

Partner Rotation and Key Audit Partner

Background

Partner Rotation

Existing Section 290 recognizes that using the same senior personnel on an audit engagement over a long period of time may create a familiarity threat. The existing section further provides that for the audits of listed entities, the engagement partner and the individual responsible for the engagement quality control review should be rotated after a pre-defined period, normally no more than seven years, and should not participate in the audit engagement until a further period of time, usually two years, has elapsed. The existing section also provides that when a firm has only a few people with the necessary knowledge and experience to serve as the engagement partner, or the individual responsible for the engagement quality control review, rotation may not be an appropriate safeguard. In these circumstances, the existing section provides that firms should apply other safeguards to address the threat.

In reviewing section 290, the IESBA considered this guidance and in particular, the need to strike a balance between addressing the familiarity threat by bringing a fresh look to the audit and the need to maintain continuity and audit quality. The IESBA recognized that in larger engagements, key audit partners, other than the engagement partner and the individual responsible for the engagement quality control review, may play a significant role in the performance of the audit and maintaining ongoing relationships with client management. The Exposure Draft, therefore, addressed the familiarity threat by extending the partner rotation requirements to all key audit partners on an audit of an entity of significant public interest.

The IESBA considered the length of time after which rotation should be required and the length of time before the individual may return to the audit team. The IESBA was conscious that in some jurisdictions a limited number of individuals have the knowledge and competencies to be a key audit partner on entities of significant public interest. The IESBA was, therefore, of the view that the existing requirement of seven years on the team and two years off strikes an appropriate balance between requiring the necessary fresh look and the need for continuity and competence.

The IESBA considered whether it was appropriate to maintain the existing position that alternative safeguards may be applied by firms with only a few people with the necessary knowledge and experience to serve as key audit partners (“the limited resource flexibility”). The IESBA was of the view that on balance, such flexibility should not be provided. The IESBA considered whether alternative safeguards, including an external review by a regulator, were available to appropriately address the familiarity threat. The IESBA concluded that such safeguards were not adequate to address the threat, noting that a review by a regulator is performed after issuance of the audit report and may be several years after issuance. The IESBA was also mindful that if there was insufficient depth within the firm to rotate the required partners this could have implications for audit

quality. The proposed revised Section 290 therefore requires rotation of key audit partners on all audits of entities of significant public interest.

Key Audit Partner

The IESBA proposed the following definition for the new term “key audit partner”:

“The engagement partner, the individual responsible for the engagement quality control review, and other audit partners on the engagement team, such as lead partners on significant subsidiaries or divisions, who are responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.”

The term is used not only in the provision on partner rotation, but also with respect to employment relationships and compensation, where the IESBA concluded that such provisions should apply to additional audit partners. The definition of key audit partner focuses on whether a partner is responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion. For example, in the case of an audit of consolidated financial statements, if the audit partner of a significant subsidiary is responsible for key decisions or judgments on significant matters with respect to the consolidated financial statements, that individual would be considered to be a key audit partner.

Discussion

Comments Received - Partner Rotation

61 respondents commented specifically on the partner rotation proposals, of whom 40 opposed the proposals directly or queried whether they were entirely in the public interest. (See Summary of Responses attached.) All accounting firms and practitioners commenting on the proposals were opposed to the Exposure Draft. Of the 16 respondents who supported the proposals, 10 were from Europe/Africa and 6 were from Asia or Australasia, being mainly regulators and member bodies. All respondents from the Americas opposed the proposals. Many respondents also wrote at considerable length in voicing their opposition to the proposals, advancing many arguments as to why the proposals were not in the public interest and were detrimental to audit quality.

Of all respondents, only two (both in Australasia) proposed a tightening of the proposals (one with respect to the period of rotation and one with respect to activities in the time off period).

The overwhelming reason given for objecting to the Exposure Draft was the practical impact of removing the limited resource flexibility.

Objections were also made to the extension of the rotation requirements beyond the lead engagement partner and the individual responsible for the engagement quality control review to all key audit partners. Often the objection to this proposal was linked to concerns about the ability of small firms to undertake audits of unlisted entities of significant public interest, when taken together with the removal of the limited resource flexibility.

A significant number of respondents also linked their concerns about the removal of the limited resource flexibility with the definition of entities of significant public interest. The three elements of (1) extending partner rotation to key audit partners, (2) extension to entities of significant public interest, and (3) the removal of the limited resource flexibility, when taken together, were often seen as likely to result effectively in small firm rotation, severe resource constraints, particularly for audits of specialized industry companies and in certain territories, and a loss of expertise on audits impacted by the proposals leading to a reduction in audit quality.

There were very few objections raised to the mandatory rotation period (seven years) and the two year time off period, although one member body (ICPAI) recommended that in small practices, or in special cases in firms, the period for listed entities could be prolonged to nine years. There was some positive endorsement of the proposal compared for example with the five year mandatory rotation for the audit engagement partner and five year time off period required in the UK. ACAG (Australia) was the only respondent to argue for a shortened rotation period to five years for key audit partners.

Comments Received – Key Audit Partner

Most of the comments on the definition of key audit partner were made in the context of partner rotation. Although some respondents argued that the definition of key audit partner should be modified, the respondents did not suggest that the group of partners covered by the key audit partner definition differed depending on its application.

Concerns about the proposed definition of “key audit partner” contained in the Exposure Draft were expressed by 17 respondents. Several agreed with the proposed definition as drafted (CGA-Canada, NIVRA, IRBA) and others suggested some edits to the proposed definition without substantially changing the meaning (FEE, ICANZ, MIA, KPMG, E&Y), but many respondents were of the view that the definition of key audit partner should be clarified. The comments on the proposed definition generally could be characterized as follows:

- Key audit partners should only include those audit partners who are responsible for key decisions or judgments on significant matters *at the group level*. (ICAEW, ICAS, ACCA, CCAB, CARB, FAR, E&Y, GT)
- The definition should be conformed to the definition in the EC Statutory Audit Directive. (ICAEW, FAR, DnR, CEBS) Key audit partner means, under that definition:

- the statutory auditor(s) designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on the behalf of the audit firm; or
 - in the case of a group audit, at least the statutory auditor(s) designated by an audit firm as being primarily responsible for carrying out the statutory audit at the level of the group and the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries; or
 - the statutory auditor(s) who sign(s) the audit report.
- Because “audit partner” is not defined, the definition should be clarified to exclude specialty partners, such as tax partners, actuaries, and “National Office” audit partners, who consult on engagements. (E&Y, PwC, DTT, CoCPA, GT)

Although the last point was raised largely by firms, the other points were shared by member bodies, firms and regulators without preponderance by any one group.

Concerns that the language of the Exposure Draft failed to convey the concept of responsibility at the group level, i.e., at the level of the group financial statements, may reflect a lack of understanding as to the meaning of the term “financial statements on which the firm will express an opinion.” In the context of the audit of an entity of significant public interest, the term was intended to mean the financial statements of the entity itself (which might be consolidated in the case of a group) and not all the individual financial statements of entities forming part of the entity’s group.

Discussion – Removal of the limited resource flexibility

By far the majority of comments received on the partner rotation proposals related to the removal of the limited resource flexibility.

Again, particular concerns were expressed about the impact of this proposal when taken together with the definition of entities of significant public interest and the extension of the rotation requirement to key audit partners. A significant number of respondents were prepared to accept the removal of the limited resource flexibility for audits of listed entities but not for audits of other entities of significant public interest.

US respondents frequently pointed to US studies not supporting audit firm rotation, arguing that this is tantamount to how the proposal would operate for certain SMPs in their audits of entities of significant public interest. A typical response from a small US accounting firm was as follows:

“audit firm rotation has significant costs that far outweigh the potential benefits, as governmental agencies (including the Securities and Exchange Commission and the Government Accountability Office), private organizations and members of academia in the United States previously have concluded. Those costs include an increase in audit failures, start-up costs and difficulties in timely reporting, loss of

institutional knowledge and reduced incentives to improve efficiency and audit quality.”

A number of respondents also referred to the SEC exemption for small firms and argued that a similar exemption should be provided in the Code. Others referred to the FDIC exemption and also pointed to the EU Statutory Audit Directive (see discussion below).

A number of respondents drew attention to the fact that although often thought of as a small firm exemption, the limited resource flexibility should apply to any situation where, for example due to the specialist nature of the audit client or due to the undeveloped or developing state of the local economy, there are in fact few audit partners available to perform the audit work such that rotation would impose severe difficulties on the ability of a firm to continue to undertake the audit. A particularly strongly worded objection to the proposal was received in a single submission on behalf of the IFAC SMP Committee and the IFAC Developing Nations Committee. The principal arguments expressed were:

- Combined with expanded definition of key audit partners it will for many SMPs and SMP networks amount to firm rotation;
- Could be reviewed as discriminatory, anti-competitive and even a restraint of trade;
- Will restrict the choice of auditors open to entities of significant public interest;
- From the perspective of an external stakeholder is not visible, so how does partner rotation improve independence in appearance?
- Cost outweighs the benefit in terms of enhanced audit quality.

Many respondents argued that a principles-based approach should be applied, in particular, in addressing any threats created by long service of auditors of unlisted entities of significant public interest. Safeguards typically mentioned in this context included:

- Involving an independent quality control reviewer either from within the firm or externally, possibly with the approval of the audit regulator;
- Monitoring of the engagement by external assessors, typically the audit regulator in a particular country;
- Undertaking an enhanced quality control review focusing on independence and competence of the engagement partner;
- Discussing the matter with the audit regulator;
- Discussing the matter with those responsible for governance;
- Encouraging joint audit arrangements to enable partner rotation to be scheduled with less disruption to the audit.

Some respondents argued that the familiarity threat from long service should be analyzed with reference to the particular facts and circumstances, in particular the extent to which management of the client has changed over the period.

The IESBA considered the comments received on the proposed removal of the flexibility in the case of limited resources. It was noted that there do not appear to be any arguments emerging from the responses that the IESBA did not consider in the course of developing its proposals. The IESBA was, however, of the view that in light of the strength of the opposition to the proposals careful reconsideration was warranted, particularly given that the opposition is coming not just from small firms, but also from some larger firms and also from a very significant number of IFAC member bodies. However, it is also noteworthy that all the independent audit oversight bodies that responded were in favor of the Exposure Draft position to eliminate the flexibility.

The IESBA reconsidered the positions taken by other independent regulators and has reviewed the SEC requirements that exempt small firms from the SEC rotation provisions. The SEC rules provide as follows:

“Any accounting firm with less than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 and less than ten partners shall be exempt from paragraph (c)(6)(i) of this section [*ie the rotation requirement*] provided the Public Company Oversight Board conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under this paragraph.”....

Although it could be said that an ex-post review of the files by an independent regulator will not identify any weaknesses in the audit process until it is too late to remedy them for that year’s audit, it does nevertheless provide a significant incentive to the audit partner to take whatever steps he or she can to ensure the quality of the audit work.

The IESBA further considered the requirements of the EU Statutory Audit Directive. The Directive requires the rotation of key audit partners for all entities of significant public interest after seven years (consistent with the ED). It does include a provision for member states to exempt statutory audits of public interest entities (other than listed entities) from certain provisions of the Directive (including the partner rotation requirements). It is not, however, known whether member states will choose to avail themselves of this provision when implementing the Directive into national law.

The IESBA also considered the arrangements for quality assurance of statutory audits of public interest entities in the Directive. Article 29 requires all statutory auditors and audit firms to be subject to a system of quality assurance organized in such a manner that it is independent of the reviewed statutory auditors and audit firms and subject to public oversight. Article 43 requires the quality assurance review to be carried out at least every three years for statutory auditors or audit firms that carry out statutory audits of public interest entities. It is likely, therefore, that member states could in theory offer a three

year independent review similar to that required by the SEC, although whether the resources would be available to conduct a review of each audit engagement where key audit partners have not been rotated is not yet possible to determine.

Discussion – Extension of partner rotation to key audit partners

Nine respondents commented specifically that partner rotation should not be extended to key audit partners or otherwise queried the definition of key audit partner in this context. A typical example of a comment on the key audit partner extension is from the Australian Member Bodies:

“Whilst we agree that the lead partner bears the responsibility for key decisions or judgments on significant matters, we do not agree that an “other audit partner” bears a similar responsibility. We therefore do not support the extension of the definition of “key audit partner” to be used in the provisions on employment relationships, partner rotation and compensation.”

A response from Mazars along similar lines reads:

“We believe that persons designated by the firm without final responsibility for the engagement and the audit opinion provided at group level, should not be required to rotate other than in specific circumstances to be determined on a case by case basis.”

DTT commented:

“As for the proposed expansion of the scope of partners covered by the proposed rotation requirements, we are concerned that regardless of the size of the entity or size of the firm, the risk that audit quality will be negatively impacted is such that we do not believe it is appropriate to mandate partner rotation beyond the engagement partner and engagement quality control reviewer. The threats associated with other key audit partners serving a client over a long period of time should be dealt on a factors and circumstances basis using the principles-based approach.”

Some of those who sought to justify an alternative proposal that only the engagement and quality control review partner should rotate generally did so on the grounds of responsibility, arguing that only the engagement partner on the audit of the entity is actually responsible. Respondents suggesting that “key audit partner” should be defined as those “at the group level” may have been arguing, in effect, that by limiting the application of the rotation requirements to those at the group level, only the engagement partner and engagement quality control reviewer would be impacted by the requirement.

The definition of key audit partner was intended to cover those partners who are responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements of the entity of significant public interest.

The IESBA considered the following two scenarios:

- In the first case, the audit client's operations reside in two divisions and there is a lead audit partner with responsibility for signing the audit report on the financial statements and two additional audit partners assigned to the engagement, one on each division.
- In the second scenario, the audit client has established two subsidiaries rather than divisions. Three audit partners also serve, one as the lead and one on each of the subsidiaries. The lead partner has responsibility for signing the audit report on the group's financial statements.

The IESBA was of the view that the answer as to which partners should be required to rotate should be the same in the two scenarios. As a result, the IESBA did not agree with those respondents who argued that key audit partner should only include those "at the group level". The IESBA also did not agree with those favoring conformity with the EC Directive. If, for example, there were no significant judgments or key decisions required to be made by the audit partner on one of the subsidiaries, the partner should not be required to rotate merely because the subsidiary was material. Rotation may be appropriate for partners on significant subsidiaries and divisions, but only if there are key decisions at those subsidiaries and divisions, such partners have responsibility for those decisions and those decisions affect the financial statements of the entity of significant public interest. The IESBA was of the view that this was not clearly stated in the Exposure Draft.

The IESBA also considered whether any clarification was needed to specifically exclude tax or specialty partners from being included in the definition. The IESBA was of the view that both the term itself referencing "audit" and the definition that refers to "other audit partners" adequately address the concerns raised.

Alternatives Considered

The IESBA considered whether to retain some form of limited resource flexibility within the partner rotation section of the Code.

The following options were considered:

- Provide some form of flexibility for entities of significant public interest other than listed entities. This might be applied as follows:
 - Broad relief to include safeguards such as enhanced internal quality control review, external review by a firm, member body or independent regulator ("broad relief");

- Narrow relief, for example requiring the audit firm to agree with its independent regulator that the audit files shall be subject to a quality assurance review by the regulator at least every three years (“narrow relief”). Whilst this has the attraction of being similar to the relief permitted by the SEC for listed entities, it is unclear, however, that this would lead to consistent implementation worldwide as many jurisdictions may not have a facility to offer independent review by a regulator, particularly for entities other than listed entities.
- Provide some form of flexibility for all entities of significant public interest, including listed entities. This might be applied as follows:
 - Broad relief for all entities;
 - Narrow relief for all entities;
 - Narrow relief for listed entities with broad relief for other entities of significant public interest.

The IESBA concluded that retention of some flexibility with respect to partner rotation was appropriate. The IESBA, therefore, asked the Task Force to develop a proposal to require partner rotation except when a firm has only a few people with the necessary knowledge and experience to serve as key audit partner and the independent regulator in that jurisdiction has provided an exemption from partner rotation for such firms if specified alternative safeguards are applied. The IESBA also asked the Task Force to consider whether, in the absence of exemption by an independent regulator, flexibility can be provided in the Code because there are sufficiently robust alternative safeguards.

With respect to a key audit partner, the IESBA asked the Task Force to modify the definition to clarify what was intended by “financial statements on which the firm will express an opinion.”

The Task Force has considered the direction of the IESBA. With respect to the definition of key audit partner the Task Force has developed the following revised definition:

“The engagement partner, the individual responsible for the engagement quality control review, and other audit partners, if any, on the engagement team, who make key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion. Depending upon the circumstances and the role of the individuals on the audit, other “audit partners” may include, for example, audit partners responsible for significant subsidiaries or divisions..”

With respect to “financial statements on which the firm will express an opinion” the Task Force has added a definition of this term to state that when an entity issues consolidated financial statements, these statements are the relevant financial statements for this purpose. The proposals contain the following new definition:

“In the case of consolidated financial statements, also referred to as group financial statements, the consolidated financial statements.”

The Task Force is considering whether this definition in isolation is sufficiently clear and may develop additional guidance to be included in a separate paper – either in a subsequent agenda positing or to be tabled at the Toronto meeting.

With respect to the limited flexibility for partner rotation the Task Force has drafted the following paragraph:

“When a firm has only a few people with the necessary knowledge and experience to serve as a key audit partner on the audit of a public interest entity, rotation of key audit partners may not be an available safeguard. If an independent regulator in the relevant jurisdiction has provided an exemption from partner rotation in such circumstances, an individual may remain a key audit partner for more than seven years, in accordance with such regulation, provided that the independent regulator has specified alternative safeguards which are applied, such as a regular independent external review.

The Task Force included the example of an alternative safeguard (such as regular independent external review) in response to comment received from the CAG.

The Task Force considered whether, in the absence of exemption by an independent regulator, any further form of flexibility can be given because there are sufficiently robust alternative safeguards. At the June IESBA meeting, some members of the Board commented that the safeguards proposed in the economic dependence ED could address the familiarity threat created by long association, as the threat to independence created by economic dependence was viewed to be at least as significant as a familiarity threat. Others disagreed. The safeguards required in the case of economic dependence are that in the first year after total fees from an audit client have represented more than 15% of the fees for the firm for two consecutive years either:

- After the audit opinion has been issued a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs a review that is equivalent to an engagement quality control review (“a post-issuance review”); or
- Prior to the issuance of the audit opinion a professional accountant, who is not a member of the firm expressing the opinion on the financial statements of the client, performs an engagement quality control review.

Thereafter, in determining which of these safeguards should be applied and the frequency of their application, consideration should be given to the extent to which the relative size of the fees from the audit client in relation to the firm's total fees is greater than 15%. At a minimum a post-issuance review should be performed not less than once every three years commencing with year 3.

Many respondents on the ED, including the AICPA, the SME/DNC, and most of the large firms argued in favor of peer review as a safeguard for small firms (or at least that the mandatory rotation should apply only to the lead audit partner and independent quality control review partner) with a threats and safeguards approach being applied to other key audit partners. (One large firm argued that in considering whether key audit partners other than the lead audit partner and the independence quality control review partner should rotate, consideration should be given to other factors such as changes that have taken place in management over past years and evaluate the extent of the familiarity threat accordingly.)

The Task Force, however, was not persuaded that the two issues of economic dependence and partner rotation should be treated similarly and is not of the view that peer review was an appropriate safeguard to address inability to rotate key audit partners. The Task Force was also mindful that the position by the IESBA to narrow the definition of entities of public interest will likely go a long way to address the concern expressed with respect to partner rotation. The Task Force, therefore, will recommend that in the absence of an exemption by an independent regulator there should be no further flexibility provided in the Code and partner rotation should be required.

Action requested

IESBA members are asked to consider the proposal and provide input to the Task Force.