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AUD 02: An analysis of audit partner perceptions regarding the state of auditor independence in South African audit firms

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Abstract

The provision of assurance services, most notably the audit function, is an activity of public protection that requires a high degree of independence between the auditor and the audit client to ensure audit quality is achieved. In the European Union, there is now a legislated move towards mandatory audit firm rotation (MAFR) to ensure auditor independence. South Africa is currently faced with the decision of whether to change legislation and follow suit. In addition, the 2014/2015 Public Inspections Report was recently released by the Independent Regulatory Board for Auditors (IRBA) and it revealed worrying statistics of ethical practice and disclosure non-compliance by audit firms, again highlighting the concerns around independence between auditor and client.

Using a qualitative and descriptive methodology, through the use of semi-structured and open interviews with experienced South African audit partners, the views of the profession around auditor independence is explored.

This study will therefore present the opinions of a small group of experienced audit partners, most being regional or national managing partners, from audit firms that perform public interest entity audits. The views of these audit practitioners indicate that the South African audit profession does not believe that any changes to regulations are necessary to address auditor independence as any problem with auditor independence is one of perception, not reality. The partners expressed a concern that the public inspections process needs to be revised by the regulator and the audit committee's role in appointing suitably independent auditors is crucially important and a role that should be strengthened before more regulation is imposed on the audit profession.

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Introduction and Literature Review

Though auditors should regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay. Whose bread I eat, his song I sing. (Buffet and Clark, 2006)

The provision of assurance services, most notably the audit function, is an activity of public protection. In the eyes of the public, especially the investing public and 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. Auditor independence is important because it has an impact on the quality of the audit. DeAngelo (1981) suggests that audit quality is defined 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 and hence why regulations are imposed to ensure the professional standards and the independence of the external audit function. Most countries, including South Africa, have moved away from self-regulation the audit profession, to a system of using an independent regulatory body. In South Africa this regulatory authority is the Independent Regulatory Board for Auditors (IRBA).

Many studies on the topic of auditor independence have been performed to date (Carey and Simnett, 2006; Daniels and Booker, 2011; Tepalagul and Lin, 2015), in significant economic jurisdictions such as the United States and Europe, which is understandable given its importance to the quality of the audit. 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 audit opinion and audit report, and therefore a lack of independence could impair the quality of the audit report provided to the public and stakeholders of the company. Recent research by Tepalagul and Lin (2015) provides a useful four dimensional approach with which to assess the impact of auditor independence on audit quality, namely, (a) client importance, (b) non-audit services, (c) auditor tenure, and (d) client affiliation with audit firms. This categorisation of the four main threats to auditor independence is useful for further research and theory and will be used in this paper, as shown diagrammatically in Figure 1.

The audit profession in most international jurisdictions is a for-profit and competitive enterprise as well as a public practice (meaning an activity that aims to protect the public from unfair presentation and fraud in financial reporting). Therefore, like any

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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 in which 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 (International Federation of Accountants (IFAC), 2006). The profits from non-audit services create self-interest threats to independence. These threats may threaten auditor independence and audit quality.

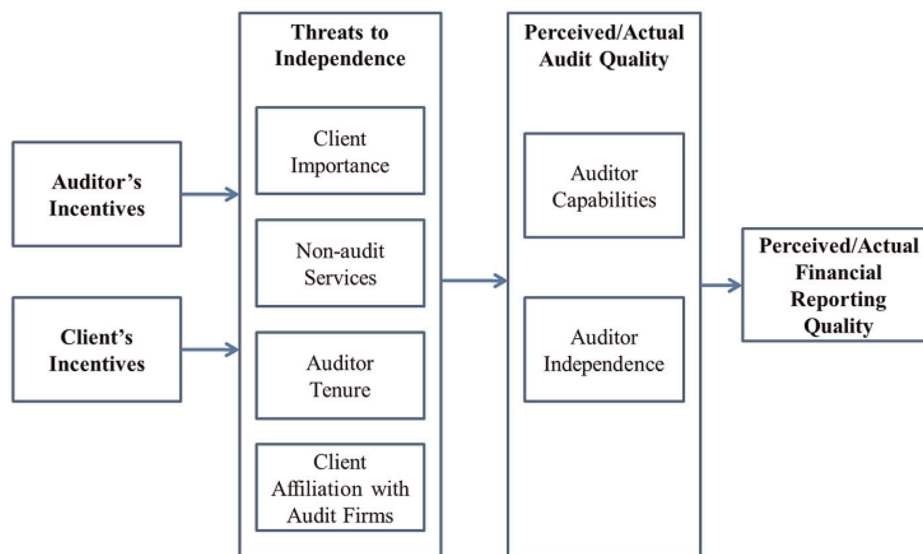

Figure 1. A framework for assessing the impact of auditor independence on audit quality.

Source: Tepalagul and Lin (2015)

As can also be seen from Figure 1, audit quality, which results in quality financial reporting of companies, is a function of the capabilities and the independence of the auditor. However, the threats to auditor independence negatively impact on this quality.

Per discussion with the CEO of the IRBA in December 2015 (the transcript of which is available upon request), the national regulator is concerned with the state of actual and perceived auditor independence in South Africa and is actively considering means of addressing this concern. Part of the reason for this concern is the recently published 2014/2015 IRBA Public Inspections Report.

The Public Inspections Report

The IRBA performs inspections on selected firms to evaluate their performance on a selection of audit engagements, as well as the design and effectiveness of their quality

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control policies and procedures. The report provides an analysis of key findings arising from firm and engagement inspections performed by the Inspections Department of the IRBA. The latest report was published in December 2015 and covers audits for the year ended 31 March 2015, and also includes an overview of the scope of the IRBA's inspections. (IRBA, 2015c)

The IRBA is concerned that a significant portion of the findings relate to relevant ethical requirements (refer below to Figure 2), and more specifically issues where independence may be considered the root cause. A root cause was identified as "Failure to fortify the importance of professional scepticism and the independence of the engagement team so as to overcome the threats that could develop as a result of their relationship with clients", as well as "Failure to strengthen and maintain independence as an underlying principle for high audit quality." (IRBA, 2015c)

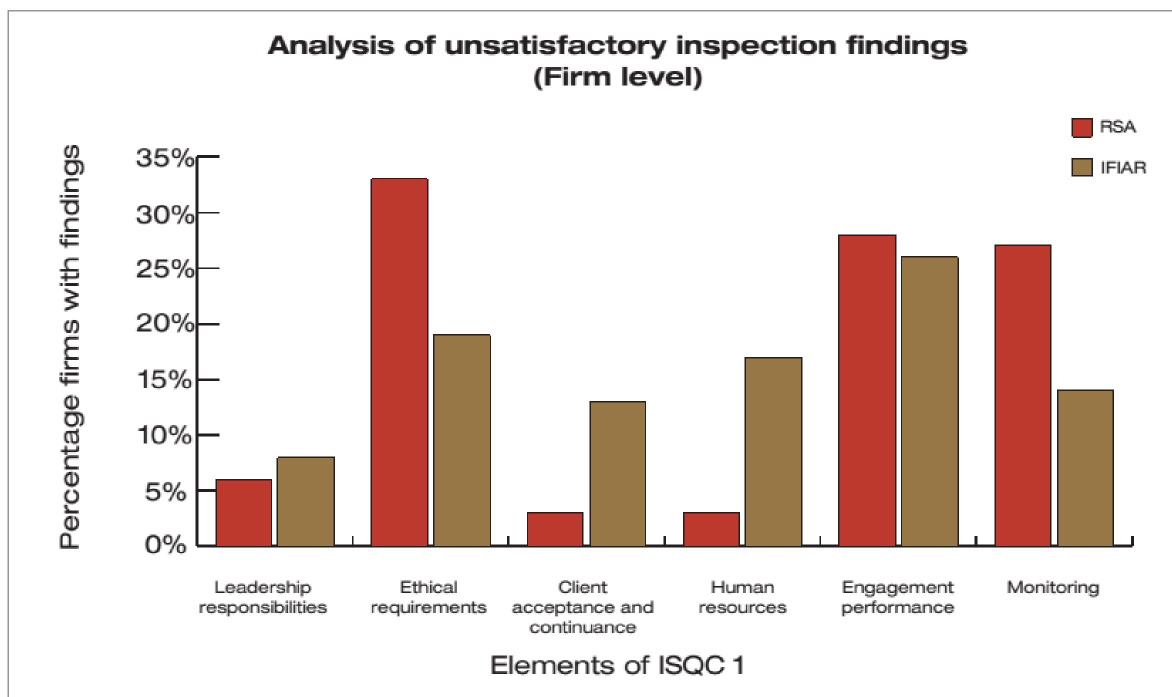

Figure 2

Source: IRBA 2014/2015 Public Inspections Report (IRBA, 2015c)

The above graph (Figure 2) from the latest 2014/2015 Public Inspections Report shows indicates a significant breach by auditors in South Africa of ethical requirements, both relative to other issues, but also in the comparison made to International Forum of Independent Audit Regulators (IFIAR) Inspections Workshop. The IFIAR inspection findings are based on a survey of 29 member countries and present as a percentage the amount of inspected firms with deficiencies found per ISQC1. It should be noted that the IFIAR results represent the largest six global network firms, whereas the results for South Africa span the entire population of large, medium and small auditing firms that were inspected.

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Per the IRBA Newsletter 32 – December 2015:

The IRBA Inspection Committee reported on 37 audit firm and 375 audit engagement inspections for the year (IRBA, 2015c, 2015d). Most firms showed one or more deficiencies, including ethics (independence), engagement performance and monitoring, which require urgent improvement. A significant number of individual audit engagement files also showed deficiencies that need urgent attention. A total of 16% of firms and 6% of engagement partners were referred to the Investigating Committee of the IRBA due to fundamental or continued noncompliance with international auditing and financial reporting standards, professional codes and legislative requirements. The report also emphasises the need for audit firms to urgently address ethics and independence matters, as well as engagement quality. (IRBA, 2015c, 2015d)

The IRBA is of the opinion that high-quality auditing and accounting practices are not only essential for reliable financial reporting, but are also critical in protecting the public interest and boosting investor confidence. According to the IRBA, compliance with auditing standards, ethics, financial reporting standards and legislative requirements is fundamental in ensuring a reliable profession that can effectively compete internationally (IRBA, 2015a). Therefore the IRBA is considering advocating a change in South African legislation in order to follow the direction of the European Union in requiring periodic rotation of the audit firm. This system is called mandatory audit firm rotation (MAFR) and its primary purpose is to protect audit quality through promoting the independence of the auditor from the audit client by way of full audit firm rotations every few years. According to the IRBA CEO and 2015 consultation paper issued by the IRBA (entitled “Measures to strengthen auditor independence”), the main reasons that the IRBA Board should consider further measures to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets.

(IRBA, 2015b; SAICA, 2016)

Mandating disclosure of audit tenure

In December 2015, the Regulatory Board (IRBA), in terms of its powers provided by the Auditing Profession Act, Act 26 of 2005, published a Rule in the Government Gazette which makes it mandatory that all auditor′s reports on Annual Financial Statements shall disclose the number of years which the audit firm (or sole practitioner) has been the auditor of the entity (audit tenure). The rule (Government Gazette Nr 39475 of 04 December 2015), effective for periods ending on or after 31 December 2015, applies to audit reports issued on the Annual Financial Statements of all public companies, as defined in Section 1 of the Companies Act of 2008, which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors (IRBA, 2015e, 2016). The

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reason for this requirement was to strengthen auditor independence and was disclosed by the IRBA as follows:

"The Regulatory Board made the decision to require the mandatory disclosure of audit tenure in the context of strengthening auditor independence which is consistent with measures implemented in other jurisdictions. This disclosure of audit tenure will lead to transparency of association between audit firms and audit clients." (IRBA, 2015e)

International regulatory developments

According to Hay (2015), current and recent auditing reforms internationally can be classified into those that that aim to improve independence, and those intended to increase competence. In recent years, most notably since the collapse of Enron in 2001, regulators have expressed concerns about auditor independence and taken actions to mitigate those concerns (Laurion, Lawrence, & Ryans, 2015). These include the passage of the 2002 Sarbanes–Oxley (SOX) Act, also known as the "Public Company Accounting Reform and Investor Protection Act", which is United States (US) legislation that, among many other requirements, prohibits the auditor (in a US context) from providing most non-audit services to its clients. More specifically, SOX imposes a one-year "cooling-off period" for former auditors taking employment at their previous audit clients and requires audit partners to rotate every five years. In terms of SOX, the US also shifted from a seven-year rotation with a two-year cooling-off period (before SOX), to a stricter five-year rotation and five-year cooling-off period for audit engagements. More specifically the requirement is to rotate (1) the partner having primary responsibility for the audit and (2) the partner responsible for reviewing the audit every five years. The audit committee is required to ensure that the requisite rotation actually takes place (Tepalagul and Lin, 2015).

In the European Union (EU), regulations have also recently changed. The European Parliament in 2014 voted in favour of Directive 2014/56/EU, amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (European Commission, 2015). These new rules force European companies to hire new audit firms at 10- to 24-year intervals, depending on certain criteria, bringing mandatory audit firm rotation into one of the world's most significant economic regions (KPMG, 2014). More specifically, public interest entities have to appoint a new firm of auditors every 10 years. However, member states have the option to extend this maximum period to 20 years (24 if there is a joint audit) provided the audit is subject to a public tender carried out after 10 years. It is expected that the United Kingdom (UK) may also implement mandatory firm rotation in the near future (KPMG, 2014). In 2012, the Financial Reporting Council in the UK introduced a provision in the UK Corporate Governance Code for FTSE 350 companies to consider tendering their audit appointment every 10 years, on a comply or explain basis. The Competition and Markets Authority finished their long running investigation of the UK large company statutory audit market in October 2013, concluding that tendering of the audit appointment should be mandatory for FTSE 350 companies at least every 10 years (PWC, 2014).

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As can be seen in the comparison between the US regulations of auditor rotation and the recently adopted EU and the UK audit firm rotation regulations, there is a difference between auditor rotation i.e. audit engagement partner and audit firm rotation (MAFR), although sometimes the terms are used loosely and the distinction is lost. Auditor rotation, as in the US and South Africa, refers to the mandatory rotation of the engagement audit partner after a prescribed five years. Under auditor rotation the audit firm retains the client, providing a different audit partner to the engagement. There is then a "cooling-off" period (five years in the US, two years in South Africa) whereby the rotated audit partner must wait until being allowed to be reappointed as engagement partner on that client. However, audit firm rotation, as is now being adopted in 2016 by the EU, is a step further than this. It requires a change of the audit firm, not simply the audit partner. The audit firm effectively loses the business of the audit client, regardless of the partners in the firm being capable of performing the audit. The EU has adopted this in an attempt to further mitigate the threats (particularly familiarity) to independence (KPMG, 2014). Other than the more significant recent examples of the UK and the EU, other countries such as Brazil, India, Italy, Spain, Singapore and South Korea have required, and some still do require, audit firm rotation (MAFR) after a maximum specified period (Cameran, Vincenzo, Merlotti, and Cameran, 2005). As mentioned, the US is a notable exception against this international trend and the European Union therefore remains the largest economic jurisdiction to apply MAFR rules. Other examples include the UK, Australia and New Zealand (SAICA, 2016).

The context in South Africa

Currently South Africa does not legislate the mandatory audit firm rotation laws as have been implemented in the EU, but rather follows a system similar to the US, with auditor rotation (i.e. individual audit partner) required every five years. This includes a cooling-off period of two years, as prescribed by section 92 of the Companies Act, 2008 (Act No. 71 of 2008). The profession in South Africa also places a large degree of reliance on the ethical standards in order to internally assess (or self-assess) threats to its independence as auditor. These standards are contained in the International Standards on Auditing (ISAs), as well as the Code of Ethics for Professional Accountants issued by the International Federation of Accountants (the IFAC Code). These are internationally recognised auditing standards for which the auditor can use as a guide to self-assess their independence from the audit client.

In South Africa there is also regulation and guidance provided to the audit committee of public interest entities to assess the independence of the auditor. This is legislated in the South African Companies Act, 2008 (Act No. 71 of 2008), as well as the King Report on Governance (King III), which is the South African standard on issues of corporate governance. As an example, the Companies Act requires the audit committee to formally assess the independence of the auditor. However, legislation, standards and regulations of the Johannesburg Stock Exchange (JSE) have all stopped short of requiring mandatory audit firm tendering or audit firm rotation as is now being implemented in the EU and the UK.

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According to Hay (2015) the research of the effects of rotation of audit firms, including systems of joint audits, is very much in its infancy and requires significant attention, especially considering the recent international focus.

The purpose of this study is to examine the perceptions of leading and senior audit practitioners about the state of auditor independence in public interest entity audits in South Africa. Is there a problem with auditor independence in reality and/or in perception i.e. in the minds of the public? If so, how could this be best addressed so as to promote high quality financial reporting and therefore the protection of the public interest? These questions must first be addressed before considering whether regulatory change is required in South Africa in order to strengthen auditor independence.

Perception of auditor independence and audit quality is important, as described in the International Federation of Accountants (IFAC) Code of Ethics for auditors (section 290:8), because of the need for the auditor to have independence in both mind and appearance to a third party (International Federation of Accountants (IFAC), 2006). 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 (ISA 200, paragraph 3), and therefore this independence of the auditor in the eyes of the market is necessary. According to ISA 200, the audit enhances "the degree of confidence of intended users in the financial statements" (ISA 200, paragraph 3).

Mixed Results in the Literature

A 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 & Lin, 2015), although there are some mixed results. According to Tepalagul & Lin (2015), some studies even find that long tenure actually improves audit quality and that short tenure is associated with lower audit quality. In addition, this study concluded that there is limited evidence that auditor independence is compromised in the presence of a high degree of client importance and non-audit services provided.

There is very extensive research on the effects of non-audit services by auditors, as reviewed by Sharma (2014, p.85). Sharma (2014, p.85) analyses 45 research studies on this topic and finds that there is a lack of evidence that auditors lose their independence, but that policy makers often feel an urge to regulate anyway, despite criticism from the accounting profession and corporate executives.

As an example of the mixed results around auditor independence, conflicting results were identified by Johnson et al. (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

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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.

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 practicing 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 & 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 imply that, unlike an audit partner, an audit firm may have stronger reputational incentives to remain independent. Therefore, rotating the firm, as opposed to the partner, may not be the best means to achieve independence and audit quality.

The mixed results in the academic literature are clear and it cannot be concluded with certainty that long audit tenures or non-assurance services measurably impair auditor independence and audit quality.

Research Methodology

This is a descriptive study that employs a qualitative research methodology. Qualitative studies aim to explain the ways in which people come to understand and account for issues, events and behaviours in their lives. Therefore the data gathered covers the perceptions, opinions and reasoning of the participants based on their unique experiences of areas related to the topic studied (DiCicco-Bloom & Crabtree, 2006).

The purpose of this study is to examine the perceptions of senior audit practitioners about the state of auditor independence in public interest entity audits in South Africa. To achieve this semi-structured interviews were performed with experienced partners, ranging between seven and thirty-three years as a practicing registered auditor, across a number of audit firms nationally. A semi-structured interview is a qualitative method of inquiry that combines a pre-determined set of open-ended questions (questions that

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prompt discussion), with the opportunity for the researcher to explore particular themes or responses further. This type of interview does not limit respondents to a set of pre-determined answers, unlike a structured questionnaire for example (Dearnley, 2005).

Semi-structured in-depth interviews are the most widely used interviewing format for qualitative research and can occur either with an individual or in groups (DiCicco-Bloom and Crabtree, 2006). The open nature of the questions encourages depth and vitality in the responses by the interviewees and allows new concepts to emerge over the course of the interviews (Dearnley, 2005).

The population and the selection

This study employs a purposive sampling technique, also known as judgemental, selective or subjective sampling. Purposive sampling is a type of non-probability sampling which focuses on sampling techniques where the units that are investigated are based on the judgement of the researcher, rather than on statistical techniques (Lærd Dissertation, 2016). Purposive sampling technique is most effective when one needs to study a certain domain which contains knowledgeable experts. In choosing a sampling method for informant selection, the question the researcher is interested in answering is of utmost importance and it is especially important to be clear on informant qualifications when using purposive sampling (Tongco, 2007).

Fourteen practicing “registered auditors” (audit partners) were selected from nine different audit firms in order to perform the interview (refer to table below). According to the book entitled “The Long Interview” by McCracken (1988), as cited in DiCicco-Bloom and Crabtree (2006), in-depth interviews are used to discover shared understandings of a particular group and the sample of interviewees should be fairly homogenous and share critical similarities related to the research question. This selection of audit partners is therefore a homogenous group that share critical experience related to the research question. The selection is also considered to be fairly representative of the population of registered auditors in South Africa, especially considering that the audit partners selected were involved in the senior leadership of their respective audit practices and were considered sufficiently experienced as audit practitioners, having worked for many years in the capacity of audit partner (ranging between seven and thirty-three years as a practicing registered auditors).

The commonly agreed and recognised distinction between the audit firms (Marx, 2009; Rapoport, 2016) has been used in this study and is as follows:

- “Big four” audit firms refer to the largest four accounting and audit firms globally, namely Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young (EY) and KPMG. These four firms are also referred to as “large-tier” firms (ICAEW, 2016a).
- The non-big four firms are either mid-tier or small-tier firms depending on their respective global size, global presence and capabilities as an audit firm in terms of resources (ICAEW, 2016b; Rapoport, 2016).

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The researcher and the participants in this study will use these terms in the interview discussions. The following is a description of the fourteen practitioners interviewed:

- All the partners were considered senior and highly experienced, ranging between seven years as a practicing audit partner and thirty-three years. The average number of years as a practicing registered auditor of all interviewees is 22 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.
- The audit firms were selected from Johannesburg and Cape Town offices of the network firms.
- Of the fourteen partners, two were women.
- The two largest black audit firms in South Africa, namely SizweNtsalubaGobodo Inc. and Nkonki Inc. were represented. These two firms are the largest “black-owned” audit firms in South Africa and have grown to considerable size to rival the traditional “mid-tier” firms.
- Five partners were from the “big four” international audit firms.
- The remaining partners were from the “mid-tier” audit firms (including the “black-owned” medium size firms) who also perform audit services of public interest entities.

The below table shows a further description of the audit partners (participants) interviewed, including the number assigned for the purposes of analysing the results of the interviews, i.e. “Audit Partner 1”; “Audit Partner 2” etc.:

Designation of Participant in Analysis of Results	"Big four" or "Mid-tier" or "Black-owned Mid-tier" firm	Position	Years as Practicing Audit Partner
Audit Partner 1	Big four	Senior partner	25
Audit Partner 2	Big four	Managing Partner	20
Audit Partner 3	Big four	Senior partner	25
Audit Partner 4	Big four	Senior partner	9
Audit Partner 5	Big four	Senior partner	23
Audit Partner 6	Black-owned Mid-tier	Managing Partner	22
Audit Partner 7	Black-owned Mid-tier	Managing Partner	23
Audit Partner 8	Black-owned Mid-tier	Senior partner	29

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Audit Partner 9	Mid-tier	Managing Partner	32
Audit Partner 10	Mid-tier	Managing Partner	17
Audit Partner 11	Mid-tier	Senior partner	16
Audit Partner 12	Mid-tier	Managing Partner	33
Audit Partner 13	Mid-tier	Managing Partner	28
Audit Partner 14	Mid-tier	Senior partner	7

Interview process and methodology

Each interview was held in person with the respective participants and lasted between one and two hours, the discussion audio being electronically recorded with the express permission of each participant.

According to Leedy and Ormrod (2010), qualitative data analysis ideally occurs concurrently with data collection so that the researcher can generate an emerging understanding about research questions, which in turn informs both the sampling and the questions being asked. This was certainly the case within this study as while the interviews were being conducted, new opinions were documented which fed into and shaped the subsequent discussions with interviewees. This iterative process of data collection and analysis eventually leads to a point in the data collection where no new categories or themes emerge, referred to as saturation, signalling that data collection is complete (DiCicco-Bloom and Crabtree, 2006). Saturation is believed to have been reached in these interviews in the sense that no new themes or categories surrounding the question of MAFR emerged in the last interviews, indicating that the sample of fourteen practitioners was sufficient for the purpose of the study. The transcribed data was then used in order to identify common, recurrent, or emergent themes around the issue of the role of audit committees in preserving auditor independence and quality financial reporting, rather than pursuing MAFR in South Africa.

Presentation and Analysis of Results

The need for improved auditor independence

There was some degree of mixed response with regard to whether or not South African auditors were appropriately independent, however most (11/14) were of the opinion that independence was not a concern in reality, especially for public interest entities where a partner rotation is mandatory every five years. The three dissenting opinions in this regard all made the point that audit committees are failing to properly and independently assess the independence of external auditors and this was part of the problem. Interestingly, there were no partners, of the fourteen interviewed, who were fully in favour of mandatory audit firm rotation (MAFR) in South Africa. This includes the three partners who expressed concern regarding the state of auditor

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independence. Most were against MAFR on the grounds that (1) it would not achieve improved auditor independence and (2) that there were too many significant negative consequences to changing legislation in favour of MAFR.

After expressing that independence in their experience was not a real concern, i.e. that the degree of auditor independence in their audits was sufficient, one partner expressed the following qualification:

"But then you say on the flipside, you know the counter argument against that, when the client is such a dominant number in your world - you know, four or five percent of your fees - you can never be independent. In reality with any client paying fees to the practitioner you can never be independent, so you get to the heart of it because I'm ultimately coming back to the client for my fee discussion and I can't be independent. And so whether you do that rotate [MAFR] it's not going to make a difference." *(Audit Partner 12)*

The point being made here was that in a regime of partner rotation or MAFR, the partner and the firm will always be dependent on the client for the audit fee and the audit fees are often significant to the auditor. Therefore MAFR would not be solving the problem entirely in any case. However, this partner agreed with most of the interviewees that independence was not actually a significant problem in reality.

One partner *(Audit Partner 10)* felt that, as a mid-tier firm partner, there are many medium size businesses that are considered public interest entities in South Africa but are relatively small private companies. These businesses are often family owned and management (who are the owners) will often rely on the professional advice of their auditors and over time will develop a good relationship with the partners at the audit firm. This good relationship with the client and the professional advice offered by audit firm should not be automatically considered an independence problem as the firm manages its conflicts of interests as guided by the Code of Professional Conduct and the integrity that comes with being a professional. Too often, in their opinion, the public assumes a lack of independence when in reality there is no such thing.

The partner who expressed this view also made the point that the public interest score, as it is currently contained in the Regulations to the Companies Act 71 of 2008, results in too many smaller businesses being labelled as public interest entities. However, this partner's point was that regulation like MAFR may force a greater degree of independence but that would lead to other unintended consequences on the profession and on audit quality. Nearly all partners interviewed expressed a strong concern that the implementation of MAFR will not improve audit quality, even if it may improve auditor independence. The concerns expressed were in regard to the unintended consequences and effects of MAFR, which are not discussed for the purposes of this paper.

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Public perception of independence

Most audit partners (11/14) agreed that there is a significant difference between the public perception of independence and the reality of auditor independence, with the public's perception being significantly worse (i.e. perception of an independence or audit quality problem) than what was in reality the case (in their opinion). These partners are all in favour of pursuing means of addressing public misconceptions about the audit function and about auditor independence before making a decision on MAFR. In their opinion the regulator (IRBA) should look at means of addressing the perception problem before looking to change legislation in the profession. A number of partners illustrated this point with the example of how, in their experience of discussing their work with company stakeholders and the general public, it is not uncommon for people to express their understanding that it is the auditor's role to guarantee the accuracy of the financial statements and to detect all forms of fraud and mismanagement. These experiences are evidence that the public does indeed misunderstand the role and value added of the auditor. In the opinion of these partners, MAFR should not be adopted in response to public perception per se, but rather other more effective and perhaps less damaging methods (to audit quality and the profession) should be pursued by both the IRBA and the profession to educate public understanding of the limitations of the audit function.

"If there were let's say, an error. We had, I'm thinking of last year, let's say, we had an error with a set of listed companies [a group of companies]. I think it's an easy scapegoat to say "ah, you guys have been for thirty years the auditors and that's why you missed it!" I think they [the public] missed completely the point. I think there's no correlation between an error and how long you've been their auditor. It's mainly because you just missed something the last year, you must understand, it's not because you've been here for thirty years because the partners are only there five years. That's definitely for me a perception - that is not a reality. If you want a fresh perspective, we do see that where the partner rotates… The partner comes in with new ideas and so I think that gets actually done." *(Audit Partner 2)*

Expressing their concern around reacting to the public's perception one partner stated:

"I'm just a bit concerned that there's a degree of over-reaction around things and that really worries me. I mean, we are professionals at the end of the day. Independence ethics is the cornerstone of what we do… you know, the firms have their policies and procedures in place around ethics and independence and it's taken very seriously. So, I mean we have, ours [referring to the firm] is even narrower than most and likewise what IRBA and the codes have got in place, so it's extremely rigid. I'm just a bit worried that this heightened focus, too much focus on it...by all and sundry, various stakeholders. I'm worried that the regulator's jumping onto something because this is what's happened overseas. We're number one in terms of World Bank Risk Report." *(Audit Partner 5)*

A number of partners raised the point that there is a high degree of ethical standards – at a professional level and at a firm level – that the audit

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practitioners need to adhere to. And in their opinions they find that the partners take this very seriously. In addition, the fact that South African audit partners are required by local regulations to place their personal name on the audit report and sign, together with the firm name, was raised as a further reason for the partner to guard his or her independence. The international audit standards do not require the name of the engagement partner on the signed audit report.

"You're personally invested. It's my name. I've signed. You're out there in the public... You're holding yourself out there. It's me, it's not [firm name], I'm signing there as well." *(Audit Partner 5)*

The Public Inspections Report

All the partners interviewed expressed varying degrees of unhappiness and concern regarding the IRBA public inspections process. The common feeling was that the reviews are too harsh on the profession and do not allow for sufficient professional judgment to be exercised by the auditor, as is the allowance and indeed the requirement of the International Standards on Auditing (ISAs). Partners described the IRBA inspections as too much of a tick-boxing exercise that does not properly account for professional judgement exercised by the audit team.

All the audit partners interviewed expressed concern over the degree of regulation in the profession. In fact, the issue of over-regulation resulted in the strongest opinions and even frustration amongst the partners. Many were particularly concerned over the nature of the public inspections process as performed by the IRBA and feared that additional regulation was damaging the ability of the practitioners to make professional judgement calls, something absolutely necessary in performing an audit, and which the International Standards of Auditing (ISAs) strongly require of the auditor. The concern was simply that MAFR would be another unnecessary regulation in an already over-burdened profession.

"So I'm saying there's a lot there that's going to lighten or reduce the expectation gap when it comes to stakeholders and users, because they'll be able to read each audit report [which] will be specific. It's not going to be a template. They will be able to understand... And independence and all of that, rather than just coming with a rule if it's mandatory. We are principles-based at the end of the day. And we're relying on judgement from the profession and from the Audit Committee. Both sides of the engagement are applying their minds and their skills and they're qualified to do so… Doesn't that make us a profession? That fact that we exercise professional judgement? We don't tick boxes. The more we tick boxes… that will directly affect the quality of what we do. That's where the regulator needs to get a balance... I hope common sense prevails. I think we've got a lot of checks and balances in place. I mean enhancing existing structures and I'm not one in favour of rules. We are principle-based, we must deal with it and the King Codes have done tremendous work over the years with the Institute of Directors." *(Audit Partner 5)*

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The role of the audit committee

All the audit partners (14/14) agreed that the audit engagement and the choice of the auditor, as well as any non-assurance services required, is a decision of both the audit committee, being those charged with governance by the shareholders, as well as the auditors themselves. The audit committee, whose existence is a legislative requirement in South Africa for a public interest entity (refer to section 94 of the Companies Act 71 of 2008), is ultimately responsible for the recommendation for the nomination and the replacement of the auditor, subject to approval by the shareholders. The decision of whether or not to ask the auditors for non-assurance services and whether or not to put the audit out for tender, is ultimately in the hands of the audit committee, being those charged with governance by the shareholders.

All the partners interviewed (14/14) agreed with the reasoning that the best means of improving auditor independence is actually to improve the quality of corporate governance in the audit clients, rather than through regulation. Improving the quality of the non-executives on the audit committees, possibly through education and promotion of King III Report principles of corporate governance (soon to be replaced by King IV), was believed to be a means of having a greater impact on auditor independence and audit quality.

In the opinion of one partner, **"the Audit Committees that I have served on over the years and continue to serve on now take auditor independence very seriously. Our firm and my experience of the other big firms, I can't talk for the smaller and medium sized firms… the audit firms themselves take auditor independence extremely seriously… If you just consider that South Africa is the pre-eminent market as far as implementation of corporate governance King III etcetera is concerned, it really is at the top of its game. And those Audit Committees are very diligent and they take all of the issues - not just auditor independence, all of their budgetary duties… very seriously."** *(Audit Partner 1)*

The pointing to instances of strong audit committees was this partner's way of explaining that when the opposite is the case, i.e. weak governance by the audit committee, this is when there is the greatest potential for independence of the auditor and audit quality to be compromised exists. Auditor independence is a function of both parties and both sides to the engagement letter need to be independent and professional. The audit committee must remain independent of management and professional in their execution of their role. The auditor must remain independent of the client and professional in their execution of their role.

Summary and Conclusion

Most audit partners do not believe that any changes to regulations are necessary to address auditor independence and the policies and structures in place currently are

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sufficient. The profession must be allowed the freedom to exercise its professional judgement and adherence to the ethical codes of conduct. Regulation restricts their ability to do that.

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.

Most audit partners (11/14) 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.

Areas for further research

Auditor independence, including public perception thereof, as well as regulatory responses, requires more attention by South African auditing academics. This research will be followed by a national survey of the South African audit profession in order to provide a representative view from the profession on auditor independence, and particularly the IRBA's intention to address it with regulation. The IRBA is currently considering mandatory audit firm rotation legislation (MAFR) as a possible response, similar to that enacted in the European Union. The impact on, and the opinions of, other stakeholders such as audit committee members, management and investment professionals in these matters need to be understood as well. Research also needs to be performed around the effectiveness of the regulator's public inspections. A direct response to the 2014/2015 Public Inspections Report from the profession in this respect is also recommended.

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