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Global Mindset, Asian Insights

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Technical Director
International Ethics Standards Board for Accountants
529 Fifth Avenue, 6th Floor
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Dear Sirs,

RESPONSE TO THE INTERNATIONAL ETHICS STANDARDS BOARD FOR ACCOUNTANTS EXPOSURE DRAFT - PROPOSED CHANGES TO CERTAIN PROVISIONS OF THE CODE ADDRESSING THE LONG ASSOCIATION OF PERSONNEL WITH AN AUDIT OR ASSURANCE CLIENT

In preparation of this comment letter, the Institute of Singapore Chartered Accountants (ISCA) has carried out a literature review, sought views from its members through a one-month public consultation and discussed the ED with members of the ISCA Ethics Committee.

Based on our literature review, there are very few research studies looking into the relationship between audit partner tenure and audit quality. While we have found that archival studies produced mixed results, experimental studies on audit partner rotation generally support the independence hypothesis. One such study is "*The Effect of Engagement and Review Partner Tenure and Rotation on Audit Quality: Evidence from Germany*"[1] which distinguishes the effect on audit quality between rotating audit engagement partner and quality review partner. Based on the study, it was found that mandatory rotation of audit engagement partner increases audit quality while mandatory rotation of quality review partner decreases audit quality. This supports the proposal in Question 7 of the ED for the cooling-off period of the Engagement Quality Control Reviewers and other Key Audit Partners on the audits of Public Interest Entities (PIEs) to remain at two years.

Generally, we agree with all the proposals in the ED and do not have significant comments or additional insights, except for the following specific questions:

[1] Gold, A., Lindscheid, F., Pott, C. and Watrin, C. 2012, "The Effect of Engagement and Review Partner Tenure and Rotation on Audit Quality: Evidence from Germany", *SSRN Working Paper Series*.

Question 1: Do the proposed enhancements to the general provisions in paragraph 290.148 provide more useful guidance for identifying and evaluating familiarity and self-interest threats created by long association? Are there any other safeguards that should be considered?

Question 14: Do respondents agree with the analysis of the impact of the proposed changes? In the light of the analysis, are there any other operational or implementation costs that the IESBA should consider?

While the proposed enhancements provide useful guidance, the list of factors affecting the significance of the threats in paragraph 290.148B may give the impression of an exclusive listing. The IESBA should amend the wordings used to enhance the clarity of the provision. For instance, the phrase "*Factors relating to the individual include*" could be refined to "*Factors relating to the individual include but not limited to*". This would be clearer to readers that they would also need to consider other factors not mentioned in the paragraph.

Furthermore, we are of the view that the IESBA should give more consideration to the practical challenges faced by the smaller audit firms when applying the proposed changes. With the proposed changes, the general provisions are now much more explicit and there is a stronger impetus to comply with the requirements. However, as explained in the following paragraphs, we foresee challenges in promoting the application of the changes among practitioners of smaller audit firms.

In certain jurisdictions where audits are required for the majority of private companies, it is common for some of the smaller audit firms in these jurisdictions to have many long-standing clients. Typically, these clients are small private companies which prefer to work with auditors who are familiar with their business operations and with whom they have already established good working relationships. The long association of the audit personnel with these clients would also mean increased level of familiarity threat. However, given the small size of these firms, they are constrained by the number of partners and staff available for rotation. This issue is more acute among the sole-proprietors. In Singapore, for instance, more than half of the audit firms are sole-proprietorships and it will be very challenging for these firms to comply with the proposed changes.

Although paragraph 290.149A recommends the application of safeguards such as performing regular independent external quality reviews of engagements, this may not be practical for the smaller audit firms because finding suitably qualified external reviewers who are willing to undertake such reviews may be difficult. Even if qualified reviewers are available, the cost of engaging them may cause the audit engagement to be not economically viable. As such, it would appear that the audit firms may have to resign from audit engagement of some of their long-standing clients which would have an adverse impact on the firms' revenue. This would make the revised Code harder to comply and to enforce.

Essentially, it is at the discretion of the smaller firms to assess and determine whether such significant threats exist and what should be an appropriate cooling-off period. This begs the question of how independent and objective these assessments will be. The smaller firms may conveniently conclude that no familiarity threat exists and not do anything significantly different from the current situation, so as not to put them in a less competitive position. As such, stakeholders may be sceptical about the effectiveness of the proposed changes.

Hence, we believe the IESBA should seriously consider the practical challenges of applying the proposed changes to the smaller audit firms. We trust that the IESBA will analyse the comments received on possible ramifications highlighted in this respect so that any major concerns raised are addressed before the proposal is made effective. It may also be worthwhile for IESBA to establish a platform for different jurisdictions to share how they are preparing their small and medium sized practices (SMPs) for the changes.

In the meantime, we suggest that the IESBA shares the views, if any, obtained from the benchmarking exercise, meetings with stakeholders and e-survey of stakeholders carried out, on the ramifications affecting SMPs, to generate greater awareness and debate in this particular area.

We also urge the IESBA to consider the different risk profiles of PIEs and non-PIEs. Inherently, PIEs have a higher degree of public interest risk compared to non-PIEs. This may warrant different approaches to be adopted for PIEs and non-PIEs in terms of requirements to avoid and safeguard against familiarity threat.

Question 3: If a firm decides that rotation of an individual is a necessary safeguard, do respondents agree that the firm should be required to determine an appropriate time-out period?

While we agree that there should be an appropriate time-out period, the smaller firms could face difficulties determining what it should be.

Paragraph 290.149B states that "If a firm decides that the threat is **so significant**......determine an **appropriate period** during which the individual shall not participate in the audit engagement......". For the smaller audit firms, should they determine that there are familiarity threats arising from certain client engagements, it will be at their discretion to determine what the appropriate cooling-off period should be. This is highly judgemental and may be difficult to justify when challenged. On a similar note, it is also going to be challenging for the regulators to determine if a significant threat has been appropriately identified at the right point in time, as well as if an appropriate cooling-off period has been determined by the audit firms.

In view of the above, we would suggest that the IESBA provide more practical guidance in the form of case studies of different scenarios, especially for the smaller audit firms with non-PIE audit clients.

Question 5: Do respondents agree with the proposal to extend the cooling-off period to five years for the engagement partner on the audit of PIEs? If not, why not, and what alternatives, if any, could be considered?

While we agree with the proposal to extend the cooling-off period to five years, we have also received feedback that five years is arbitrary and would pose a greater practical challenge to the audit firms with fewer partners in terms of what the rotated engagement partner is allowed to do. Under the proposed change, a rotated engagement partner shall not be a member of the engagement team or provide quality control for the audit engagement for two years. Consultation with the rotated engagement partner by the engagement team may be provided only after two years have elapsed and if it is given in the capacity as a technical or industry expert. In a small set-up, the rotated engagement partner may be the only expert in the firm (other than the incoming engagement partner). As such, the engagement will be deprived of the knowledge and expertise of the rotated engagement partner in the initial two years and this could be detrimental to audit quality. It may be worthwhile for the IESBA to consider more closely the impact on these firms.

Question 8: Do respondents agree with the proposal that the engagement partner be required to cool-off for five years if he or she has served any time as the engagement partner during the seven year period as a KAP?

We agree with the proposal but have reservations about the basis used to justify the proposal.

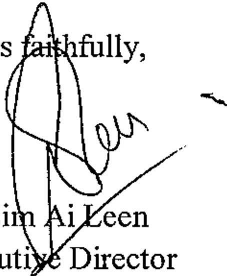
As the spirit of the proposed changes in the ED is to address the familiarity and self-interest threats, the basis of any proposal should be robust. It should not be based on ease of application as described in page 11 (in the Explanatory Memorandum) of the ED. Hence, we are of the view that more should be done to explain the rationale as it is important to ensure that the basis is well articulated, which will go a long way towards promoting the adoption by practitioners.

Other Comments

For the second bullet point in the second paragraph of 290.148A, we propose to include *"those charged with governance"* to be consistent with the succeeding provisions.

Should you require any further clarification, please feel free to contact Mr Kang Wai Geat, Deputy Head, Technical Standards Development and Advisory, or Mr Ang Soon Lii, Manager, Technical Standards Development and Advisory, at ISCA via email at waigeat.kang@isca.org.sg or soonlii.ang@isca.org.sg respectively.

Yours faithfully,



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