



**ASSOCIATION FOR THE ADVANCEMENT OF BLACK ACCOUNTANTS OF SOUTHERN AFRICA**  
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**NPO 045-145**

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Dear Sir and Madam

**RE: MANDATORY AUDIT FIRM ROTATION (“MAFR”)**

The invitation by Hon. YI Carrim, MP, Chairperson of the Standing Committee of Finance (National Assembly) for comments on the Independent Regulatory Board for Auditors (“IRBA”) Consultation Paper on Mandatory Audit Firm Rotation (MAFR) published on 25 October 2016 refers, as a stakeholder, interested and affected party, herewith the comments and feedback by the Association for the Advancement of Black Accountants of Southern Africa (“ABASA”). The focus of the ABASA’s response is to address the questions as outlined in Sections 1 and 7 of the IRBA consultation paper, which requests our views on:

1. Whether the requirement for MAFR is clear and comprehensive;
2. How best it [MAFR] should be implemented to accomplish effectively the primary objective of strengthening auditor independence to enhance audit quality;
3. Quantify the potential costs of implementing MAFR in the listed company/audit firm;
4. Whether the scope of MAFR should be extended beyond listed companies to other entities that operate in public interest;
5. Any other comments on the implementation of MAFR

**Context**

The IRBA highlights in its Consultation Paper, the extensive reliance South Africa has on external capital. Amongst the elements that create an environment where foreign direct investment can occur is a reliable and appropriately regulated capital market. The paper further sites how recent global corporate and audit failures have investors and the public at large requiring greater transparency and to be more informed to ensure that their rights are well protected. This has created an increase in what the public demands of auditors, creating

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sanctions against those who fail to report irregular activities and demanding increased auditor independence.

The above, coupled with requests and pronouncements pertaining to accounting and auditing profession from the Ministry of Finance over the years, have caused the IRBA to embark on determining avenues which will best strengthen the independence of auditors. Having considered the global implementation of Mandatory Audit Tendering and Joint Audits, the Board of the IRBA assessed the key threats to independence that had arisen from inspections findings, the length of audit tenure and familiarity threats between auditors and audit committee chairpersons as well as auditors and Chief Financial Officers. The Board thus resolved that MAFR, with the possibility in certain instances to implement MAFR adjacent to Joint Audits, is an effective means to respond to the potential risks and threats facing auditors, and shall ensure improved audit quality.

**1. Is the requirement for MAFR clear and comprehensive?**

The code of professional conduct requires that, upon undertaking a reporting assignment, practitioners should be independent in fact and appearance. The code further states that independence is a quality related to objectivity and integrity which enables a practitioner to apply unbiased judgement and objective considerations to the facts assessed in arriving at an opinion or decision.

The global crises that the IRBA Consultation Paper alludes to, did not stem from South Africa, yet had a direct impact on the relationships between South African corporates and their auditors owing to the magnitude thereof. The South African market has to date undertaken measures to safeguard against this risk, including amendments in the JSE requirements as well as enforcing stronger corporate governance principles through improvements in the King code.

It therefore behoves us to postulate that the need to address auditor independence stems more from **perceived** threats to independence versus **actual** threats to independence experienced. The foregoing conclusion is made in light of the details of the investigations reports not being available for public consumption.

Potential threats in the local context that have been identified include the market concentration of firms servicing listed entities, where it is stipulated in the Consultation Paper that “global companies that are large, complex and often in specialised industries are audited primarily by one of the “Big 4“. The potential collapse of one of these firms could therefore possibly disrupt stability in the financial market and damage investor confidence.”

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An investigation by Jackson, Moldrich and Roebuck (2008), found that “audit quality increases with audit firm tenure, when proxied by the propensity to issue a going-concern opinion, and is unaffected when proxied by the level of discretionary expenses.” This study, however, was based on an examination of **actual** audit quality, which was found to have a positive association with length of audit tenure, yet the study inherently brings to light that the **perception** of audit quality is not addressed, which may increase with audit firm rotation.

**2. How best should MAFR be implemented to accomplish effectively the primary objective of strengthening auditor independence to enhance audit quality?**

A study was conducted by Carrera, Gómez-Aguilar and Ruiz-Barbadillo (2009) of Spain, where firm rotation every 9 years was mandatory (albeit unenforced) between 1988 and 1995. It sought to assess whether the going concern opinions for audit reports of financially stressed companies in the early 1990’s as well as post 1995 were affected owing to MAFR. The study found no evidence to suggest that a mandatory rotation requirement is associated with a higher likelihood of issuing going-concern opinions.

The results further showed that the auditor’s incentives to protect their reputation positively impact the probability of issuing going-concern opinions, whilst incentives to retain existing clients did not impact on their decisions in both the mandatory rotation and post-mandatory rotation periods.

A South Korean study showed that where firms were mandatorily rotated, audit quality did not significantly change compared with long tenure audits experienced prior to rotation (Kwon, Lim & Simnett, 2014). Additional to this, a study of audit quality in the Florida municipal audit context show that audit firm rotation in the government audit environment has an indirect association with higher audit quality (Elder, Lowensohn & Reck, 2015).

Based on the above analyses, MAFR has not proven to improve auditor independence to enhance audit quality, thus would not be deemed to be the ideal vehicle to achieve this.

**3. Quantify the potential costs of implementing MAFR in the listed company/audit firm.**

ABASA has found that, upon analysing the effects of MAFR in Italy, the outgoing firm’s efforts nor quality do not increase, yet the final year fees are 7 percent higher than normal, thus indicating instances of opportunistic pricing (Cameran, Francis, Marra & Pettinicchio, 2015). The contrary is observed of the incoming auditors, whose fees are discounted by up to 16 percent, although they are likely to experience higher than estimated engagement hours in the

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initial year of service, which suggests lowballing. Subsequent fees charged by the new firm will exceed the initial discounted fees and at times are abnormally higher (Cameran, Francis, Marra & Pettinicchio, 2015).

This would not make the costs a trivial matter. Rather, higher costs would be acceptable if audit quality were improved, however evidence to the contrary is found (Cameran, Francis, Marra & Pettinicchio, 2015) i.e. the quality of earnings for audits in the first three years are lower than the later years of audit tenure. The evidence on Italy does not support the case for mandatory rotation owing to the costly nature of rotation as well as the juxtaposed improvement in quality with longer auditor tenure.

Further investigations performed in South Korea revealed that audit fees post the regulated period for MAFR were significantly higher than in the period prior to the regulation thereof, but are discounted compared to the fees imposed post the regulation of MAFR for continuing engagements (Kwon, Lim & Simnett, 2014).

The above scenarios may not place a rand value to the implications of MAFR, but certainly should bring to light the financial considerations that the implementation thereof should bare.

**4. Should the scope of MAFR should be extended beyond listed companies to other entities that operate in public interest?**

The IRBA Consultation Paper refers to concerns that have challenged governments and regulators globally since the financial crisis. These include, events that continue to shape regulatory reforms, global developments and the risk of failure of one of the major audit firms. The aforementioned concerns are not limited purely to listed entities, thus creating the case that any measure to address independence concern and thus improve audit quality, should be implemented across all sectors where there is private and public interest.

The private interest element stems from the fact that, although private entities are by nature not required to publicly disclose their financial results, the reliance on these for a potential investor intending on acquiring a stake in these institutions is high. It therefore becomes important that a potential investor can place reliance on the internal preparation process as well as the external independent audit review process followed (if any).

The IRBA has the benefit of its inspections process and the resulting reports to use as a reference for identifying audit quality issues within the South African market. With the lack of access to this information, it is not easy to conclude that independence issues lie exclusively in listed entities. Further analysis of the pervasiveness of independence and thus audit quality concerns across all industries and for all entity types and sizes, may shed light on the need for

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the intervention to perhaps rather be focused on specific entity types, rather than be applied as a blanket-wide approach.

**5. Any other comments on the implementation of MAFR**

A review of 26 reports by regulators or other representative bodies from around the world reveals that 22 conclude that MAFR is not beneficial and 4 are in favour thereof. Furthermore, a majority of a sample of 33 academic studies did not support mandatory audit firm rotation, therefore an alternative means to ensuring increased perceived auditor independence should be pursued.

Findings of the South Africa Report on the Observance of Standards and Codes (2013) (“ROSC”) indicate that the “IRBA contributes to strengthened auditing practices through providing support to auditors to apply stipulated international auditing and ethics standards and conducting quality reviews.” We agree with the strengthening of the role of the IRBA as this will ensure improved quality of financial statements, through improved approach, methodology, more rigorous inspections to offer greater value with the enhancement of the independence of the committees involved in quality reviews and disciplinary processes. Punitive measures should be introduced as a means to deter unethical behaviour, with clearly defined and implemented follow-up mechanisms followed for reportable irregularities submitted.

The ROSC further advocates for the strengthening of the IRBA inspection methodology and independence of its Inspection and Investigation Committees in line with international good practice. The inspection methodology should focus on reviewing all applicable auditing standards reducing the inspection team’s dependence on firm internal reviews to select review files. More robust risk analysis should be conducted when choosing engagements and particular areas within an engagement review.

Improvement is needed in the follow-up process of reportable irregularities submitted by the IRBA to the different regulators. This is to ensure that corrective actions are taken. Furthermore, the proposed legislation to regulate both professional accountancy organizations and an audit regulator should require review of financial statements of large public interest entities for compliance with financial reporting requirements.

As an organization, we advocate for the transformation of the profession across the board, to better reflect the demographics of the country. This includes the introduction of new players in the market, allowing the ability of smaller and medium-sized players to service large clients and transformation of the demographics of the Big 4 firms, medium sized and small firms to have partnership bodies and ownership structures that are on par with the demographics of South Africa.

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In turn, we recommend that the small and medium practices (“SMPs”) should be encouraged to strengthen their resources and capabilities in order to be competitive in providing professional services. The SMPs that want to be competitive in the market place need to raise their professional capabilities through expansion. It is worth noting that if an accounting firm is not a viable size, it is difficult for that firm to continuously support enhancement of professional capabilities. Merger of a number of SMPs and/or networking with regional/international network of accounting firms may be the most effective vehicle for SMP expansion in South Africa.

The SMPs should also give more thought to how else they could strengthen resources and capabilities, and how they could focus on alternative service offerings in niche and high value-creating areas.

Furthermore, we believe that the IRBA can do much more to assist in ensuring that there are more black partners who are accredited to service JSE listed entities and the likes. This assistance includes, conducting more frequent partner audit file assessments, not only with review findings, but with recommended actions to address the finding, setting transformation targets of firms, with penalties incurred for non-compliance, these targets including the encouragement of “shadow partners” of listed and other public companies, who through mentorship from a fellow partner and exposure to a more complex entity, gain experience in ensuring accreditation.

Kind Regards

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Ms Gugu Ncube  
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