

9 May 2016

Mr Ken Siong
Technical Director
International Ethics Standards Board for Accountants
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017
USA

Dear Ken,

IESBA Limited Re-exposure of Proposed Changes to the Code Addressing the Long Association of Personnel with an Audit Client.

Thank you for the opportunity to comment on the IESBA's limited re-exposure draft of proposed changes to certain provisions of the Code addressing the long association of personnel with an audit client. We submit the feedback from the New Zealand Auditing and Assurance Standards Board (NZAuASB) in the attachment.

Whilst supportive of the project, the NZAuASB is concerned at the level of complexity that the proposals will bring to the rotation requirements and is concerned that the IESBA is moving away from establishing a strong principled approach to a complex rules based system. There is no magic number that will always be appropriate and undue focus on trying to establish those bright line rules detracts from the overarching requirement to evaluate at what stage the familiarity threat is so large that cooling off is required, and at what stage it is appropriate to rotate back on. This will be engagement specific and should be risk related rather than driven by the number of years on and off, as there may be significant changes in the accounting issues, in the management of the client and within the mix of partners available to the firm.

The NZAuASB urges the IESBA to consider a more simplified but equally robust framework to addressing familiarity threats, as overly complex rules may result in accidental breaches or provide opportunity for gaming to get around the rules. The NZAuASB would prefer a strong principled-based approach to establishing cooling off requirements and is concerned that these proposals will have unintended consequences, as explored in response to each question posed.

We commend IESBA for being responsive to the feedback received in response to the first exposure draft of proposed changes to the long association provisions in establishing requirements that achieve a balanced approach, that weighs up the issues of promoting audit quality, objectivity and professional scepticism while addressing familiarity threats. This is very relevant in the context of the vast array of jurisdictional requirements that establish rotation requirements. The proposal to recognise jurisdictional safeguards will make the provisions of the Code more practical to comply with. However, the NZAuASB is concerned that the conditions are too rules driven and lack a sound principle based position. The NZAuASB considers that this approach may have unintended consequences as explored in our response attached.

The NZAuASB has concerns that the proposals to extend the cooling off period of the engagement quality control reviewer lack a clear reason for change or empirical evidence to support that such a change is needed and could have unintended consequences, creating undue supply pressure. They should be considered in conjunction with the actions the IAASB is considering in the audit quality project looking at the competencies of the engagement quality control reviewer. These concerns are explored in more detail in the attachment. The NZAuASB is not in favour of these proposals.

In formulating this response, the NZAuASB sought input from New Zealand constituents. Feedback from New Zealand practitioners, from both larger and smaller firms, has been reflected in the attached submission.

Should you have any queries concerning our submission please contact either myself at the address details provided below or Sylvia van Dyk (sylvia.vandyk@xrb.govt.nz).

Yours sincerely,

A handwritten signature in blue ink, consisting of several overlapping loops and a long horizontal stroke extending to the right.

Neil Cherry
Chairman – New Zealand Auditing and Assurance Standards Board

Email: neil.cherry@xrb.govt.nz

Submission of the New Zealand Auditing and Assurance Standards Board

IESBA Limited Re-exposure of *Proposed Changes to the Code Addressing the Long Association of Personnel with an Audit Client*.

I Schedule of Responses to the IESBA's Specific Questions

1. Do respondents agree that the IESBA's proposal in paragraphs 290.150A and 290.150B regarding the cooling-off period for the EQCR for audits of PIEs (i.e., five years with respect to listed entities and three years with respect to PIEs other than listed entities) reflects an appropriate balance in the public interest between:

- a) Addressing the need for a robust safeguard to ensure a “fresh look” given the important role of the EQCR on the audit engagement and the EQCR's familiarity with the audit issues; and
- b) Having regard to the practical consequences of implementation given the large numbers of small entities defined as PIEs around the world and the generally more limited availability of individuals able to serve in an EQCR role?

If not, what alternative proposal might better address the need for this balance?

Response:

- a) The NZAuASB agrees that the Code should create robust safeguards to maintain the independence of the EQCR, noting the importance of the role of the EQCR. The NZAuASB, as articulated in response to the 2014 IESBA exposure draft, while not underestimating the role of the EQCR and other key audit partners (KAP), is of the view that the EQCR and other KAP roles differs from the engagement partner and that the IESBA should consider the appropriate and balanced response to the threats created by each role separately.

The NZAuASB considers that the most appropriate safeguard to ensuring a 'fresh look' from the EQCR is the requirement to rotate off after 7 years. The NZAuASB considers that the familiarity threats are lower for the EQCR partner as compared to the engagement partner for the following reasons:

- The EQCR does not participate in the engagement but is part of the firm's quality control processes and is not the final decision maker on an engagement.
- The EQCR will spend less hours on the engagement than the engagement partner. The EQCR therefore does not have the same level of familiarity threat as the engagement partner.
- The EQCR role is to provide an independent view and challenge the engagement team's judgements and conclusions. The role of the EQCR does not create the same level of connection with the engagement and the engagement issues as the engagement partner.
- The EQCR has no contact with the client. In New Zealand, the EQCR is not generally known to the audit client and has no contact with client management. Local regulations have not previously imposed more stringent rotation requirements on the EQCR whereas they have done so for the engagement partner. Local regulators have not cited any need to amend the existing cooling off period of two years. The NZAuASB notes that the EU regulation does not address the EQCR role either. The NZAuASB understands that the International Auditing and Assurance Standards Board is exploring the merits of the EQCR meeting with the client, this is not done presently.
- When the cooling off periods for the EQCR and engagement partner differ, there will be a different engagement leader when the EQCR rotates back on. This reduces the familiarity threat since the role of the EQCR is to perform an objective evaluation of the significant judgements made by the engagement team and the engagement leader will have changed, meaning the EQCR is evaluating the judgements of a different team. Two years away from the engagement team is sufficient time to enable a fresh look when the EQCR returns.

Given that the familiarity threat is considered to be lower, the NZAuASB considers that a 2 year cooling off period is a sufficiently robust safeguard to address the familiarity threat for the EQCR and remains a balanced response when alternative safeguards are considered, bearing in mind the practical difficulties that a longer cooling off period could create, as explored in response to part b below.

The NZAuASB therefore does not agree with the proposal to extend the cooling off period of an EQCR and does not consider that the current rotation requirements for the EQCR pose a perception problem. Rather the NZAuASB continues to support retaining the same cooling off period for the EQCR and other KAPs, and retaining the extant requirements of a 2 year cooling off period, because the NZAuASB considers that 2 years is an appropriate safeguard for the familiarity threat posed.

As outlined in the explanatory memorandum, the IESBA received support from a substantial body of respondents to retain the 2 year cooling off period for the EQCR. The NZAuASB has similarly had support from all constituents with whom the matter has been raised for retaining a 2 year cooling off period for the EQCR. The NZAuASB understands that the driver for the revised proposals is therefore stemming from support within the CAG (although the CAG has mixed views on the need for change) for the EQCR to be subject to the same five-year cooling off period as the engagement partner. But it is not clear as to why this proposal is needed, or what the problem with the 2 year cooling off period is. Concern has been raised by some inspection reports that inspection findings could or should have been found by the EQCR. There is no empirical data to show that the EQCR's failure to make those findings was as a result of the cooling off period being too short.

The NZAuASB does not consider that having a shorter cooling off period for the EQCR is indicative that the role of the EQCR is unimportant, rather it recognises that the familiarity threats differ. The NZAuASB also queries the need for such a change given the lack of empirical evidence to justify it. The explanatory memorandum notes that there may be a perception problem that an effective fresh look cannot occur without a longer cooling off period. However, it is not clear if this is actually a problem, given that the role of the EQCR is as part of the firm's quality control processes rather than as a second opinion. The familiarity threat will differ as the EQCR's role is to debate the issues on the audit engagement with the engagement partner rather than with the client. While the cooling off period differs for the engagement partner and the EQCR, the EQCR will be having that debate with different engagement partners. If the cooling off period aligns and the same engagement partner and EQCR are used in similar rotation cycles, then potentially the same people will be debating the same client matters on each rotation.

All key audit partners, by definition, are those who make key decisions or judgements on significant matters with respect to the audit. The IESBA is not however proposing to extend the cooling off period for other key audit partners. The NZAuASB is supportive of retaining the two year cooling off period for other key audit partners, in recognition of the different familiarity threat that exist, however queries why there is a focus on the EQCR. The NZAuASB considers that the familiarity threats for the EQCR are more similar to those of other key audit partners than to the engagement partner.

- b) The NZAuASB considers that extending the cooling off period may have unintended consequences for audit quality, as it will add additional supply pressure to the number of EQCRs available. The IESBA has acknowledged this concern in the explanatory memorandum. This is a significant issue for a smaller jurisdiction like New Zealand, where there are a number of PIEs, given the New Zealand definition of a PIE which captures many unlisted entities. The issue is of concern to the NZAuASB as the standard setting body for New Zealand.

The unintended consequence of increasing supply pressures is that firms will be forced to require more junior partners to perform the EQCR. A possible outcome is that this will result in a more junior partner becoming the EQCR for a more senior partner. Firms take care to match the EQCR to the engagement partner to enable an effective challenge or evaluation of the decisions made by the engagement partner. The NZAuASB is concerned that the effectiveness of the EQCR role will be diminished if the review is not performed by a suitably experienced engagement partner with appropriate authority to objectively evaluate significant judgements and conclusions made by the engagement team. Requiring less experienced partners without the relevant industry knowledge to perform the review increases the risk of reducing the quality of the review, with a negative impact on audit quality and appears to be in conflict with the IAASB's drive to enhance audit quality.

Some practical repercussions of extending the cooling off period that have been raised include:

- Requiring partners to move around more in order to meet the requirements. Not all partners would be able or willing to relocate in order to meet rotation requirements and this may ultimately impact on the attractiveness of the profession.
- Tighter rotation rules for engagement partners and the EQCR in combination, will be challenging for all firms. In a relatively small market such as New Zealand, even the larger firms are continually dealing with perceived conflicts of interest. For example, an engagement partner and in some cases an EQCR cannot work on more than one client in the same industry. Extending the cooling off period for both the engagement partner and the EQCR will compound this problem.

The IAASB's work on enhancing audit quality

The NZAuASB is concerned with how the proposals to extend the cooling off period of the EQCR interrelate to the audit quality matters that the IAASB are considering in the *Invitation to Comment, Enhancing Audit Quality in the Public Interest*, and what actions the IAASB should take with respect to quality control, including exploring actions related to the EQCR. One aspect being considered is the qualifications and experience required to perform the EQCR role. If the EQCR is to be effective, it must be performed by suitably experienced individuals. If suitably experienced individuals are key to the effectiveness of the EQCR role as part of the firm's internal quality process, adding additional supply pressure by requiring extended cooling off time frames will not enhance the quality of the EQCR.

The NZAuASB urges that the IESBA works closely with the IAASB in establishing the cooling off period for the EQCR to ensure that the right balance is achieved in terms of improving the effectiveness of the EQCR function within the firms. This requires a balance between ensuring that the EQCR is performed by suitably experienced individuals as well as requirements to ensure that the EQCR is performed by an independent practitioner, with sufficient safeguards to protect against familiarity threats. The NZAuASB does not consider that extending the cooling off period to 5 years for the EQCR of listed entities will achieve the correct balance. In fact, even extending the cooling off period from 2 to 3 years for non-listed public interest entities will add supply pressures.

Distinction between listed and non-listed PIEs

The NZAuASB is strongly opposed to creating a distinction between listed and non-listed PIEs, even though in the New Zealand context, PIEs include a large number of unlisted entities. Whilst the NZAuASB understands that this distinction is being made to compensate for practical supply challenges and was developed as a compromise solution, it is strongly of the view that creating sub-levels and inconsistencies for PIE engagements is adding unnecessary complexity, and that alternative options should be explored. There was substantial support for applying the cooling off period for the engagement partner for all PIEs consistently. This approach supports the distinction throughout the extant code between requirements that apply to PIEs as compared to non-PIEs. All PIEs, by their nature, are entities of public interest, and there has been no previous distinction between listed and non-listed PIEs. Retaining a consistent approach to all PIEs is favourable as it provides clarity, consistency and stability. Distinguishing between the PIE requirements is conceptually problematic and will become very complicated to comply with in practice.

Taken as a whole, the proposals that allow for variation between regulators, jurisdictions and type of PIEs, the NZAuASB is concerned that the proposals are becoming increasingly complex and rules driven. The focus on a bright line rule of time on and time off, that is entity specific, detracts from requiring the practitioner to stand back and assess whether familiarity threats have been mitigated for that engagement. The NZAuASB would much prefer to see a principled approach to addressing the familiarity threats with the onus on the practitioner to justify the time on time off ratio, based on the risks and circumstances of the engagement rather than overly complicated and possibly overly prescriptive rules.

Alternative solution

The NZAuASB is concerned at the overall approach proposed. The proposals appear overly rules-driven and unnecessarily complex with overall implications for the audit process, supply risks in a country such as New Zealand and other unintended consequences that we have identified from constituent's feedback.

The NZAuASB encourages a more principles based approach that requires the firm's internal processes to consider whether the familiarity threat for the EQCR has been appropriately addressed rather than more complex and convoluted rules, that will become increasingly complex to apply, increasing the compliance costs to the firm, and potentially negatively impacting on the quality of the EQCR performed. The NZAuASB considers that there is justification for a shorter cooling off period for the EQCR than the engagement partner given that the familiarity threats for the EQCR are lower, because the EQCR is not usually known to the client, will spend less hours on the engagement than the engagement partner, does not participate in the engagement or make final decisions.

2. Do respondents support the proposal to allow for a reduction in the cooling-off period for EPs and EQCRs on audits of PIEs to three years under the conditions specified in paragraph 290.150D?

Response:

Yes, the NZAuASB considers that it is appropriate to reduce the cooling off period if the time-on period is reduced. The NZAuASB is supportive of a more flexible approach as proposed, allowing flexibility at a jurisdictional level and commends the IESBA for listening to the feedback received in response to the 2014 exposure draft. The NZAuASB previously recommended that the IESBA explore a more flexible approach and is therefore more supportive of a proposal that permits some flexibility. The NZAuASB considers that three years is an appropriate cooling off period where the time on period is reduced. Feedback received from New Zealand constituents in response to the IESBA's proposals is consistent with the NZAuASB's views expressed above.

However, the NZAuASB has concerns about the conditions proposed as it seems inconsistent to limit the flexibility of time on time off to where the national standard setter or regulator imposes a restriction on the time on period. Where a firm decides to rotate an individual off an engagement after 6 years instead of 7, why should that partner be subject to a cooling off period of 5 years and not 3? This is explored in more detail in response to question 3 below.

3. If so, do Respondents agree with the conditions specified in subparagraphs 290.150D(a) and (b)? If not, why not, and what other conditions, if any, should be specified?

Response:

No, the NZAuASB does not agree with the conditions specified as this will result in overly restrictive cooling off requirements for a firm that elects to rotate an individual off after say 6 years as engagement partner (this partner would still be subject to the 5 year cooling off period) as opposed to a firm that is required by a regulator or some other regulatory body to rotate off after less than 7 years who could then cool off for 3 years. This could have the unintended consequence of encouraging national standard setters or regulators to reduce the time on period to allow for more flexibility. In theory, a firm only needs 3 partners (to cover the role of engagement partner and EQCR) per client to meet a 6-year time on 3-year time off rotation cycle, whereas this ratio increases for different combinations.

This level of specificity removes the focus on whether the familiarity threats have been mitigated and places unnecessary focus on a number of years. If a firm could elect to rotate off after 6 years, there is no difference to the familiarity threats than if regulatory requirements impose this time on restriction. It therefore seems overly rules driven to allow more flexibility where regulation imposes a shorter time on period, than where time on restrictions are self-imposed by the firm or practitioner. Too rigid an approach may have unintended consequences. From a standard setting perspective, a more flexible approach that recognises that the firm may also reduce the time on period to accommodate for partners for taking maternity or paternity leave, or other practical examples of where partners are temporarily unavailable (due to illness or secondment) would be more practical to apply and appropriately address the threat to familiarity. If the IESBA recognises that the time-on time-off period needs to be considered in conjunction, there is no justification in principle for distinguishing between a firm imposed time on period as compared to a regulatory imposed time on period.

For these reasons, the NZAuASB recommends that the conditions in paragraph 290.150D need reconsideration and should allow for the application of professional judgement as to whether a shorter time on period justifies a shorter cooling off period.

The NZAuASB urges the IESBA to consider an alternative condition, as outlined below:

"290.150D An independent standard setter, regulator or legislative body or the firm itself may have evaluated the familiarity and self-interest threats to independence that arise from long association with an audit client and determined that a different set or combination of safeguards to those required in this Code are appropriate to reduce the threats to an acceptable level. In such circumstances, the cooling-off periods of five consecutive years specified in paragraphs 290.150A and 290.150B may be reduced to three consecutive years, if:

(a) An independent standard setter, regulator or legislative body has implemented an independent regulatory inspection regime; and

(b) ~~Established requirements for either:~~

(i) ~~The~~ A time-on period for the engagement partner or the individual responsible for the engagement quality control review is shorter than seven years during which an individual is permitted to be the engagement partner or the individual responsible for the engagement quality control review; or

(ii) there are established requirements for ~~M~~ mandatory firm rotation or mandatory re-tendering of the audit appointment at least every ten years."

If the IESBA pursues the option as proposed, the NZAuASB urges the IESBA to provide some additional guidance as to what is meant by "regulator or legislative body" and "independent inspection regime". For example, would this include requirements established by the listing rules of a stock exchange. Additional guidance to identify the types of additional regulatory safeguards that are expected to be in place in order for the conditions to be met would assist to promote consistency.

The NZAuASB recommends that the IESBA consider ways to make it clearer within the text of the Code, that the cooling off period of the EQCR would not exceed that of the engagement partner where the conditions in 290.150D apply for the engagement partner. It was only apparent how this would work after reading the draft questions and answers, and therefore the NZAuASB does not consider that the requirements are sufficiently clear on their own.

4. Do respondents agree with the proposed principle "for either (a) four or more years or (b) at least two out of the last three years" to be used in determining whether the longer cooling-off period applies when a partner has served in a combination of roles, including that of EP or EQCR, during the seven-year time-on period (paragraphs 290.150A and 290.150B)?

Response:

The NZAuASB considers that the revised proposal is a more proportionate response which will lower the impact of extending the cooling off period to five years. The NZAuASB is supportive of including specific requirements to deal with the practical difficulties of applying the rotation requirements where the engagement partner or EQCR has been involved in a variety of roles for the seven-year time on period. The NZAuASB has no strong preference as to the number of years specified but again raises the concern that the proposals appear to be too rules based, lacking an emphasis on mitigating the threats, and providing opportunity for gaming.

A New Zealand respondent raised concern whether a 5 year cooling off period is required when an individual has served only 2 out of the last 3 years as engagement partner or EQCR, querying whether the significant increase in the cooling off period is justified for only a minor period served in the capacity as engagement partner or EQCR.

The NZAuASB considers that paragraph 290.150A could be misleading as it is drafted and recommends that this principle must be simplified and clarified. Feedback from New Zealand practitioners reflects the concern that the proposals could be misinterpreted. The NZAuASB understands that the bullet points are targeting the key audit partners who act in a variety of roles during the time on period, rather than the engagement partner who acts as the engagement partner for 7 years.

The proposal is confusing because the definition of a key audit partner includes the engagement partner. As drafted, the first bullet point could be misunderstood to mean that after 4 years the engagement partner is required to cool off for 5 years. It is then also not clear why a partner who served as engagement partner for at least two of the three years should have to cool off at all.

The NZAuASB recommends that the following option be explored:

290.150A In respect of an audit of a listed entity, an individual shall not be the engagement partner or the engagement quality control reviewer ~~a key audit partner~~ for more than seven cumulative years (the “time on” period), after which the individual shall serve a cooling-off period of at least 5 consecutive years, subject to paragraph 290.150D.

{These changes make it clear how the rotation requirements work when there is no changing of roles or unusual situations to cater for. The next bullet points can then cater for the non-consecutive service in a variety of roles.}

Where a key audit partner serves in a variety of key audit partner roles during the time on period, that individual shall also serve a cooling off period of five consecutive years if during a cumulative seven year period that key audit partner acted as engagement partner or engagement quality control reviewer, or in a combination of these roles for:

- a) Four or more of the seven years; or
- b) At least two out of the last three of the seven year time on period.

Where a key audit partner serves in any other combination of roles during the seven-year time-on period, the individual shall serve a cooling off period of two consecutive years.