SOUTH AFRICAN RESERVE BANK

Prudential Authority

Discussion paper on joint audit requirement for insurers and insurance groups

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Contents

1. Introduction

The purpose of this discussion paper is to provide regulated insurance institutions and auditors (including prospective auditors) of licensed insurers or controlling companies of insurance groups with information pertaining to the requirement for the appointment of joint auditors and to request comments in order to obtain input from auditors and regulated institutions regarding the proposed scope and application of the joint audit requirement for insurers and insurance groups.

In discharging its mandate, the Prudential Authority (PA) relies substantially on the work of the external auditors of all relevant regulated institutions. Work conducted by auditors and the quality of that audit work are of critical importance for the achievement of the PA's objectives as well as the promotion of stability of the South African financial system.

The PA engages with auditors of all relevant regulated institutions on an ongoing basis in the course of executing its respective regulatory and supervisory responsibilities. Auditors conduct audits, reviews and other procedures that are related to the regulatory reports that are submitted periodically to the PA. As a result, audit quality is very important as the audited regulatory reports provide the relevant required assurances to the PA regarding the completeness and accuracy of information submitted to the PA which is an important component of the PA's ongoing supervision of the regulated institutions.

A joint audit engagement is defined as an audit by two or more separate firms that are engaged to jointly audit an institution's financial statements (or, in the case of the regulatory audits, the regulated institution's regulatory returns) and issue a joint auditors' opinion in respect of those financial statements or regulatory returns, thereby complementing each other's work and taking joint responsibility for the audit and the audit opinion.[1]

[1] The definition is adapted from the Independent Regulatory Board for Auditors' Guide for Registered Auditors on Joint Audit Engagements.
https://www.irba.co.za/upload/Final_Guide_Joint%20Audit%20Engagements%20_%20Aug%202020.pdf

2. Background

The practice of joint audits has been enforced by the PA in respect of the large South African banking groups for many years and the PA has found that this has contributed significantly to the overall strengthening of audit quality for these institutions. The PA has found value in the combination of specialised professional resources and the cooperation between the respective audit firms that are involved in the joint audits for banks. The PA is also of the view that, as these banking groups are complex in nature and due to their size and potential impact on financial stability, specialised skills and resources are required to achieve quality audits of such institutions. Two or more audit firms combining specialised resources and acting jointly are in a better position to audit these complex institutions. For these reasons, which are also largely applicable to insurance firms, the PA has decided to extend the joint audit requirement to certain insurers (refer to section 5 for the applicability criteria for insurers).

Audit firms have a varied mix of skills, resources, expertise, knowledge and experience and as such a joint audit arrangement would enable audit firms to collaborate and leverage off each other's strengths, which is expected to significantly contribute to overall audit quality.

The financial services sector is an ever-changing sector with regulatory, auditing and accounting changes and updated requirements introduced on a continual basis. The insurance industry in particular has undergone significant changes with the introduction of the Solvency Assessment and Management (SAM) regime in 2018 and auditors are expected to provide the PA with the relevant required assurance on the quantitative reporting templates. Audit firms in a joint audit arrangement would have to keep abreast of these changes. A joint audit arrangement could also result in robust debates on issues that affect the regulated institution and as such is expected to contribute to overall audit quality.

As all firms in the joint audit arrangement are responsible for the audit opinion, audit firms would be expected to perform rigorous cross reviews on the work performed by the other auditor(s). Audit firms would have to be able to explain their audit methodology, bases for decisions made and conclusions to the other auditor, and the other auditor can challenge these. This provides for an objective quality review and contributes to overall audit quality.

Joint audit arrangements are expected to enhance auditor independence and diminish over-familiarity as sections of the audit would be rotated between firms in the joint audit arrangement.

In addition to client acceptance procedures, auditors in a joint audit arrangement perform an assessment of the proposed joint auditor to determine whether they would be willing to work with the other auditor. If there are any significant concerns noted, the auditors would be expected to communicate this to the PA or the Independent Regulatory Board for Auditors (IRBA). This contributes to quality control, which also enhances independence.

A joint audit also provides for continuity and stability in the short term, should one of the firms not be in a position to continue with the engagement for any reason. The other firm can continue with the audit in such a situation without significantly impacting the timing and quality of the audit.

Joint audits also provide an opportunity for a wider pool of audit firms to provide their resources, skills and expertise to the regulated institutions.

The PA is also aware that there may be certain challenges associated with joint audit arrangements, such as an increase in audit fees, challenges with different audit methodologies and challenges in allocating sections of the audit in a way that all audit risks are identified and appropriately addressed. The PA, however, believes that the benefits of joint audit arrangements do outweigh the challenges. Audit firms are encouraged to ensure that their internal processes will adequately address any risks pertaining to the joint audit arrangement. In this regard, audit firms' attention is drawn to the IRBA 'Guide for Registered Auditors: Joint Audit Engagements'[2], which the PA believes will assist auditors in executing joint audits.

[2] https://www.irba.co.za/upload/Final_Guide_Joint%20Audit%20Engagements%20_%20Aug%202020.pdf

It should also be noted that the South African audit profession has been under scrutiny due to audit failures which have been widely documented in the media. The issues around the audit failures brought into question audit quality, the role of audits and concentration within the audit industry. The PA notes that audit firms are continuing to put measures in place to address the concerns that have been raised and believes that arrangements related to joint audits will help further enhance these measures.

3. Alternatives considered

In reaching the decision to require certain insurers to appoint joint auditors, the PA considered various alternatives, such as the combined assurance model, shared audits, existing partner rotation requirements, oversight by the audit committee as well as skills and resources of audit firms.

The combined assurance model is followed by many institutions to manage risks. The combined assurance model as explained by the King IV Report entails that assurance is provided by risk and opportunity line functions, specialist functions, internal audit, external audit and governing bodies. The functions in the combined assurance model are mostly internal functions, with external audit being the only function that provides external independent assurance. The different functions have different objectives and most often work as independent units. The combined assurance model is a risk management tool that governing bodies use. The PA believes that this model generally supports the PA's regulatory and supervisory assurance needs; however, the PA's core reliance in this regard in terms of independent assurance is on the external audit function. Given the nature, complexity and size of some of the insurers, the PA believes that the external audit function, as an independent function, should be executed jointly, as part of the combined assurance model.

A shared or sub-contracted audit is an audit engagement where a portion of the audit work is outsourced or sub-contracted by the engagement auditor to another firm(s). The engagement auditor takes overall control, responsibility and accountability for the audit engagement, regardless of the outsourcing or sub-contracting of a portion of the audit work to another firm(s). A shared audit is one where the audit team is extended with the involvement of another firm(s), i.e. the other firm(s) is part of the audit team and the engagement auditor retains sole responsibility of the audit. A shared audit is similar to a single auditor audit and as a result does not achieve what the PA seeks to achieve with joint audits.

The Companies Act No. 71 of 2008 (Companies Act) sets out the audit partner rotation requirements. Section 92(1) of the Companies Act states that the same individual may not serve as the auditor or designated auditor of a company for more than five consecutive financial years. Section 92(2) of the Companies Act sets out the cooling off period if the auditor or designated auditor ceases to be the auditor. The PA believes that the partner rotation requirements address independence and ensure that a new auditor is appointed within a reasonable timeframe in order to have “fresh” eyes on the audit. The PA, however, believes that the rotation requirements in the Companies Act address independence at an engagement partner level but not at firm level. Joint auditors will have to comply with the rotation requirements of the Companies Act. As stated in section 92(3) of the Companies Act, if a company has appointed two or more persons as joint auditors, the company must manage the required rotation in such a manner that all joint auditors do not relinquish office in the same year. This ensures continuity.

Audit committees play a significant oversight role for the regulated institutions. In executing their duties, audit committees rely on management and external auditors. The duties of the audit committee include the nomination to appoint an external auditor. Auditors present their audit approach and results to the audit committee. As such, audit committees form a critical part of the overall governance process. The PA believes that the appointment of joint auditors will result in a more robust audit process, which will support the PA and the audit committees of regulated institutions to duly discharge their respective responsibilities.

The PA acknowledges that the audit firms are approved by the PA, amongst other factors, on the basis of their requisite skills and resources to execute audits for regulated institutions. Given the specialised and complex nature of the regulated institutions, there are instances where some firms may be more skilled or resourced than others. Joint audits therefore, will enable appropriate skills and resource sharing. Auditors will be able to challenge one another and/or learn from each other. The banking and insurance industries are ever evolving industries with regular audit, accounting and regulatory updates and as a result joint audits will promote appropriate knowledge sharing in these areas.

4. Other considerations

During the PA's engagement with the insurance industry on this matter, the insurance industry raised some concerns with the decision on joint auditors. These concerns included cost versus benefit considerations, mandatory audit firm rotation (MAFR), International Financial Reporting Standard 17 *Insurance contracts* (IFRS 17) implementation and section 90 of the Companies Act.

The insurance industry raised the concern that joint audits will result in increased audit fees, as insurers will in essence pay more for the same service. The PA believes that joint audits will not result in "the same service" or a duplication of work but in improved service as the work will be allocated between the firms. However, the PA acknowledges that some additional costs may arise due to cross reviews, which contribute to improved service and enhancing audit quality. The PA therefore believes that the benefits of joint audits outweigh the costs, and enhanced audit quality will benefit both the insurer and the PA.

The IRBA has issued a Rule that auditors of public interest entities must comply with MAFR for financial years commencing on or after 1 April 2023. The main objective of MAFR is to strengthen the independence of auditors. The Rule requires that audit firms may serve for a maximum of ten years before rotating off the client for a cooling off period of five years, before being eligible to audit the client again. MAFR seeks to address independence at an audit firm level. The industry raised the concern that introducing a joint audit requirement for insurers in conjunction with MAFR and the requirements of the Companies Act will add complexity, especially in light of the fact that only a few audit firms have the capacity, skills and resources to audit large insurance institutions.

In addition, joint audits require at least two firms to be appointed and the requirements of MAFR and the Companies Act would result in a limited pool of auditors being eligible to be appointed as joint auditors. The insurance industry further raised concerns that they are currently preparing for the implementation of IFRS 17 and many insurers have appointed audit firms as IFRS 17 consultants/implementation partners. As a result, it would be difficult for insurers to appoint joint auditors from a limited pool of audit firms, due to the non-audit services that are provided.

The PA has taken note of these concerns but it believes that although MAFR addresses independence considerations, joint audits provide additional benefits from a stability and audit quality perspective and therefore that the two requirements are not mutually exclusive. It is further noted that the proposed amendments in the Companies Amendment Bill, 2018, reducing the period following which a person who was closely involved in the affairs of a company may be appointed as an auditor of a company after ceasing to be so involved, from 5 years to 2 years, would address concerns relating to eligibility criteria for auditors. In addition, the PA has factored the above concerns in deciding on the effective date of this requirement, and holds the view that the intervening period would allow insurers to make the necessary adjustments to ensure compliance by the effective date.

5. Joint audit requirement applicability

The joint audit requirement discussed in this paper is aimed at those institutions that are regarded to be systemically important[3], taking into account factors such as size, complexity and interconnectedness, amongst others. These would, by implication, also be institutions that are deemed to be significant from a financial stability perspective. This assessment should be performed and applied at the level of the ultimate controlling company of an insurance group (i.e. in instances where an insurance group may be designated within a broader insurance group, the assessment should be performed at the highest insurance group consolidation level). It should also be noted that this requirement should be applied separately to, and in addition to, banking groups with joint audit requirements where applicable. The PA may apply its discretion in including or excluding a regulated institution from the joint audit requirement based on qualitative factors such as the range and complexity of products/portfolios, type and number of entities within the insurance group and geographical footprint.

The allocation of responsibility between auditors across the insurance group will be at the discretion of management and the professional judgement of auditors (e.g. whether audit work is allocated according to the balance sheet, business units or legal entities), who should take into account factors such as MAFR[4] (including in-country rotation requirements in jurisdictions outside of South Africa), existing joint audit requirements where the insurance group is part of a banking group or vice versa[5] and any applicable restrictions in terms of the Companies Act and applicable auditing standards. The PA does, however, expect that there be a reasonable/appropriate allocation of audit work between the firms. It may also be necessary

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[3] For criteria to be considered, refer to https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/2020/10294

[4] MAFR is applicable to public interest entities, therefore in instances where there may be more than one public interest entity within a group, this would need to be taken into account in selecting joint auditors.

[5] The Prudential Authority does not require that where applicable, the joint auditors at the banking group level be the same or different to the joint auditors at the insurance group level; this is at the discretion of management.

for management to consider the impact of the joint audit on group audits, especially in instances where some of the group entities may not be audited by one of the joint auditors.

6. Implementation date

In deciding on the effective date of this requirement, the PA was cognizant of other activities within the insurance sector which would be affected by the joint audit requirement, such as MAFR and IFRS 17, both of which come into effect in 2023. Based on interactions with selected insurers, the views and preferences on the effective date varied. Whilst some institutions have already voluntarily opted for joint auditors, primarily motivated by a need for a smooth transition into MAFR, other institutions have expressed a preference for more time to allow for a cooling off period in order for a wider selection of audit firms to be eligible for appointment by the effective date. In contrast, some insurers expressed a preference for an earlier effective date so that the joint auditors would already be involved as part of the IFRS 17 implementation journey to ensure that, for example, both auditors are involved in the discussions and sign off on any applicable accounting policies prior to the implementation of IFRS 17.

Taking the above factors into account, the PA has considered that an effective date of 1 January 2023 (i.e. joint audits to be applicable for financial years commencing on or after 1 January 2023), with the option of early adoption, would be the most appropriate. This would address both the concerns raised above as well as ensure that the effective date is not delayed beyond this period, thereby exposing the sector to stability and continuity challenges should the existing appointed auditor not be available or able to continue with the engagement.

7. Invitation for comments

The PA invites regulated institutions and auditors to provide comments on this discussion paper. Respondents should please note that comments are not sought on whether the PA should implement a joint audit requirement for insurers but rather on the proposed application and effective date thereof. Respondents are asked to submit comments via email to Tinyiko Nxumalo: Tinyiko.Nxumalo@resbank.co.za. Responses should be received by no later than 31 January 2021.