

## **EAST RAND MEMBER DISTRICT OF CHARTERED ACCOUNTANTS MAFR PROJECT**

**17 March 2017**

### **Presentation to the Standing Committee on Finance**

#### **Introduction**

The East Rand Member District of Chartered Accountants ("ERD") is a representative body, being the representative of numerous Chartered Accountants practicing as such on the East Rand of Johannesburg.

Several members of ERD submitted comments to the Independent Regulatory Board for Auditors ("IRBA") pursuant to the publication of the IRBA consultation paper on Mandatory Audit Firm Rotation ("MAFR") on 25 October 2016. Without exception, the members of ERD oppose the implementation as proposed by the IRBA, or at all.

#### **Purported Purpose of MAFR**

The IRBA purports to concentrate on the **independence of auditors** (see para 2.1, page 9). ERD submits that this assertion is based on an erroneous assumption that enduring audit appointments are the breeding ground of familiarity and a concomitant drop in standards and independence. It is ERD's submission that nothing could be further from the truth.

#### **The Audit Environment in South Africa**

The second Report on the Observance of Standards and Codes, Accounting and Auditing ("ROSC") was done by the World Bank at the request of the Minister of Finance in 2013. In ROSC, many recommendations were made – none of which even implied MAFR – and an assessment of progress was made from the first ROSC (of 2003) to the second ROSC (2013).

In this time, SA have Auditors achieved the number 1 position in the world for the strength of auditing and reporting standards for the fifth year in a row (IRBA Strategic Plan for the fiscal years 2016 to 2021, Executive Summary Page iv) and possibly 7 years in a row (IRBA 2016 Consultation Paper, p9, para 2.2)

The World Economic Forum ranked SA as number 1 out of 148 countries for its auditing standards for 2010, 2011, 2012, 2013 and 2014. (Para 5.1.5 P15)

## The Purpose of Regulation - is MAFR going to encourage Independence?

IRBA has made many comparisons, but has presented no documented studies to support its case. Overseas empirical evidence and study suggests MAFR is not going to encourage Independence!

**Are there Adverse Consequences of Mandatory Auditor Rotation? Evidence from the Italian Experience**, Mara Cameran, Jerr R. Francis, Antonio Marra and Angela Pettinicchio, Auditing: A Journal of Practice & Theory, Vol 34 No 1, Feb 2015, PP 1-24

These authors used empirical data from Italy as an example, there mandatory auditor rotation has been required since 1975. Their approach was to assess the case for mandatory audit rotation in the Italian context, by analyzing the arguments:-

1. *The Problem*: auditors with long tenure can develop close relationships with clients that impair their ability to be independent and that lower audit quality;
2. *The Solution*: a periodic change of auditors will bring a fresh perspective to the audit, leading to more skepticism, greater auditor objectivity, and improved audit quality.  
(Page 2)

This is similar to the IRBA position - In other words, lengthy cozy relationships are the problem, and MAFR is the solution.

The sample comprised 204 publicly listed companies in Italy audited by the Big 4 accounting firms over the period 2006 to 2009. The information used included publicly available data from consolidated annual reports AND proprietary information supplied by the Big 4 on actual audit engagement hours and audit fees for these entities. (page 7)

The findings:

1. MAFR in Italy led to abnormally higher fees by the outgoing auditor and to abnormally high fees by the incoming auditor, after a low initial engagement;
2. THUS MAFR is costly to clients;
3. The costs could be justified if there was an improvement in audit quality, however, the data suggests exactly the opposite: - a decline in the quality of audited earnings in the initial three years, following MAFR, when compared to later years of tenure.
4. This is consistent with what is called the "learning curve effect" and the extra effort required from the client to get the new auditor going.

The authors concluded that MAFR in Italy adversely affected audited earnings.

**The Effect of Auditor Rotation, Professional Scepticism, and Interactions with Managers on Audit Quality**, Kendall O Bowlin, Jessen L Hobson and M David Piercey, The Accounting Review, Vol 90, No4, 2015, pp1363 to 1393

These authors (representing three American Universities) examine the effect of MAFR on auditors adopting a "Skeptical Frame" i.e. they assess management representation of the business in terms of management's potential dishonesty. (P1364) The Audit standards applied in South Africa require an auditor to be skeptical in this sense.

Their findings suggest (p1365) that **"...a skeptical, presumptive doubt auditor assessment frame could actually lead to *increased* audit failure under mandatory audit or rotation."**

And

**"... professional skepticism requirements are intended to elevate auditors' skepticism of their clients and, ultimately, audit quality. We present evidence that the benefits of skepticism could be offset under mandatory auditor rotation."** (p1388)

**Does Mandatory Audit Firm Rotation Enhance Auditor Independence? Evidence from Spain,** Emiliano Ruiz-Barbadillo, Nieves Gomez-Aguilar and Nieves Carreira, Auditing: A Journal of Practice & Theory, Vol28, No1, May 2009, pp113 to 135

The stated aim of this paper was to examine the impact of MAFR on auditor independence. The report was based on a study of Spanish Archival material over the period 1991 to 2000, concerning financially distressed companies. In this period, Spain required MAFR from 1991 to 1994, and a comparison was made with specific references to going concern representations by auditors of these entities both under and not under MAFR conditions.

Using a sample of 1326 financially distressed Spanish Companies during the period 1991 to 2000, these authors stated **"...we find no evidence to suggest that a mandatory rotation requirement is associated with a higher propensity for auditors to issue a qualified audit opinion. ... We do however find a positive association between auditors' incentive to protect their reputation and the likelihood of issuing going-concern opinions, regardless of the existence of a mandatory rotation regime."** (P116)

And

**"We find no evidence to support the hypothesis that mandatory rotation mitigates the effect of economic dependence."** (P132)

The fact that South Africa persistently ranks at number 1 in the world for strength of auditing and reporting standards suggests that MAFR is a waste of time and money (both at a state or regulatory level, and at the level of the clients subjected to MAFR.

Christine Ramon, CFO Forum Chair, posted by CFO South Africa on 11 October 2016 :- **"There are a number of countries that have considered MAFR and decided not to implement this, most notably the USA, Japan, Australia, Canada and New Zealand. Countries that did implement it, but subsequently repealed it include South Korea, Singapore, Spain, Argentina and Brazil. Only the EU, UK, India and China have adopted MAFR, but there has not yet been any evidence to support the contention that it leads to better audit quality and auditor independence."**

### What of other measures?

1. **Audit committees** under the Companies Act - should determine if a rotation is needed.
2. **Shareholders** have rights to hire and fire auditors under the Companies Act - Shareholders and Audit Committee responsibility and rights under the Companies Act are completely abrogated under MAFR – it is inconsistent with the Companies Act.
3. **Directors'** responsibility to follow good governance under the Companies Act.
4. **Professional ethics and control** by the IRBA.

It is submitted that these controls/ measures are adequate to ensure auditor independence.

### Pros and Cons

#### Disadvantages of MAFR:

1. For multinationals or multi-jurisdictional entities, there may be a shortage of audit choice – limited to the big 4. MAFR will not encourage such entities to use the smaller firms (or transformation) as only the big 4 have the combination of global footprint, access to international expertise and industry specific knowledge;
2. Loss of industry and company specific knowledge, for arbitrary reason and at arbitrary times;
3. Not economically viable if there is no proven benefit, will be disadvantageous to the public;
4. It is not necessary given the prevalence of economic and institutional incentives for independence, combined with legislative intervention and standards.

#### Advantages of Long Tenure Audit Advisors:

1. Management changes over time, for new management it can be invaluable to have access to an audit team that knows history of the business, management teams and past objectives and performance;
2. Streamlined processes and concomitant cost saving to the client;
3. Doesn't over burden a profession identified in ROSC as being deficient by 22 thousand qualified people to perform financial reporting and auditing functions (ROSC 2013, page 2, paragraph 3 and page 20 paragraph 3.30);
4. Don't lose company and industry specific knowledge at arbitrary times;

#### Alternatives to MAFR:

1. Joint audits by two independent firms – eg MTN and the SA Banking Industry – which will allow opportunity for smaller (non-big 4) firms to participate and receive skills sharing and transfer;
2. Mandatory Audit Partner Rotation – already in place in certain instances;

3. Gender and racial representation of professional accountants is improving due to initiatives implemented by various stakeholders (ROSC Page 2 Paragraph 4);
4. Assess and amend the Companies Act to implement more rigorous audit requirements for low public interest score companies, or introduce other classifications of company;
5. Stock Exchange regulations;
6. Industry specific regulations – eg the banking and financial services sector;
7. Enhance the duties of audit committees under the Companies Act;
8. A consolidated plan to qualify more accountants (ROSC page 20 paragraph 3.30) with more programs like the Thuthuka Project.
9. Provide comprehensive supervision of the accountancy Profession (ROSC page 43 para 8.2 to 8.3);
10. Strengthen Audit quality review through the IRBA (ROSC page 44-46, paras 8.4 to 8.9);
11. Establish a legally backed review of financial statements (ROSC p46, para 8.10);
12. Broaden Professional education and training (ROSC page 47, paras 8.11 to 8.12);
13. Strengthen the Financial Reporting Standards Council (ROSC page 47, para 8.13);
14. Strengthen Professional Accountancy Organizations (ROSC page 47, para 8.14);
15. Introduce Limited Liability Partnerships for the Profession (ROSC page 47 para 8.15)
16. Make information accessible to the public (ROSC page 48 Para 8.16); and
17. Strengthen Small and Medium Size Practices (ROSC page 48 para 8.17).

## Conclusion

Effective regulation must promote a sustainable and viable auditing profession in South Africa (IRBA Strategic Plan for the fiscal years 2016 to 2021, para 3.1, p 2).

The IRBA has presented not a shred of evidence that independence and/or transformation will be benefited by MAFR and contribute to a sustainable profession.

**Dated at Bedfordview this 17<sup>th</sup> Day of March 2017**

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Chartered Accountants  
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