EXPLORING THE PERSPECTIVES OF AUDIT COMMITTEE MEMBERS ON MANDATORY AUDIT FIRM ROTATION IN A SOUTH AFRICAN CONTEXT

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I hereby declare that I have read and understood the regulations governing the submission of Master of Commerce dissertations, including those relating to length and plagiarism, as contained in the rules of the University, and that this dissertation conforms to those regulations.

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ABSTRACT

This study examines the perspectives of experienced audit committee members on mandatory audit firm rotation (MAFR) in a South African context. This follows the recent initiatives by the Independent Regulatory Board of Auditors (IRBA) to make audit firm rotation compulsory in South Africa. Semi-structured, in-person interviews were conducted with audit committee members in South Africa to explore and contribute to the existing literature on audit committee member positions on MAFR. Twenty-two audit committee members were interviewed. Key discussion areas revolved around the regulator's intended impact of MAFR in South Africa, including the promotion of auditor independence, the lowering of audit firm market concentration and acceleration of the rate of transformation in the South African audit industry. The findings show a general consensus among the audit committee members interviewed that MAFR will not achieve any of the objectives of the IRBA and that the members are predominantly in opposition of MAFR. Furthermore, the members proposed various arguments against MAFR, illustrating how the policy has limited benefits, if any, and will introduce many monetary and non-monetary costs into the audit industry, which could negatively impact the appeal of the audit industry. The vast majority of members held the view that the primary purpose of MAFR in South Africa is not to promote auditor independence, but is rather intended to address market concentration and transformation. However, the findings indicate that MAFR is believed to not be the best solution for these issues and, as such, further research and alternative measures should be sought by the regulator.

Keywords: mandatory audit firm rotation • audit committees • auditor independence • audit quality • auditor rotation • audit • South Africa

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CHAPTER ONE: INTRODUCTION

A prevalent way of communicating financial information about an entity to those outside the entity is through financial reports (Johnson, Khurana, & Kenneth Reynolds, 2002). According to the Conceptual Framework published by the International Accounting Standards Board (IASB), financial reports must "faithfully represent the phenomena that it purports to represent" (IFRS Foundation, page A27, 2010). In order for users of financial reports to be able to rely on faithfully represented financial information, financial reports must be credible. An audit is a primary means of providing reasonable assurance as to whether the financial report is "presented fairly, in all material respects" (International Federation of Accountants (IFAC), page 73, 2012). This assurance is provided to external users of financial reports in the form of an auditor's opinion, which is contained in the financial reports of the audited entity. In this way, the auditor's opinion provides assurance to the users of financial reports regarding its credibility (IFAC, page 73, 2012).

In the same way that the financial report of an entity must be credible, so too must the opinion of the auditor. The ability of the audit process to provide reasonable assurance on the credibility of a financial report depends on the quality of the audit (Johnson *et al*., 2002). DeAngelo (page 186, 1981) defines audit quality as the "probability that a given auditor will *both* (a) discover a breach in the client's accounting system, and (b) report the breach." This definition has become widely used in the auditing industry and suggests that auditor competence and auditor independence can be seen as key factors affecting audit quality (Kwon, Lim, & Simnett, 2014). As such, audit quality is improved if the auditor detects and subsequently corrects or reports a material misstatement (Johnson *et al*., 2002).

In a recent study, Tepalagul and Lin (2015) explicitly identify four main threats to auditor independence. These threats include client importance, non-audit services, auditor tenure and client affiliation with the firms. According to Tepalagul and Lin (2015) if auditors are not independent, they will be less likely to report irregularities, thus impairing audit quality.

The threat of long audit tenure is one that has particularly concerned regulators with regard to auditor independence. The length of auditor tenure is viewed as a threat to independence due to the close relationship and familiarity that may develop between the auditor and the client as the auditor spends more time with the client (IRBA, 2009; Tepalagul & Lin, 2015). This familiarity increases the likelihood of the auditor acting in favour of management, which in turn would reduce auditor independence and audit quality (Casterella & Johnston, 2013; Dopuch, King, & Schwartz, 2001; Geiger & Raghunandan, 2002; Tepalagul & Lin, 2015).

Various measures have been implemented by regulators to address the threat of long audit tenure. The IFAC Code of Professional Conduct (2006), for example, recommends rotation of the individual audit partner so that the client does not have the same audit partner for an extended period of time. Section 92(1) of the Companies Act (Act No. 71 of 2008) states that the designated auditor may not serve as the auditor of an entity for more than 5 consecutive years. Furthermore, audit committees play an important role in corporate governance and the monitoring of auditor independence (Dobija, 2013). The mandate of the audit committee involves overseeing financial reporting and its related disclosures, selecting an independent auditor and continually evaluating the auditors independence (Companies Act No. 71 of 2008; Fontaine, Khemakhem, & Herda, 2015; King IV Report, 2016). As such, the audit committee may voluntarily choose to rotate an auditor if it feels that the auditor is not sufficiently competent or independent. However, some regulators have sought to further promote auditor independence by prescribing more defined audit committee duties, audit committee accountability and extending the rotation requirement beyond the audit partner to the audit firm (Fiolleau, Hoang, Jamal, & Sunder, 2013). The solution whereby the audit firm is required to rotate off a client after a prescribed period of time is known as Mandatory Audit Firm Rotation (MAFR).

A notable example of further regulation is that of the European Union. In 2014, the European Union issued a directive introducing a policy of MAFR (IRBA, 2016). The policy requires mandatory rotation of the audit firm every 10 years, unless the audit undergoes a tendering process in which case the rotation period can be extended to 20 years (The Council of the European Union & European Parliament, 2014). However, the regulations surrounding MAFR in the European Union are complex and many believe that the motivation behind the audit reform process is politically driven (Chourdhury, 2017). Before this directive was issued, a few member states had considered MAFR in their own capacity but ultimately decided against its implementation. France and the United Kingdom, for example, considered MAFR but concluded that it would decrease audit quality and increase audit costs (Nombembe, 2017).

There are approximately 41 countries where MAFR has been implemented and continues to be implemented (Nombembe, 2017). Each country has varying maximum audit tenure lengths and the MAFR requirement applies to different types of companies and industries to varying degrees. Italy is an example of a country where there is a statutory requirement for audit firms to rotate (Kwon et al., 2014). The policy was introduced in 1975, requiring a nine-year rotation period (Kwon et al., 2014; Nombembe, 2017). Other examples of countries with MAFR for some entities include China, India, Morocco, the Netherlands and Russia (Nombembe, 2017).

Other countries have implemented MAFR previously and subsequently revoked the policy. After introducing MAFR in 2002, the Monetary Authority of Singapore announced its intention to discontinue this policy in 2016 (Chourdhury, 2016; Nombembe, 2017). The reason given was that research did not provide conclusive evidence that MAFR is associated with improved audit quality and that there were negative consequences associated with frequent auditor rotation (Chourdhury, 2016). Argentina repealed MAFR in its entirety in 2016 as the country was more in favour of partner rotation (Nombembe, 2017). South Korea adopted MAFR in 2003 and it became effective in 2006 but was subsequently repealed for public companies in 2009, the reason being that MAFR "[did] not improve audit quality" (Nombembe, page 14, 2017). Canada also implemented and discontinued MAFR due to a lack of cost-effectiveness and the preference of partner rotation (Chourdhury, 2016; Nombembe, 2017). Before the recent directive issued by the Council of the European Union, Spain and Austria also implemented MAFR for certain types of entities but repealed the policy due to a reduction in audit quality and a disruption in the audit market structure (Nombembe, 2017).

On the other hand, there are countries who have considered the implementation of MAFR but chosen not to implement it. MAFR has been proposed in the United States a few times, however, due to switching costs and a diminished ability for the audit firm to gain a deep understanding of the audit client, both auditors and audit clients have opposed its implementation (Dopuch et al., 2001). Japan also considered MAFR but decided against it as MAFR would decrease audit quality, increase audit costs and lead to a decrease in the auditor's knowledge of the client. Furthermore, it was not required by other major countries at that time (Nombembe, 2017).

In terms of the South African context, currently only mandatory audit partner rotation is in implementation. In terms of the Companies Act (Act No. 71 of 2008), the individual partner is required to rotate every five years. Furthermore, the duties of audit committees have been legislated in terms of Section 94 of this Act and recommendations are provided within the King Code on Corporate Governance (King IV Report, 2016) on how the audit committee should promote the independence of the external auditor. The Independent Regulatory Board for Auditors in South Africa (IRBA), however, stated that it did not believe the current measures in place to be sufficient in promoting auditor independence (IRBA, 2016).

On the 2 June 2017, the IRBA issued a statement that it had gazetted MAFR "*to enhance auditor independence and protect public interest"* (IRBA, page 1, 2017b). The Rule prescribes that the auditor, including a network firm[1], of a South African public interest entity shall not serve as the incumbent auditor for more than 10 consecutive years, following which the auditor is required to rotate (IRBA, 2017c). The IRBA Code of Professional Conduct for Registered Auditors (2009) defines a public interest entity as a listed entity or an entity that is defined as such by regulation or where an audit is required by regulation. Only after the expiration of 5 years will the auditor be eligible for reappointment[2] (IRBA, 2017c). The Rule will be effective for financial years

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[1] The IRBA defines a network firm as a firm belonging to a network, where a network is defined as "a larger structure:

(a) That is aimed at co-operation; and

(b) That is clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand-name, or a significant part of professional resources." (IRBA, 2009)

[2] A transitional provision, that will only apply at the effective date, states that "If, at the effective date, the public interest entity has appointed joint auditors and both have had audit tenure of 10 years or more, then only one audit firm is required to rotate at the effective date and the remaining audit firm will be granted an additional two years before rotation is required" (IRBA, 2017c)

beginning on or after the 1 April 2023 (IRBA, 2017c). According to Bernard Agulhas, CEO of the IRBA, the issuing of this Rule is aligned to the global developments and concerns of international regulators regarding auditor independence (IRBA, 2017b).

In terms of the responses of interested and affected parties to the IRBA's consultation letter, the perspectives of various audit committee members were documented. The perspectives of audit committee members are important to consider when implementing a policy such as MAFR given the role that they play in promoting auditor independence (Fontaine *et al*., 2015). Only one other study by Fontaine, Khemakhem and Herda (2015) has explored the perspectives of audit committee members. This study was performed in a Canadian context. The responses to the IRBA's consultation paper, some of which were submitted by audit committee members, and the results of the study performed by Fontaine *et al* (2015) indicate that audit committees members in general are not in favour of MAFR.

The purpose of this study is to explore the perspectives of South African audit committee members on MAFR. This research contributes to the literature by providing insight into the opinions and thought processes of audit committee members. Given that one of the most important roles of the audit committee is to nominate an independent external auditor and to evaluate the auditor's independence at least annually, audit committee members develop a sense of what independence entails. Therefore, audit committee members could provide useful insights on how a rule, such as MAFR, would impact the committee's ability to exercise professional judgment and, consequently, external auditor independence and audit quality.

This paper also contributes to South African specific research in that the considerations surrounding MAFR do not solely revolve around auditor independence. Although the IRBA (2016) have stated that the promotion of auditor independence is the primary objective of MAFR, market concentration and transformation considerations are key areas of focus in the professional debate. The IRBA (2016) believes that MAFR could provide non-Big Four firms with the opportunity to participate more meaningfully in audit tenders, thus helping to lower the level of concentration in the audit firm market. A description of the Big Four firms is provided in Chapter Three under Population and Participant Selection. Furthermore, South Africa has a history of racial segregation and the transformation of the audit industry is considered to be too slow (IRBA, 2016). The

IRBA (2016) holds the view that MAFR could provide more opportunities for audit firms owned or managed by previously disadvantaged race groups to tender for larger clients, thus contributing more to socio-economic racial transformation (IRBA, 2016).

The remainder of this paper is structured as follows: Chapter Two reviews the relevant literature on MAFR, in which prominent themes are developed that motivate the research questions. The research methodology is set out in Chapter Three, which is followed by a presentation and analysis of the results in Chapter Four. Finally, Chapter Five concludes with an overview of the key research findings and discusses limitations and areas for further research.

CHAPTER TWO: LITERATURE REVIEW

The next section is set out as follows. Firstly, data considerations from previous studies on MAFR will be discussed, followed by a review of the proponents and opponents of MAFR. The role of the audit committee and its relevance in promoting auditor independence will then be reviewed. The literature review will conclude with a discussion of MAFR in the South African context, focusing on the professional debate between the IRBA and professionals and their conflicting views regarding MAFR.

PREVIOUS DATA CONSIDERATIONS

Literature proposes arguments both for and against MAFR. In terms of the threat of audit tenure length, various arguments have been put forward highlighting the proposed benefits of MAFR, as it effectively curtails the audit tenure. However, there are instances where audit firm rotation has been enforced in a mandatory environment, as opposed to a voluntary one, making the policy and its associated benefits and costs difficult to research (Cameran, Francis, Marra & Pettinicchio, 2013; Hay, 2015).

Most studies on audit firm rotation have been conducted using data from environments in which audit firm rotation is voluntary (Lennox, Wu, & Zhang, 2014). The issue therein is that voluntary events are endogenous and, therefore, any extension of such findings to environments where rotation is mandatory could be problematic (Kwon *et al*., 2014; Lennox *et al*., 2014). For example, a client may wish to dismiss their audit firm and change to a lower quality firm when the audit firm identifies material misstatements, rather than running the risk of the auditor issuing a modified audit opinion (Kwon *et al*., 2014). With a lower quality firm, the likelihood of the new firm identifying the misstatement is lower and if the firm does identify a problem, management may be more able to convince the auditor to not report the misstatement (DeAngelo, 1981a; Kwon *et al*., 2014). This implies that clients without reliable financial reporting functions or unethical management may tend to rotate auditors more often. This could result in self-selection bias in that clients with longer audit tenure may have more reliable financial reporting functions or ethical management than those with shorter audit tenures (Kwon *et al*., 2014). Therefore, in a voluntary environment, it is difficult to distinguish whether the decrease in audit quality at the time of auditor rotation is due to the lack of the auditor's client-specific knowledge, or due to the already unreliable financial reporting environment of the client (Lennox *et al*., 2014).

Carey, Geiger and Connell (2008) also found that a voluntary change is more likely following the issue of a modified audit report and, therefore, characteristics of auditor-client relationships following a voluntary rotation are not necessarily the same as those following a mandatory rotation (Casterella & Johnston, 2013). Ultimately, conclusions about the effectiveness of MAFR appear to depend on whether the data obtained was from mandatory or voluntary rotation environments (Casterella & Johnston, 2013). This distinction should therefore be considered when reading the following sections on previous literature on the effectiveness of audit firm rotation.

PROPONENTS OF MAFR

Despite the differences in data type, a common argument in favour of MAFR is that the policy limits the number of years that an auditor can spend on an engagement with a specific client (Casterella & Johnston, 2013; Dopuch *et al*., 2001; Geiger & Raghunandan, 2002; Tepalagul & Lin, 2015). Consequently, the potential for the auditor to become too familiar with the client is limited and the threat of audit tenure is mitigated (Casterella & Johnston, 2013; Dopuch *et al*., 2001; Geiger & Raghunandan, 2002; Tepalagul & Lin, 2015). Proponents of MAFR argue that shorter audit tenure periods will enhance auditor independence and, in turn, improve audit quality (Casterella & Johnston, 2013). Additionally, it is argued that long tenure may result in a sense of complacency for the auditor, meaning that the auditor is not as rigorous in performing audit work in order to provide reasonable assurance over the financial reports (DeAngelo, 1981b).

Dopuch *et al* (2001) conducted an experiment in which the willingness of an auditor to issue a biased report in favour of management was assessed. (A biased report in favour of management refers to an audit report that is not in line with audit evidence obtained but management has persuaded the auditor to issue a different, more favourable report, such as an unqualified report.) The experiment was conducted in a mandatory audit firm rotation environment and an environment with no audit firm rotation requirements. It was found that, in environments of mandatory rotation, the willingness of auditors to issue biased reports was reduced relative to environments with no rotation requirements. Mandatory rotation meant that the auditor had less time to develop a close relationship with the client and was more likely to exercise objective professional judgement and detect and report on material misstatements (Geiger & Raghunandan, 2002).

Daniels and Booker (2011) also performed an experiment involving different audit firm rotation environments, however, the experiment focused on financial statement user perceptions on audit quality and audit independence. Daniels and Booker (2011) found a positive relationship between MAFR scenarios and clients' perceptions of auditor independence but no change in audit quality perceptions. This implies that, although actual audit quality may increase with MAFR, this is not perceived by the users of financial statements.

Kwon *et al* (2014) note that the professional skepticism of the auditor is likely to increase on audit partner rotation due to the new audit partner having a fresh view on the audit, which enhances auditor independence. However, Kwon *et al* (2014) explain that partner rotation is considerably different to firm rotation for various reasons. As a result, the effect of increased professional skepticism would be less so than with audit firm rotation, due to the potential knowledge transfer and the sharing of information between staff within the audit firm (Kwon *et al*., 2014).

In a paper exploring MAFR in an Italian setting, Cameran, Principe and Trombetta (2016) tested how audit quality changes throughout the tenure of the audit by looking at the level of abnormal working capital accruals throughout the tenure. In Italy, the rotation rules are such that an auditor can be reappointed for two consecutive three year periods and must rotate after the third three year period (M. Cameran et al., 2016). Cameran *et al* (2016) find that audit quality improves in the period prior to rotation as abnormal working capital accruals are more conservative in this period. This could possibly be attributed to the notion that the auditor no longer has a financial incentive to retain the client and the firm that will soon takeover might discover negligence of the current auditor (M. Cameran et al.,2016). This implies that MAFR leads to an improvement in audit quality just prior to rotation.

Another benefit of MAFR is that it could potentially address the threat to auditor independence as identified by Zhang (1999). This threat to independence includes conflicts of interest between the auditor and client with respect to financial reporting values, which could result in management pressuring the auditor to accept their values (Zhang, 1999). A possible solution to this could be MAFR, as MAFR would limit the auditor's stake in future engagements. As a result, penalties, such as dismissal, imposed by management if the auditor does not act in their favour, would have less of an impact on the auditor's tendency to accept inappropriate reporting values (Zhang, 1999).

Other benefits of MAFR, as identified in a study conducted by Harris and Whisenant (2012), include less earnings management, less earnings smoothing and more timely recognition of losses, all of which improve audit and financial reporting quality. The results of the study by Harris and Whisenant (2012) indicate that environments which have adopted MAFR tend to have a higher level of audit quality, measured as *"the amount of unexpected opportunistic discretion in earnings before and after the adoption of MAR rules",* compared to those that have not adopted MAFR. However, Harris and Whisenant (2012) also find that audit quality decreased in both the years before and after the rotation of the auditor, implying that there is a risk of impaired audit quality around the rotation period which regulators need to consider.

OPPONENTS OF MAFR

A number of academics and practitioners oppose the implementation of MAFR (Mara Cameran et al., 2013; Casterella & Johnston, 2013; Jackson, Moldrich, & Roebuck, 2008; Johnson et al., 2002; Ruiz-Barbadillo, Gómez-Aguilar, & Carrera, 2009). The General Accounting Office in the United States of America performed interviews and surveys on accounting firms, chief fiscal officers and audit committee chairs of Fortune 1000 companies regarding the potential effects of MAFR (Daniels & Booker, 2011). The majority of the participants were in agreement that the potential costs of implementing MAFR would exceed the proposed benefits (Daniels & Booker, 2011).

The main argument against MAFR is that it would result in a lack of client-specific knowledge, which is necessary for the auditor to deliver a high-quality audit (Casterella & Johnston, 2013; Kwon *et al*., 2014). Over time, the auditor gains client-specific knowledge relating to the client's accounting systems, internal controls, operations and control structure (Kwon *et al*., 2014). This knowledge is key in enabling auditors to detect material misstatements or omissions, without which the auditor may rely increasingly on management's representations (Johnson *et al*., 2002; Kwon *et al*., 2014). As MAFR would require more frequent rotation of auditors and shorter audit tenure, auditors would have less time to obtain this understanding and knowledge, thereby impairing audit quality (Casterella & Johnston, 2013; Johnson *et al*., 2002; Kwon *et al*., 2014).

The findings of Geiger and Raghunandan (2002) are consistent with the notion that shorter audit tenures result in decreased audit quality (Johnson *et al*., 2002). Geiger and Raghunandan (2002) found that auditors with clients on the verge of bankruptcy were less likely to modify their audit opinions in the first few years of the engagement.

Obtaining this client-specific knowledge and understanding is costly and time-consuming, as the incoming firm needs to spend time building its knowledge of the client in order to perform an effective audit, resulting in higher audit hours and audit costs (Kwon *et al*., 2014; Public Company Accounting Oversight Board, 2011). Thus, rotating audit firms results in significant start-up costs for the incoming auditors (DeAngelo, 1981b). Additionally, the client may lose out on the benefits associated with an auditor who is an industry specialist because MAFR would force the client to 'rotate-off' an auditor, even when the client believes that the auditor is the most appropriate for the client's business (Kwon *et al*., 2014). Furthermore, in terms of financial statements user's perceptions of auditor independence, Tepalagul and Lin, (2015) found that users generally do not perceive auditor independence to be impaired by long audit tenure, implying little benefit to implementing MAFR (Jackson *et al*., 2008).

ISA 200 (IFAC, page 76, 2009) defines audit risk as a "function of the risks of material misstatement and detection risk". Detection risk refers to the risk that the procedures performed by the auditor will not detect material misstatements that could exist (IFAC, 2009). As shorter audit tenures are associated with a decreased ability of the auditor to detect material misstatements or omissions (Geiger & Raghunandan, 2002), detection risk is higher in the initial years of the engagement, meaning that audit risk is higher. Therefore, as shorter audit tenures are one of the consequences of MAFR and there is high audit risk in the initial stages of the audit engagement, implementation of MAFR could lead to a decline in audit quality.

Studies have also been performed that find no impact of MAFR on audit quality (Kwon *et al*., 2014; Ruiz-Barbadillo *et al*., 2009). Ruiz-Barbadillo *et al* (2009) studied the effect of MAFR on audit quality in Spain, where MAFR was enforced between 1988 and 1995. This study focused on financially distressed clients and the likelihood of the auditor issuing a going-concern audit report between 1991 and 2000. Hence, data from when MAFR was in place and from the period after MAFR was repealed was included (Ruiz-Barbadillo *et al*., 2009). The results showed no change in the likelihood of audit firms issuing a going-concern audit report between the period during and post the implementation of MAFR, which according to Ruiz-Barbadillo *et al*. (2009) suggests that MAFR has no impact on audit quality. However, Ruiz-Barbadillo *et al*. (2009) experienced limitations in their study in that the MAFR policy in Spain was never truly enforced. The rotation period was nine years and the policy ended after 7 years, meaning it is unclear as to how MAFR truly affects audit quality (Lennox *et al*., 2014).

Kwon *et al* (2014) also studied the effects of MAFR on audit quality in Korea between 2000 and 2009. This period included the years between 2006 and 2009 when MAFR was in place. In comparing mandatory rotations to voluntary rotations both before 2006 and during the implementation period, the results showed no significant change in audit quality (Kwon *et al*., 2014).

Another argument against MAFR is that it could potentially reduce audit fees as a result of the tendering process, which could be detrimental to the audit profession in terms of attracting and retaining talent (Bourne, 2017; Shango, 2017). In order to win over a new client, firms may offer a discount on the initial fee as a tactic for competing with the competition (Kwon *et al*., 2014). According to Bourne (2017), this is already a challenge in the audit industry and MAFR will increase the level of technical complexity in an already complex environment, which could see a decline in audit quality over time. Studies performed by Cameran *et al*. (2013) and Kwon *et al*. (2014) find evidence to the contrary. Cameran *et al*. (2013) studied the effects of MAFR in Italy, where MAFR has been in place since 1975 and found that, although audit fees in the initial year of the engagement were discounted, subsequent fees were higher and exceeded the initial fee discount. Kwon *et al*. (2014) also found that audit fees increased significantly once MAFR was introduced in Korea.

For almost 40 years, various parties have debated as to whether the rotation of the audit firm should be mandatory or voluntary (Kwon *et al*., 2014). The views and results of research performed have been mixed and the lack of situations in which true mandatory audit firm rotation is or was required has meant that many conclusions have been based on data from environments with voluntary audit firm rotation (Casterella & Johnston, 2013). Consequently, Casterella and Johnston (2013) advise regulators to recognize the difference between the two environments before making generalizations of the findings from voluntary rotation environments (Kwon *et al*., 2014). Ultimately, the proposed benefits and costs of MAFR can be identified as a theme in the literature relating to MAFR. The findings from this section inform the first theme in this study:

> **Theme identified: Benefits and costs of MAFR and the related impact on audit quality.**

This theme, and those to follow, will be used to inform the research questions of this study, which are explored further in Chapter Three.

THE ROLE OF THE AUDIT COMMITTEE

There are many contrasting views on whether MAFR enhances auditor independence, and thus audit quality. Apart from policies of mandatory audit partner rotation and MAFR, the role of the audit committee is centered around ensuring the independence of the external auditor (King IV Report, 2016). Harber and Willows (2016) performed a study in which 14 audit partners from audit firms of various sizes were interviewed regarding their views of MAFR. Some of the partners interviewed agreed that the best way to improve auditor independence would be to enhance and develop the duties of the audit committee, therefore improving the corporate governance within the entity (Harber & Willows, 2016). This view indicates that regulators should perhaps consider the role of the audit committee in enhancing auditor independence before implementing MAFR.

According to IRBA, “maximum audit quality is achieved in an environment where the audit committee is clear about its responsibilities and is enabled to work independently from the management of the company” (IRBA, page 7, 2016). Regulators have implemented regulations and structures whereby responsibility is delegated to the audit committee to enhance auditor independence (Fiolleau *et al*., 2013).

Section 94 of the Companies Act (Act No.71 of 2008) deals with legislation that applies to audit committees. In terms of s94(4), all audit committee members must be independent from the company. Section 94(7) prescribes various audit committee duties, including the nomination of an independent auditor and the preparation of a report to be included in the Annual Financial Statements. The report prepared by the audit committee details whether the audit committee is satisfied that the auditor was independent of the client throughout the financial year. For this reason, there is a view that the audit committee "owns the appointment process and has the primary responsibility of gathering relevant information and making the appointment decision" (Fiolleau *et al*., page 865, 2013).

Furthermore, s94(7)(d) requires the audit committee to determine the nature and extent of non-audit services, which was one of the four threats to independence as identified by Tepalagul and Lin (2015). As such, the audit committee has the ability to limit the provision of non-audit services that could compromise independence. Ghafran and O'Sullivan (2013) found evidence that the actions of independent audit committees result in less non-audit services being performed by the auditor, therefore improving auditor independence. Additionally, the more independent and larger the audit committees, the higher the level of assurance quality (Ghafran & O'Sullivan, 2013).

In addition to the legislation contained in the Companies Act, the King IV Report (2016), referred to from hereon as King IV, also gives recommendations as to the composition and duties of the audit committee. Although King IV is not legislation, it is a JSE listing requirement for all South African listed companies to comply with the Code, therefore making compliance with King IV compulsory for all listed companies (Johannesburg Stock Exchange, 2017a).

Paragraph 55 of King IV recommends that "the members of the audit committee should, as a whole, have the necessary financial literacy, skills and experience to execute their duties effectively" (King IV Report, page 56, 2016). If the audit committee exercised their duties effectively, it would perform sufficient work so as to nominate an independent auditor for the company. Additionally, the committee would be able to effectively assess the independence of the auditor for each financial year in order to produce the report required by s94(7)(f) of the Companies Act. The findings of Ghafran and O'Sullivan (2013) were consistent with the notion that audit committees consisting of members with greater accounting or financial expertise were associated with a higher level of audit quality and independence.

Paragraph 59(a) of King IV also recommends that the audit committee prepare a statement regarding whether the audit committee is satisfied with the independence of the external auditor. This statement should address specific considerations, such as the steps and controls in place to determine the nature and extent of non-audit services, the tenure of the external audit firm and the rotation of the external audit partner (King IV Report, page 56, 2016). These recommendations complement the requirements of s97(7) of the Companies Act (Act No. 71 of 2008) and form part of the measures in place to promote auditor independence.

Opponents of MAFR believe that MAFR would diminish the duties of audit committees as required by the Companies Act and King IV (Harber, 2016). In a study performed by Harber (2016), a number of the audit partners interviewed believed that MAFR would diminish the audit committee's duties in terms of the Companies Act and remove the need for important deliberation and decision-making by the committee. Additionally, many audit partners felt that the forced rotation associated with MAFR would limit the audit committee's ability to nominate and retain the auditor that most suits the company's need (Harber, 2016). This opinion is consistent with that of Kwon *et al*. (2014) who note that MAFR would hinder the client's ability to retain an auditor that the client believes is best suited to its business.

As mentioned previously, there was consensus among all audit partners interviewed by Harber (2016) that the best way to promote auditor independence is through development of the audit committee. This notion is consistent with the findings of Ghafran and O'Sullivan (2013) that audit and corporate failures, such as Enron and Arthur Andersen, occurred within companies that appeared to have a weak governance structure. An improvement in the composition of the audit committee, for example, through audit committee member education and the promotion of King IV, was mentioned as a way to develop the audit committee and improve independence (Harber, 2016). Ineffective audit committees result in a higher threat to independence, because those committees are less likely to carry out their duties effectively in terms of the Companies Act and King IV. Ultimately, there was a general consensus between the audit partners that measures involving the improvement of the client's governance would be more effective in promoting auditor independence than MAFR (Harber, 2016). The findings from this section inform the second theme of this study:

> **Theme identified: The role of the audit committee in ensuring auditor independence.** This theme also recurs in later sections of this literature review.

MAFR IN A SOUTH AFRICAN CONTEXT

Given the recent global developments in MAFR, particularly the developments in the European Union, the Independent Regulatory Board of Auditors (IRBA) stated that it needed to respond accordingly in order to promote auditor independence (IRBA, 2016). In June 2017, the IRBA issued a rule prescribing MAFR for all public interest entities with a rotation period of ten years.

The key process leading up to the ruling begun in 2013, when the World Bank issued its second Report on the Observance of Standards and Codes (ROSC) – Accounting and Auditing (A&A) for South Africa (IRBA, 2017b). In response to the report's recommendations, the IRBA revised its strategic focus to comprise Four Strategic Pillars, one of which includes the strengthening of the independence of the IRBA and of registered auditors (IRBA, 2017a). A research project was subsequently undertaken by the IRBA in April 2015 to achieve this strategic focus, in which mandatory audit tendering, joint audits and MAFR were considered. Of these three alternatives, MAFR was determined to be the most appropriate (IRBA, 2017a). Following this research period, the IRBA entered into a period of consultation with interested and affected parties. This began in October 2016, when the IRBA issued a Consultation Paper detailing its proposal of MAFR. Interested and affected parties were asked to submit their written comments on the Consultation Paper, to the IRBA by 20 January 2017.

In the Consultation Paper, the IRBA addresses the theme of the current status of auditor independence, as well as other issues it believes to be prevalent in the auditing industry. The IRBA holds the view that the current measures in place to promote auditor independence in South Africa are not sufficient (IRBA, 2016, 2017a). An example of such a measure includes section 92 of the Companies Act (Act No. 71 of 2008), which requires mandatory audit partner rotation every 5 years. According to the IRBA (2016, 2017), audit partners tend to not report on other audit partners from the same firm where the partner's audit work was of a poor quality, implying a possible threat to independence.

> **Theme identified: The current status of auditor independence in South Africa.** Given that the policy of MAFR intends to solve the issue of auditor independence, a lack of auditor independence should therefore be perceived as a problem if the implementation of MAFR is to be deemed necessary. Therefore, the status of auditor independence is a theme that underpins the implementation of MAFR and informs the motions of the IRBA in South Africa.

Another issue is that of market concentration of the audit firms. Research performed by the IRBA (2016) shows that roughly 95% of the world's major companies are being audited by one of the Big Four audit firms. Locally, the trend is similar with more than 90% of the market capitalization of companies listed on the JSE being audited by Big Four firms (IRBA, 2017a). This situation implies that a failure in any one of those firms could have detrimental effects, such as disrupting the financial markets and diminishing investor confidence. An example of such an effect was experienced in South Africa in 2017 when the independence of KPMG, one of the Big Four audit firms, was allegedly compromised. Further details of this incident are presented towards the end of this subsection. The IRBA believes that MAFR would increase the level of competition by allowing other smaller firms to tender for the audit when a Big Four firm is 'rotated-off' the client.

The concentrated nature of the auditing environment may have also had implications for the transformation of the audit industry in South Africa. The IRBA (2016, 2017) raised transformation of the audit industry as a concern, stating that it believed the transformation process to be too slow. The IRBA revealed the results of its research in a document addressing 'Frequently Asked Questions' in June 2017. The IRBA found that 72% of the audit reports of actively trading companies listed on the JSE, as at 31 December 2015, were signed off by white registered auditors (IRBA, 2017a). Furthermore, the IRBA found that, of the remaining 12% of companies that were actively trading, 3% were signed off by black South Africans. Ultimately, the IRBA has implied that it finds this level of transformation concerning. Although the IRBA has stated that auditor independence is the primary issue that MAFR is intended to address, it believes that MAFR would help smaller firms to compete for new clients when larger firms are 'rotated-off' their clients. The IRBA did, however, note that the effect of MAFR in increasing access to auditing opportunities might not prevail immediately but could be advanced over a longer period of time (IRBA, 2017a).

The IRBA has also considered the perceived negative effects of MAFR. One such effect includes the loss of client knowledge and expertise on rotation (IRBA, 2017a). However, the IRBA does not believe this to be a problem because different clients across the same industry will have similar characteristics and the knowledge acquired by the audit firm from previous clients may be useful when working with future clients (IRBA, 2017a). Furthermore, prior to accepting the audit, auditing standards require that the audit firm must consider whether they have the competencies, resources and capacity to accept the audit (IRBA, 2017a). In this way, the auditor should consider if there are situations in which specific expertise or experience are required. Based on this consideration, the auditor should then accept, continue or decline the engagement in terms of the auditing standards (IRBA, 2017a). The IRBA also adds that there are no differences between the skills and competences of all auditors registered with the IRBA, further implying that more than one auditor is capable of performing the same audit work (IRBA, 2017a).

The issue of whether or not MAFR would negate the audit committee's role as the "auditor gatekeeper," which relates to Theme 2 of this study, is also raised (IRBA, 2016, 2017a). In terms of King IV (King IV Report, 2016), the audit committee has the duty to nominate external auditors and to annually assess their independence. The IRBA's belief is that the audit committee will still fulfil the role of nominating the audit firm for appointment by the shareholders. The shareholders ultimately approve and adopt the recommendations of the audit committee and, therefore, need to become more knowledgeable on issues surrounding auditor independence (IRBA, 2016).

An analysis of the responses to the IRBA's Consultation Paper (issued in October 2016,) indicates that the general view was that MAFR would not address the issues raised by the IRBA. A primary concern raised by respondents was that more research needed to be performed by the IRBA in order to support its view that MAFR is the appropriate course of action in a South African context (Bourne, 2017; Hoole, 2017; Ramon, 2016). A discussion of some of these responses follows:

- Many respondents, including the IFAC, the CFO forum, SAICA and the Big Four Audit Firms, believed that the notion that MAFR will improve audit quality is not supported by international research. Chourdhury (2017) pointed out that evidence from research to date does not clearly demonstrate that MAFR improves audit quality and that further research is needed. Some respondents also raised the point that South Africa has strong auditing and accounting standards, as is evidenced by the country being ranked first in the world for seven consecutive years in that regard by the World Economic Forum (Hoole, 2017, Shango, 2017). Therefore, the IRBA should consider whether MAFR would improve audit quality in the context of South Africa's strong corporate governance environment.
- All four of the Big Four firms responded that they were not in favour of MAFR and detailed various issues that they perceived relating to MAFR and its inability to achieve the objectives set out by the IRBA, regarding audit quality and independence. There was a consensus that MAFR would have a negative impact on the auditing industry. The frequent tendering process, as a result of MAFR, has the potential to reduce audit fees which could have a detrimental impact on attracting and retaining talent within the audit profession (Bourne, 2017; Shango, 2017). Another disadvantage of MAFR includes all the costs related to the tender of the audit, which results in additional costs incurred by audit firms when competing for clients and additional time investment required from audit committees, boards and the client's management (Bourne, 2017; Hoole, 2017).
- Loss of client knowledge was also raised as a concern by the firms. According to Bourne (page 7, 2017) "auditors of insurance companies and banks will attest to the fact that it takes at least 3 years or more to obtain an adequate knowledge of the client and industry," thus implying that the quality of the audit in the later years of the engagement tends to be higher than in the initial years.
- Respondents to the IRBA's Consultation Paper also addressed the issue of transformation, noting that they had all made a conscious effort towards promoting transformation and felt that the IRBA had discounted these efforts. For example, as per Ernst and Young's response to the IRBA's consultation letter, 36.4% of their partners are black, 54.16% of their staff are black and 66% of the Executive Committee, including the CEO, is black (Bourne, 2017).

Consequently, Ernst and Young have a Broad-Based Black Economic Empowerment[3] (B-BBEE) contribution level one, which is the highest level of compliance with the B-BBEE codes (BEE Scorecard (Pty) Ltd., 2017; Bourne, 2017).

- Finally, respondents agreed that there are better alternative measures to MAFR for promoting auditor independence and that the IRBA should consider these measures before pursuing MAFR. Other measures include, for example, further development and enforcement of the Code of Professional Conduct, stronger audit committee oversight of external auditors and the improvement of the role and function of audit committees, such that the committee can better fulfil its duties in terms of the Companies Act (Bourne, 2017).

Ultimately, together with academic literature, the professional debate elaborates on the common themes of the benefits and costs of MAFR. Audit fee related issues, lowballing (a practice whereby a lower fee is charged initially in order to compete with other firms so as to win the audit tender) and transformation and market concentration issues can be identified as individually prominent themes. Therefore, the motives of the IRBA, together with the responses to the Consultation Paper, inform the following themes in this study:

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[3] 'Broad-based black economic empowerment' means the viable economic empowerment of all black people [including], in particular women, workers, youth, people with disabilities and people living in rural areas, through diverse but integrated socio-economic strategies that include, but are not limited to—

(a) increasing the number of black people that manage, own and control enterprises and productive assets;

(b) facilitating ownership and management of enterprises and productive assets by communities, workers, co-operatives and other collective enterprises;

(c) human resource and skills development;

(d) achieving equitable representation in all occupational categories and levels in the workforce;

(e) preferential procurement from enterprises that are owned or managed by black people; and

(f) investment in enterprises that are owned or managed by black people;' (Act No.46 of 2013: Broad-Based Black Economic Empowerment Amendment Act, 2014)

Theme identified: Market concentration and transformation considerations for MAFR in South Africa. This is a unique theme surrounding MAFR in South Africa and is considered to be one of the primary objectives of the IRBA in implementing MAFR within South Africa.

Theme identified: Audit fee related issues, including lowballing, and their impact on audit quality.

After having considered the responses, the IRBA gazetted MAFR in June 2017. Within weeks of the ruling, the independence of one of the Big Four audit firms came under public scrutiny. This was echoed by a drop in South Africa's World Economic Forum ranking for auditing and reporting standards from first place to thirtieth place (World Economic Forum, 2017). It is alleged that KPMG acted negligently and unethically in failing to identify and/or report on accounting irregularities relating to work performed in 2014-2015 for entities run by the Gupta family[4] (KPMG, 2017; Malope, van Rensburg & Dlwati, 2017). Following the allegations, the firm lost four of its larger clients within a week and the Finance Minister has instructed state-owned entities to review any work that the firm has performed (Malope *et al*., 2017).

As a result of the allegations, an independent investigation into KPMG South Africa was launched by KPMG international (KPMG, 2017; KPMG International, 2017). As at 15th September 2017, KPMG South Africa staff had not been found guilty of any illegal actions or corruption (KPMG, 2017). However, KPMG South Africa released a statement on the findings of the investigation, in which the firm admitted that its work performed did "*[fall] considerably short of KPMG's standards"* and announced a series of leadership changes (KPMG, page 1, 2017). According to the National Treasury, the developments have undermined auditor independence in South Africa and have thus reaffirmed its belief that MAFR should be implemented (Malope *et al*., 2017). As at November 2017, the major clients that have retired KPMG as its auditor as a result of the allegations include Sygnia, The Foschini Group and AVI (Crotty, 2017; Planting, 2017). AVI has said that it will not reappoint KPMG after its 2017 financial year (Crotty,

[4] The Guptas are a family from India that relocated to South Africa in 1993 (BBC, 2016). The family has had close business connections with the current South African President's family and is accused of wielding a large political influence in South Africa (BBC, 2016).

2017). Both Sygnia and The Foschini Group have appointed Deloitte as the new auditor and AVI has yet to appoint a new auditor for its 2018 financial year. Therefore, in light of the notion that MAFR could help to promote market concentration, it would seem that companies are tending to appoint another Big Four audit firm when it comes to rotation, therefore, not reducing market concentration.

CONCLUSION

From the literature reviewed, various conclusions can be drawn about the effectiveness of MAFR in promoting auditor independence and enhancing audit quality. Globally, it appears that many different countries are in various stages of considering, implementing and/or discontinuing MAFR. These mixed responses to MAFR as a policy seem to indicate as lack of conclusive evidence regarding whether MAFR is the best solution to promoting auditor independence. On the one hand, academic arguments exist in favour of MAFR (Daniels & Booker, 2011; Dopuch *et al*., 2001; Harris & Whisenant, 2012; Zhang, 1999). On the other hand, South African auditing industry professionals appear to be against the policy's implementation, noting that auditor independence in South Africa is sufficient (Bourne, 2017; Chourdhury, 2017; Hoole, 2016; Shango, 2017). Recent South African developments, namely those relating to KPMG, could, however, counter this notion and consequently support the IRBA's concerns regarding auditor independence.

Despite differing conclusions regarding MAFR, the issues and considerations raised by both proponents and opponents of MAFR are similar. As such, the following five common and recurring themes have been identified in the literature and are summarised below:

- Benefits and costs of MAFR and the related impact on audit quality
- The role of the audit committee in ensuring auditor independence
- The current status of auditor independence in South Africa
- Market concentration and transformation considerations for MAFR in South Africa
- Audit fee related issues, including lowballing, and their impact on audit quality

These themes will inform the research questions of this study, which are presented in Chapter Three.

CHAPTER THREE: RESEARCH METHODOLOGY

The objective of this study is to explore and document the perspectives of South African audit committee members on MAFR. In order to focus on audit committee members' perspectives on MAFR in depth, information in addition to that acquired through the responses to the IRBA's consultation letter needs to be obtained. One such way of obtaining this data is through in-person interviews. As such, the researcher conducted in-person interviews with a sample of audit committee members using the method that is described below. The other advantage of in-person interviews is that anonymity is guaranteed and, therefore, the interview might provide a more in-depth perspective than a response letter submitted to the IRBA (Fontaine *et al*., 2015).

Various themes have been identified through consideration of the academic literature on MAFR, the points raised by the IRBA in the consultation paper and the interested and affected parties' responses to the IRBA. These themes were predominantly issues surrounding MAFR raised by the various sources of literature, for which conflicting views and conclusions exist. Considering the prevailing themes in the literature review, research questions were proposed that are linked to these themes. The themes identified together with the research questions are presented in Table 1. For the purposes of achieving a logical flow of interview questions and the analysis of results, the order of the themes has been modified in this chapter from the order presented in Chapter Two. These themes and research questions form the framework according to which the semi-structured interview questions will be developed and the results analysed.

Table 1: Themes and Research Questions

Theme identified	Research question(s)
1. The current status of auditor independence in South Africa.	1.1. How do audit committee members in South Africa perceive the current status of auditor independence? 1.2. Do audit committee members believe the current measures in place to promote independence are sufficient?
2. The role of the audit committee in ensuring auditor independence.	2.1. Do audit committee members believe that audit committees are effective in promoting auditor independence? 2.2. What impact do audit committee members believe MAFR will have on the role of the audit committee in ensuring auditor independence?
3. Benefits and costs of MAFR and the related impact on audit quality.	3.1. What impact will MAFR have on audit quality in South Africa? 3.2. What costs (monetary and non-monetary) do audit committee members believe will result from MAFR and do these costs exceed the intended benefits?
4. Audit fee related issues, including lowballing, and their impact on audit quality.	4. How will MAFR affect audit fees, including the practice of lowballing, and, ultimately, audit quality?
5. Market concentration and transformation considerations for MAFR in South Africa.	5.1. What affect will MAFR have on the market concentration of the auditing environment? 5.2. Will MAFR help to promote the transformation of the auditing profession in South Africa?

In order to answer the research questions listed above, semi-structured interviews were undertaken. In this way, the researcher was able to explore and understand the breadth of issues and opinions around the adoption of MAFR in South Africa.

Semi-structured interviews involve the development of predetermined questions which allow the interviewer to further explore the responses of the interviewees (Doody & Noonan, 2012). Thus, this approach does not limit respondents to a predetermined set of answers (Dearnley, 2005). According to Schultze and Avital (2011), interviews are different from other research methods in that they engage interviewees directly with the interviewer, resulting in first-person accounts and interpretations of the interviewees' lived experiences. The open nature of the questions also helps new concepts to emerge by encouraging depth and vitality (Dearnley, 2005).

POPULATION AND PARTICIPANT SELECTION

The population of this study is audit committee members of South African listed companies. Given that the audit committee plays an important role in the corporate governance of a company (Dobija, 2013), the perspectives of audit committee members on MAFR could be useful for regulators in determining whether to pursue a policy of MAFR. Globally, the perspectives of audit committee members on MAFR have only been explored in one paper by Fontaine *et al.* (2015), which is discussed briefly in the literature review. No such studies exist yet in a South African context. Audit committee members will be referred to as "members" for the remainder of this study.

To select the sample, a technique called "purposive sampling" was used. According to Tongco (2007), purposive sampling is a type of non-probability sampling that does not rely on statistical sampling but rather on the judgement of the researcher. In other words, subjective methods are used to determine the sample selection (Etikan, Musa, & Alkassim, 2016). Purposive sampling is useful for researching an area comprising knowledgeable experts (Tongco, 2007). This technique involves selecting informants, in this case interviewees, based on the qualifications, qualities and/or experience that they possess (Etikan *et al*., 2016; Tongco, 2007). In this way, the quality of the data gathered, therefore, relies on the purposive sample chosen (Tongco, 2007). The interviewer should thus concentrate on selecting reliable and competent interviewees who are capable of assisting with the relevant research (Etikan *et al*., 2016; Tongco, 2007).

To purposively select the sample used in this research project, a homogenous sampling method was employed. Homogeneous sampling involves the selection of interviewees who share similar characteristics or experiences (Etikan *et al*., 2016). Only members of South African listed entities were selected, as the requirement to mandatorily rotate audit firms only applies to public interest entities which includes listed entities (IRBA, 2009, 2016). The population was simplified to listed entities, despite the definition of public interest entities being wider than listed entities, for the sake of simplicity. Furthermore, members with 2 years or more experience as audit committee members were selected to ensure a sufficient level of experience as an audit committee member. This selection process is in line with the tenures of the members in the study by Fontaine *et al*. (2015) and ensures the selection of suitably homogenous audit members who share the critical experiences necessary to explore the research questions.

During the process of collecting data through semi-structured interviews, a point was reached in the interview process when no new themes of categories emerged. According to DiCicco-Bloom and Crabtree (2006), this point is referred to as saturation and it signals that data collection is complete. Saturation was reached after 22 members were interviewed (20 of which were in-person interviews and two of which were via Skype). Therefore, the sample size of 22 was sufficient for the purposes of answering the research questions.

Access to the members interviewed in this study was obtained through professional contacts and referrals. The members interviewed were based in either Cape Town or Johannesburg. Given that the majority of South African listed companies are based in either Johannesburg or Cape Town, the sample for this study is considered to be a fairly representative sample of audit committee members in South Africa (Johannesburg Stock Exchange, 2017b). The following is a description of the 22 members interviewed:

- Seventeen (77%) have had experience as an audit committee chair (currently or previously).

- Twenty-two (100%) had a Bachelor of Commerce degree.
- Six (27%) have a Masters of Commerce degree.
- Two (9%) had obtained Higher Diplomas in Tax Law.
- One (5%) had obtained a Masters in Business Administration.
- Twenty-one (95%) are Chartered Accountants (South Africa).
- Five (23%) are women.
- Twenty-two (100%) have been audit committee members of more than one company.
- The public listed entities for which the interviewees are audit committee members are situated in various geographic locations within South Africa, however, the members are based either in Cape Town or Johannesburg and travel to board meetings if necessary.

The researcher did not note any discrepancies in response themes between members who had had experience as an audit committee chair and those who had not, or across the members' financial expertise or qualifications. A description of the sample of members of this study is contained in Table 2, including the designation of the member, which is used to analyse the results of the interviewees, for example, "Audit Committee Member 1", "Audit Committee Member 2," etc. These designations are abbreviated as "ACM" followed by the number assigned to the member.

Table 2: Description of Audit Committee Member Interviewees

Designation of member	Number of companies[5]	Longest Tenure (Years)[6]	Average Tenure (Years)	Summary of ` Qualifications	Location of ACM
ACM 1	3	10	7	CA(SA)	Cape Town
ACM 2	2	7	7	CA(SA), MCom	Cape Town
ACM 3	2	10	6	CA(SA)	Cape Town
ACM 4	1	5	5	CA(SA)	Cape Town
ACM 5	2	8	8	CA(SA), MCom, BA, LLB, FCIS	Cape Town
ACM 6	6	7	5	CA(SA), BCom(Hons)	Cape Town
ACM 7	4	9	5	CA(SA), MCom, HDip, Tax Law	Johannesburg
ACM 8	2	3	3	CA(SA), BCom(Hons	Cape Town
ACM 9	3	3	2.5	CA(SA), BCom(Hons)	Cape Town
ACM 10	3	2	1.5	CA(SA), MCom, HDip Tax Law, HDip Business Processing	Johannesburg
ACM 11	2	9	8.5	CA(SA), BCom(Hons)	Johannesburg
ACM 12	2	8	6	CA(SA), BCom(Hons)	Cape Town
ACM 13	2	15	11.5	BCom, MCom, FCMA, FIBSA	Johannesburg
ACM 14	2	12	11	CA(SA)	Johannesburg
ACM 15	6	4.5	3.5	CA(SA)	Johannesburg
ACM 16	4	4.5	4.5	CA(SA)	Cape Town
ACM 17	5	11	8	CA(SA), MBA	Cape Town
ACM 18	3	7	7	CA(SA), MCom	Johannesburg
ACM 19	3	6	5.5	CA(SA)	Cape Town
ACM 20	5	9	8	CA(SA), BCom(Hons), CMS (Oxford)	Cape Town
ACM 21	6	14	9	CA(SA), CD(SA)	Johannesburg
ACM 22	8	8.5	6	CA(SA)	Johannesburg

[5] This column refers to the total number of companies for which the member has sat on the audit committee during the member's lifetime (not necessarily simultaneously). Previous positions and current positions are included.

[6] This column refers to the longest audit committee position tenure that the member has held with an individual company.

In the interviews, the members and interviewer commonly refer to the “Big Four” audit firms and mid- and small-tier audit firms. The “Big Four” audit firms include Ernst & Young (EY), KPMG, Deloitte and PricewaterhouseCoopers (PwC), which are the major global accounting firms (ICAEW, 2017). Mid-tier and small-tier audit firms are those firms, other than the Big Four, that are classified as mid-tier or small-tier depending on factors such as resources and capabilities, global presence and size (ICAEW, 2017). In light of recent events regarding auditor independence in South Africa, it is worth noting that the interviews were conducted before the KPMG incident in 2017. These developments are discussed in the subsection on MAFR in a South African context in Chapter Two.

INTERVIEW PROCESS

In order to conduct the interviews, predetermined, semi-structured questions were constructed. The predetermined questions were developed from the research questions which were, in turn, drawn from the themes identified in the literature (refer to Table 1). For the purposes of developing these questions and for the analysis to follow, a grounded theory approach was implemented, allowing the researcher to develop theories as research was being performed (Strauss & Corbin, 1997). This set of standard questions was then used to guide the discussion, whilst opportunities for the interviewer and interviewee to further explore a response were also allowed.

Pilot interviews were conducted to determine whether the interview questions needed to be revised. The interviewer found that the proposed interview questions were adequate in answering the research questions. Therefore, no changes were made to the original draft of questions. The interview questions can be found in Appendix 1.

The researcher was present at each interview and could both lead the interview and take notes during the interview. The average interview duration was 33 minutes with a minimum duration of 19 minutes and a maximum duration of 54 minutes. Ethical clearance was obtained prior to conducting the interviews via the College of Accounting of the University of Cape Town. Each interview was recorded electronically after each participant had signed a consent form agreeing to the interview being recorded. All the recorded interviews were then transcribed. The interviewer confirmed the accuracy of the transcriptions by simultaneously listening to the audio recordings whilst reading the transcribed interview. No discrepancies, other than the spelling of industry terminology, were noted.

There is a low risk in terms of researcher bias because the interviewer is an academic with no personal or financial interest in whether MAFR is adopted in South Africa. Consequently, all questions posed to the members, the analysis of responses and documentation thereof were performed objectively.

CHAPTER FOUR: PRESENTATION AND ANALYSIS OF RESULTS

The results from the interviews conducted in this study are presented and analysed below. The interviewer applied the methodology described in Chapter 3: Research Methodology, to the documents containing the transcripts of the interviews in order to obtain the results. The results are presented according to the framework developed in the said methodology chapter, whereby themes were identified in the literature review and research questions formulated, from which interview questions were accordingly developed. The themes are presented in the same order in which they were identified in the framework. As such, the results are presented according to the following key themes:

1. The current status of auditor independence in South Africa.
2. The role of the audit committee in ensuring auditor independence.
3. Benefits and costs of MAFR and the related impact on audit quality.
4. Audit fee related issues, including lowballing, and their impact on audit quality.
5. Market concentration and transformation considerations for MAFR in South Africa.

5.1. THE CURRENT STATUS OF AUDITOR INDEPENDENCE IN SOUTH AFRICA

Of the 22 members interviewed, 17 (77%) believed that there is no problem with the current status of auditor independence in South Africa. ACMs 6, 9 and 14 agreed that independence was adequate at the Big Four Firms but were concerned about independence at the non-Big Four Firms.

Many members raised the point that in terms of independence, *"… one [has] got to be actually looking at the people" (ACM 1).* The current rotation systems in place within the firms conducting the audit mean that the audit team working for a particular client at any given time is sufficiently independent. "…*[A]s a matter of course the clerks who are engaged, the associates who work on the audit, are naturally all growing and they are changing their role, changing their position so they will get more senior every year, so… [doing] different bits of the work as they grow, and eventually most of them leave to go to other… [firms or jobs]" (ACM 1).* This means that the audit team generally does not consist of the same individuals for an extended period of time and there are *"new eyes on it [the audit] the whole time" (ACM 1)*. Additionally, members noted other means of ensuring independence, such as having a senior partner review the other partners' work and a quality assurance partner, who never personally meets with the client, providing additional reviews.

ACM 20

"I think it's very good and I've been through a number of scenarios where audit firms have had to propose for the audit work at the large listed companies and we have very, particularly in the top level of the audit firms – have got independence in those particular organisations. So, you talk of the top-four and then the next series beneath the top-four – no issues in my opinion of independence."

ACM 3

"I am not aware of any issues with auditor independence. In my personal experience, I find that the firms take the issue of audit independence quite seriously. I definitely get the sense that it is part of the firm's internal quality control processes, and in my capacity as Chairman of the audit committee, it is something that they draw to my attention often in a practical way. I don't think there is an issue."

A few audit committee members also mentioned the fact that auditors and companies are both subject to legislation that exists to promote the independence of auditors. Such legislation includes the Companies Act, s94 which requires the company's audit committee to review the independence of the external auditor. Listed companies are also required to comply with King IV, which sets out guidelines on how the audit committee should assess the independence of the auditors. The majority of members believed that *"there are so many statues and regulations that companies and auditors, and audit committees… have to comply with"* to ensure auditor independence and thus implementing MAFR is not *"… going to change anything in that respect* [with respect to independence]*" (ACM 4)*.

ACM 8

"The Audit Committee and the Board's duties, as far as [the] independence of the auditors is concerned, are very well defined through a number of things, [such as the] Company's Act, the JSE Listings Requirements and King IV. It's very well defined there and it's a very clear set of guidelines and, in addition to that, you've got Audit Committees, in following those guidelines, to think very deeply about the independence of the auditors and they've taken a direction where they must use their discretion in a very wise way in thinking about that. So, I think there's enough guidance given to Audit Committees in order to make their auditor independence decisions."

Additionally, ACM 4 commented on how *"… there is so much reputation at play"* and that *"…reputation is money."* Therefore, fraudulent behaviour on the part of the auditor or the client could result in that person *"…[losing] bucket-loads of money" (ACM 4).* Factors such as the legal consequences that could face a negligent or fraudulent auditor and the potential damage to the auditor's reputation, were considered strong enough to dissuade an auditor from not acting independently.

ACM 14

"… the censures within the large firms for those partners on an individual basis are so severe these days that, you know, it is not worth a partner's career and future, to be honest, to give an incorrect [opinion] or an opinion simply to please a client these days."

ACM 18

"I think auditors are also cautious because of professional integrity requirements, the risk of litigation… so generally auditors look thoroughly at the risks."

Despite these assurances, two of the 22 audit committee members interviewed (9%) believed that auditor independence in South Africa still needs to be improved. ACM 21 noted that listed companies' audit committees are often comprised of former partners from the incumbent audit firm, indicating a possible *"structural issue"* (see quote below), indicating a lack of independence:

ACM 21

“Okay, well it [auditor independence] does need to be fixed. It needs improvement because the make-up of the audit committees is basically, largely made-up of the former partners of the incumbent auditors. I think there’s a problem… They’re an ex-incumbent audit firm, so you can see then that it really becomes a problem. So, because of those structural issues, I think something has to be done… So, there is perceived lack of independence…”

ACM 21 also noted that the strong disagreement of CEOs of companies affected by the implementation of MAFR indicates a possible independence issue. According to the participant, auditors are the “*suppliers*” of a “*service”* and that service can be performed by any auditor, not only the incumbent auditor. Many CEOs and governing structures have been *“fight[ing] for their auditors”* and, consequently, the auditors’ independence is questionable.

ACM 7 believed that auditors are currently lacking independence and that there is a lack of *“questions”,* or perhaps measures, that challenge the independence of the auditor. Consequently, this participant believed that additional measures need to be introduced to prevent the further erosion of auditor independence.

ACM 7

“My view is that I don’t think there are questions really which have manifested in certain misdemeanours or certain behaviours challenging the whole question of auditor independence… The issue is that sadly, over time, auditors have been found to have been lacking on such matters [independence]. And I think in order to help the auditing profession… steps need to be taken to make sure that we prevent these things [the erosion of auditor independence] before…disasters occur.”

When asked whether long audit tenure could potentially lead the auditors to issue a biased or inappropriate audit report, 21 of the 22 members (95%) interviewed believed that this was not the case. Some members agreed that, whilst in theory long audit tenure could lead to the impairment of independence, in practice the natural rotation of the audit team prevents this. ACM 5 explained how this notion "…*presumes that everything is static within an audit company or an audit firm, whereas it's not because you are getting new article clerks, they want for better trainees coming, you have change of partners, it is a fluid environment."* As a result, long audit tenure for the firm does not imply long audit tenure for the individual team members. In this light, members noted that partner rotation has been a positive step towards improving auditor independence, but firm rotation is something very different. With partner rotation, independence is still maintained, and a fresh set of eyes is brought onto the audit every five years, but the benefit of client specific experience and knowledge remains.

A few members also noted that, even when long audit tenure has the potential to impair independence, the audit firms and the companies have many checks and balances in place to prevent this from happening. ACM 14 listed such checks and balances, which includes *"…a review partner of some sort… often whom you as a client never get to see… [meaning that] behind the scenes you know that there is someone who is reviewing key and critical and potentially controversial issues where calls need to be made…".* Additionally, *"… the censures within the large firms for those partners on an individual basis [for issuing inappropriate audit reports] are so severe these days" (ACM 14)*. Therefore, these censures act to deter auditors from not being independent.

ACM 3 pointed out that *"…relationships [between management and the auditors] all change over time."* Not only does the audit team rotate, so too does the group of individuals at the client with which the audit team works. The member stated that he/she had had no experience of a long tenure with the same audit partner and Chief Financial Officer and suggested that it seemed random to make the auditor rotate and not any other individual involved in the audit process. In this light, ACM 3 *"[did not think] rotating the firm… is necessary."* Another member, who has many years of experience as an audit partner, also drew attention to how, although some audit firms have been with the same client for decades, in general, the Chief Executive Officer and Chief Financial Officer has not remained the same over that period.

ACM 15

“Well I think that is a very sweeping statement. I think it is unlikely [that long audit tenure impairs independence] for the reasons I have mentioned in the first question, with all the checks and balances... Secondly… for example, in… the [IRBA’s] first lot of frequently asked questions, [it was stated that] we have audited some firms for 86 years. There hasn’t been the same CEO for 86 years.”

In response to whether long audit tenure could bias the audit opinion, ACM7 held that view that it might not necessarily bias the audit opinion, however, more issues could potentially be discovered by a new auditor and brought to the attention of the audit committee. In this way, *“a change [in auditor] would have… [identified these issues]”* and more value could be added to the audit through audit firm rotation.

ACM 21 did agree that long audit tenure had the potential to lead to a biased audit report. However, the member qualified that statement by stating that, at the same time, a tenure that is too short is also not good. According to ACM 21, it takes a few years for the audit partner to understand the client. Switching audit firms too soon would mean that this process is repeated too often. ACM 21 clarified that he/she considers any audit tenure longer than 10 years to be too long.

On the topic of auditor independence in South Africa, some members believed there to be a discrepancy between the independence of the Big Four audit firms and the medium to small audit firms. The experience of most of the members interviewed was primarily with the Big Four audit firms. None of these members believed there to be problems with auditor independence at that level. However, some members mentioned that independence is more of an issue for the smaller firms.

One of the primary reasons for this lack of independence is that the larger the audit firm, the lower risk of dependence on key clients. With smaller firms, however, there is a higher risk that a fee received from a client is large in the context of the small firm’s client portfolio. As such, the smaller firm is more likely to be influenced by the wishes of the client’s management so as to not lose the client’s business.

ACM 14

"… I really haven't ever felt that there is a problem at all of auditor independence in South Africa particularly with regards to the large firms, and one of the advantages of being large is that if you are large enough, no client is large enough to influence you… Auditor independence, in my view, is much more relevant if you are a small firm and you have individual clients who are significant in the context of your practice as a whole in terms of fees or reputation or so on."

ACM 9

"… I have got a big firm experience from Deloitte's and KPMG. And certainly, there I don't believe there is any doubt about audit firm independence but, certainly lower down, someone called Graham Maddock, who you might recall having seen his name in the press, spent a little bit of time in jail, [relating to] the Fidentia account… He pitched up at a braai with a 4x4, and said "no, a client had given that to him." This is probably what… like twelve to fifteen years ago? Anyway, the girls were in the kitchen skinnering[7] *as they were and I got into big trouble because his wife had just been given a big diamond ring… So I believe, [regarding] the smaller firms, there is no mistake there. Their independence is a different story…"*

ACM 6 spoke about an experience with a company that was being audited by a smaller firm. According to ACM 6, *"…there… [was] no question that they [management of the client] were interested in getting rich quickly but they cut corners, they did a number of things that… [ACM 6 thought] were somewhat dishonest."* Furthermore, ACM 6 expressed *"concern… that the audit firm had a relationship with these guys [management] and they [the audit committee] were becoming uncomfortable but… [the audit firm was] doing nothing about it."* Initially, ACM 6 thought that the reason behind not appointing a Big Four audit firm was that it would be too expensive. However, ACM 6 ultimately believed that the reason is because a big firm would have "*probed too much*."

[7] "Skinnering" is a South African slang term for gossiping.

It was noted by ACM 14 that independence between Big Four firms and small firms may be different but the possibility of being negligent, overlooking an event or making an error is no different between the two types of firms.

Overall the results of the interviews provide the following answers to research questions 1.1 and 1.2:

1.1. How do audit committee members in South Africa perceive the current status of auditor independence?

The majority of members did not believe the status of auditor independence in South Africa warranted the implementation of MAFR. Two members did, however, feel strongly that independence of auditors has been eroded and that the implementation of MAFR could help to prevent further erosion. Some of the members who believed that auditor independence was adequate did note that this practice applied to the larger audit firms to a greater extent than the smaller audit firms. The discrepancies between the independence of small, medium and large audit firms could be an area for further research.

1.2. Do audit committee members believe that the measures currently in place to promote independence are sufficient?

In line with the notion that the members believe that there are no problems with auditor independence in South Africa, the majority of members are satisfied with the current measures in place to promote auditor independence and believe that they are sufficient to ensure ethical behaviour.

5.2. THE ROLE OF THE AUDIT COMMITTEE

With regard to the role played by the audit committee in ensuring auditor independence, many members expressed concern that MAFR would diminish this role. Most members were of the opinion that the current measures to ensure auditor independence, including the functions of the audit committee, were sufficient and that auditor independence was not a problem in South Africa.

The first point raised by many members was that the provisions of the Companies Act and King IV, governing audit committees, are sufficient. The duties of audit committee members according to the Companies Act (section 94(7) and (8)) relate mainly to ensuring auditor independence. As such, the majority of members believed that the current audit committee mechanisms in place are sufficient to ensure auditor independence. If audit committees function effectively and fulfill their role as intended by the Companies Act and King IV, a financial report user should be satisfied with the independence of the external auditor. ACM 3 held the view that IRBA's belief that the current measures to ensure auditor independence in South Africa are not sufficient is *"quite insulting to both audit firms and audit committees."* The IRBA's belief would imply that audit committees are *"not doing their jobs" (ACM 3)* sufficiently in terms of the Companies Act and King IV.

> *ACM 8*
>
> "… One of the most *important roles of an Audit Committee is to ensure that you appoint the right auditors and that they are independent... So you've got to ask yourself the question, "is this actually a questioning of Audit Committees [effectiveness]…?" The Audit Committees that I've been on always have been acting very independently and been independently minded and have followed their duty in the law..."*

Some of the members discussed how MAFR could perhaps inhibit the decision-making abilities of the entity. Firstly, the members noted that the concept of independence is one that requires professional judgment. A *"legal requirement [exists]… that says the audit committee is responsible for making these [auditor appointment] decisions" (ACM 2).* By being forced to rotate firms every 10 years, the audit committee might be *"… [forced into] a position where… [it has to] appoint someone else" (ACM 2)* other than the auditor that it deems most appropriate for the client. This requirement, therefore, limits the ability of the audit committee to exercise complete professional judgement in the year of rotation. In this sense, MAFR would potentially diminish the role of the audit committee.

Two of the members interviewed, however, agreed with the IRBA and felt that current audit committee mechanisms ensuring auditor independence were not sufficient. According to ACM 7, auditors are regular human beings and are not immune to familiarity threats. Consequently, it should not be left to the audit committee and auditors to self-regulate the auditor's independence, but independence should rather be regulated externally with a policy, such as MAFR. In this way, there would be a *"separation of power" (ACM 7)*, which would better ensure independence. The same member claimed that it is very rare for audit committees to voluntarily tender the audit, which the member believed to be evidence that perhaps independence is an issue.

Some members added that the ability of the audit committee to ensure auditor independence depended on the composition and competence of its members. It was noted that more independent and financially literate audit committee members would be more capable of fulfilling their role as an audit committee member. A point was raised by ACM 14 that individual audit committee members also have their *"personal reputations to preserve."* A member's reputation plays a large role in the member's credibility and most competent audit committee members will be very cautious of anything negatively affecting their reputation.

> *ACM 1*
>
> *"…If you have got a competent set of [audit committee] members who are experienced and skilled sufficiently, they are well-equipped to determine the independence, and not only the independence but equally, and probably far more importantly, the competence of the auditors to actually do the audit…"*
>
> *ACM 14*
>
> *"…If you make a mistake, you know it follows you… Errors follow you… So one of the most important things is to remember that individual audit committee members also have their personal reputations to preserve… A very strong aspect of ensuring independence is simply the judgement of the audit committee members."*

In terms of the composition of the audit committee, ACM 4 suggested that ex-auditors, excluding the auditor who has acted as the designated auditor for the entity within the past 3 years as this would impair independence, tend to be valuable audit committee members. This is because ex-auditors understand the audit process and where the audit risks would be and, therefore, can ask the right questions. ACM 4 suggested that it would be useful for at least one of the audit committee members to be an ex-auditor. Likewise, ACM 11 emphasized that audit committees need a strong chairman and that they believed the strongest chairmen came out of the auditing profession. ACM 11's reasons also included the notion that ex-auditors have a strong technical background and are thus more able to challenge the incumbent auditors and management.

> *ACM 11*
>
> *"I think that audit committee's need a very strong chairman and I believe the best audit committee Chairman comes out of the profession. Somebody who has spent their life in the profession… You need a strong chair with a good technical breakdown, who can challenge the auditors, who can challenge the CFO, who can act in a meditating capacity if they have to."*

The results of this section provide the following answers to research questions 2.1 and 2.2:

2.1. Do audit committee members believe that audit committees are effective in promoting auditor independence?

Ultimately, the general consensus among the members was that audit committees are currently fulfilling their mandate effectively. Furthermore, the common view held was that the current audit committee mechanisms are sufficient to ensure auditor independence. Some members did, however, note that the effectiveness of the committee depends, to an extent, on its composition and competence. Two members believed that the audit committee does not sufficiently promote auditor independence and that its role could be complemented by MAFR.

2.2. What impact do audit committee members believe MAFR will have on the role of the audit committee in ensuring auditor independence?

A few members commented on how MAFR could diminish the role of the audit committee. As a result of being forced to 'rotate off' a firm and having to appoint another firm, the committee might be forced to appoint an auditor who it does not believe is the most appropriate for the client. In this way, MAFR could negatively impact the role of the audit committee in selecting, according to its professional judgment, the auditor most suited to the client.

5.3. BENEFITS AND COSTS OF MAFR AND THE RELATED IMPACT ON AUDIT QUALITY

When asked whether they believed the intended benefits could exceed the expected costs of MAFR, 20 of the 22 (91%) members interviewed were uncertain as to what the benefits of MAFR would be in South Africa. Three of these members stated that they believed there are no benefits. Consequently, the general view held by the members interviewed, barring the two members who believed that auditor independence in South Africa needs improvement, was that the costs of MAFR would exceed any intended benefits.

ACM 13

"As I said I don't think there will be benefits. I think… it will be a negative quality that you will get out of it."

ACM 5

"The cost would be significantly high, and then one presumes that there are going to be benefits, whereas I don't agree with that… You are just looking at higher costs and not necessarily benefits."

A potential benefit of MAFR was raised by ACM 8 in that a new audit team will bring a fresh set of eyes and may ask new questions. This benefit occurs as a result of the different perspectives of the new audit team. ACM 8 did, however, note that this result is already achieved with audit partner rotation and furthermore, there is a continuity in the auditors' understanding of their client that would not be present with mandatory audit firm rotation.

ACM 8

> *"[Audit quality] will be weaker in the beginning, with the one advantage that new questions will be asked, that haven't been asked before because people look at it with new perspectives… [With audit partner rotation], new questions are asked but the total audit team behind the partner is not ripped apart, so you still have some continuity in the understanding of the company."*

Ultimately, the members interviewed did not discuss many benefits of MAFR, apart from the potential benefits relating to market concentration and transformation, which will be discussed under a later theme.

Many costs and concerns, however, were raised by the members. A common concern was that of the loss of institutional knowledge. Audit firms build up an understanding and knowledge base of the client over the years in which they are the incumbent auditors. This knowledge is important and vital in order for the auditor to perform an effective audit. Such knowledge includes the understanding of the client's business model, the environment in which the client operates, the financial reporting system of the client and, hence, where the key risks lie. Many members argued that with partner rotation, a fresh set of eyes is brought onto the audit and independence is maintained. At the same time, the institutional knowledge, understanding of the client and working papers still remain within the audit team. The whole audit team does not rotate at once, meaning that the understanding can filter down through the team and individual members are promoted or change positions. Audit firm rotation, however, brings about a situation where the audit firm has to start from scratch, and build up that institutional knowledge from the beginning. As this understanding takes a few years to build up, in terms of audit quality, detection risk and, thus, audit quality is lower in the first few years following a rotation.

The issue of auditors having to face a steeper learning curve in the first few years of the audit links to the issue of audit fees discussed in the previous subsection. Unless audit fees are increased to the extent that the client absorbs the increased costs of the auditor having to spend more time and resources in order to understand the client, the audit firm will face a high level of loss absorption in the first few years of the audit. In this case, there is a risk that corners might be cut leading to a lower level of assurance. Furthermore, as discussed above, audit firm rotation might not be financially healthy for the profession.

ACM 20

"Well, the biggest cost you're going to face if… you bring in a new firm, is [that] they don't have the knowledge that the other firm has got… So now as an Audit Committee you've got to rely on their opinion… In order for them to give you their sound-opinion they're going to have to do a lot of research. In order to do that it's going to cost them a hell of a lot more money..."

ACM 12

"*If you are going to have MAFR, the incoming firm is going to ask or repeat a whole lot of stuff which is part of the institutional knowledge, as it were, of the departing firm. And they [the incoming firm] are going to have to rebuild from scratch that kind of institutional memory... So you are just going to repeat that exercise every so many years, which is stupid."*

ACM 22 tied this issue into a potential cost that he/she foresees for non-executive directors. He/she expressed concern that, due to *"the learning curve… [being] so high… you're [the audit committee] probably only going to get meaningful, value-add contribution from the auditors, from the second, if not the third year."* This could potentially hinder the audit committee's ability to act as a form of assurance for the shareholders.

ACM 11 raised the point that different industries face specific industry issues, which impact on the way in which the audit is conducted. As such, firms who audit a client in a specific industry for a long time become industry specialists, thus allowing them to conduct an efficient and effective audit. Frequently rotating auditing firms will cause this industry specialism to be lost. New auditors coming into the industry will need to gain an understanding of the client by asking numerous questions of management and spending time conducting research. ACM 11 also commented on how this practice could also necessitate the client's management having to spend time supplying information on situations that the previous auditors understood and, thus, leading to their irritation with the new auditors.

> *ACM 11*
>
> *"I think that they would come up with… some very good questions, to which the previous auditor probably knows the answer. You know you get industry specific things that is the way the industry works... Why doesn't the gold industry ever have any debtors? Well because we pay in 2 or 3 days that is the rule. You know you have got to ask all sorts of questions and you are going to distract the CFO, the staff are going to get really pissed off [sic] with you [the incoming auditor]. It seems like only the other day we were explaining all this to new auditors."*

An additional cost of MAFR could present itself in the form of multinational complexities. ACM 17 illustrated how many multinational companies have subsidiaries or branches in South Africa that need to be audited. These multinational companies often have holding companies situated in jurisdictions, such as the United States of America and various countries in Asia, that do not require mandatory audit firm rotation. ACM 17 pointed out it is unlikely that the whole group of companies will rotate their auditors globally because a subsidiary of the group is required to do so in South Africa. This would then result in subsidiaries being audited by other audit firms, which could lead to additional audit costs. In this regard, ACM 17 believed that the IRBA *"[didn't] seem to have thought it [MAFR] through."*

Different audit firms performing various functions for different clients was raised as a potential issue by five of the members interviewed (23%). ACM 3 pointed out that the majority of the listed companies employ different audit firms to perform various services for the company that may not be performed by the external assurance provider. For example, a company could have one firm employed as its IT service provider, another employed as its tax adviser, another employed as the internal auditor and another working on its service level arrangements. If the company is required to rotate its external auditor, ACM 3 believes that *"the knock-on effect [… would be] really* *significant [… because the rotation would] have to happen simultaneously"* between all the service providers. The other four members supported this notion and elaborated on it by pointing out that it might lead to companies not appointing the most suitable audit firm for the various functions due to independence issues.

> *ACM 16*
>
> *"[It will be] chaos, because… an audit firm… cannot do certain consulting work or certain work [within] a year or two years, whatever the period is, [of having been the external auditor]. So, I am thinking it is going to make it very difficult… [as the company] may be forced to… appoint a firm for the wrong reasons… Maybe… under the circumstances, because of independence issues [and the company has] other firms doing the tax work and internal audit, you may be left only with one firm and maybe they are not the right choice."*

ACM 10 alluded to how he/she looks at the cultural fit, or "*personality"* fit between the company and the audit firm and how MAFR could force the company to appoint an auditor where the fit is not ideal.

> *ACM 10*
>
> *"… There are normally… all four big firms involved in various circumstances. Taxation one firm, internal audit another firm, management advisory services [another firm] and then your [external] audit firm and what happens then is, you can see… the culture of the various firms. Sometimes the culture and the personality… [fit with the] firms is actually the most important thing... It is not about independence or non-independence, it is just about the fact how they go about doing work."*

On a related note, ACM 3 believed that audit firms might move away from assurance services towards providing more non-assurance services in future. ACM 3 pointed out that often *"a lot of audit firms make more of their money from not doing external assurance, and more of it from consulting".* Non-assurance providers are subject to lower risk and will not be subject to MAFR, thus making the service more appealing than providing external assurance.

ACM 15 also touched on a notion in which the Big Four audit firms would start *"shrinking"* as a result of MAFR. ACM 15 illustrated this notion through an example using the audit firms and banks. According to ACM 15, certain financial expertise is needed by an audit firm to audit a bank. Since there is no requirement in terms of MAFR that states that if a firm 'rotates-off' a bank, the firm must 'rotate-onto' another bank, the firm might be left with no banking audits. However, the firm is left with the individuals who would have performed the audit, who are banking specialists. Instead of waiting until the audit firm is next 'rotated-onto' a bank, these individuals may leave to pursue careers within the banks themselves, thus resulting in the audit firm losing its banking expertise.

Another common concern among many of the members revolved around the time that would be consumed by various parties as a result of the audit tender process. In terms of the audit committee, the audit committee members would need to spend more time dealing with audit tenders, which, according to ACM 3, are *"time consuming and stressful".* Often during times of audit tenures, more time is required of audit committee members as non-executive directors because a tender requires additional work. ACM 2 pointed out that this could potentially decrease the appeal of being an audit committee member going forward. Furthermore, ACM 13 believed that the time and effort put into the audit tenders would have no impact on audit quality, given that the audit committee would most likely appoint another Big Four audit firm, the audit quality of which tends to be of a similar standard to the other Big Four firms.

> *ACM 12*
>
> *"There may be a cost in terms of the focus of the audit committee's time... They sometimes refer to it [audit tendering] in a rather sexist phrase – [the] beauty parade… Somebody [a member of the audit committee] has got to put together a document which explains exactly what the audit entails. That has got to get distributed to the audit firms. They then are going to produce their presentations, which you are going to spend a few hours going through before the special meeting which gets called, in order for them to give the presentation… Then they tell you how wonderful they are, and you have then got to interrogate that and, as a*

committee, decide on what you are going to do. So… [the committee is] going to spend a fair amount of time on it [the tender process] ...".

Another common concern in terms of time consumption was the time that the client would need to spend re-educating the auditor after each rotation. A few of the members explained how the client needs to sit with the new auditor to help the auditor gain an understanding of the business, its financial reporting system and controls, in order for the auditor to perform an efficient audit. This process is time consuming and would need to occur far more regularly with MAFR.

ACM 4 pointed out that this would be particularly cumbersome for smaller public interest entities. These entities might not have a large staff to begin with, meaning that their management team might have more time constraints, making it more difficult to spend time educating auditors. In terms of the listed clients, ACM 12 commented on the time constrains under which the finance function operates and the deadlines in terms of financial reporting. The member noted that MAFR would place this function under greater pressure given the time the finance function would need to spend with the auditors.

ACM 3

"From the client's perspective, it [the rotation of an audit firm] is hugely time consuming. You know, the staff have to explain stuff over and over again. There is no institutional knowledge that is retained [from the previous auditor]. So I think the cost from a time perspective is huge."

ACM 4

"… At the head office, we didn't have a hell of a lot of staff, and the staff just don't have the time to keep re-educating the auditors. So there is a cost pressure or time pressure on the company itself. And we were listed, so in terms of the listing requirements… [we had] deadlines to get… [our] results out. So it just adds a hell of a lot of stress… [to] the whole system."

Furthermore, the members pointed out that the audit firm's team itself would need to spend a lot of time educating itself on the client's details. ACM 10 was of the belief that in order *“to set up an audit of a new client, you [the audit firm] most probably incur set up costs in the order of 50 to 60% of a normal audit fee”* as a result of the extra hours worked by the audit team. MAFR would result in this process occurring more regularly, thus increasing the frequency of incurring set up costs for the audit firms. A few members also raised the issue that the tendering process for an audit firm itself is time-consuming and costly and MAFR would most likely divert resources in terms of time and finance away from auditing and towards tendering or marketing.

In conclusion, the results to this section provide the following answers to research questions 3.1 and 3.2:

3.1. What impact will MAFR have on audit quality in South Africa?

The majority of members agreed that audit quality is likely to decrease with the implementation of MAFR.

3.2. What costs (monetary and non-monetary) do audit committee members believe will result from MAFR and do they exceed the intended benefits?

The most common costs discussed by the members include a loss of institutional knowledge due to the rotation of the audit firm, increased time spend by the audit team to perform the audit work and increased consumption of client management’s time by the auditor. Other common concerns included increased time spent by the audit committee relating to audit tenders, multinational complexities and difficulties that could arise as a result of various firms performing different functions within a company. Ultimately, the majority of the members agreed that the costs would exceed the intended benefits of MAFR.

5.4. AUDIT FEE RELATED ISSUES, INCLUDING LOWBALLING, AND THEIR RELATED IMPACT ON AUDIT QUALITY

With regard to the benefits and costs of MAFR, many members discussed the effects of the policy on audit fees. The responses were, however, very mixed.

Eight of the members were of the opinion that MAFR posed the threat of increased lowballing in the audit profession. As a result of more frequent tendering, there will be more opportunities for lowballing to occur. ACM 13 pointed out that, even though theoretically audit committee members should not only be concerned with the price of an audit, price is a real concern, which increases the risk of lowballing. These eight members also referred to the risks of lowballing, including the risk that auditors may end up "cutting corners" as they will have fewer resources to perform the audit. This could include using more junior, less experienced staff in place of more experienced staff, which would reduce audit costs but could also reduce audit quality.

Two of the members also discussed how lower audit fees could make the profession unattractive as it will be difficult to retain and attract talent because the audit firms might struggle to pay them. This is because there are increased costs in the first few years of conducting the audit because the auditor spends more time acquiring knowledge of the company. Without an increase in the audit fee, the costs are not borne by the clients but rather by the auditing firms. This fact was illustrated by ACM 11, who compared work outside of the audit environment to work inside the audit environment. ACM 11 commented on how, after completing their accounting articles at audit firms, *"young CAs [chartered accountants] … are going to be attracted… [to] what is in the outside world [outside of the auditing profession]*" because *"CAs outside the profession have far limited risk, if any [and] they earn mega bucks more than anybody who stays in the profession, and they have a far more regulated lifestyle".* As a result, lowballing could lead to professionals choosing to leave the audit environment for other jobs. Alternatively, the cost of employing CAs in an audit firm will need to increase to keep them within the profession, increasing future audit costs.

One member did, however, confirm that the bigger firms have more resources in general and would be less likely to cut corners to preserve their reputations. ACM 4 argued that smaller firms are more likely to cut corners so as to reduce the losses made on the audit. On the other hand, another member believed that lowballing was an issue primarily between the Big Four firms, indicating that the practice affects all audit firms, regardless of size.

ACM 12

"So [lowballing] will definitely happen… but if any audit committee that turns around and says their major reason for appointing an auditor is price based, you know, will give me a big worry. I would be very concerned about that. I know pricing is an issue, so it will definitely happen."

ACM 21

"Lowballing is real. It takes place and it's nauseating… The funny thing is that it's actually done by the big-four firms themselves…"

ACM 4

"It really depends on the audit firm. I mean, call it the big four, and then the next four if you want to call them that – they are not going to jeopardize their reputations by being penny-wise-pound-foolish. But if [MAFR is implemented], the smaller firms are definitely going to cut back on processes and procedures to not make such a big loss."

Another view held by three of the members was that lowballing already exists and that MAFR will have no impact on lowballing. ACM 4 described how firms lowball to win audits in new sectors and industries to which they have little exposure. This could potentially be because the firm is not as familiar with the sector and, therefore, determining an appropriate audit fee is more difficult. Thus, the firm may unintentionally lowball.

Eight members felt that MAFR will not have an impact on lowballing due to the role that the audit committee plays in auditor selection. According to these members, the mandate of the audit committee extends beyond the audit fee to issues, such as expertise and capabilities. As a result, a good, strong audit committee should see through any lowballing and ultimately select the audit firm that is most qualified for the job.

The role of the audit committee involves considering the audit fee and the proposal of the audit firm and considering whether it will be able to recover the auditing costs. ACM 1 mentioned the notion of dealing with the lowest bidder at your own peril, implying that audit committee members are aware of the risks of selecting an audit firm purely because it is offering the lowest price. On this note, two of the members stated that, from their experience as audit committee members, one would rather pay a higher audit fee if it will ensure higher audit quality. Ultimately, whether lowballing exists or not, these members were of the belief that MAFR would not impact the practice of lowballing due to the duties and considerations of the audit committee in selecting auditors.

ACM 16

"I think yes, MAFR could result in lowballing, and ultimate impacting audit quality. But having said that, I am contradicting all this, is that if you have an audit committee, a competent audit committee who will see through lowballing and will not necessarily accept the lowest fee."

ACM 17

"I mean just first the comment on lowballing, it's not obvious to me as… an audit committee member that we want to have the firm that's got the lowest fees... It may well be, because we need certain work done and we need quality in terms of that work, that quality… is way more important than the fees… From an audit committee member [perspective], you often would prefer to pay a little bit more and make sure that you're getting the right quality."

Having commented on the effect that the audit committee's role has in preventing lowballing, two members also noted that for big companies, the audit fee is not a big cost for the company. Thus, the cost of changing auditors is *"negligible in monetary terms" (ACM 12)* and, therefore, a slight undercutting in the audit fee would not be sufficient incentive for choosing one audit firm over another, even from management's perspective. Consequently, the practice of lowballing to win audit tenders is not a major issue.

ACM 1

"… People talk a lot about audit costs. But in the scheme of running any company, the audit cost is one of the lowest costs in the business. It really isn't a big cost in the business."

Another view held by five of the members is that lowballing does not generally happen in practice, even when there are voluntarily audit firm rotations. Therefore, MAFR will have no impact on the practice. According to ACM 6, audit fees charged by the Big Four firms do not differ substantially. This statement supports a comment made by ACM 19 that audit fees tend to be within 10% of each other. ACM 18 also added that, in recent voluntary audit firm rotations, *"there was no material difference in the fee*".

ACM 6

"[When it comes to audit firm selection], my experience is they would probably look for quality [over lower fees]. I say that because I don't think the fee differs much between the top four firms. You know if one firm is charging one and a half or a fifteen million audit fee there might be five hundred thousand difference between them but it isn't that significant. So… [when changing from one big firm to another], I wouldn't really expect… [there] to be a massive saving in fees."

Ultimately, the tendering firm's fee might be a bit lower than the incumbent firm's fee but generally the difference is not substantial. ACM 20 explains why this is by describing how auditors determine the audit fee: *"…effectively, when you go out to tender now, the four-firms that you go and talk to, that asked to tender, will be looking at the fees that have been charged up until that particular point in time. Their [the tendering auditors'] fee might come in a little lower but it's not going to be really low compared to the current fees because […] they're working on the basis of what is required in order to give the opinion at the end of the day and what, in order to achieve that, is the staffing requirements and the time and so on, and they work their fees out on that*." Therefore, audit firms tend not to lowball because they are aware of the issues it would cause them in future in terms of cost recovery.

Furthermore, ACM 20 explained that audit fees normally cannot increase beyond inflation, so it would be difficult for the auditors to increase their fees in future to recover their costs and compensate for the initial discounted, lowballed fee. Thus, *"… what they're doing is they're compounding their problem over the next five-years or however long they're in for, so they're not going to come on a low-baller*."

ACM 22

"… I think low-balling was a factor at some stage in the past. In my experience – I haven't really encountered that in the last number of years, simply because firms understand that if they're going to go in very low, well, they are going to sit with that for the next few years… You're saying "well, if you're coming in at that fee then, well, that's what you stick with for the next two-years, other than your inflationary increase… So, if they are lowballing and coming in very low, well, they're [the audit firms] going to pay the price for it, in terms of their level of recovery."

ACM 20, however, believed that MAFR would have the *"opposite"* effect to lowballing. He/She explained that fees could end up increasing as a result of more frequent rotation because the auditors are aware that they will need to go through the learning process with each rotation and that they will only have 10 years in which to recover their costs. Therefore, auditors will include this increased cost into the audit fee in the first few years.

A potential audit fee benefit of more frequent rotation as a result of MAFR was raised by ACM 14. Each rotation offers the audit committee a chance to examine the incumbent auditor's fee and compare it with other firms' proposed fees, which may enable the audit committee to determine the appropriate fee level.

ACM 14

"You know what your base fee has been with your incumbent firm for many years, so you have a base to start with... And then if you ask 2 or 3 other firms to propose and their costs are wildly different from that base, you have got to ask the question, "how can you do that?"… And at least

that would lead to a very good discussion to try to find out… [whether] we been paying too much for a number of years with our incumbent firm… It would open up a discussion as to what a fair level of fees should be."

Finally, ACM 7 made a comment on the cost of MAFR and related it to the Fees Must Fall issue in South Africa[8]. According to this member, there may well be costs related to MAFR in respect of both audit fees and time outlay. However, the cost of not taking a step to improve auditor independence, such as the implementation of MAFR, could lead to bigger issues in future.

ACM 7

"… At a personal level, that is one area [monetary costs of MAFR] that made me very angry because there are two things we need to realise in the whole world in this field. There is the cost of doing something, there is also the cost of not doing something… We ignored the plight of students who cannot pay fees because it was costly to deal with it until the whole country was up on fire [sic]. So [this is] the price we have since paid for not doing it. So… [we include the monetary cost of MAFR but] we don't cost morality, we don't cost inclusiveness, we don't cost part of the other benefits which could arrive [as a result of MAFR]. So I don't agree with that notion [that MAFR will lead to increased costs]."

In summary, the results of this section provide the following answer to research question 4:

4. How will MAFR affect audit fees, including the practice of lowballing, and, ultimately, audit quality?

The views of members were diverse. Responses ranged from believing that MAFR would increase the practice of lowballing to believing that lowballing does not occur in practice. Therefore, the overall effect that MAFR could have on audit fees was not

[8] Fees Must Fall is a national movement in South Africa aimed towards the lowering of tuition fees for students (Pillay, 2016).

conclusive. Further research could be conducted into the affect that mandatory rotations of audit firms has on the audit fee charged by the firm.

5.5. MARKET CONCENTRATION AND TRANSFORMATION CONSIDERATIONS FOR MAFR IN SOUTH AFRICA

High levels of market concentration and the slow rate of transformation in the audit industry were concerns raised by the IRBA (2016) in its consultation paper. The IRBA (2016) did, however, state that the primary intention behind MAFR is to promote independence. Yet, the IRBA does believe that MAFR will provide opportunities for more firms to compete for clients through the process of audit tendering, if they are competent to do so, as a result of MAFR (IRBA, 2016). This practice will contribute towards transformation and a more competitive audit market (IRBA, 2016).

Regarding this notion, some of the members interviewed believed that addressing market concentration and transformation are the true motives behind the IRBA's implementation of MAFR and not the promotion of independence. These members felt that, if this is the true motive behind MAFR in South Africa, the IRBA should not mask the reason for its implementation with the promotion of auditor independence. Furthermore, two of the members indicated that they did not see the link between improving audit quality and addressing market concentration, whilst another member expressed that he/she struggled to draw the links between MAFR and the improvement of auditor independence. Ultimately some of the members held the view that the improvement of auditor independence and audit quality were not the primary objectives behind the implementation of MAFR.

> *ACM 8*
>
> *"I think that [the notion that MAFR will improve the market concentration of audit services] is valid but then the Competition Commission must rather look at this and deal with the competition concerns. But then… if that's the issue, we mustn't throw this over the perceived problem of independence. You mustn't… [propose] independence arguments… [while] the real purpose is to break up concentration or to… give the black firms a chance."*

ACM 2

"*I also don't see a link between market concentration and improving audit quality… You know if audit quality is defined as the probability of detecting a breach [or misstatement and subsequently reporting it to the relevant parties] ... I don't know [that improving] market concentration addresses that."*

When asked about their views on how MAFR would affect the market concentration of audit services in South Africa, fifteen of the twenty-two members (68%) firmly believed that MAFR would have no impact thereon. Two of the members (9%), the same members who believed that auditor independence in South Africa needed improvement, believed that it would have an effect on market concentration by improving the level of competitiveness between the audit firms. Five of the members (23%) held mixed views in that MAFR could increase competition between audit firms but that the consequences of increased competition were not necessarily clear or beneficial.

One of the primary arguments put forward by the members interviewed as to why MAFR would not affect the market concentration of audit services is that the audit market in South Africa is segmented. In other words, only the larger audit firms have the resources, competencies and capabilities needed to audit large or international clients and it is, therefore, unlikely that a small to medium tier firm would be appointed as the auditor of such clients. Ultimately, these members suggested that audit firms of various sizes operate in different markets and will continue to do so regardless of the frequency of audit tendering because of the disparity in the capabilities of larger and smaller audit firms.

ACM 11

"The mid-tier and smaller firms are servicing a completely different market to the big firms. The big firms no longer do little audits. It is not cost efficient, it is not the best use of their resources... It is like saying "gosh all the cardiologists are doing all the open-heart operations, what about the poor GP's? We actually need to create a situation where the GP's

can sort of start doing open heart operations." They are completely different markets."

ACM 9:

"I definitely think it will create an opportunity for… the middle tier firms, but I don't think it will last for long because I think it is going to be very clear that they haven't got the competence. So, unless they [the mid-tier firms] build up the competence [through a joint audit] either the audit committee will see incompetence in second tier firms or they are going to make one big mistake where they get the pants sued off them, and some big company is going to lose a lot of money."

ACM 6

"… in many of the larger audit firms where I have been involved, I think there are virtually none, but certainly very few small firms, or you know black firms, that would actually have the skills [to audit the financial sector clients] … I think you could virtually… write off the entire financial sector."

Expanding on the same argument, four of the members spoke about how international clients are unlikely to appoint non-Big Four audit firms for various reasons. These reasons include the global expertise of the Big Four firms, which most of the smaller firms do not possess, that are needed for certain audits, as well as the potential requirements or demands of international companies to be audited by a Big Four firm.

ACM 3

"… If you are a small South African firm and you are trying to develop your own training, and develop your own auditor procedures and so on, it has got to be more expensive. And if it is not more expensive, it is probably because you are doing less of it. So, I think that is raising the risk of the audit, or raising the cost. Or possibly both. So, I think economies of scale is a massive thing. When I see the stuff we get from

the big four audit firms, it is mostly global stuff. It is not developed in South Africa, it is industry specific, it is very pertinent to what we do, and it is drawn on the best experience in the world. So, you know – a small local firm just can't compete."

ACM 2

"The other challenge is what the certain markets look like, you know, for specific industries, whether it is because of regulatory reasons, because they are multinationals, because they are seeking funding in international bond markets… Because of those reasons… they may have a very limited pool of whom they could audit, or who the auditors could be. So if you are a South African company but you have got bonds listed in Switzerland and Switzerland says "well in terms of your covenants you have got to be audited by one of these four companies", that is not going to change how you pool in small and medium sized firms into the sort of audit space to be able to give them the opportunity."

ACM 22

"I think the other thing you've got to take into account is that with… South African companies that are more multinational but have alternative listings… you can't have an international debt list, for example, and have a very small firm in South Africa as an auditor for those international listings, etcetera. You would need to go with an international firm."

ACM 9 raised a unique idea that MAFR could result in audit partners *"hopping"* between the Big Four audit firms when the firms are rotated. There is nothing in the current legislation or regulations preventing auditors from moving to a different firm and, after a 2-year cooling period, continuing to be the engagement partner on the same client. This could result in partners moving between the Big Four firms as they rotate between clients, so as to retain some of the client specific knowledge in the audit performed by the new firm.

ACM 9

"… The easiest solution to all this is partner hopping… So here, mandatory firm rotation isn't going to achieve anything other than ultimately partner hopping... There is no limitation on a partner jumping ship. And that is what is going to happen. So you will have the same audit partner, just a different audit firm… [There is a particular partner auditing Old Mutual who is] most probably [the] South African expert on insurance… [if his firm is rotated off Old Mutual], they [the newly appointed firm for Old Mutual] will approach him and it will be exactly the same for all of the experts in their industry."

Two of the members interviewed illustrated how it would be inefficient to increase the number of large competing audit firms by referring to the historical development of audit firms. These two members pointed out that, historically, there has been a natural process of mergers between audit firms, as a result of realising economies of scale, sharing expertise and cost reduction. Consequently, the profession is more efficient with fewer larger firms operating in the large listed client space.

ACM 20

"I don't think it [MAFR] really will [improve market concentration of audit services]. Let's go back in history – why did the bigger firms get established because they were… [eight or more firms] that were merged... I don't think that [the increase in the number of large audit firms] will happen [again]… The only way it could work… is [if] the mid-tier firms… [merge] to create a fifth big one and then a sixth-big one? That's the only way because that's been the history of the big firms [merging to form bigger audit firms]."

A unique view was held by ACM 14 in that he/she believed that there is *"not much of a mid-tier"* in terms of the audit industry in South Africa. According to ACM 14, as clients have grown and spread geographically, so too have the Big Four audit firms. As such, clients tend to be small or large, with fewer sizes in between. ACM 14 felt that, through MAFR, the IRBA is trying to recreate and promote the mid-tier audit firm space, when in reality *"market forces are not* *actually asking for that."* Therefore, in an attempt to *"artificially"* grow competition, the auditing profession will become inefficient.

As a result of the segmented nature of the audit industry in South Africa, the most common comment made by the members interviewed was that MAFR will result in a rotation of the Big Four audit firms amongst their current clients. For all the listed reasons as to why clients will tend to appoint Big Four firms, the members believed that as soon as one Big Four firm is due to 'rotate-off' a client, another Big Four firm will be appointed. This argument supports the notion that MAFR will not affect the market concentration of audit services in South Africa nor will it promote the industry's transformation. ACM 12 described the pending end-result as *"a merry-go-round"* between the Big Four firms.

> *ACM 19*
>
> *"The need is… [in] most instances, for the listed companies [to be audited by the] … bigger audit firms, with the capacity and the competence to do the audits. Why would rotation change that? It won't make any difference to competition as such."*
>
> *ACM 17*
>
> *"The market concentration won't change, it will just be a rotation between the big four, so I don't think it makes it more competitive."*
>
> *ACM 18*
>
> *"With the recent [audit firm] changes, I don't know where I saw that article where they listed a number of listed companies that have changed auditors… but if you look at just that article you will see that all the new auditors are the big firms, I think save for one."*

Both members who believed that MAFR would help to promote transformation competition in the audit industry noted that the risk of Big Four firm rotation is prevalent. However, these members held the view that the manner in which audit committees and clients currently appoint auditors is not in line with the goals behind transformation. According to ACM 7, MAFR should create an environment in which the audit committee can be responsible and act to appoint, and therefore include, firms other than the Big Four and that simply rotating the audits between the Big four firms is *“mischievous.”* He/She believes that inclusion can be achieved through joint audits, whereby the smaller firms are gradually exposed to more and more interaction with the client and, in this way, can develop their expertise. Ultimately, if this process is followed by the audit committees of larger clients, the smaller firms will have the opportunity to development and become competitive, so that when it comes to future rotations, the smaller firms could be considered viable auditor options.

ACM 21 held the same belief that MAFR will allow medium sized firms to be more included in audit tenders and therefore in future, more audit firms will be equally competing for the larger audits. However, he/she raised the issue that many audit committee members will most likely appoint another Big Four firm, thus not giving the medium or small black firms a chance. In order for MAFR to have an effect on transformation, ACM 21 explained that the selection of the new audit firm needs to be regulated to some extent.

> *ACM 21*
>
> *“Now, others [other audit committee members] argue that, “no, they’re going to play musical chairs. There’s going to be this one [Big Four Firm] going out and another one coming in...” Yes, people can be naughty... They can be naughty and Audit Committee members… [can] say “no we don’t care about transformation, we will hit back at IRBA, in making sure that we still get PWC. Next… we’ll get [Deloitte] then get EY.” So, the Black firms will never come… I’ve seen it from both angles. Having been an Audit Committee member and having been a supplier of audit services, as a Black firm. There are people, Audit Committee chairs, CFOs, who are so adamant that they don’t want to see a Black firm stepping on their toes inside their company. They just believe it’s too risky and they are not interested to take a risk… My only concern is that IRBA has not legislated that requirement. Because if IRBA had legislated that… [for example] a minimum of 20% must be given to a disadvantaged firm, then… [transformation] may be achieved. Now, we have not*

achieved [transformation] because it is still at the discretion of… [audit committees and CEOs].”

On the topic of transformation, a number of members felt that the transformation of the Big Four firms had been discounted by the IRBA. It was felt that the Big Four firms had transformation agendas and had made progress in terms of transformation over the past few years.

ACM 17:

“… there’s this notion… [that] presupposes that the big firms are themselves not transformed... I think it’s a myth to say that only companies like Gobodo are the transformed companies. Why can an Ernst & Young or a Deloitte or KPMG not themselves be transformed? So this is the kind of nonsense myth that’s created… that it’s got to be started by a black person for it to be a transformed company...And that’s… patently nonsense.”

ACM 15:

“So if you look at the big four they probably have as many or if not more black partners than the smaller firms. The short cut would be, by the way, to transform the big firms, in which they push them into making that transformation a little more pressing.”

ACM 18

“… What we [the audit committee] normally do is each year when the auditors present their plans we look at their committees we ask about transformation and we are pleased that some of the firms, like PWC, are now level one [BBEEE score]. And all of them have made very good progress… I just think that if the big firms are embracing transformation in doing the right things we need to recognise that.”

A point of concern was raised by ACM 3 in how this notion of ‘black’ and ‘white’ audit firms has developed. He/She pointed out that the Big Four firms tend to provide the best opportunities and training facilities for their trainees as a result of their size, the nature of their clients, their global exposure and resources. ACM 3, therefore, felt that the notion of 'black' firms and 'white' firms is "*destructive"* as it could create feelings of guilt for black trainees who want to sign with bigger firms and feelings of obligation to work for smaller 'black' firms in order to support transformation. Thus, it could *"work against the development of black skills."* According ACM 3, a better means of achieving transformation would be to move the focus away from 'black' and 'white' firms, towards small, domestic, international and big firms and focus on the opportunities that can be provided to black trainees through the various size audit firms.

The results of this section provide the following answers to research questions 5.1 and 5.2:

5.1. What effect will MAFR have on the market concentration of the auditing environment?

The majority of members interviewed did not believe that MAFR would help to decrease the level of market concentration in the audit industry. A common belief was that clients will appoint another Big Four audit firm when the client is required to rotate off its current audit firm.

5.2. Will MAFR help to promote the transformation of the auditing profession in South Africa?

Ultimately, there were mixed responses from the members interviewed as to whether MAFR has the potential to promote transformation of the audit industry in South Africa. However, all members agreed that there were structural issues or obstacles that would prevent this from happening. Some of the issues raised by members who did not believe that MAFR would contribute towards transformation, such as the Big Four *"merry-go-round"* issue, were the same obstacles raised by members who believed that MAFR had the potential to promote transformation. In summary, many members felt that the issue of transformation in the audit industry would best be addressed through continued transformation of the Big Four firms, as opposed to limiting the measurement of transformation to the growth and development of the 'black' firms.

CHAPTER FIVE: CONCLUSION AND AREAS FOR FURTHER RESEARCH

This study explored and documented the perspectives of a sample of audit committee members on the potential consequences of MAFR in the South African context. In light of the primary objective of MAFR being the promotion of auditor independence, the most significant finding of this study is that the majority of members did not believe that MAFR would achieve this desired objective.

Firstly, the majority of members (20 out of 22) (91%) did not believe there to be an issue with the current status of auditor independence in South Africa. Therefore, a measure, such as MAFR, would not further contribute to the promotion of auditor independence and, consequently, audit quality. Ultimately, most audit committee members believed that MAFR would be detrimental to audit quality for various reasons. Rotating audit firms on a frequent basis would result in a loss of client-specific or industry-specific knowledge, which is considered crucial for performing a high-quality audit. Many members also pointed out that MAFR would most likely lead to an increase in a variety of monetary and non-monetary costs for both audit firms and audit committees, that could potentially decrease the appeal of a career in quality assurance.

The findings of this study also highlight certain South African-specific considerations with regards with MAFR and the auditing industry and contribute to the South African MAFR debate. The issues of market concentration and transformation in the audit industry and MAFR's intended impact thereon are unique considerations for MAFR in South Africa. One of the most important findings of this study is, therefore, that the majority of audit committee members do not agree that MAFR will have the IRBA's desired impact on market concentration and transformation. Many members illustrated how market concentrate would most likely increase. There are various factors which deter larger clients from appointing an auditor other than a Big Four firm. These factors include the greater international exposure of the Big Four firms, the enhanced quality of audit work in complex, specialised industries, such as the banking industry, and the greater level of resources which the Big Four Firms can utilise. MAFR will not change this which, therefore, means that, when it comes to audit firm rotation, the larger clients will only have three firms from which to choose.

Evidence from the interviews also shows that the rate of transformation in the audit industry is not likely to improve with MAFR. Whilst all members interviewed agreed that the transformation of the audit industry is important, most of them believed that MAFR was not the best solution for achieving a faster rate of transformation. On the contrary, most members believed that MAFR would negatively impact transformation. This opinion resulted from the IRBA's concept of transformation as being confined to audit firms owned by previously disadvantaged racial groups, namely black-owned firms, as opposed to also considering the transformation efforts of the Big Four firms. Many members believed that the Big Four firms provide accounting trainees with exposure to larger clients, both international and local, which would, in turn, support the development and skills of black accounting trainees.

This study has contributed to the literature surrounding the debate regarding the effectiveness of MAFR as a policy for promoting auditor independence. Given the conflicting results of previous studies and the lack of studies performed in a mandatory rotation environment, this study provides insights, from a sample of interviewees who specialise in the determination of auditor independence, on the potential effectiveness of MAFR. The results from this study could contribute to the data used by policy makers and regulators in determining whether MAFR would achieve its intended objectives.

AREAS FOR FURTHER RESEARCH

Although the findings above express the views of the majority of the members interviewed, they do not encompass the views of all the members. Strong views were held by a small percentage of the members, who expressed why they believed that MAFR was a positive step towards achieving improved transformation in the audit industry. As such, a limitation of this study is that the sample of 22 members does not seek to be a representative of the national view of audit committee members in South Africa. Further research could be conducted that encompasses a larger sample, which could, in turn, introduce diverse views.

Furthermore, the interviews conducted in this study were conducted prior to the KPMG scandal that unfolded in September 2017 in South Africa. Further research could explore how the views of various stakeholders, particularly audit committee members, may have developed or changed as a result of the incident.

Ultimately, MAFR is a policy that has not been implemented in many jurisdictions long enough to obtain conclusive evidence that it is effective in improving audit quality through limiting auditor tenure. As the policy has become effective in the European Union and is to become effective in South Africa in 2023, there will be more opportunities for research in a mandatory rotation environment. Such research could further inform the perspectives and opinions of stakeholders, such as regulators and audit committee members, as to the effectiveness of the policy. Further comparative research in other jurisdictions would be useful in determining whether MAFR is a suitable policy for promoting auditor independence in South Africa. However, the uniquely South African considerations of how MAFR will impact market concentration and, particularly, transformation, add complexities to be considered within a South African context.

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APPENDICES

APPENDIX 1: INTERVIEW QUESTIONS

The interview questions are shown alongside the related theme in order to aid the discussion of the results. These themes are presented in Chapter Two.

Question(s)	Theme
1. The IRBA believes that it needs to respond to global developments in the promotion of auditor independence, which most notably includes the implementation of MAFR by the European Union. What is your opinion of the current status of auditor independence in South Africa?	1
2. The IRBA does not believe that the current measures to ensure auditor independence in South Africa are sufficient. What is your view on this?	1
3. Has your company ever had any problems with auditor independence?	1
4. Have you ever had an experience where an auditor has issued an audit opinion that you believe to be inappropriate?	1
5. Previous studies have found that long audit tenure may result in external auditor familiarity or complacency, thus resulting in a potentially biased audit report. What has been your experience in this regard?	1
6. DeAngelo (1981) defines audit quality as the combined probability of the auditor detecting a breach of statutory or regulatory requirement and reporting the breach to the appropriate party(ies). What impact do you think MAFR will have on audit quality?	1, 3
7. Respondents to the IRBA's consultation paper believe that the costs of MAFR will exceed the intended benefits. What is your view on	3, 4, 5

this? What unintended costs do you foresee resulting from MAFR for your company?	
8. Various respondents to the IRBA's consultation paper held the view that auditor independence could best be enhanced through developing the duties of the audit committee. How do you think the duties of the audit committee could be enhanced or developed in order to improve audit quality?	2
9. What processes or mechanisms do you have in place to ensure auditor quality and do you believe they are sufficient?	2
10. What is keeping you with your company's current audit firm?	2
11. What would cause you to change audit firms?	2
12. The IRBA believes that MAFR will promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets, provided they are competent to do so. What is your view on this?	5
13. The IRBA believes that MAFR will address market concentration of audit services by creating a more competitive environment, which in turn will improve audit quality. Describe your thoughts on this.	5
14. "Lowballing" is a practice whereby a lower fee is charged initially in order to compete with other firms so as to win the audit tender. What effect do you believe MAFR will have on the practice of lowballing and ultimately audit quality?	4