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Proposed Amendments to Professional and Ethical Standard 1 (Revised) Provisions Addressing the Long Association of Personnel with an Assurance Client

Dear Warren

On behalf of Ernst & Young I am writing to provide comment on the NZAuASB's exposure draft "Proposed Amendments to Professional and Ethical Standard 1 (Revised) Provisions Addressing the Long Association of Personnel with an Assurance Client". We welcome the NZAuASB's initiative in requesting comment from constituents regarding the important matters in this exposure draft.

We provide responses as requested as follows:

1. *Do you agree with the proposals to adopt the revised international requirements dealing with long association?*

   We support the convergence of New Zealand standards with international standards and therefore agree with the proposal to adopt these revised requirements.

2. *Do you agree that:*

   a. *The New Zealand PIE definition remains appropriate in light of the international changes made to the long association provisions?*

      We do not agree the New Zealand PIE definition is appropriate. We believe that the definition of a PIE in New Zealand is too broad. The challenges posed by the changes to the long association provisions are exacerbated by the wide PIE definition.

      We note the definition of a PIE in Australia is the same as the international definition. We do not consider that there are significant differences between the Australian economy and New Zealand economy which justifies a difference in the definition of a PIE. The new long association provisions will have a less disruptive impact on the Australian environment as fewer entities are caught under their PIE definition.

      As the New Zealand PIE definition is so broad and because the timeframe for adoption of this amendment is so short, a very large number of entities' audits will be impacted by these changes in a very short timeframe. In our view, this may negatively impact audit quality.

      The proposed effective date of "periods beginning on or after 15 December 2018" and the IESBA FAQs, which make it clear that a lead audit partner must have completed their cool-off prior to the start of the audit period following the aforementioned date, mean we have already passed the final date for rotation of most audits under the old rules. This makes the new rules retrospective. Given the very large number of entities caught under the PIE rules in New Zealand and the relatively small auditor marketplace, this provides significant challenges to rotate audits affected in a fashion which promotes and maintains audit quality, especially in specialist industries. We note that the exposure draft itself states in paragraph 22 that "audit firms will need time to consider the implications, especially in remote locations or in industries that require specialist expertise".

As we understand the new rules,

- For a December year-end, the new rules apply to the year-ending 31 December 2019, so an engagement partner must have cooled-off for the 2017 and 2018 years. This means that December 2016 is the last year that a partner can sign-off without needing to cool-off for 5 years, instead of 2 years.

- For a June year-end, 30 June 2020 would be year 1 of the new rules, so an engagement partner must have cooled-off for FY 2017/8 and 2018/9, and the year-ending 30 June 2017 is the last year that a partner can rotate and still only cool-off for 2 years.

In our view, a hurriedly introduced 5 year cooling off period may actually lead to diminished audit quality due to the small number of industry experienced partners available. We would contrast New Zealand with the US market where audit partners generally only work in 1-2 industries and are therefore much better placed to rotate on to new clients in the industry they are experienced in.

Many entities which fall under the PIE definition are located in smaller towns and cities of New Zealand, where the supply of partners through which to rotate is (much) smaller. The larger accounting firms can allocate clients to partners in other offices, but we consider it more beneficial to have partners located geographically close to their clients. Such a solution may not be available to smaller firms.

As a final observation, we note that many of the entities captured as PIEs in the table in paragraph 17 will be covered by the standards issued by the Auditor General.

b. *Applying the revised requirements to all PIEs as defined in New Zealand is in the public interest?*

We agree that applying the revised requirements to a narrowed PIE definition is in the public interest. As previously outlined, we think that the definition of a PIE in New Zealand as it currently stands is too broad.

We acknowledge that the PIE definition does not only impact long association matters. However, the proposal extends a retrospective arm to a very broad range of entities.

3. *Do you consider that it is in the public interest to retain entities that voluntarily report using the tier 1 reporting requirements within the New Zealand PIE definition?*

No, we do not consider it is in the public interest to retain entities that voluntarily report using tier 1 reporting requirements within the New Zealand PIE definition. The reason clients choose to voluntarily report under Tier 1 has little to do with the public interest and has no link to whether it is appropriate to apply more stringent auditor long association provisions (or other provisions related to being a PIE).

Some of these voluntary Tier 1 entities are small and adopt Tier 1 for ease of reporting to parent entities. We are not aware of a justifying rationale for capturing entities which voluntarily choose to adopt Tier 1 financial reporting as PIES and therefore requiring compliance with the long association provisions related to PIEs.

While we do not think there are a large number of voluntary Tier 1 reporters, the PIE requirements are encouraging these entities to reduce their disclosure (which may otherwise be of interest to users) purely to enable them to assert compliance with Tier 2 and therefore avoid the PIE definition.

In our view, excluding "voluntary PIEs" from the New Zealand PIE definition is consistent with IESBA's PIE definition and application guidance. These entities have not been caught under the mandatory Tier 1 definition and therefore do not have a large number nor a wide range of stakeholders, do not hold assets in a fiduciary capacity and are not considered to be large. In our view, it was not appropriate to include these voluntary PIEs in the definition in the first instance.

4. *For dual listed entities (listed on the NZX and ASX), do you consider there to be unintended consequences of having different rotation requirements for the engagement partner for listed entities in New Zealand and Australia? If so, please explain.*

   Given the close economic ties between New Zealand and Australian entities, it is highly beneficial for the audit standards to be as closely aligned as possible. We do not believe it to be justifiable to require New Zealand entities to apply stricter rotation requirements than their Australian counterparts. In our opinion, every effort should be made to ensure that the New Zealand rotational requirements for listed entities align with those of Australia. As currently proposed, this is not achieved.

5. *Do you agree with the New Zealand proposal to align the auditor rotation requirements for audits of financial statements and other recurring assurance engagements for public interest entities? If not, why not?*

   In our view, alignment of rotation requirements will have little practical impact as in many cases the partner undertaking the other recurring assurance engagement for PIEs is likely the partner undertaking the audit and will already be covered by the rotation requirements. While we do not disagree with the NZAuASB's aligning of section 291 with section 290, we are not clear what the NZAuASB's rationale is for amending this element of the standard for New Zealand. It is not clear that there is a specific difference in the New Zealand environment that would justify a change from the international standard. As a standard taker, in our view, the international standards should be amended in New Zealand where there is a clear difference in our market that would require amendment.

6. *The transitional provisions provide for an alternative cooling-off period permitted under legislation or regulation that will have effect for audits of financial statements for periods beginning prior to 15 December 2023. The NZAuASB requests feedback on the impact of this transitional provision in the New Zealand context.*

   To ensure alignment with the rotation requirements in Australia which we understand will be applying the 3 year rotation until 2023, we strongly believe it is essential for this transitional requirement to be adopted in New Zealand. This transitional amendment also allows much needed time for audit firms to prepare for the changes to rotation.

   We are aware of the NZAuASB's current position that to apply the transitional provision in New Zealand would be contrary to its stated strategy of not adopting a lesser standard than the international version. In our view, this is a very literal interpretation that is not in the best interests of the public in New Zealand.

   In our view, it is very possible to make an argument that applying the transitional provisions to all PIEs is not adopting a lesser standard that the international version. In our view, the NZAuASB should argue that because other countries are making use of the transitional provisions, our standard would not be weaker for applying the provision to all PIEs because the country we have closest economic ties to is applying the provisions to the same sorts of entities. In fact, if we do not apply the transition provisions we will be out of step with Australia and other countries.

It is a very literal interpretation of transitional provisions to argue that we cannot apply the transitional provisions in New Zealand purely on the basis that Australian rotation rules are in corporations' law and ours are not.

To allow much needed time for the new rules to be applied is not, in our view, lessening the standard. During the transition period, similar entities in NZ and Australia (and possibly other countries) would be subject to the same rotation rules. In our view, in the public interest, the NZAuASB should take a pragmatic approach to the application of the transitional provisions.

In our opinion, the NZAuASB should apply the transitional provision to all PIEs in New Zealand with the rationale that due to;

- the very broad nature of our PIE definition,
- the unique business environment (with a small number of qualified auditors auditing complex specialised industries and remote locations); and,
- the importance of aligning our rotation rules with those of Australia,

it is in the public interest to allow additional time for the profession to adapt to the new rotation rules so as not to reduce audit quality.

7. *Do you consider any further compelling reason amendments are needed? If so, what amendments should be made and why?*

   We consider no further reason for amendment.

8. *Do you have any other comments on ED NZAuASB 2017-1?*

   We have no further comment on this exposure draft.

In summary, we believe that, in the NZ context, the breadth of entities affected and the timeframe to address the new rules is likely to diminish audit quality in the short term. In New Zealand the current proposals combined with the wide PIE definition and lack of application of the transitional provisions will result in one of the smallest economies having some of the strictest rotation rules in the world. We consider it poor process to apply new standards retrospectively (acknowledging that this is due to the timeframe of the international standard's release) and believe there is a strong case to either reduce the number of entities affected (by changing the scope) and deferring the implementation date (to allow a more planned and managed approach).

Please contact me if you would like to discuss this submission further.

Yours Sincerely

Marcus Henry
New Zealand Professional Practice Director
Ernst and Young