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AUD004 An Analysis of Audit Firm Tenure Disclosure in JSE Listed Companies by Those Charged with Governance

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ABSTRACT:
In order to strengthen the auditor independence in South Africa and improve transparency of the auditor-client relationship, the Independent Regulatory Board for Auditors (IRBA) introduced the audit tenure disclosure rule in December 2015. This regulation requires the auditor to clearly disclose on the audit report the number of years that the audit firm has been appointed as auditor.

The objective of this research report is to investigate the nature and extent of the voluntary disclosure, if any, of audit firm tenure by management and those charged with governance in the annual reports of South African companies, prior to the introduction of this regulation by the regulator. Audit tenure disclosure is considered a proxy for the disclosure of the nature and the extent of accessible information for the users of the annual financial statements regarding auditor tenure and therefore the ability of the users to development an assessment of the threats to auditor independence based on long standing auditor-client relationships.

Using the annual reports of the one hundred largest companies (by market capitalisation) listed on the Johannesburg Stock Exchange, an analysis of audit firm tenure disclosure is performed. The findings show that that eighty five percent of the companies do not provide such disclosure prior to 31 December 2015 and as a result the information available for users of the audited financial statements for their consideration of the assessment of perceived auditor independence is very limited. The extent of the disclosure made by companies of the tenure of the auditor is very low and as a result the information available for users of the audited financial statements for their consideration of the assessment of perceived auditor independence is limited. Management and those charged with governance should be made aware of this lack of key disclosure.

Suggestions for the nature and extent of key information that would be useful for users of financial statements to understand the discharge of the audit committee's duties during the period in regard to auditor independence, as well as to allow users to make their own informed assessment of auditor independence, is provided.

Key words: Auditor tenure; Auditor independence; Audit disclosure, Audit committee; Firm tenure

INTRODUCTION

It is commonly agreed that the provision of assurance services, most notably the external audit function, is an activity of public protection. In the eyes of the public, especially the investing public, but also all stakeholders of the company, the audit function provides the much needed stamp of credibility and assurance as to the fair presentation of the company's financial reporting.

As is clearly stated in international professional and ethics standards governing auditors, the auditor must act at all times with the required independence (both independence in mind and in appearance), objectivity and professional scepticism that is required for the purposes of providing an audit opinion on the fair presentation of the company's financial statements. Auditor independence is important because it has an impact on the quality of the audit. DeAngelo (1981), as quoted by many recent academic studies on audit quality, provides a useful definition of audit quality as the probability that:

(a) The auditor will uncover a breach of statutory or regulatory requirement; and

(b) Report the breach to the appropriate parties.

If auditors do not remain independent, they might be less likely to report irregularities or insist that financial statements be prepared to their satisfaction, thus, impairing audit quality (Carey and Simnett, 2006). This potentially lessens the credibility of the financial reporting process. If auditors do not remain independent, they might be less likely to report irregularities, through the various reporting channels available. The most notable reporting channel is via the auditor's opinion and the audit report in which that opinion is contained, and therefore a lack of independence could impair the quality of the audit report provided to the public and stakeholders of the company. Other reporting channels, to provide some South African examples, would be as a whistle blower to relevant regulatory authorities, such as the Independent Regulatory Board of Auditors (IRBA), the Financial Services Board (FSB), the JSE Ltd or the tax revenue authorities (SARS). The independence of the auditor encapsulates two dimensions of independence: independence in mind as well as independence in appearance to a reasonable third party (IFAC Code, 2006).

Often, as a result of corporate failures, regulators and the public cast doubt over the independence of assurance providers and auditors (Ye, Carson and Simnett, 2011). In an attempt to restore the confidence of the public and thus the credibility of assurance services, regulators implement direct measures to enhance the independence of the auditor (Ye, Carson and Simnett, 2011). Regulators introduce these measures to address the circumstances which may diminish the independence of the auditor (Tepalagul and Lin, 2015). One such circumstance is long tenure of the audit firm (Tepalagul and Lin, 2015).

Auditor independence in general and mandatory audit firm rotation (MAFR) in particular has received significant attention in recent years from regulators, academics and business practitioners (Fontaine, Khemakhem and Herda, 2016). This increased attention is due in part to the high-profile accounting scandals that have occurred in recent years such as Enron (2001), WorldCom (2001), Parmalat (2003), Bernard L. Madoff Investment Securities (2008) and Lehman Brothers (2008). Most national jurisdictions have had their own, albeit perhaps smaller, examples of financial fraud and associated accounting deceptions that have caused significant losses to many parties concerned. In South Africa, LeisureNet (2000), Regal Bank (2001), Randgold & Exploration (2005) and Fidentia (2007) are examples of corporate financial reporting fraud and irregularities. The global financial crisis during 2007-2009 again raised doubts regarding the ability of the auditor to detect and report financial irregularities, raising further concerns that financial reporting regulations needed to be strengthened. Sometimes the nature of the scandal is such that the responsibility for the fraud and negligence involved is shared by the auditors of the companies involved, the most famous example of this being the demise of largest accounting firm in the world at the time, Arthur Andersen, after the Enron collapse.

The South African audit industry regulator, the Independent Regulatory Board for Auditors (IRBA), expresses these concerns in recent correspondence as follows:
"High-profile cases associated with Enron, WorldCom, Parmalat, Tyco International, Royal Dutch Shell, Siemens, and locally with corporations such as Leisurenet, Randgold and Regal Bank have made auditors a focal point for governments and oversight structures. Coupled with the earlier comment that investors and the public are also demanding more information and transparency and have become more aware of their rights to be protected, these developments are resulting in global role players revisiting measures to address concerns around the independence of auditors." (IRBA, p.10, 2016d)

These are just a few examples among many whereby the quality of the audit function as a means to prevent or detect corporate fraud and gross mismanagement has been challenged (Laurion, Lawrence and Ryans, 2015). There has thus been an increased focus in the larger jurisdictions such as the United States and European Union where regulators have implemented regulations to improve auditor independence and audit quality. Mandatory audit firm rotation (MAFR), which refers to the legislated requirement for a limit on the number of years that an audit firm (not simply the audit practitioner) can be consecutively appointed, is one of the key regulations intended to improve auditor independence. Although the adoption of MAFR in the United States has not happened and is considered unlikely (Fontaine, Khemakhem and Herda, 2016), there have been significant other regulatory changes. MAFR has however, after much debate, been implemented in Europe as of 2014 (Hakwoon, Hyoik and Jong Eun, 2015; IRBA, 2016a), as well as other jurisdictions.

Mandating audit firm tenure disclosure

In an attempt to enhance the independence of auditors in South Africa and to afford users the ability to assess the potential threat that extended audit firm tenure may pose to the independence of the auditor, the IRBA has introduced a new regulation. IRBA has mandated a disclosure to be placed in the audit reports issued by audit firms on audits conducted on public interest entities. This disclosure must state clearly the number of years that the firm has audited the entity (IRBA, 2015).

LITERATURE REVIEW

The International Financial Reporting Standards (IFRS) state that the objective of financial statements is to provide information to users of the financial statements concerning the financial position and performance of an entity (International Financial Reporting Standards, 2007: IAS1). For primary users, such as investors, the financial statements of an entity form a foundation for the communication of this financial information. In terms of the International Standards on Auditing (ISA), it is the responsibility of the management of the entity to prepare the financial statements, not the auditor (International Auditing and Assurance Standards Board, ISA 210, 2009). This fact may result in the existence of information asymmetry between management and users of the financial statements (Johnson, Khurana and Reynolds, 2002). There is also the potential for conflicts of interest to occur between the users and management, which may arise due to conflicting incentives on the part of management to potentially misstate financial information (Antle, 1984; Johnson, Khurana and Reynolds, 2002).

As a result of the potential for conflicts of interest and information asymmetry, the role of an independent third party, the auditor, in providing assurance over the financial statements, may improve the quality of financial information communicated to users through the annual financial statements (Johnson, Khurana and Reynolds, 2002). The assurance provided by the auditor provides the users of the financial statements with a degree of confidence in the reliability of the financial information; in turn this allows the users an opportunity to engage in informed economic decision-making processes (Tepalagul and Lin, 2015; SAICA, 2016). The role of the auditor is therefore inextricably linked to the quality of the organisation's financial reporting.

The International Auditing and Assurance Standards Board (IAASB) acknowledges the observations of audit quality provided by academic literature and summates these findings into two components of the audit, which are "a technical component and a service component" (IAASB, p.3, 2012). The technical component of the audit encapsulates the considerations of auditor independence and auditor competence, whereas the service component of the audit considers the efficiency and the cost of the audit process (IAASB, 2012). The component of the audit which is considered of most importance is dependent on the relative stakeholder of the audit, and it is noted that the users of the financial statements consider the technical component of the audit to be of most significance (IAASB, 2012). The IAASB also acknowledges that different stakeholders within the audit will have different perceptions of the quality of the audit (IAASB, 2013).

Auditor independence

The IRBA requires all registered auditors to adhere to the IRBA Code of Professional Conduct, a code that conforms to the relevant international standards released by the International Ethics Standards Board for Accountants. Audit firms and members of audit teams involved in audits of financial statements and review engagements are required to be independent of audit clients, in order to protect the public's interest by providing independent audit opinions (IRBA, 2014). The code requires independence in mind, referring to the uninfluenced mind of the auditor, ensuring that the professional scepticism, professional judgement, and objectivity of the auditor remain unimpaired. The code also refers to independence in appearance, referring to a reasonable third party's perception of the auditor's independence (IRBA, 2014). Perception of audit quality is important, as described in the Code of Professional Conduct for auditors (IRBA, section 290:8, 2014), as the need for the auditor to have independence in both mind and in appearance to a third party. The audit opinion provides assurance to the market and the public of the credibility of the financial statements, as explained in the International Standards on Auditing, and therefore this independence of the auditor in the eyes of the market is necessary. According to the International Standards on Auditing ISA 200, the audit enhances the degree of confidence of intended users in the financial statements (International Auditing and Assurance Standards Board, ISA 200, 2009).

The two dimensions of independence are equally important constructs (Nieschwietz and Woolley, 2009). In accordance with the definition of audit quality proposed by DeAngelo (1981), independence in mind directly influences audit quality, as a lack of independence may lead the auditor to behave inappropriately if a misstatement or error has been detected. However, if the users of the financial statements on which the auditor is to provide an opinion have a poor perception of the independence of the auditor, the credibility of those financial statements is diminished (Kaplan and Mauldin, 2008; Daniels and Booker, 2011).

Tepalagul and Lin (2015) provided a framework with which to assess the circumstances that may have an effect on auditor independence and subsequently affect audit quality (refer to Figure 1 below). This framework is consistent with the Code of Professional Conduct framework for auditors to assess any potential threats to their independence, as well as the means to implement the appropriate measures to reduce the significance of an identified threat.

Regulation and laws in South Africa provide additional requirements for auditor independence, namely the Companies Act, 2008 of South Africa hereafter referred to as ‘the Companies Act’ and the King IV Report on Corporate Governance. The Companies Act requires the audit engagement partner of a statutory audit to rotate every five years (The Companies Act, No.71 of 2008:s92). Public companies and state owned companies are required to establish an audit committee (The Companies Act, 2008:s94). The committee is required to be appointed in terms of the King IV Report on Corporate Governance if the entity is listed, and accordingly all members of the committee should be considered sufficiently independent of the company (IoDSA, 2016). The audit committee then has the duty to nominate an independent auditor, define the level of non-assurance services allowed to be provided to the entity by the auditor, as well as to prepare a report for inclusion in the company’s annual financial statements which includes a declaration by the committee that the committee has assessed the independence of the external auditor (The Companies Act, 2008:s94).

Audit firm tenure and independence

The focus of this paper is on the information available to the user of the financial statement regarding the threat to auditor independence based on long audit firm tenure. Audit tenure is the length of time in years that the audit firm has been appointed by the client. Regulators and researchers have over many years researched and debated audit firm rotation as a means for enhancing the independence of the auditor (Kaplan and Mauldin, 2008; Jenkins and Vermeer, 2013) as auditor rotation will, among other things, limit the tenure of the audit firm. Audit tenure has long been considered a significant threat to auditor independence. According to Casterella and Johnston (2013) the proponents of regulations that require shorter audit tenures would result in higher quality audits due to enhanced auditor independence. In contrast, opponents believe that audit quality would decline because the new auditor would lack experience with the client (Casterella and Johnston, 2013).

Tepalagul and Lin (2015), as can been seen represented in Figure 1 below, show a widely accepted theoretical framework for understanding auditor independence and its link to audit quality. The audit profession in most international jurisdictions is a for-profit and competitive enterprise as well as a public practice. Therefore, like any business, the auditors have profit incentives to yield to client pressure to retain their business, especially the business of their most significant clients, which in turn compromises auditor independence (Tepalagul and Lin, 2015). Added to this potential compromise of independence is the reality that many audit clients require non-assurance services from their auditors, which are often more lucrative than the audit fee (Tepalagul and Lin, 2015), possibly resulting again in compromised independence in the audit engagement (Tepalagul and Lin, 2015). These threats to independence are explained at length in the IFAC Code of Professional Conduct whereby numerous guidelines are provided to enable the auditor to manage these conflicts of interest. Long auditor-client tenure and client affiliation with audit firms create familiarity between the parties as relationships form (IFAC Code, 2006). The profits from non-audit services create self-interest threats to independence. These threats may threaten auditor independence and audit quality.

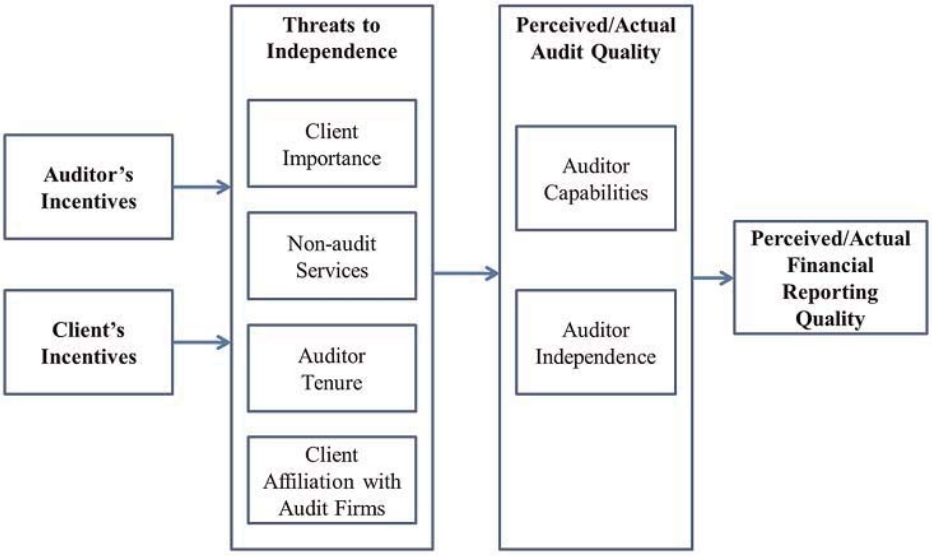

Figure 1. A framework for assessing the impact of auditor independence on audit quality.

Source: Tepalagul and Lin (2015)

Prior research has confirmed a positive association between auditor expertise and audit quality. For example, client-specific experience, a proxy for expertise, enhances auditors' ability to respond to fraud indicators (Brazel, Carpenter and Jenkins, 2010); and industry expertise has been found to be positively associated with financial reporting quality. Jackson, Moldrich and Roebuck (2008) found that audit quality increases with audit firm tenure, when proxied by the propensity to issue a going-concern opinion. This was also confirmed by the findings of Ruiz-Barbadillo, Gómez-Aguilar and Carrera (2009). Cameran et al. (2015) concluded that the quality of audited earnings declines in the first three years following rotation, relative to later years of auditor tenure.

In recognition of the possibility for long audit tenure to impair auditor independence, IRBA issued the regulation for audit firms to disclose audit tenure in the audit reports on the 4th of December 2015. The primary reason provided by the regulator was to raise transparency regarding the firm's tenure and not that of the individual auditor which is an objective in agreement with regulations in international jurisdictions (IRBA, 2015).

The disclosure of the tenure of the auditor will allow for a degree of transparency in regards to the audit firm-client relationship and allow for the users of the audited annual financial statements the necessary information to assess any threats that the length of the relationship might pose to auditor independence in their perception of auditor independence. Most would agree that it is important to provide the users of the financial statements with this information so that they are able to make their own assessment of whether the auditor is likely to be independent and whether perhaps they should lobby for shareholders to consider replacing them. This is the intent of the IRBA disclosure rule.

However, the academic literature is not clear on whether audit tenure really does impair auditor independence or audit quality. An important study by Tepalagul and Lin (2015) consisted of a comprehensive review of academic research pertaining to auditor independence and audit quality. Through a review of published articles during the period 1976-2013 in nine leading journals related to auditing, most studies concluded that long auditor tenure does not impair independence (Tepalagul and Lin, 2015).

A Belgian study by Knechel and Vanstraelen (2007) that used a sample of stressed bankrupt and non-bankrupt companies, found that auditors do not become less independent over time nor do they become better at predicting bankruptcy. According to Knechel and Vanstraelen (2007), the evidence for tenure either increasing or decreasing audit quality is weak.

Other researchers produce conflicting findings on the association between auditor tenure and auditor behaviour. In a study of audits of US public schools, Deis and Giroux (1992) report that quality-control findings decrease as auditor tenure lengthens. Using data for audit partner tenure in Australia for a period where partner rotation was not mandatory, the relationship between audit quality and long audit partner tenure was investigated by Carey and Simnett (2006). The three measures (proxies) of audit quality examined were 1) the auditor's propensity to issue a going concern opinion for distressed companies, 2) the direction and amount of abnormal working capital accruals, and 3) just beating (missing) earnings benchmarks. For long tenure observations the results showed a lower propensity to issue a going concern opinion and some evidence of just beating (missing) earnings benchmarks, consistent with deterioration in audit quality associated with long audit partner tenure (Carey and Simnett, 2006).

Further conflicting results were identified by Johnson, Khurana, and Kenneth Reynolds (2002) who examined whether the length of the relationship between a company and an audit firm (audit firm tenure) is associated with financial reporting quality. Johnson et al. (2002) categorised auditor-client relationships into periods of short, medium and long tenures. Using two proxies for financial reporting quality, based on accounting accruals, and a sample of large audit firm clients matched on industry and size, Johnson et al. (2002) found that relative to medium audit firm tenures of four to eight years, short audit firm tenures of two to three years are associated with lower-quality financial reporting. Again, in contrast to the shorter periods, Johnson et al. (2002) found no evidence of reduced financial reporting quality for longer audit firm tenures of nine or more years.

A US study on the raising of going concern (financial distress) uncertainties by auditors suggests that audit failures are more likely in the early years of the auditor-client relationship (Geiger and Raghunandan, 2002). The results were consistent with the position that auditors may be more influenced by their newly obtained clients in the earlier years of the engagement. Therefore this does not support that auditor rotation be made mandatory or that long tenure reduces audit quality.

Bamber and Iyer (2007) used a theory-based measure for the extent to which auditors identify with a client, which was then used to directly measure auditors' attachment to the client and consequently the threat of this attachment to auditors' objectivity. The responses of 252 practising auditors were obtained, providing support for the predictions of Bamber and Iyer (2007). Specifically, Bamber and Iyer (2007) found that auditors do identify with their clients and that auditors who identify more with a client are more likely to agree with the client preferred position on an audit and financial reporting matter. However, more experienced auditors and auditors who exhibit higher levels of professional identification are less likely to acquiesce to the client's position. Differing incentives were identified for the partner in comparison to the firm. The incentive of the individual audit partner may conflict with that of the audit firm so that long partner tenure increases the likelihood of the auditor acquiescing to the client's preferences, whereas audit firm tenure is associated with the decreased likelihood of auditor concessions (Bamber and Iyer, 2007). By looking at the differing incentives of the firm as a whole, compared to that of the individual partner in the firm, the results implies that, unlike an audit partner, an audit firm may have stronger reputational incentives to remain independent. Therefore, rotating the firm in a system of MAFR, as opposed to the partner, may not be the best means to achieve independence and audit quality.

An investigation into the effects of audit partner rotation among US publicly listed companies by Laurion et al. (2015) used a sample of US partner rotations and non-rotations, revealed that partner rotations result in substantial increases in material restatements (124.8%) and total valuation allowances and reserves (0.8% of assets). This suggests that US partner rotations do provide a fresh look at the audit engagement.

Researchers have also explored the impact of partner rotation on auditor effort and audit quality. There is empirical evidence that the effort provided by the auditor, or invested by the auditor into the engagement, increases following a rotation of the audit partner. Bedard and Johnstone (2010) showed evidence that planned engagement effort increases following partner rotation, suggesting that new partners apply themselves and their resources more to gain client knowledge in the first year on the engagement. This suggests that new partners work harder to reduce the information asymmetry that they face in directing a first-time audit (Bedard and Johnstone, 2010). In this way, a "fresh set of eyes" is a benefit to the audit and would be a positive aspect of partner or firm rotation (Bedard and Johnstone, 2010).

In conclusion, there are mixed results around the effect that partner rotation has on independence and audit quality. However, as noted by Tepalagul and Lin (2015), most studies conclude that audit tenure does not impair independence, even though there does appear to be benefits to partner rotation, such as a more conservative and diligent approach to the audit by the incoming partner.

Investor perception of audit quality

Moon and Ghosh (2005) attempted to examine investors' perspectives of audit quality as affected by audit firm tenure. The foundation of the study rests on the premise that audited financial statements will be less reliable if the users of those statements, specifically investors and information intermediaries, perceive audit quality to be reduced as a result of the effect of a long audit tenure on the independence of the auditor (Moon and Ghosh, 2005). To proxy investor's perception of earnings quality and thus audit quality, the authors make use of "earnings response coefficients from returns-earnings regressions" (Moon and Ghosh, p.587, 2005). Moon and Ghosh (2005) find that as audit tenure increases the magnitude of the earnings response coefficients increases, which leads the authors to conclude that investors perceive audit tenure as a means to impact audit quality positively.

Public perception of auditor independence

Studies have also attempted to isolate the effect of audit firm tenure on the independence of the auditor. However, researchers are unable to observe the state of mind of the auditor to assess the auditor's independence in mind, therefore research on the independence of the auditor focuses on specific users' perceptions of independence (Kaplan and Mauldin, 2008; Nieschwietz and Woolley, 2009).

In an experiment-based study, Kaplan and Mauldin (2008) used the responses of Master of Business Administration students to a given theoretical case, as a representation of non-professionals' perceptions of the auditor's independence as affected by either audit partner rotation or audit firm rotation. The perceptions of the participants in the study did not show significant differences between partner or firm rotation, leading the authors to conclude that mandatory audit firm rotation may not have a beneficial effect on the perceptions of non-professional investors of auditor independence (Kaplan and Mauldin, 2008).

A study examining the perceptions of private and institutional investors in the United Kingdom was conducted by means of a questionnaire, enquiring of the sample participants how they perceive certain audit firm and client relationships (Dart, 2011). A long audit firm-client relationship was a factor explored and a majority of the participants in the study disagreed that the length of the audit would impair the independence of the auditor. Upon further analysis, Dart (2011) found that institutional investors were less concerned by the impact of a long audit tenure on the independence of the auditor in comparison to private investors.

Practitioner perceptions of auditor independence

In a recent descriptive study conducted by Harber (2016), open-ended interviews were conducted with leading audit practitioners in South Africa. The purpose of the study was to gauge the perceptions of a small group of experienced registered auditors (audit partners) on the status of auditor independence in the audits of public interest entities in a South African context. The study did not aim to form a representative view of the auditing profession as a whole on the status of auditor independence, but rather to identify the breadth of the prevailing views, concerns and recommendations held by practitioners (Harber, 2016). Fourteen partners of audit firms in South Africa formed the selection (not a representative sample) in the study, from both large and mid-size audit firms. All the partners were considered senior and highly experienced, ranging between seven years as a practicing registered auditor and thirty-three years. The average number of years as a practicing registered auditor of all interviewees was twenty-two years. Seven of the partners were either regional or national managing partners in the firms and therefore in key leadership and strategic roles. The remainder were senior partners who also held significant leadership responsibilities and portfolios within their respective firms or network of firms (Harber, 2016).

Most audit partners interviewed did not believe that any changes to regulations are necessary to address auditor independence because the policies, regulations and structures in place currently are sufficient. They believe that the profession must be allowed the freedom to exercise its professional judgement and adherence to the ethical codes of conduct and that regulation restricts their ability to do that (Harber, 2016).

The partners expressed a strong belief that the public inspections process itself needs to be re-looked at by the regulator and moved in a direction that allows professional judgement and less compliance focus. The audit committee's role in appointing suitably independent auditors and continually assessing any factors such as tenure and non-assurance fees, that may compromise that independence, is crucial (Harber, 2016).

Most audit partners (11 of 14) expressed the view that there is no problem with auditor independence in reality, but rather that public perception and public misunderstanding of the audit function, was the issue. Rather than respond with more regulation (such a MAFR), they would have the regulator address public understanding of the role (and the limitations) of the audit function (Harber, 2016).

RESEARCH PROBLEM AND OBJECTIVE

There is a degree of mixed results in the literature regarding whether or not audit tenure impairs the quality of audits. However, the findings do favour the view that audit tenure does not impair independence and may even result in increased audit quality through gained institutional experience. There is also evidence that the perception of auditor independence (in the minds of the investing public) is important and according to audit practitioners, often misunderstood (Harber, 2016). This perception has been expressed as a reason why the regulator and many in the public are in favour of MAFR and further auditor regulation. The IRBA has responded by requiring auditors in South Africa to disclose audit tenure on the face of the audit reports to aid users of financial statements in making their own informed judgements. The new rule is to be implemented for audit reports issued on or after 31 December 2015.

In light of this new audit tenure regulation and due to the relevance of independence to the external audit function, there is a question as to whether audit committees and management are assisting users of financial statements in assessing auditor independence through adequate disclosure of tenure and other factors considered that impact on independence. Since the audit firm must disclose auditor tenure, what information is forthcoming from the other side of the engagement, i.e. the audit committee?

It is submitted that a simple disclosure of audit firm tenure by the board of a company is a proxy for the disclosure of further information from those charged with governance that allow users of financial statements in making their own informed judgements. There is uncertainty regarding whether those charged with governance have been providing this disclosure before it was mandatory for auditors themselves to provide it.

The objective of this study is to investigate the nature and extent of disclosure of audit tenure in annual reports, prior to the audit tenure disclosure rule issued by the IRBA. Disclosure in the annual report, outside of the auditor's report, is provided by management and/or those charged with governance. The audit committee and the board in a public-interest entity have a legal obligation in terms of section 94 of the Companies Act, 2008 to formally assess the independence of the auditor.

In terms of section 94(7)(f) of the Companies Act, an audit committee of a company has the duty to prepare a report, to be included in the annual financial statements for that financial year

- *describing how the audit committee carried out its functions;*
- *stating whether the audit committee is satisfied that the auditor was independent of the company; and*
- *commenting in any way the committee considers appropriate on the financial statements, the accounting practices and the internal financial control of the company*

(The Companies Act, 2008)

In terms of the King III Report on Corporate Governance, which was effective in the period to which the annual reports analysed were issued, principle 3.10 recommends the audit committee report to the board and shareholders on how it has discharged its duties (IoDSA, 2009). This is consistent with the principles in the recently released King IV Report (effective November 2016).

The perception of auditor independence is a very important aspect of the concept of independence, as explained by the Code of Professional Conduct's requirement to be "independent in mind" by considering the opinions that could be formed about auditor independence in the minds of reasonable third parties (IFAC Code, 2006). It stands to reason, and is explained clearly in the King Reports on Corporate Governance, that it is therefore the obligation of those charged with governance to provide users of financial statements with a sufficient degree of disclosure regarding matters of importance to the understanding of the financial statements. The board, in addition to the auditor, should disclosure audit tenure in the annual report, and provide the users of the financial statements reasoning as to why they assess the auditor to be sufficiently independent. Disclosure of this nature is an indication of good corporate governance disclosure. Audit firm disclosure and justification of auditor independence should come from those charged with governance and should not simply be an audit tenure disclosure by the auditor on the audit report only.

This study will therefore document which of South Africa's largest companies provide such disclosure and whether any auditors have proactively also done so in their audit reports, prior to the introduction of the IRBA audit firm tenure disclosure rule. This investigation will allow for an assessment of the extent to which information, regarding the tenure of the audit firm, was available to the users of the financial statements for use in their consideration of their perception of auditor independence.

RESEARCH METHODOLOGY

The primary purpose of this study is to determine the nature and extent of the disclosure relating to the tenure of the audit firm in South African companies' most recent annual reports and annual integrated reports, prior to the introduction of the new audit tenure disclosure rule.

Data Selection

Companies were selected based on sets of primary and secondary criteria.

Primary Criteria

The companies to be selected in the sample had to meet three primary criteria:

1. The company is required to have prepared annual financial statements for inclusion in an annual report published by the company.
2. The annual financial statements of the company are audited.
3. The company is subject to the new audit tenure disclosure rule as of 31 December 2015, as required by IRBA.

The primary criteria were selected for the following reasons:

Criteria 1: The annual financial statements, included in the annual report, are to be analysed to determine the nature and extent of any disclosure of the length of audit tenure, made to the users of those statements. Without an annual report no determination can be made.

Criteria 2: The study seeks to research a specified disclosure - audit firm tenure. If a company's annual financial statements are not audited then no audit firm is engaged in a relationship with the company and therefore there is no audit firm tenure.

Criteria 3: The study aims to determine the extent of audit tenure disclosure prior to the regulation mandating audit firm tenure disclosure. IRBA requires only certain companies to adhere to this audit tenure disclosure. Therefore only those companies that are subject to the new regulation were selected (IRBA, 2015). This selection was made as these are the companies which IRBA considers to have a high level of public interest as the regulation applies to public interest entities as defined in the IRBA code (IRBA, 2015).

Based on the above criteria, the companies selected for this research study were companies with a listing on the Johannesburg Stock Exchange. A listed company meets the definition of a public company as stated in the Companies Act 2008 in section 1, and as such the company is required to prepare annual financial statements, which are to be audited (The Companies Act, 2008:s30). The preparation of audited annual financial statements is also a listing requirement of the Johannesburg Stock Exchange (Johannesburg Stock Exchange Limited, 2015). A listed company also meets the definition of a public interest entity as defined in the IRBA code in section 290.25, and as such is required to adhere to the mandatory audit tenure disclosure rule.

Therefore, companies listed on the Johannesburg Stock Exchange meet all three of the primary criteria.

Secondary Criteria

Secondary criteria for selection in the sample was as follows:

1. The company had prepared audited financial statements for inclusion within an annual report for a financial year ending between 31 December 2014 and 30 December 2015.
2. The company had a market capitalisation, as of July 2016, greater than R10 billion.

The secondary criteria were selected for the following reasons:

Criteria 1: The audit tenure disclosure rule required by IRBA is to be applied for financial years ending on or after 31 December 2015. Therefore the annual reports that were to be analysed had to be prepared before this date in order to be able to document if the tenure of the audit firm was disclosed, prior to the introduction of the regulation.

Criteria 2: The Johannesburg Stock Exchange (JSE) defines market capitalisation as equating to the total value of a company listed on the exchange, which is calculated by multiplying the share price of the company by the number of shares that the company has in issue (Johannesburg Stock Exchange [JSE], 2013). The JSE categorises the market capitalisation of companies into either small, medium or large according to two different sets of criteria.

The first definition is made as follows:

- Large: Companies ranked in the Top 40 Index
- Medium: Companies ranked from number 41 to 100 based on market capitalisation
- Small: Companies not ranked in the top 100 by market capitalisation

The second definition is made as follows:

- Large: A market capitalisation of over R10 billion
- Medium: A market capitalisation of between R1 billion and R10 billion
- Small: A market capitalisation below R1 billion

This study has selected companies of which have a market capitalisation categorised as large. Under the provided definitions, the Top 40 Index represents approximately 85% of the market capitalisation of the entire exchange (as of July 2016), in comparison to the second definition, which represented approximately 97% (as of July 2016). This second definition was selected due to the larger representation of the stock exchange as a whole.

The Sample

As of July 2016, 101 companies had a market capitalisation exceeding R10 billion. 100 companies were selected for inclusion in the sample based on meeting the sets of primary and secondary criteria. One company, The Bid Corporation Limited, was removed from the sample as the company was recently formed in 2016 and as a result the company had published no annual report.

Sample Descriptive Statistics:

- The companies accounted for roughly 97% of the market capitalisation of the entire Johannesburg Stock Exchange
- The 100 companies constitute two Johannesburg Stock Exchange indices, namely the Top 40 Index and the MidCap Index
- In terms of the Industry Classification Benchmark (ICB) according to industry, seven of the nine industry classifications were represented
- Representation in the sample based on ICB industry classification:
    - Oil and Gas: 0%
    - Basic Materials: 21%
    - Industrials: 8%
    - Consumer Goods: 12%
    - Healthcare: 4%
    - Consumer services: 15%
    - Telecommunications: 4%
    - Utilities: 0%
    - Financials: 35%
    - Technology: 1%
- Representation in the sample based on sector analysis:
    - SA industrials: 44%
    - SA Resources: 21%
    - SA Financials: 35%
- 19% of the companies in the sample had a primary listing other than on the Johannesburg Stock Exchange
- The most significant primary listing on an exchange other than the Johannesburg Stock Exchange was a listing on the London Stock Exchange. 13% of the companies have a primary listing on the London stock exchange.
- 21% of companies have a secondary listing on other international exchanges.

Data Collection Process

The annual reports of the sampled companies for the specified period were obtained from each of the companies' websites. In some cases companies had separately published their full statutory annual financial statements from their annual report and in those cases both the annual report and the annual financial statements were obtained. Companies listed on the Johannesburg Stock Exchange are not required, in terms of the listing requirements, to issue an integrated report, but if the respective company had published an integrated report then this was obtained in addition to the annual report (Johannesburg Stock Exchange Limited, 2015).

A predefined list of attributes was developed, based on the purpose and aims of this research study, which would be used to search for the relevant information within the obtained reports. The list of attributes is as follows:

- Disclosure of audit firm tenure – a yes or no attribute.
- The section of the report where the tenure of the audit firm was disclosed, if such information was disclosed.
- Additional qualitative information disclosed surrounding the circumstances of audit firm tenure, in addition to the length of the tenure of the audit firm, if such information was disclosed. The documentation of this information will allow for comment and further analysis on the nature and context of the disclosure, if such disclosure was made.
- The audit firm that audited the company's financial statements.
- The primary exchange that the company is listed on. Stock exchanges in international jurisdictions have differing listing requirements to those of the Johannesburg Stock Exchange. International jurisdictions also have specific laws and regulations, which companies within those jurisdictions must adhere to. As discussed in the first section of this report, the international regulatory environment with regards to regulations addressing the tenure of audit firms is diverse and therefore it is relevant to document the primary exchange of the company so as to evaluate the laws and regulations that the company is subject to as a result of the place of the company's listing.
- Secondary exchange listing. The reasoning for the inclusion of this attribute is the same as that discussed under primary exchange above.

A text analysis was performed on the annual reports of the one hundred companies and the above attributes were entered into a spreadsheet using Microsoft Excel.

PRESENTATION AND DISCUSSION OF RESULTS

The new regulation mandating the disclosure of the tenure of the auditor (the audit tenure rule) is a mandatory disclosure requirement for inclusion in South African audit reports for financial years ending on or after 31 December 2015. Therefore where there was audit tenure disclosure in the audit report before this date (by the auditor) or in other parts of the annual report (by management or those charged with governance), it was provided either in the spirit of good corporate governance disclosure, or in accordance with international (not South African) regulations, which may apply to the reporting entity with operations in other jurisdictions.

Of the one hundred annual reports and annual financial statements that were reviewed and analysed, it was found that only fifteen companies had disclosed the number of years that the audit firm had been the auditor of the respective company (audit tenure). This is less than expected. All of these disclosures occurred outside of the audit report, which was expected, since the auditors had not yet applied the auditor tenure rule. Eighty-five companies therefore did not provide disclosure of audit tenure anywhere in the audit report. Of the fifteen instances of disclosure, this information was disclosed in either the Audit Committee Report for the year, or in a report covering corporate governance matters, produced by the board.

Refer to Table 1 below for more detail.

Table 1: The list of companies that provided audit tenure disclosure

Company	Primary Listing	Financial Year	Auditor	Section of the Annual Report
British American Tobacco plc	London Stock Exchange	31 December 2014	PricewaterhouseCoopers	Governance Section - Directors Report - Audit and Accountability
SABMiller plc	London Stock Exchange	31 March 2015	PricewaterhouseCoopers	Audit Committee Report
BHP Billiton plc	London Stock Exchange	30 June 2015	KPMG	Risk and Audit Committee Report
Compagnie Financiere Richemont SA	Swiss Exchange	31 March 2015	PricewaterhouseCoopers	Corporate Governance
Glencore plc	London Stock Exchange	31 December 2014	Deloitte	Corporate Governance Report - Audit Committee Report
Old Mutual plc	London Stock Exchange	31 December 2014	KPMG	Governance Section - Audit Arrangements
Aspen Pharmacare Holdings Ltd	Johannesburg Stock Exchange	30 June 2015	PricewaterhouseCoopers	Audit & Risk Committee Report
Mondi plc	London Stock Exchange	31 December 2014	Deloitte	Audit Committee Report
Mondi Ltd	Johannesburg Stock Exchange	31 December 2014	Deloitte	Audit Committee Report
Investec plc	London Stock Exchange	31 March 2015	Ernst & Young	Corporate governance and corporate responsibility Report
Intu Properties plc	London Stock Exchange	31 December 2014	PricewaterhouseCoopers	Governance - Audit Committee Report
New Europe Property Investments plc	London Stock Exchange	31 December 2014	PricewaterhouseCoopers	Corporate Governance
Capital & Counties Properties plc	London Stock Exchange	31 December 2014	PricewaterhouseCoopers	Audit Committee Report
Redefine International plc	London Stock Exchange	31 August 2015	KPMG	Audit & Risk Committee Report
Lonmin plc	London Stock Exchange	30 September 2015	KPMG	Governance - Audit & Risk Committee Report

As discussed in the research methodology section, it was necessary to document the company's primary listing. Stock exchanges require constituents to comply with their specific listing requirements, as well as the laws and regulations within the country of that exchange. A majority (13 of 15) of the companies that had disclosed the audit tenure have a primary listing on an international exchange, other than the Johannesburg Stock Exchange.

Companies with a primary listing on the London Stock Exchange comprised twelve of the fifteen companies who had provided disclosure in regards to audit tenure. Companies listed on the London Stock Exchange (LSE) are required to comply with the Listing Rules of this exchange. In terms of the Listing Rules of the LSE, companies with a premium listing on the LSE are required to report their compliance with the UK Corporate Governance code, amongst other regulations. The code is not prescriptive in terms of rules, but rather requires companies to apply the principles of the code on a "comply or explain" basis (Financial Conduct Authority, 2016:27), similar to the South African King III Report basis.

The UK Corporate Governance Code requires a section of a company's annual report to outline the duties performed by the audit committee. Within this section information regarding the tenure of the current audit firm should be disclosed. Of the twelve companies that have a primary listing on the LSE, eleven are said to have a premium listing on the exchange and therefore are subject to comply with the requirement to disclose the tenure of the audit firm.

New Europe Property Investments is listed on the Alternative Investment Market (AIM) sub-market of the LSE and therefore is not considered to have a premium listing. Companies listed on the AIM are not required to comply with the UK Corporate Governance Code, but may choose to apply the principles of the code or may choose to apply a different framework of corporate governance better suited to the needs of the company, as long as a declaration as such has been made by the company as to which code the company has chosen to apply. New Europe Property Investments has elected to apply the Quoted Companies Alliance Corporate Governance Guidelines for Smaller Quoted Companies.

Compagnie Financiere Richemont has a listing on the Swiss Exchange. In terms of the rules of the exchange, all listed companies are required to apply the Corporate Governance Directive. The Directive requires that the report issued by the company should disclose information as to when the current auditors of the company were formally elected for the first time. Compagnie Financiere Richemont is compliant with the directive in terms of the disclosure of audit firm tenure.

Considering the above, it is concluded that twelve of the fifteen companies, which had disclosed the tenure of the audit firm, had done so as a result of compliance with the respective listing requirements of their primary exchange.

The remaining three of the fifteen companies that provided disclosure, namely, New Europe Property Investments Plc., Mondi Limited, and Aspen Pharmacare Holdings Limited, are not required by regulation to disclose the tenure of the audit firm. Mondi Limited and Aspen Pharmacare Holdings limited have primary listings on the Johannesburg stock exchange and no other secondary listings. As such, these companies are not subject to other international regulations in regards to audit tenure disclosure. New Europe Property Investments Plc. is also not required by regulation to disclose audit tenure, as it is not listed on the main board of the LSE. Consequently, these three companies have provided auditor tenure disclosure voluntarily so as to allow the users of the financial statements to better assess the independence and suitability of the appointed audit firm.

Application to stakeholder perceptions

Perception of audit quality differs amongst different users of the audited financial statements. The different perceptions of audit quality arise as a result of the different stakeholder's degree of involvement within the audit. The perception of audit quality are also affected by the information that the users of the audited financial statements have access. In a survey conducted by the IAASB, it was found that users of the financial statements, specifically investors, consider that the perception of the independence of the auditor to be an important determinant in audit quality (IAASB, 2013).

Therefore, users of the financial statements in developing their perception of the independence of the auditor and by implication, audit quality, rely on information that is accessible in regards to the audit. The Public Company Accounting Oversight Board (PCAOB) states that the ability of the users of the audited financial statements to assess the quality of the audit is limited by the information regarding the audit that is provided. The PCAOB concluded and communicated to its stakeholders that there is value to be added through disclosure of such information that may be useful for users to form opinions in this regard (PCAOB, 2015).

The new audit tenure rule mandated by the IRBA to increase the degree of transparency in regards to auditor independence allows users the opportunity to assess auditor independence for themselves. Users of financial statements are now provided with important information, namely the tenure of the audit firm, to allow them to consider for themselves any threats that may arise and impact the independence of the auditor as a result of the length of the audit firm-client relationship. As can be clearly seen from the results of this study, this information was clearly not available for most of the large exchange listed companies before the IRBA introduced the rule.

The assessment of the extent of audit tenure disclosure prior to the introduction of the audit tenure rule sheds light on the extent of information that was available to the users of the financial statements in their assessment of the independence of the auditor. Eighty-five of the one hundred company annual reports analysed did not disclose information about the tenure of the audit firm. The public therefore had limited ability in their assessment of the potential threat of the long association between the auditor and the client. Management and those charged with governance in these companies clearly did not prioritise such disclosure, either because they were not aware of the importance of such disclosure to the users of the financial statements, or simply because such disclosure, not being a regulatory requirement in South Africa, was not in their best interests to disclose.

CONCLUSION AND AREAS FOR FURTHER RESEARCH

It is therefore submitted, considering the importance of auditor independence in the mind of the public, and the obligation of the board of a company to provide users of financial statements with a sufficient degree of disclosure regarding matters of importance to the understanding of the financial statements, that the board, in addition to the auditor, should disclosure audit tenure in the annual report, and provide the users of the financial statements reasoning as to why they assess the auditor to be sufficiently independent. Disclosure of this nature is an indication of good corporate governance disclosure. Audit firm disclosure and justification of auditor independence should come from those charged with governance and should not simply be an audit tenure disclosure by the auditor on the audit report only.

This study has reported which of South Africa's largest public interest companies provide such disclosure and whether any auditors have proactively also done so in their audit reports, prior to the introduction of the IRBA audit firm tenure disclosure rule. In light of the new regulation issued by the IRBA, this study set out to explore the nature and extent of disclosure made by companies of audit firm tenure prior to the introduction of the IRBA audit tenure disclosure rule in South Africa. The main finding of this study shows that the extent of the disclosure made by companies of the tenure of the auditor is low in a South African context and as a result the information available for users of the audited financial statements for their consideration of the assessment of perceived auditor independence is limited. Management and those charged with governance should be made aware of this lack of key disclosure.

The limited availability of information may be partly to blame for the findings by Harber (2016) that leading audit practitioners within South Africa believe that the public's supposed negative perception of auditor independence differs significantly to that of the independence of the auditor in reality. How can users of financials statements accurately assess for themselves the independence of the audit firm if those charged with governing the company do not provide sufficient detail in which they can base that judgement? Auditor tenure is just one (albeit a particularly important) piece of information that will both inform the users of the financial statements with regard to the duties and judgements made by the audit committee, as well allow the users to themselves form an opinion as to whether the audit committee should be considering placing the audit out for tender. It is submitted therefore, that audit tenure disclosure by the company (not by the auditor) is a useful proxy for the quality of an audit committee's disclosure and discussion in the annual report of the discharge of their duties in regard to the independence of the appointed auditor. The audit committee specifically, and the board in general, have an obligation to inform the users of the financial statements in this regard. The results of this study show clearly that very few audit committees are providing the information required by users of financial statements to understand auditor independence and how the audit committee has assessed this very important contributor to quality financial reporting. Audit committees must provide more disclosure than simply that which is required by regulation.

A suggestion of the nature such disclosures, although not exhaustive, are as follows:

- The audit fees payable, split between assurance and non-assurance services.
- The process followed and key factors considerations for the assessing of the suitability of the audit firm, as well as their independence from the company, especially in light of the common threats to auditor independence as illustrated by Tepalagul and Lin (2015) in Figure 1 above. The independence of the audit partner and the audit firm itself should be considered and disclosed separately.
- The nature and extent of non-assurance services provided by the audit firm should be considered and disclosed separately.
- The annual report of the audit committee is the document that should contain these disclosures for the benefit of the users of the financial statements.

Future research implications have emerged from this study. Research is required to understand the reasons why management and those charged with governance have not provided key disclosures to suit the needs of users in regard to auditor independence and suitability. Research is required to assess the effectiveness of the mandatory disclosure of audit firm tenure as a means of providing information to the users of the financial statements for their use in their assessment of perceived auditor independence. The usefulness of such disclosures, and the best format and nature for such disclosures, should be studied. Investors in particular may have information requirements that are different to those of regulators, those who enter into business contracts with the company, or the general public. Therefore the needs of various users of financial statements can be explored.

The findings of this study support the introduction of the regulation by IRBA, which mandated the disclosure of the audit firm's tenure with the objective of enhancing the degree of transparency in regards to the association between audit firms and their audit clients. However, it is clear that those charged with governance do not provide necessary disclosures and need to address this. The newly effective requirements of the King IV Report on Corporate Governance (superseding the King III Report) need to be understood by those charged with governance of listed companies and used to improve the current lack of auditor tenure and auditor independence disclosure in the annual reports that has been found in this study.

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