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Warren Allen
Chief Executive
External Reporting Board
PO Box 11-250
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Dear Warren

ED NZAuASB 2017-1: PROPOSED AMENDMENTS TO PES 1 (REVISED) PROVISIONS ADDRESSING THE LONG ASSOCIATION OF PERSONNEL WITH AN ASSURANCE CLIENT

As you will be well aware, the translation of the international requirements on auditor rotation to the New Zealand context is not easy.

The Auditor-General has previously submitted on the international proposals in submissions to the International Ethics Standards Board for Accountants (IESBA) dated 7 November 2014 and 11 May 2016. Copies of these submissions can be found on the International Federation of Accountants website.

The significant matter that we wanted to draw to the attention of the IESBA was that the proposals, when translated to the New Zealand context, did not seem to reflect a proportionate response to those entities to whom the IESBA was primarily seeking to target. Whilst the IESBA was somewhat vague in defining the nature of the targeted entities, our sense was that the requirements were primarily aimed at those entities that solicit funds (such as donations and investments) from the public. In the New Zealand context this group of entities would be described as "FMC reporting entities considered to have a higher level of public accountability" under the Financial Markets Conduct Act 2013.

We have some difficulty in the decision by the NZAuASB to automatically apply the international requirements to a seemingly wider group of entities in New Zealand (being those entities falling under the New Zealand definition of public interest entity) without attempting to establish comparability with the notion of a public interest entity internationally. As a consequence we do not know if the proposals achieve comparability with the international standard. We understand that comparability with international requirements is the primary principle applied by the NZAuASB in its standards setting activity.

We suspect the proposed New Zealand requirements will exceed international requirements. We do not have any difficulty with an "international plus" requirement, as long as the anticipated benefits of that approach exceed the cost. To date, we have yet to be persuaded that the proposals satisfy the "cost/benefit" test.

We understand that the definition of "public interest entity" in New Zealand was developed in the context of financial reporting. That definition was then applied to the independence provisions of the Code of Ethics in circumstances where the definition was seen as "proportionate" to the threat to independence. In our opinion, the NZAuASB needs to make a similar assessment on the application of the proposed requirements to "public interest entities". We think a proportionate response is to apply the requirements to "FMC reporting entities considered to have a higher level of public accountability". We would note that this is the same category of entities that are subject to the key audit matters requirements in ISA (NZ) 701: *Communicating Key Audit Matters in the Independent Auditor's Report*.

We have included our responses to the questions asked by the NZAuASB in the Attachment to this letter.

If you have any questions about our submission, please contact Roy Glass at roy.glass@oag.govt.nz.

Yours sincerely

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Attachment - Responses to Questions for Respondents

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

   No, not in the manner set out in ED NZAuASB 2017-1. Please refer to the comments in our covering letter, which provides the context for our disagreement.

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?*

   The New Zealand PIE definition is appropriate for the original purpose for which it was created, being to define those entities that are subject to Tier 1 financial reporting requirements in New Zealand. However, the PIE definition is not appropriate for the proposed changes that respond to concerns about auditors' long association with an entity. Please refer to the comments in our covering letter.

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

   One can argue that every enhancement made to a professional and ethical standard, or to an auditing standard, is in the public interest. However, the public interest benefit must, at a minimum, outweigh the costs associated with the enhancement.

   In this instance, as discussed in the covering letter, it is not apparent to us that the public interest benefit equals, or exceeds, the cost of applying the proposals to public interest entities. Furthermore, we do not consider that the NZAuASB has provided sufficient evidence to justify applying the proposed requirements to public interest 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?*

   We do not agree that it is in the public interest for the proposed requirements to be applied to entities that voluntarily report using the Tier 1 financial reporting requirements. We do not consider that the NZAuASB has provided sufficient evidence to justify applying the proposed requirements to public interest entities. Consequently, the case for applying the proposed requirements to entities who voluntarily elect to apply the Tier 1 financial reporting requirements has not been justified.

   As discussed in our response to Question 2(b) above, the proposed requirements must satisfy the cost/benefit test.

   If not, do you consider that including such entities within the New Zealand PIE definition:

   (a) *Creates even further auditor supply pressures that are contrary to, rather than in the public interest?*

   In our opinion, applying the proposed requirements to entities that voluntarily report using the Tier 1 financial reporting requirements will create auditor supply pressures, over and above the auditor supply pressures that will be created in applying the proposed requirements to public interest entities.

(b) *Has any other unintended consequences?*

In most circumstances, the new requirements will necessarily result in additional audit costs. Rather than incur additional audit costs, some entities that voluntarily report using the Tier 1 financial reporting requirements may decide to adopt a lesser form of reporting that they are permitted to apply. The consequences of this decision will be to deprive users of the financial statements of (potentially) useful information. In addition, the proposed requirements may deter some entities from voluntarily adopting Tier 1 reporting.

The consequence of these decisions is lesser reporting, which is unsatisfactory from a public interest perspective.

In our view, the NZAuASB needs to reflect on the deterrent effect of the proposed changes on voluntary improvements in financial reporting. It makes no sense that an entity is "penalised" for voluntarily adopting better reporting.

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.*

The Auditor-General is the auditor of a small number of dual listed public entities. Because the proposed requirements for New Zealand listed entities will be more stringent than those entities listed in Australia, there are unlikely to be any unintended consequences from an Auditor-General's perspective.

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?*

We do not agree that the proposed auditor rotation requirements should be applied to public interest entities, for the reasons included in the covering letter.

However, it does make sense to apply any enhanced requirements uniformly across all recurring assurance engagements (including audits of financial statements) carried out within an entity.

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.*

We have not fully engaged with the transitional provisions. Nonetheless, auditors should be permitted a reasonable lead time to transition to the new requirements because of the resourcing implications of the proposals.

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

Please refer to the comments in the covering letter.

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

Rotation of the External Quality Control Reviewer

There is a particular issue around the rotation of the engagement quality control reviewer (EQCR) that has not been addressed in the proposal, and that we believe requires consideration. The independence of the EQCR from the operational aspects of the audit is fundamental to the EQCR role. Therefore, it follows that the EQCR can move directly from the EQCR role to another key audit partner (KAP) role without a cooling-off period, as long as the move occurs within a seven-year time-on period. However, the effectiveness of the EQCR role would be significantly diminished if the individual is able to move directly from an operational role to an EQCR role, within a seven-year time-on period, without a cooling-off period. This is because the individual performing the EQCR would be monitoring their own work (carried out in a prior period), and this would effectively negate the benefit of the EQCR.

Restrictions on Activities During the Cooling-off Period

Paragraphs 290.164 and NZ291.141.11 place restrictions on what an individual can do during the cooling-off period.

We are concerned that these paragraphs permit a degree of contact with the entity, and that this contact will effectively negate the purpose of the cooling-off period – being to remove the threats to independence that may arise when an individual is involved in an audit or review engagement over a long period of time. The proposed requirements (at paragraph 290.148) specifically state that a self-interest threat may be created through an interest in maintaining a close personal relationship with a member of senior management or those charged with governance.

Such contacts can be maintained under the proposed standard in the following ways:

- Paragraph 290.164(c) permits on-going contact as long as the individual is ***not responsible*** for ***leading*** or ***coordinating*** the firm's professional services to the audit or review client or ***overseeing*** the firm's relationship with the audit or review client [emphasis added].

  By implication, paragraph 290.164(c) permits a current key audit partner to engage in such activities, which is questionable.

- Paragraph 290.164(d)(i) would permit an individual to interact with senior management or those charged with governance provided the interaction was not ***significant*** or ***frequent*** [emphasis added].

In summary, the cooling-off restrictions permit on-going interaction during the cooling-off period. The opportunity given by the proposed standard that permits interactions between an individual and the entity during a cooling-off period effectively negates the whole purpose of the auditor rotation proposals.