

# Assurance NewsFlash

April 2006

No. 3/2006

## Capital Market Rule on Auditor Independence: Potential Implications

In 2002, Bapepam issued Regulation No. VIII.A.2 titled "Independence of Accountants Providing Audit Services in the Capital Market". In accordance with the Regulation, in order to maintain auditor independence, Bapepam requires rotation of auditors as follows:

- An accounting firm is allowed to perform general audit services on a particular client for five consecutive financial-years at the maximum and an audit partner for three consecutive financial-years at the maximum.
- In addition to the rule above, an accounting firm and an audit partner is required to refrain, for the period of three consecutive financial-years ("cooling-off period"), from auditing the entity that it or s/he previously audited before reaccepting that particular entity as an audit client.

Bapepam is in the process of revising Regulation no. VIII.A.2 on auditor independence and is seeking inputs from the public to improve the draft proposal. One of the significant points under the draft Regulation is clarification by Bapepam that the three-year cooling off period would also be applicable even when the accounting firm has audited the client for a period of less than five financial-years in a row and when the audit partner has audited the client for a period of less than three years in a row.

Specifically the Bapepam regulation states that even if the provision of audit services is less than five-years in a row (for the accounting firm) or three years in a row (for the audit partner) for a client, the accounting firm or the audit partner still has to wait for a period of three financial-

years before going back to the same client to provide audit services.

Therefore when an accounting firm has audited a listed company for two years in a row, for instance, it does not mean that the firm is exempted from the three-year cooling-off period on the ground that it has performed an audit on that client for less than five years in a row. In that case the accounting firm is still required to refrain, for three years, from auditing the same client.

The auditor rotation rule as stipulated in Bapepam Regulation VIII.A.8 is clearly focusing on improving auditor independence and the quality of audits. As a firm we are supportive of raising audit standards and appropriate safeguards on auditor independence. However, in our view the cost of the measures in the decree and the proposed changes as described above, taken in isolation, may outweigh the perceived benefits.

It seems that the rotation requirements under the Bapepam regulation are more onerous than the rotation requirements in most other jurisdictions throughout the world and exceed what is considered to be global best practice. The Sarbannes-Oxley Act in the US, for example, requires rotation of audit partners after five years but stops short of requiring rotation of audit firms. Rotation is considered as only one measure in a comprehensive range of initiatives designed to improve audit quality and auditor independence.

It is interesting to note that while the regulation is directed at regulating the accounting/auditing profession, it has significant implications for all entities in Indonesia. Some of the possible impact of the implementation of the auditor rotation rules on the companies:

- A company will incur additional costs to re-tender audits and educate new auditors every five years.
- The short rotation period (3 years) for audit partners will impact the ability of audit firms to apply real industry expertise where it is required. For example, most local accounting firms have insufficient numbers of financial services and energy and mining experts to rotate partners on a three-year cycle. This may impact audit quality and client service.
- Foreign-owned entities will be required to continue using their worldwide auditors for overseas reporting while using a separate

firm for local statutory reporting, potentially resulting in duplication of effort and cost

- Companies in highly competitive industries may be required to appoint the auditor of a major competitor as their local statutory auditor.
- The decree is silent on the question of group reporting. It would be inefficient to have several different auditors auditing that particular group. Audit risk would increase significantly.
- Accounting firms will incur significant additional costs as a result of an increase in tendering activities. They may also be less inclined to invest in long-term relationships with clients and it is likely that in the short term audit fees will need to increase.
- The accounting profession in Indonesia may not be able to cope with such a rapid change of auditors. Accounting firms need adequate time to understand the

client and its business and plan an audit in order to ensure audit quality. There is a risk, in the short term, that accounting firms concerned with maintaining quality standards may not be able to accept audit appointments on such short notice.

In conclusion we fully support the idea to improve auditor independence and governance in the accounting profession; however we believe that there are some issues that should be considered and resolved before the rule on auditor rotation is fully implemented.

We would encourage you to provide input into the discussion on audit rotation through the established channels.

Please contact your engagement partner should you require further information or if you wish to receive a copy of the new Bapepam rules with respect to auditor rotation.

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