The Committee Secretaries
Ms T Sepanya & Mr A Wicomb
Standing Committee on Finance
c/o National Assembly
Parliament of the Republic of South Africa

E-mail: tsepanya@parliament.gov.za

and email: awicomb@parliament.gov.za

13 February 2017

Dear Standing Committee on Finance Members

Re: Invitation for Public Comment: Mandatory Audit Firm Rotation

We welcome the opportunity as a major stakeholder for the auditing profession to respond to the invitation by the Standing Committee on Finance ("the Committee") to comment on the proposed course of action by the Independent Regulatory Board for Auditors (the "IRBA") to introduce Mandatory Audit Firm Rotation ("MAFR").

As a significant role-player in the auditing profession, PricewaterhouseCoopers ("we" or "us") would appreciate being afforded the opportunity to orally address the Committee on the topic of MAFR and some of the issues addressed in this letter.

The IRBA indicated that "*the main reasons why the Board must consider further measures are the following:*

- *It will strengthen auditor independence and so protect the public and investors, which is part of the IRBA's strategy;*
- *It will address market concentration of audit services and create a more competitive environment, which will positively influence audit quality; and*
- *It will promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets, provided they are competent to audit in those markets.*"

We understand from interactions with the IRBA that it has accepted that MAFR will not address the very critical and important imperative of transformation. Given this change in the original stance by IRBA, we urge the committee to place the important issue of transformation of the profession on the agenda for a future meeting and we would gladly accept an invitation to participate in a debate of this nature via oral and written submissions. As a firm we believe that transformation is a critical foundational pillar in the long term sustainability of the profession in South Africa.

In this letter, we highlight 6 themes which we believe shows that MAFR is not feasible or warranted in the South African market, nor will it achieve the outcomes the IRBA believes it will. To the contrary, we believe that MAFR will further constrict an over-regulated market and concentrate the market further.

PricewaterhouseCoopers Inc., 2 Eglin Road, Sunninghill 2157, Private Bag X36, Sunninghill 2157, South Africa
T: +27 (11) 797 4000, F: +27 (11) 797 5800, www.pwc.co.za

1. The South African Capital Markets

We believe that the audit plays a critical role in the effective functioning of the capital markets by building trust between companies and their shareholders and underpinning the delivery of reliable, relevant and timely information to them about the organisation in which they have invested. We also believe in, and support, the IRBA's mission of protecting the financial interests of the South African public and international investors in South Africa.

We believe that in South Africa we currently have a properly functioning capital market. This is evidenced in the views given by the World Economic Forum ("WEF") on South Africa on our highly regarded auditing and reporting standards, a strong JSE regulator, corporate boards that have a strong ability to carry out their responsibilities and most of all, a world class corporate governance framework.

2. Independence

In South Africa there are several positive measures in place that contribute to auditor independence. These include:

a. The IRBA Code of Professional Conduct;
b. Audit partner rotation as set out in the Companies Act, 2008, ("Companies Act");
c. Cooling-off periods for the auditor as set out in the Companies Act;
d. Statutory obligation of the Audit Committee in terms of the Companies Act to ensure auditor independence;
e. Appointment of the auditor by shareholders at the annual general meeting as set out in the Companies Act;
f. Disclosure of audit tenure;
g. Additional disclosure which has now been brought into the Report on Corporate Governance for South Africa 2016, ("King IV");
h. International Standards on Auditing; and
i. Revisions and additions to the auditor reporting standards which have resulted in a significantly expanded auditor report including the communication of Key Audit Matters.

<u>We are not convinced that there is credible and empirical evidence that supports the decision to implement MAFR, or that it is reasonable to conclude that it will strengthen auditor independence, let alone the question whether or not there is a failure by the current measures to protect auditor independence.</u> The information available from the IRBA does not seem to support the decision made, nor is the decision based on sound reasons. Given the low instances of independence breaches documented and sanctioned by the IRBA, the adverse effect of MAFR does not appear proportionate to the objective it seeks to achieve, and the purpose may be achieved by less restrictive means, yet probably more impactful.

To the contrary, a study was performed in Spain (where MAFR was abandoned) on the impact of auditor independence. The study concluded that it could "not find any proof that MAFR increased auditor independence" *(Ruiz-Barbadilo).* In the discussions on auditor independence (including the IRBA's consultation paper), reference is almost always made to audit failures and therefore audit quality. It is worth noting that studies have shown that audit failures are more prevalent during the first three years of an audit engagement, indicating a significant learning curve in the first years of the engagement for the external auditor, especially with large public companies. *(Carcello and Nagy)*

This is not surprising, due to the loss of the auditing firm's significant cumulative knowledge of the company's business, people, processes, controls and risks, putting audit quality at significant risk. An auditor's familiarity with the business and the environment in which it operates are essential to a quality audit – this should not be equated with over-familiarity with management. Any risk, or perceived risk, of over-familiarity with management should be addressed through a partner (and senior member) rotation regime.

The risk of audit failure may be only heightened by the number of IFRS standards that are going to be implemented over the coming years – i.e. Revenue recognition, Leases and Financial instruments (on hedging, impairment, classification and measurement), with more to come.

MAFR can be even more significant for companies of significant size or that operate in complex industries – such as large global conglomerates, financial institutions, oil and gas companies, etc. This coupled with the fact that certain firms in South Africa are stronger in certain sectors than others, only increases the importance of audit quality where a firm does not have the required industry knowledge in these sectors.

Notwithstanding the potential for different perspectives and while MAFR may be perceived to improve audit independence, it will not result in improved quality. In fact, it may worsen it. We would say that implementing MAFR with the objective of improving perceived auditor independence, would result in counterproductive effects.

It remains that there is no empirical evidence that MAFR increases auditor independence or reduces over-familiarity or enhances audit quality. On the contrary – the loss of knowledge, disruption and limitations on choice from companies are likely to have the opposite effects. MAFR reduces the quality of the audit. As there is no evidence to support the view that MAFR increases auditor independence, and should the IRBA continue to support this measure, we would request that the IRBA understands the unintended consequences of such a measure, including counterproductive time taken away from management to run the business, increased costs to companies and the audit firm, as well as the negative impact on retaining top talent in the audit profession.

During the financial crisis, banks in Singapore were devoting a substantial amount of time and resources towards heightened vigilance – a period of unprecedented stress in the global financial markets. The regulator temporarily suspended the requirement for banks to change their audit firms after five years, to minimize the disruption that could arise when appointing a new audit firm. The regulator believed that the banks would benefit from some degree of audit continuity during these challenging times. More recently, the regulator in Singapore, the Monetary Authority of Singapore ("MAS"), announced in September 2016 that it was discontinuing MAFR and had set out other proposed safeguards, instead of MAFR, to enhance the independence and quality of audits. This included increased expectations of audit committees set out in Corporate Governance guidelines and increased scope of partner rotation and cooling off requirements amongst others. Both of these requirements already exist in South Africa. Furthermore the regulator in Singapore found that international research does "*not provide conclusive evidence linking mandatory firm rotation with an improvement in audit quality*", and that from their observations and feedback from stakeholders, "*there are also negative consequences associated with frequent rotation of external auditors*". The MAS specifically noted that the time to gain familiarity with large and complex entities and the loss of cumulative audit knowledge, could result in poorer audit quality and heightened audit risks in the early years of appointment.

In the UK, both the Competition and Markets Authority (CMA), previously known as the Competition Commission and the Financial Reporting Council, chose to introduce a mandatory tendering regime and not to introduce a mandatory audit firm rotation regime. It was noted that the imposition of mandatory audit firm rotation would reduce choice and could, potentially, have an adverse effect on audit quality. In addition, it is also worth remembering that the EU imposed MAFR on the UK when the UK regulators had already decided not to go ahead with a rotation regime.

In the US, and as part of the comments received by the Public Company Accounting Oversight Board (PCAOB), even those that didn't vehemently oppose the rotation concept and who acknowledged that working toward greater auditor independence was important, believed that MAFR was probably not the best way to do it.

The views given to the PCAOB by senior finance executives in the US on MAFR were that "*requiring companies to rotate their auditors would not provide any additional audit quality that wasn't already being provided by having lead audit partners rotate*". They believed that "*...the current five-year rotation requirement of lead audit partners captures substantially all the benefits of mandatory audit-firm rotation in a cost-effective manner, including the important attribute of a fresh set of sceptical eyes*". (PCAOB engagement with corporate sector)

The American Institute of Certified Public Accountants ("AICPA") believes that mandatory rotation would hinder the ability of the audit committees to oversee external auditors. The AICPA believes that audit committees should be further strengthened and encouraged to take a more proactive role in overseeing the independent auditor, which would include selecting (or retaining) the most qualified firm for the job. In a letter co-signed by 31 large public companies and large non-profit organisations in the US, they believed that mandatory firm rotation, if implemented, would harm corporate governance, reduce audit quality, diminish the role of audit committees, increase the incidence of undetected fraud and increase costs. As such, the AICPA has stated that they oppose MAFR, "*... due to costly and unintended consequences*". The US has decided not to implement MAFR.

We believe that audit committees play a fundamental role in overseeing the audit and management's relationship with the auditor. MAFR takes away the committee's freedom to decide which accounting firm best meets the needs of the company and its shareholders. Other than the independence procedures that the profession has in place under the IRBA Code of Professional Conduct, as well as additional individual firm specific independence procedures, the audit committee is entrusted with assessing the independence of the auditors.

We would welcome the opportunity to work together with the IRBA and other stakeholders to develop less intrusive measures than MAFR to achieve on IRBA's objectives of strengthening auditor independence. We have shared these suggestions with IRBA in our comment letters to them.

3. Audit market concentration

As it relates to audit market concentration, we once again strongly encourage the IRBA to share the basis of its findings and research and how MAFR can solve market concentration concerns. We believe, for the reasons set out below, that MAFR does not improve market concentration.

Based on observations of the UK audit market, the anticipated introduction of MAFR has made no substantive change to the Big-four firm market share. *"Despite changes to UK audit rules requiring more frequent audit tendering by listed companies, there has not been any substantive change in the share of FTSE 100 audits outside the Big-four firms. Even allowing for the audit switches which have been announced, but will not come through until subsequent year-ends, there has not been a radical shift." (The FTSE 100 Auditors Survey)* Similar observations are made on the FTSE 350: "In the last six months, there have been 25 audit tenders completed by FTSE 350 companies, and none have been awarded to a non-Big-four firm." *(Economia – April 2016).*

Based on the experiences found in Italy (a market that has applied MAFR from the 1970's to present), a study showed that MAFR had contributed significantly to the increased concentration of market share to the largest accounting firms, specifically the Big-four audit firms. *(SDA Bocconi Institute in Milan)*

<u>MAFR reduces competition in the audit market and restricts free market forces</u>, because the current auditor cannot compete, even if there is no better alternative. This is detrimental to a proper functioning capital markets environment. A review was performed by Copenhagen Economics, where it was concluded that MAFR may weaken competition, as companies gravitate towards a large accounting firm upon rotation, ultimately increasing concentration rather than reducing it. *('Review of the EC Impact Assessment' by Copenhagen Economics)*

At the Audit Committee Leadership Summit in 2014 (where European and North American Audit Committee Leadership Networks met with several audit committee members of Dutch companies to discuss their experiences in complying with the new Dutch law related to auditing), the view was given that *"... mid-tier firms have not yet benefited from the wave of tendering in the Dutch market"*.

Finally, in considering a report by the CMA in the UK where it undertook a comprehensive review of the market for large company audits, it was determined that MAFR was not an appropriate remedy for the following reasons:

- It would <u>restrict or distort competition</u> by restricting choice.
- It could <u>undermine good corporate governance</u> as companies and their shareholders should be able to appoint the audit firm and partner, best placed to meet their needs.
- It would <u>force companies to incur substantial switching costs</u> associated with appointing a new audit firm and result in loss of knowledge and understanding of a company that could enhance professional scepticism and audit quality.
- It could <u>interrupt the provision of non-audit services</u> (NAS) and reduce the likelihood of companies buying NAS from firms that also provided audit services and/or audit firms in bidding for non-audit work, resulting in a reduction of competition in the provision of NAS.
- It would <u>dampen competitive pressure</u> outside of the prescribed windows for switching.

It is clear from the above that MAFR has not changed the market concentration of the Big-four firms and has not created more opportunities for small/mid-tier audit firms. As such, we do not believe that MAFR would "*promote transformation by creating opportunities for small/mid-tier audit firms*".

4. The future of our profession

At PwC, we want the best people to join the profession and we want to hire the best people into the firm. As such we want to grow the pool of audit resources and skills in the country. MAFR will have a negative impact on the ability of the profession to attract and retain the best talent, which will have a negative impact on audit quality.

In South Africa, where a skills shortage exists, market pressure will potentially create a significant need for resources that don't exist. The frequent need to redeploy staff to new client accounts will require flexibility and additional resources, which could represent another threat to quality. There is a substantial human element in imposing MAFR.

At the Audit Committee Leadership Summit in 2014, the view was expressed that mid-tier firms are facing the same staffing issues affecting larger firms, and they are also grappling with the challenges of developing many proposals. The environment has been a strain for even the biggest firms. "*There's a level of fatigue in the profession. A lot of emotional energy is burned on these proposals. There's a limited capacity [on the part] of all firms*." This is not attractive to a new generation of auditors and financial professionals. This will only be exacerbated as accounting continues to be the top degree in demand by employers.

The impact on the transformation agenda could also be acute. In a market where the retention of skilled black professionals is a challenge, such measures may only serve to make the profession that much less attractive. With the increased pressure on audit fees and staff compensation, audit firms are already challenged to retain top talent with better prospects being offered in other markets and other industries.

5. Other markets compared to South Africa

In looking further at other markets and taking into account how developed our capital markets are, it is worth noting that of the top 20 markets ranked by financial market development by the WEF, of which South Africa is placed 11th, thirteen countries have decided not to adopt MAFR. Of the remaining six countries, five have had to adopt MAFR as a result of being part of the EU, all of whom had not applied MAFR before or had rejected it. The other one of the six was China.

The following are the top 20 countries ranked by financial market development by the WEF, and their position on MAFR.

New Zealand	1	Considered MAFR and rejected
Singapore	2	Considered, implemented and repealed
US	3	Considered MAFR and rejected
Hong Kong	4	Considered MAFR and rejected
Finland	5	Did not apply MAFR – now apply by virtue of being under the EU
Australia	6	Considered MAFR and rejected
Canada	7	Considered MAFR and rejected
Switzerland	8	Do not have MAFR
Norway	9	Did not apply MAFR – now apply by virtue of being under the EU
Sweden	10	Did not apply MAFR – now apply by virtue of being under the EU
South Africa	11	Do not have MAFR – now considering
Panama	12	Do not have MAFR
Malaysia	13	Considered MAFR and rejected
Luxembourg	14	Did not apply MAFR – now apply by virtue of being under the EU
China	15	Do apply MAFR
United Kingdom	16	Did not apply MAFR – now apply by virtue of being under the EU
Japan	17	Do not have MAFR
Guatemala	18	Do not have MAFR
Israel	19	Considered MAFR and rejected
Germany	20	Did not apply MAFR – now apply by virtue of being under the EU

Analysing this further, none of the top ten countries (i.e. all those ranked ahead of South Africa), including New Zealand, Singapore, Hong Kong, Australia, Canada and Switzerland apply MAFR, except for Finland, Norway and Sweden who are forced to apply MAFR by virtue of being part of the EU.

The point to make here is that, countries with a comparable capital market to South Africa have rejected MAFR. Furthermore, it is interesting to note that some of the countries that rank behind South Africa and that have decided to adopt MAFR, do not have a strong corporate governance framework and in some cases do not have audit committees, as we do in South Africa.

6. The importance of the audit committee

The Audit Committee fulfils an important role in a properly functioning capital market like South Africa in overseeing the external audit process and making the auditor appointment decision. The introduction of mandatory rotation in any form would force the Audit Committee of a company to change its auditor and would deprive it of its right to make an informed decision, by reducing the Audit Committee's choices while at the same time imposing costs and increasing audit risk. It conflicts with their statutory responsibilities under the Companies Act.

As such MAFR reduces the audit committee's ability to fully discharge its oversight responsibilities and in turn disenfranchises shareholders' ability to obtain the highest quality audit in the most efficient way. The introduction of mandatory rotation in any form would force the Audit Committee of a company to change its auditor and would deprive it of its right to make an informed decision, by reducing the Audit Committee's choices while at the same time imposing costs and increasing audit risk. As the Audit Committee would be forced to change auditors and select from a smaller base, it could find itself having to appoint an auditor that it judged would not be able to provide either the quality or cost efficiency of the existing firm.

For this reason, audit committees, and most of the investors they represent, have said to the PCAOB in the US, that they strongly oppose MAFR. In obtaining feedback from corporates Patrick Mulva, vice president and controller of ExxonMobil, stated that: "*Mandatory auditor rotation has been met with... universal rejection by board audit committees, including ExxonMobil's, as the proposal diminishes the audit committee's role in hiring, assessing and firing audit firms.*"

7. Conclusion

We believe that in South Africa we have a properly functioning capital market. The audit plays a critical role in the effective functioning of the capital markets by building trust between companies and their shareholders.

We at PwC are determined to respond positively to changing needs and opportunities that strengthen our capital markets, whilst at the same time not compromising on audit quality. Independence is an important factor in achieving on this.

We do not believe that MAFR increases auditor independence or enhances audit quality. There is no empirical evidence that it does. In addition, it does not improve market concentration. MAFR has been implemented and repealed in many other markets, due to not achieving on these objectives and in having unintended consequences including having counter effects than intended.

We also believe that as the Companies Act regulates the appointment and removal of auditors, audit partner rotation, and the responsibilities of the Audit Committee, the Companies Act is the most appropriate statute to also consider the implementation and regulation of MAFR. In addition, MAFR takes the rights away from shareholders to appoint the most appropriate auditor. As such, any consideration of MAFR in South Africa should be led by the Specialist Committee on Company Law ("SCCL"). This would require a proper consultation process being part of a Parliamentary process, with a public hearing open to impacted and affected parties. This would also include a vote on the amendments through the National Assembly and National Council of Provinces. We believe this is appropriate considering the significant impact of MAFR on our capital markets.

We would be pleased to be afforded the opportunity to discuss this further with you.

Yours sincerely

Dion Shango
Chief Executive Officer