



South African Reserve Bank
Office of the Deputy Governor
Kuben Naidoo

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Hon YI Carrim
Member of Parliament
Chairperson: Standing Committee on Finance
National Assembly
Parliament

Dear Hon YI Carrim

Comments by the South African Reserve Bank to the Standing Committee on Finance regarding the consultation paper published by the Independent Regulatory Board for Auditors on 25 October 2016 pertaining to mandatory audit firm rotation for submission

The South African Reserve Bank (SARB) would like to thank the Standing Committee on Finance (SCoF) for the opportunity to provide comments on the consultation paper released by the Independent Regulatory Board for Auditors (IRBA) on 25 October 2016 pertaining to mandatory audit firm rotation (MAFR).

High levels of audit quality, enhanced by auditor independence, are important prerequisites to sound reporting and oversight and hence crucial in assisting the SARB in fulfilling its mandate to achieve and maintain price stability in the interest of balanced and sustainable economic growth in South Africa – crucial specifically to the mission of the SARB's Bank Supervision Department (BSD) to promote the soundness of the domestic banking system in the interest of financial stability. As the SARB, we therefore welcome this opportunity to provide our comments on the consultation paper as we feel it is an important consideration in strengthening auditor independence in the country.

The SARB is not a listed entity and is therefore not directly affected by the proposals in the consultation paper. However, as the banking regulator, it is an interested party and will provide comments to this extent. As such, the comments provided will be specific to the matters affecting the SARB.

Auditor independence in the Bank Supervision Department

From a bank supervision perspective, audit quality and auditor independence play a significant role in contributing to a sound and stable banking system. Auditor independence is a key requirement for attaining the desired levels of audit quality. It is with this objective in mind that the Office of the Registrar of Banks (this Office) has charged the audit committees of banks with the responsibility of monitoring and assessing the independence of external auditors, as prescribed under section 64 of the Banks Act 94 of 1990 (Banks Act). In its guidance on the external audits of banks¹, the Basel Committee on Banking Supervision (BCBS) also noted that the audit committee should monitor and assess the independence of the external auditor. In addition, the BCBS expects the auditor of a bank to be objective and independent in both fact and appearance with respect to the bank – a requirement which the SARB considers to be of great importance.

The independence of auditors is a matter that should not only be considered by the auditors prior to accepting an audit assignment, but those charged with the governance of an entity should be expected to assess this as an important element in discharging their governance responsibilities. This would contribute favourably to the attainment of good corporate governance practices. It is for this reason that the SARB expects the responsibility for the nomination of an auditor to rest with audit committees of banks after thorough independence assessments have been made by the audit committees.

In addition, and also as a means to enforce some level of accountability, section 61 of the Banks Act provides that the Registrar of Banks must approve the appointment of an auditor before such an auditor can take up office. Such an appointment requires that the audit committee does a proper assessment of the suitability of the auditor to hold office, after which the Office of the Registrar of Banks would also do a fit and proper assessment prior to the approval of the auditor's appointment. The Banks Act also provides that the Registrar of Banks may appoint an auditor for a bank should the bank fail to do so within the prescribed period. In addition, the Registrar of Banks may refuse the reappointment of an auditor and withdraw any previous approval for the appointment of an auditor should there be reasonable grounds for such a refusal or withdrawal, as set out in the Banks Act. These may include factors related to tenure as well as any other ethical or professional reasons.

Comments on the consultation paper

The consultation paper by IRBA notes various threats to independence, including familiarity threats between chief financial officers (CFOs) and incumbent auditors as well as audit committee chairs and incumbent auditors, the long audit tenure of audit firms, and the independence of audit committee members. It is worth noting that MAFR would not necessarily address these concerns since, for example, for as long as the natural inclination of auditors is towards serving as CFOs, there will always be a familiarity threat between the auditor and the client, although it is acknowledged

¹ Basel Committee on Banking Supervision, *External audits of banks*, March 2014. Available at <http://www.bis.org/publ/bcbs280.pdf>.

that such a threat will be higher in the absence of audit firm rotation. Similarly, audit firm rotation would not prevent the appointment of a retired audit partner, who was a member of the audit team, as the chair of the audit committee. It may also be argued that long audit tenure may contribute to an improvement in audit quality as it would enable the auditor to familiarise themselves with the client to the extent that it would be more difficult for the client to deceive an auditor who is familiar with the client, which would in turn assist in strengthening controls at the client's organisation. It is not clear from the consultation paper how a lack of rotation of auditors impairs the independence of audit committees to the extent that existing auditors are inappropriately appointed, since the appointment of auditors rests with the shareholders of the company and not with the audit committee, whose responsibility is to make recommendations for the appointment of auditors.

The consultation paper notes the countries in which MAFR has been implemented. However, based on research performed by IRBA on these countries, it is not clear how MAFR has contributed to strengthening auditor independence; the SARB has found no empirical evidence that would appear to support such. It is also not clear i) how many countries in total had considered MAFR, ii) how many of those rejected it, including the reasons therefor, iii) what the reasons were for the countries that had decided to implement MAFR over other available options such as mandatory audit tendering and joint audits, and iv) how many countries had implemented MAFR and later rejected it, including the reasons that drove this decision. It is worth noting that several countries which had initially adopted MAFR and later withdrew this requirement², the latest being Singapore, cited reasons such as a lack of evidence to support improvements in audit quality and auditor independence, a loss of cumulative audit knowledge following audit firm rotation, an increase in the amount of time spent by management on educating new auditors during a transition, a lack of flexibility to enable companies to defer a rotation when it is inopportune (e.g. during a major transaction), a reduction of an audit firm's ability to accumulate sector/industry expertise, and increased complexity of audit compliance within global firms due to differing audit rotation requirements in various jurisdictions³. Should IRBA mandate audit firm rotation, a consideration of approaches to address these concerns should be made.

MAFR may also have a direct impact on the ability of audit committees to function independently and, in turn, may have a negative impact on the audit committee's accountability. This is because MAFR may be perceived to take away from audit committees their right to determine which auditor should be appointed, and should an auditor be appointed purely as a result of the requirement to rotate, the audit committees may absolve themselves from any accountability should the auditor not be able to deliver a quality audit. This may also weaken the oversight effectiveness of the audit committees over the auditors.

It is not clear at this point through which legislation IRBA intends to implement MAFR. Section 92 of the Companies Act 71 of 2008 (Companies Act) requires the rotation of audit partners every five years. Should MAFR be implemented outside of the Companies Act, for example through the Auditing Profession Act 26 of 2005, it

² Argentina, Canada, Czech Republic, Korea, Latvia, Singapore, Slovak Republic and Spain

³ Global Network of Director Institutes, *Mandatory audit firm rotation: GNDI perspective*, May 2013.

Available at <http://gndi.weebly.com/mandatory-audit-firm-rotation-gndi-perspective.html>.

may be inconsistent with the Companies Act; it would furthermore also be a requirement not for companies but for auditors. However, it is companies that appoint auditors, and should MAFR be a requirement, the SARB is of the view that it should be enacted through the Companies Act which already prescribes measures pertaining to auditor rotation and the role of audit committees.

It is important to bear in mind that imposing MAFR would likely fail to achieve the desired levels of auditor independence and could lead to undesirable unintended consequences. In the banking sector, for example, given the complexities of banks and the additional prudential requirements imposed on them, the audit of banks requires specialised knowledge and experience of applicable legislation and regulations. Audit resources with these relevant specialist skills and experience are a scarcity and care should be taken that auditor rotation does not result in the appointment of auditors without the desired level of skills and experience, which could in turn impair audit quality. This could be further exacerbated by the restriction on the appointment of an audit firm that had been providing non-audit services to the client for the five years preceding its appointment as auditor per section 90(2) of the Companies Act. It is common practice in banking that the audit firms which possess the desired skills and expertise, who are not the appointed auditors, provide non-audit services to the bank to assist with the implementation of the additional prudential requirements imposed by banking supervisors, which precludes them from appointment when the time for rotation arises, leaving as an option firms without the desired level of expertise. It is partly for this reason that the SARB requires the engagement of joint auditors for the audits of larger banks. This serves in part to enhance audit quality and independence as there will be some level of oversight between the joint auditors. This also contributes to audit quality in the sense that when one auditor is rotated, another remains, which facilitates continuity and makes for a less disruptive transition. MAFR would, however, make this requirement difficult to achieve for banks as there is already a limited number of firms with the required skills for the audit of banks and, coupled with the restriction on non-audit services, MAFR would make it challenging to appoint two auditors with the desired levels of expertise. It is important, therefore, that this trade-off between auditor independence and audit quality be managed appropriately.

IRBA considered three different options to address concerns around auditor independence, being MAFR, mandatory audit tendering, and joint audits. We do, however, feel that without changing the current legislative requirements relating to audit tenure, additional measures may be imposed to strengthen auditor independence without seeming to undermine the role of those charged with governance in an entity. One suggestion is to encourage large banking groups to consider engaging smaller audit firms to audit certain segments or entities in the group in addition to their joint auditors. Another would be to request more detailed disclosures by the audit committee regarding the appointment of an auditor as far as the assessment and decision-making processes were concerned. This would demonstrate the factors taken into account, which should include independence assessments, when deciding to appoint an auditor, be it a new or a continuing auditor. IRBA may then require mandatory rotation where there is specific evidence related to the entity in which weaknesses in auditor independence arose as a result of a lack of auditor rotation, or such concerns could be raised with the Registrar of Banks to consider intervening or even removing the auditor in question.

As mentioned in the introductory remarks of the consultation paper, South Africa has been ranked number 1 in the world for its audit and reporting standards for seven consecutive years. Notably, this does not mean that there is no room for improvement. Therefore, any measures that may further strengthen the country's audit and reporting standards will put the country in better stead. However, it is also important to ensure that such measures do not potentially weaken the country's ranking, whether actual or perceived. This would be achieved through ensuring that any decisions made affecting audit and reporting standards take place after due comprehensive research, taking into account the successes and failures of the countries that have gone before ours, noting the similarities and differences with these countries in assessing how suitable these countries' considerations were for South Africa's operating environment, and deciding on a carefully considered, tailored course of action which would result in harmonious and effective implementation with minimal undesirable outcomes and an overall increased improvement in audit practices.

The SARB acknowledges that there may be concerns related to auditor independence. However, it is also acknowledged that these concerns may not necessarily manifest equally in all sectors of the economy. As stated above, as the banking regulator, we have put specific measures in place to address potential independence concerns to ensure that bank audits are executed to the highest degree of quality and with the required levels of independence. It is therefore our view that the proposals on strengthening auditor independence should be tailored to the specific needs of the sectors concerned. As the banking regulator, we also place responsibility for the oversight of auditors and their performance on the audit committee and would regret to see that responsibility undermined.

In order to address these concerns, we strongly feel that IRBA should propose different approaches, as appropriate, depending on the areas of concern identified; a blanket approach for all listed entities is not the most ideal way to address this challenge. With specific reference to the entities regulated by the SARB, joint audits have been imposed for the larger banking groups as a measure of strengthening audit quality, oversight and independence. Taking this into account, it would be preferable if the entities subject to joint audits were exempted from MAFR. Alternatively, the period before mandatory rotation should be extended in order to prevent excessive prescription on the audit of such entities. No concerns relating to auditor independence have been brought to our attention, either by IRBA or any other party. Should IRBA have specific concerns relating to auditor independence in the sectors regulated by the SARB, we would welcome any engagement on such concerns, which would include a discussion on the best course of action required to address such.

The SARB welcomes the opportunity to also do an oral submission to the SCoF and as such requests to do a presentation to the SCoF at the most convenient time.

Should you have any queries or wish to discuss the contents of this letter, please do not hesitate to contact Mr N Maree (Acting Deputy Head) of this Office, at telephone number 012 313 4268 or e-mail address neil.maree@resbank.co.za.

Yours sincerely



Kuben Naidoo

Deputy Governor and Registrar of Banks

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