

17 January 2017

Mr. Bernard Agulhas
Chief Executive Officer
Independent Regulatory Board for Auditors
South Africa
Via email

Dear Mr. Agulhas,

On behalf of the Association of International Certified Professional Accountants (the Association), I am writing to voice opposition to the Independent Regulatory Board for Auditors' (IRBA) Consultation Paper issued 25 October 2016 calling for mandatory audit firm rotation (MAFR). The Association combines the strengths of the American Institute of CPAs (AICPA)¹ and The Chartered Institute of Management Accountants (CIMA)² to power opportunity, trust and prosperity for people, businesses and economies worldwide. It represents 650,000 members and students in public and management accounting and advocates for the public interest and business sustainability on current and emerging issues. With broad reach, rigor and resources, the Association advances the reputation, employability and quality of CPAs, CGMAs and accounting and finance professionals globally.

As we understand the proposal, the IRBA has several goals in considering MAFR. Chief Executive Officer Bernard Agulhas initially indicated the following in his public comments:

- “It will strengthen auditor independence and so protect the public and investors, which is the regulator’s strategy;
- “It will address market concentration of audit services and create a more competitive environment, which will positively influence audit quality; and

¹ The American Institute of CPAs (AICPA) is the world’s largest member association representing the CPA profession, with more than 418,000 members in 143 countries, and a history of serving the public interest since 1887. AICPA members represent many areas of practice, including business and industry, public practice, government, education and consulting. The AICPA sets ethical standards for the profession and U.S. auditing standards for private companies, nonprofit organizations, federal, state and local governments. It develops and grades the Uniform CPA Examination, offers specialized credentials, builds the pipeline of future talent and drives professional competency development to advance the vitality, relevance and quality of the profession.

² The Chartered Institute of Management Accountants (CIMA), founded in 1919, is the world’s leading and largest professional body of management accountants, with members and students operating in 176 countries, working at the heart of business. CIMA members and students work in industry, commerce, the public sector and not-for-profit organizations. CIMA works closely with employers and sponsors leading-edge research, constantly updating its qualification, professional experience requirements and continuing professional development to ensure it remains the employers’ choice when recruiting financially-trained business leaders.

- “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.”³

Background and History of Mandatory Audit Firm Rotation Proposals

In order to address each of these goals, it is important to provide some background, history and current status regarding the consideration of MAFR in the United States and other parts of the world.

Experience in the United States

During the legislative process leading to passage of the *Sarbanes-Oxley Act of 2002*, the concept of mandatory audit firm rotation was considered but not adopted. The U.S. Congress instead adopted provisions that significantly improved the quality of corporate governance, financial reporting, and auditing. These include establishing the Public Company Accounting Oversight Board (PCAOB), a nonprofit corporation, and charging it as the independent oversight authority over public company audits, strengthening audit committee oversight, and various measures to promote auditor independence.

Since its creation, the PCAOB has taken numerous positive actions to promote audit quality and auditor independence, and we believe it has been effective in these efforts. In order to explore additional steps to promote auditor skepticism, independence and objectivity, the PCAOB, in August 2011, issued a Concept Release that included the possibility of MAFR. The PCAOB held a series of public hearings and received nearly 700 comment letters on the Concept Release. Over ninety percent of those who commented opposed MAFR.⁴ It is clear from the record that such a requirement would be costly and likely have significant negative impacts on audit quality with uncertain benefits. Among the most notable comments is a letter from the Government Accountability Office (GAO) in which it comments, “Even if the PCAOB could clearly establish that a lack of independence or objectivity is causing audit quality problems, it is unclear that such a problem would be prevented or mitigated by a mandatory audit firm rotation requirement.”⁵

The U.S. House of Representatives also passed the *Audit Integrity and Job Protection Act* on July 8, 2013, prohibiting PCAOB’s rotation proposal on a vote of 321-62. The Senate also indicated its support through introduction of a companion bill. Upon conclusion of the House’s action, I issued a statement that included the following: “In the absence of evidence that mandatory audit firm rotation would enhance audit quality, the House has sent regulators in the United States and Europe a clear message that the time has come to end the debate over rotation. In Europe, there is a misimpression that the continued consideration of the PCAOB’s concept release means that the U.S. is headed toward adoption of a mandatory firm rotation

³ Michael Harber, “Mandatory rotation: what is the price for audit firms?”, *Moneyweb*, September 22, 2016, <http://www.moneyweb.co.za/moneyweb-opinion/mandatory-rotation-what-is-the-price-for-audit-firms/>.

⁴ <http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx>.

⁵ http://pcaobus.org/Rules/Rulemaking/Docket037/390_GAO.pdf.

requirement. Today's House vote will go a long way toward alleviating confusion and uncertainty for policy makers and stakeholders on both sides of the Atlantic.”⁶

Further, on February 5, 2014, in abandoning the concept of MAFR in the United States, PCAOB Chairman James Doty told the U.S. Securities and Exchange Commission, “We don’t have an active project or work going on within the board to move forward on a term limit for auditors. ... We nevertheless will continue to think about what impacts independence. There may be a change of focus here.”⁷

Experience in the European Union

The European Union adopted MAFR in May 2014 with an effective date of 17 June 2016 for most companies. Those rules require “public interest entities – which include listed companies, banks, and insurance companies – change auditors after 10 years. This period can be extended to 20 years if the audit is put out for bid, or 24 years in instances of joint audits, in which more than one firm conducts the audit.” Further, the rules also include a “prohibition on EU audit firms from providing several nonaudit services to their clients, including certain tax, consulting, and advisory services. Firms will be banned from providing services to audit clients linked to management or decision-making, as well as many services linked to financing, capital structure, and investment strategy of the audited entity.” And finally, there is “a prohibition on contractual clauses in loan agreements that require the audit to be performed by one of the Big Four firms.”⁸ Even before MAFR is fully implemented in Europe, the *Financial Times* analyzed the FTSE 100 and found there has been little change in the composition of the audit market and that only two companies are not handled by the Big Four: “When they set out to reform the auditing industry, Europe’s regulators had two main objectives: improving competition and increasing choice. Now, after a record year of auditor switching by FTSE 100 companies, it seems they have achieved only one of them: competition has increased but choice has diminished.”⁹

Experience in the Rest of the World

International Federation of Accountants (IFAC) Chief Executive Officer Faye Choudhury noted that the same week that the IRBA announced its timeline for new MAFR requirements, the Monetary Authority of Singapore (MAS) announced its intention to discontinue the very same policy. He further notes that multiple other countries are in “various phases of implementing or discontinuing mandatory audit firm rotation, with similarly diverse objectives. South Korea, Argentina, and Brazil have implemented and discontinued the policy for certain sectors; the EU is now implementing with numerous variations across

⁶<http://www.aicpa.org/advocacy/cpaadvocate/2013/pages/housepasseslegislationbanningauditorrotationmandate.aspx>.

⁷ Emily Chasan, “PCAOB’s Auditor Rotation Project is Essentially Dead,” *The Wall Street Journal*, February 5, 2014, <http://blogs.wsj.com/cfo/2014/02/05/pcaobs-auditor-rotation-project-is-essentially-dead/>.

⁸ <http://www.journalofaccountancy.com/news/2014/may/201410229.html#sthash.dndmzqCl.dpuf>.

⁹ Harriet Agnew, “Audit merry-go-round increases competition but limits choice”, *Financial Times*, January 17, 2016, <https://www.ft.com/content/a5ba734a-b577-11e5-8358-9a82b43f6b2f>.

Member States – some of which, such as Spain and Italy, had previously implemented and discontinued the policy.”¹⁰

The Association Strongly Opposes MAFR

The Association strongly opposes MAFR and further believes that it may have a negative impact on audit quality, increase market concentration to a more limited number of auditing firms, and will hinder, rather than promote, transformation of the profession.

The Association notes that Mervyn King, Chairman of the King Commission, and Parmi Natesan, Executive of the Centre for Corporate Governance, write on behalf of The Institute of Directors in Southern Africa (IoDSA) “that auditor independence, in particular, is achieved through other robust mechanisms already in place in South Africa, namely:

- “the appointment of the auditor by the shareholders of the company at the AGM [annual general meeting];
- “statutorily appointed independent Audit Committees having oversight over auditor independence; and
- “audit partner rotation every 5 years.”¹¹

The Association concurs with these IoDSA conclusions and with each of the concerns raised as well. Below is an analysis of the most significant factors supporting our longstanding position.

Negative Impact on Audit Quality

An auditor’s independence, objectivity, and professional skepticism are critical to the execution of high quality audits. We recognize, however, that these are not the only considerations impacting audit quality. Audit quality also depends, in part, on a combination of the auditor’s risk analysis and audit methodology; the auditor’s skill, experience, and technical support specific to the industry; the audit tools used, and even the relevant jurisdictions’ auditing standards.

Importantly, the various factors driving audit quality must be considered not in isolation, but as a whole. The IRBA has noted “the importance of a sustainable and viable auditing profession in South Africa.”¹² MAFR could affect the profession’s ability to attract and retain talent, which would have an obvious impact on audit quality and on the profession in South Africa, if realized. Professionals within firms must develop specific competencies, including industry-specific expertise. Imposing MAFR could have the unintended consequence of impairing the profession’s ability to develop industry-specific expertise and, according to research by multiple researchers, potentially have a detrimental effect on audit quality.¹³

¹⁰ Faye Choudhury, “Mandatory Audit Firm Rotation-Are We Going ‘Round in Circles?’”, October 18, 2016, <http://www.ifac.org/global-knowledge-gateway/viewpoints/mandatory-audit-firm-rotation-are-we-going-round-circles>

¹¹ Mervyn King, Chairman King Committee, and Parmi Natesan, Executive Centre for Corporate Governance, Letter to the IRBA Board, 27 September 2016.

¹² IRBA Consultation Paper, p.9, October 25, 2016.

¹³ See, *Audit Quality Attributes, Client Size and Cost of Capital*, Guy D. Fernando, Randal J. Elder, and Ahmed

Causes Loss of Institutional Knowledge and Experience

Audit risk is reduced and audits are most effective when the audit firm has a strong understanding of the audited organization's operations. Such institutional knowledge and experience is cumulative, and over time, the audit firm's ability to efficiently perform an effective audit improves. MAFR, by definition, would cut off this institutional knowledge and firm experience with the audited organization, which could impact audit quality. Several academic studies, both within and outside the United States, have come to similar conclusions noting that a reduction in audit quality can result from the auditor lacking a solid base of experience and understanding of a business.¹⁴ Importantly, rotating the audit partner every five years, as is required of public company audits in the United States, maintains the firm's institutional knowledge and allows for new and fresh interactions that truly drive the audit partner and audit committee relationships.

Audits of multi-national organizations could be significantly more impacted by MAFR than domestic-only organizations. These organizations already must navigate increasingly complex regulatory environments and various accounting standards, both in terms of transactions and organizational structures. For these types of audits, the loss of specialized expertise, institutional knowledge and experience with the multi-national environment resulting from MAFR would be severe. It would present a material cost to the company and to the capital markets. And, importantly, staggered MAFR terms in various countries could create additional inefficiencies and present severe logistical challenges for multi-national audit engagements. Indeed, Choudhury also noted, "for global businesses trying to coordinate their audits worldwide, the complexity, costs, and risks of trying to navigate this patchwork regulatory environment detracts from their focus on obtaining the highest quality audit – possibly even going so far as necessitating multiple auditors in different jurisdictions to meet different rotation requirements."¹⁵

Without a doubt, companies already voluntarily change auditors from time to time, and auditors and companies manage these transitions. Such changes are significantly different from those imposed by MAFR. Specifically, MAFR takes the decision to change auditors away from audit committees. In a voluntary situation, the audit committee has generally weighed the costs and benefits of its decision and stands prepared to invest appropriate internal resources to identify and evaluate potential new audit firms and inform the newly

M. Abdel-Meguid (April 2008); *Auditor Industry Specialization and Earnings Quality*, Steven Balsam, Jagan Krishnan, and Joon S. Yang (September 2003); *Auditor Industry Specialization, Auditor Changes, and Accounting Restatements*, Accounting Horizons, Vol. 22, No. 4, Robin N. Romanus, John J. Maher, and Damon M. Fleming (2008); *Earnings Quality: Some Evidence on the Role of Auditor Tenure and Auditors' Industry Expertise*, Ferdinand A. Gul, Simon Yu Kit Fung, and Bikki Jaggi (March 2009).

¹⁴ See, *A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy*, SDA Bocconi University (Milan-Italy) M. Cameran, M. Livatino, and N. Pecchiari A. Viganò (2003); *Auditor Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge*, Bin Srinidhi, Sidney Leung, and Ferdinand A Gul (April 2010); "Required Study on the Potential Effects of Mandatory Audit Firm Rotation" GAO Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services (November 2003).

¹⁵ Faye Choudhury, "Mandatory Audit Firm Rotation-Are We Going 'Round in Circles?'" October 18, 2016, <http://www.ifac.org/global-knowledge-gateway/viewpoints/mandatory-audit-firm-rotation-are-we-going-round-circles>.

selected firm about the company's operations and accounting policies and practices. MAFR, however, could result in circumstances where the company under-invests in this effort, potentially because of competing demands on company resources, such as a significant economic or political event that impacts the company's operations.

Academic research has also suggested the potential for higher audit risk during the first year of the audit engagement.¹⁶ Companies and auditors currently manage these risks with voluntary changes in audit firms. MAFR would cause an increase in this effort, with no indication that commensurate benefits would accrue to the company or investors, or that audit quality would improve.

Limits Auditor Specialization

Many audit firms have established specialized expertise in certain market sectors. This specialized expertise is critical to the execution of high quality audits, especially in complex industries and accounting areas.¹⁷ MAFR could hinder this knowledge development and limit firms' ability to provide high quality audits. Importantly, with the imposition of MAFR, firms without a currently significant client base in a given specialized industry would be discouraged from investing the resources to develop such expertise. Reducing the ability of the profession to develop and maintain specialized expertise would reduce audit quality, to the ultimate detriment of public companies and their investors.

Creates Resource Strains

New audit engagements also require higher levels of firm resources to help provide the audit firm with an understanding of the company's business and operations. New engagements require access to an array of company personnel to assist the audit firm in understanding the company and its environment, including its internal controls over financial reporting. Audit committees must spend time soliciting proposals from several firms, evaluating proposals and making a hiring decision, and overseeing the audit firm transition. Overall, the level of resource commitment for a new audit engagement is increased for all parties involved and MAFR could further strain each of these resources.

Could Increase Audit Market Concentration

The IRBA has suggested that MAFR "will address market concentration of audit services and create a more competitive environment, which will positively influence audit quality."¹⁸ The

¹⁶ *Audit Firm Tenure and Fraudulent Financial Reporting*. Auditing: A Journal of Practice and Theory, Vol. 23, Issue 2. Carcello, J.V. and Nagy, A.L. (September 2004).

¹⁷ See, *Earnings Quality: Some Evidence on the Role of Auditor Tenure and Auditors' Industry Expertise*, Ferdinand A. Gul, Simon Yu Kit Fung, and Bikki Jaggi (March 2009); *Auditor Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge*, Bin Srinidhi, Sidney Leung, and Ferdinand A Gul (April 2010); *Does auditor tenure improve audit quality? Moderating Effects of Industry Specialization and Fee Dependence*, Chee-Yeow Lim, Singapore Management University, and Hun-Tong Tan (September 2009).

¹⁸ Michael Harber, "Mandatory rotation: what is the price for audit firms?", *Moneyweb*, 22 September, 2016, <http://www.moneyweb.co.za/moneyweb-opinion/mandatory-rotation-what-is-the-price-for-audit-firms/>.

Association is very concerned that MAFR could do the exact opposite – increase concentration and decrease the number of auditor firms competing for new engagements.¹⁹

One of the most practical concerns is the limited number of audit firms available from which to choose. The GAO noted in its 2003 study, “Some companies, especially those with geographically diverse operations or those operating in certain industries, may be somewhat limited in the choice of auditing firms capable of performing the audit. Not all audit firms have offices or staff located in all the geographic areas, whether domestically or internationally, where the clients conduct their operations, nor do all audit firms have personnel with certain industry knowledge to be able to perform audits of clients that operate in specific environments.”²⁰

When considering MAFR in the U.S., the PCAOB’s Standing Advisory Group noted that MAFR could cause some audit firms with smaller public company audit practices to abandon their public practice and focus instead on private company audits.²¹ (In South Africa this would equate to smaller listed companies and other non-listed entities.) We believe that smaller audit firms could decide not to serve the listed company market because they are not willing or able to absorb the additional administrative and financial costs associated with MAFR, including the costs of tendering, transitioning, as well as engaging the appropriate in-house expertise to compete for regularly rotating engagements. The Association encourages the IRBA to carefully consider the harmful impact on small businesses, non-governmental organizations, and other organizations needing audit services.

Further, the Association believes some multi-disciplinary firms could abandon their listed company audit practice in favor of providing non-audit services to those companies. Similar to the impact on smaller audit firms, the Association believes this would negatively affect the number and quality of participants in the listed company audit market.

Cost of Mandatory Audit Firm Rotation on Audit Firms and Companies

The Association strongly agrees with the conclusion in the study from the Korean Audit Market in 2010 which states, “imposing mandatory audit firm limits on the duration of the auditor-client relationship may result in unintended costs without improvements in audit quality.”²²

In conjunction with passage of the *Sarbanes-Oxley Act* in 2002, Congress tasked the GAO to explore and comment on the mandatory firm rotation concept. Issued in 2003, the GAO study

¹⁹ *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market*. Soo Young Kwon, Young Deok Lim, and Roger Simnett (November 2010).

²⁰ United States Government Accountability Office, Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, PUBLIC ACCOUNTING FIRMS: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO-04-216, November 2003.

²¹ PCAOB, Transcript Excerpt: Standing Advisory Group Meeting, http://pcaobus.org/Rules/Rulemaking/Docket037/11092011_SAG_Independence_Transcript.pdf (November 9, 2011).

²² *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market*. Soo Young Kwon, Young Deok Lim, and Roger Simnett (November 2010).

did not support mandatory firm rotation and concluded that its benefits were hard to predict while its costs (including financial as well as loss of institutional knowledge) were fairly certain. The GAO's survey results show that an MAFR environment would lead to more costly audits. Specifically, "initial year audit costs under mandatory audit firm rotation would increase by more than 20 percent over subsequent year costs to acquire the necessary knowledge of the public company" and "companies estimated that under mandatory audit firm rotation, they would incur auditor selection costs and additional audit support costs totaling at least 17 percent or higher as a percentage of initial year audit fees."²³ Although the markets in South Africa may differ from the United States, the Association maintains that the overall business climate is more – not less – complex today than in 2003, and that these costs are likely to be significant in a MAFR environment.

Limits the Audit Committee's Ability to Determine the Best Audit Firm for the Company

Along with the rest of the company's board of directors, the audit committee acts as a watchdog of management's actions, protecting investors. The chief function of an audit committee is to oversee the external audit process, including the selection of the appropriate audit firm to conduct the audit. MAFR undermines this key audit committee responsibility and specifically eliminates the one firm that the audit committee previously decided was best able to provide the audit services needed by the company. Constraining audit committees in their selection of audit firms is counter to enabling them to do their most important work – obtain the highest quality audit in the most efficient way.

Reducing choices of potential audit firms could be exacerbated by other constraints, such as independence restrictions that would prevent some firms from being eligible to conduct the audit. Other constraints could include the geographical reach, proximity, expertise, and specialization of available audit firms. As a result of these constraints, MAFR may force an audit committee to select a firm that may not be best suited to meet the company's audit requirements. Additionally, the company could be required to change some or all of its other financial service providers (e.g., tax) to comply with independence requirements. In fact, Section 90(2) of the South Africa *Companies Act*,²⁴ prohibits companies from hiring the same professional services firm to perform its audit and certain non-audit services. Performing any of these services by an audit firm, or a network-affiliated firm, would result in disqualifying that firm from the audit for a period of five years under simultaneous application of the *Companies Act* and an MAFR regime. And even if an exception were adopted, the time and resources required to manage all of these transitions would be significant with no demonstrable benefit.

Limits Ability to Attract and Retain Talent

The Association believes that the profession's ability to provide high-quality audits is contingent upon the talent attracted to and retained by accounting firms. Collectively, the

²³ United States Government Accountability Office, Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, PUBLIC ACCOUNTING FIRMS: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO-04-216, November 2003.

²⁴ Companies Act, 2008 (Act No. 71 of 2008), <https://www.acts.co.za/companies-act-2008/index.html>

Association and its related organizations work diligently to attract top students into the profession and to work with firm leaders to strengthen their strategies to retain, develop, and advance diverse talent within their organizations.

The U.S. Department of the Treasury's Advisory Committee on the Auditing Profession stated in its 2008 report, "To ensure its viability and resilience and its ability to meet the needs of investors, the public company auditing profession needs to continue to attract and develop professionals at all levels who are prepared to perform high quality audits in this dynamic environment."²⁵ World markets have only continued to increase in complexity since 2008. The Association believes that audit quality relies heavily upon the attractiveness of the audit profession as a career choice for top talent individuals, which comes in the form of multiple dimensions diversity. High-quality professionals are needed to conduct audits, particularly within highly specialized industries and multi-national regulatory environments, both of which are attractive to young professionals today.

The Association is committed to growing a diverse talent pool for the auditing profession, but believes that MAFR creates additional significant challenges in attracting and developing professionals at all levels to perform high quality audits. Importantly, because the Association also supports the IRBA's goal of enhancing transformation within the profession, we encourage efforts to make the profession more attractive by reducing even potential perceived barriers such as reduced career opportunities that may occur under MAFR. Profession-wide efforts confirm the profession's commitment to achieving transformation and becoming more diverse.

Diversity in the Accounting Profession

The AICPA and CIMA, as the predecessor organizations to the Association, have long traditions in upholding high standards for accounting professionals and working in the public interest. Those traditions are founded in rigorous entry examinations, licensing standards, and continuing professional education, each of which have a significant positive impact on audit quality and also encourage and promote diversity within the profession and its workforce. The Association believes that the past, current and future efforts within the accounting profession to reflect the global community provide the best approach to address and solve the issues facing business, government and public interests.

Conclusion

The Association believes that each of these factors demonstrates that MAFR should be rejected. It is clear from at least some of the regulatory regimes that have adopted it that MAFR has not had the intended benefits and its continuation is either being questioned or discontinued. MAFR takes away the key responsibility of audit committees which, along with the board of directors, are in the best position to watch management actions and ensure that companies are obtaining high quality audits to protect the investing public.

²⁵ Advisory Committee on the Auditing Profession, Final Report, Section VI Human Capital, VI:1, <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf> (October 2008).

The Association firmly believes MAFR is not in the public interest, risks harm to audit quality, would impose significant costs on businesses and shareholders without commensurate benefit, would be economically disruptive and create other negative consequences. For these reasons, we ask that the IRBA reject a move to require mandatory audit firm rotation.

Sincerely,

A handwritten signature in black ink, appearing to read "Barry C. Melancon". The signature is fluid and cursive, with a long horizontal stroke at the end.

Barry C. Melancon, CPA, CGMA
Chief Executive Officer

cc: comments@irba.co.za