will assist with the transfer of knowledge to the new partner resulting in the maintenance of audit quality. The risk of loss of quality is greater for smaller audit Firms who may not have the required personnel.
7. Which of these individuals are in roles that you think should be subject to rotation after a specified period, because the threats to independence that would be created by their long association with the audit client are so significant? Select all that apply. o Lead audit engagement partner o The partner assigned to undertake the quality control review of the audit engagement o Other partners assigned to the audit engagement o Managerial staff assigned to the audit engagement o Junior staff assigned to the audit engagement o None of the above – I don't support rotation requirements	• Lead audit engagement partner • The partner assigned to undertake the quality control review of the audit engagement • Other partners assigned to the audit engagement • Staff in the other categories may need to be refreshed if they are constantly assigned with the same part of the audit assignment over an extensive period, but we do not support formal rotation rules for these persons (except for the period where a current partner has served as a senior manager – refer to proposed safeguard 2 noted in response to question 5).

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8. If you selected "Other partners assigned to the audit engagement," how would you define the "other" partner roles that you think should be subject to rotation? That is, what characteristics of the role would lead you to conclude that their use on the audit team over a long period of time would create threats to independence so significant that rotation was required? You may wish to consider, for example, group audit situations and audit partner roles at a material subsidiary.	Other partner roles that should be subject to rotation should be those that satisfy the definition of Key Audit Partner under the Code. This definition is sufficient to capture all partners who make significant judgments in respect of the audit engagement.
9. What do you think the predetermined rotation period(s) should be for each role? Please also provide the rationale for your choices. Rotation periods: • No rotation • 3 years • 4 years • 5 years • 6 years • 7 years • Other Roles: • Lead audit engagement partner • The partner assigned to undertake the quality control review • Other partners assigned to the audit engagement • Managerial level staff • Other individuals, please describe	• Lead audit engagement partner – 7 years • The partner assigned to undertake the quality control review – 7 years • Other partners assigned to the audit engagement who meet the criteria to be a Key Audit Partner– 7 years • Senior Managerial level staff – not mandatory rotation but a review when they have completed 10 years in a senior manager equivalent /partner role. The current provisions in the Code can be improved with the additional safeguards proposed in response to question 5. The audits of listed entities in Australia are subject to the requirements of the *Corporations Act 2001.* Under the Act, where an individual plays a significant role in the audit of a listed company or listed registered scheme for 5 successive financial years, the individual is not eligible to play a significant role on the audit again unless the individual has not had such a role on the client for two successive years. The *Corporations Act* was recently amended in Australia to enable the 5 year rotation period to be extended by 2 years with the approval of the Audit Committee of the client and subject to notification with the regulator.
10. Once rotated off the audit engagement, how long do you think the individual should be required to not participate in (i.e., be off) the audit engagement? Please also provide the	• Lead audit engagement partner – 3 years (refer comments below) • The partner assigned to undertake the quality control review – 2 years (refer comments below)

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rationale for your choices. <u>No participation period:</u> • No rotation • 1 years • 2 years • 3 years • 4 years • 5 years • Other <u>Roles:</u> • Lead audit engagement partner • The partner assigned to undertake the quality control review • Other partners assigned to the audit engagement • Managerial level staff • Other individuals, please describe	• Other partners assigned to the audit engagement – 2 years • Managerial level staff – no rotation (refer comments at 9 above) The current provisions in the Code use a two year time out period for all partners including the engagement partner. However, the partner who creates a significant risk to familiarity is the engagement partner. Thus there should be a differentiation between the engagement partner who is the one most familiar with the client compared to other partners on the engagement (i.e. familiarity threat would be lower). A two year complete prohibition from involvement with the client following rotation is considered adequate in the management of threats to independence in respect of partners <u>other</u> than the engagement partner. *<u>Proposed Safeguard 4</u>* The time out period of the engagement partner should be <u>greater than 2 years</u> (say 3 years) rather than the current one size fits all approach in the existing Code (i.e. two year time out period).
11. Do you think an individual who has rotated off the engagement should have any relationship with the client entity while rotated off? Select all that apply. o Should have no relationship at all o Could provide non-audit services o Could act as the person responsible for the overall relationship between the Firm and the client as long as not a member of the audit team and does not influence over the outcome of the audit o Other, please describe	• should not have a role either performing or assisting in performing a professional service provided by the firm in the timeout period. The key purpose of rotation is to manage the threat to independence arising from familiarity. If the relationship between the client and the audit partner is maintained (i.e. on non-assurance engagements) then the threats to independence have not been effectively addressed as the partner has maintained a professional relationship in connection with a professional service provided to the client.
12. If the Code were to allow a	The Code currently allows for an

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predetermined rotation period to be extended under particular circumstances, what factors do you think should be satisfied for such an extension to be permissible, and how long should the extension be?	exemption from rotation by auditors of public interest entities where such exemption is provided by an independent regulator and conditional to alternative safeguards being specified and applied. This is considered an appropriate circumstance under which an extension to the rotation period should be allowed. The length of the extension should be determined by the regulator after taking into consideration the unique circumstances of the engagement. Other than the extension provided by a regulator (an independent party) we do not believe it is appropriate for a Firm to self-assess and extend the mandatory partner rotation. As discussed in the response to question 9 above, the audit of listed entities in Australia are subject to the requirements of the *Corporations Act 2001*. Under this law, rotation must take place after 5 years on the engagement. However, an additional 2 years is now permissible subject to approval of the audit committee.
13. Do you think there should be any other exceptions to the requirement to rotate, and if so, in what circumstances? o No o Yes	• No Exceptions should be available as currently permitted by the Code. That is, in the event of unforeseen circumstances outside the Firm's control such as serious illness of the intended Engagement Partner.
14. Do you think that "Those Charged with Governance" should be involved in the rotation decision? If so, how, and to what extent? o No o Yes	• Yes Input from 'Those Charged with Governance' would be beneficial in terms of the rotation decision. However, due to the nature of the familiarity threat, it may not be appropriate that 'Those Charged with Governance' have extensive involvement with the rotation decision of the Firm. Input from 'Those Charged with Governance' should be sought in respect of their expectations and this information should be used as input into the Firm's decision making process.

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15. In respect of your answers above, what type of entities do you think rotation requirements should apply to? Select all that apply. o Listed entities only o Other public interest entities o Other, please specify	• Listed and other public interest entities Current rotation requirements of the Code that apply to listed and other public interest entities are considered appropriate in respect of management of threats to independence. *<u>Proposed Safeguard 5</u>* However, auditors of non-public interest entities should also be required to assess the significance of threats to independence as a result of the long association of senior personnel. While the rotation requirements for such entities need not be as prescriptive, guidance should be provided for the audit Firm to conduct an assessment of threats to independence and the potential need for rotation of the engagement partner on a periodic basis (say every 10 years) rather than the Code remaining silent on the matter. There should be communication with Those Charged with Governance as well. However the final decision should be made by the Firm (whether to continue with the same engagement partner or rotate to another partner) and then the rotation decision should be communicated to Those Charged with Governance. This way rather than having an audit engagement where a partner can continue indefinitely, every 10 years an assessment will need to be made by the Firm whether they allow the same engagement partner to continue.
16. Do you think that the length of time an individual has been a member of an audit team prior to becoming a partner (e.g., joining as a junior and growing up on the job) could create threats such that rotation might be appropriate at an earlier stage or that some of this time served prior to becoming a partner should count towards the period after which rotation is required? If so, please provide comments on any	• Yes The need to rotate from an audit client should not be limited to the title of an individual. That is, an individual who serves in a senior role on an audit client for a number of years prior to taking on the role of engagement partner should be considered for earlier rotation. While the individual

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circumstances that you think may warrant this and when. o No o Yes	may not have been acting in the role of partner, relationships developed with the client while serving in a senior manager equivalent role may lead to an increased familiarity threat. The time period where the individual was a junior team member on the engagement need not be taken into consideration when determining the period of service for rotation. This is because the role and level of influence a junior team member has on key audit judgements in the early years will be low. However as referred to earlier there is an overall good practice to ensure audit tasks are given to a range of different staff members over time
17. Do you have any comments on the benefits and/or challenges and/or practical implications of requiring rotation of audit partners after a specified period?	There are challenges for smaller audit Firms with limited resources. Firms in the SMP sector may struggle to maintain audit quality following mandatory rotation, particularly where the outgoing partner is prevented from any further involvement with the client. Benefits of audit partner rotation after a specified period are undeniable as a mechanism to manage the threat to independence where the audit remains with the same Firm. This is in contrast to the mandatory rotation of the audit Firm itself, which can be a costly undertaking. In addition to independence threats, the risk of becoming too familiar with the client and hence complacent is also managed as audit partners are rotated. These benefits far outweigh the challenges of rotation particularly in respect of public interest entities.
18. Finally, do you have any other comments on the topic of the threats to independence created by long association of personnel with an audit client?	Threats created by long association of personnel with an audit client have been acknowledged by legislation locally. In Australia there are a number of legislative requirements relevant to auditor independence. One specific requirement is for listed entities to disclose where an extension to rotation requirements has been granted by the independent regulator. In addition the reasons for the extension must be disclosed to the financial report. Other legislative requirements also act

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	to manage threats to independence arising from the provision of non-assurance services by audit Firms. Listed entities are required to disclose amounts paid or payable for non-assurance services provided by the audit Firm. The requirement to have these disclosures generally deters companies from engaging their audit Firms to provide significant non-assurance services and in some instances this has encouraged companies to adopt internal policies that have guidelines on the extent to which they can engage the external auditor to provide non-assurance services. Certain proxy advisers focus on this issue in regard to their recommendations on director re-election if there is an imbalance in audit and non-audit fees.
19. Select all that apply. o I am a member of an audit committee o I am a company director o I am a representative of an IFAC member body o I am a representative of an audit regulator o I am a representative of a standard setter o I am a professional accountant o I am an auditor o Other, please specify	• I am a representative of a standard setter • Please note that inputs have also been received from members of the standard setter who are company directors of listed entities in Australia.
20. Which best describes the organization(s) you belong to, regulate or serve? o Listed/public interest entity o Small- or medium-sized entity o Public sector o Not for profit o Other, please specify	• Not for profit
21. In what country is your organization located?	Australia