

## **Mandatory rotation of audit firms**

Review of current requirements, research and publications

July 2002



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# 1 Executive summary

## *Background*

The Institute is committed to quality audits and recognises the need to re-examine its position on aspects of ethical and auditing standards when these are called into question. Comments regarding the factors contributing to recent company failures and the lessons to be learned has led, *inter alia*, to a demand to reconsider auditor independence, one aspect of which is whether the effectiveness of auditor performance may be negatively impacted by the length of the auditor-client relationship (the ‘over-familiarity threat’) and whether mandatory auditor rotation should be required as a safeguard to ensure and/or demonstrate that auditor independence is not compromised.

The concept of mandatory auditor rotation is that a company’s auditors should provide services for a defined period only, after which they should be replaced by a different firm of auditors.

This paper sets out the findings from reviews of:

- current regulatory requirements setting out how the over-familiarity threat is addressed
- reports of recent reviews commissioned by Governments
- research and studies carried out by academics.

## *Current regulatory requirements*

There is no regulatory requirement for UK listed companies to change auditors after a number of years in office. However, where the same audit engagement partner acts for an audit client for a prolonged period, a familiarity threat is recognised as arising. As a result, the UK regulatory requirements are that, for listed companies, the audit engagement partner cannot act for more than seven years and cannot return to that role for a further five years.

## *Findings of reviews commissioned by Governments*

The two most recent Governmental reviews – the Review of Auditing in the Republic of Ireland and the Independence of Australian Company Auditors Review (the ‘Ramsay Review’), both of which reported in 2001 – included mandatory rotation in their considerations but concluded that it is not required. The Ramsay review stated ‘the anticipated cost, disruption and loss of experience to companies is considered unacceptably high, as is the unwarranted restriction on the freedom of companies to choose their own auditors’.

## *Other overseas studies*

These include two recent studies carried out in Spain by Arrunada and Paz-Ares entitled ‘Economic consequences of mandatory auditor rotation’ published in 1995 and in Italy by SDA Universita Bocconi in 2002 entitled ‘The impact of mandatory audit rotation on audit quality and on pricing: the case of Italy’ and are particularly apposite. Spain had a system that required mandatory auditor rotation until 1995 when it was dropped. Italy still requires mandatory rotation for listed companies. Both studies identify (i) the significant additional costs incurred by firms and management and (ii) the adverse effects on audit quality in the early years of appointment (due to a lack of cumulative client knowledge) that arise from mandatory rotation.

### ***Key themes and arguments***

The results of the governmental reviews and academic research has shown that there are a number of key themes and arguments, both for and against, mandatory rotation. These are predominantly concerned with the expected impact of mandatory rotation on:

- Auditor objectivity and independence
  - (i) rotation as a means of enhancing independence
  - (ii) the perception of objectivity and independence
  - (iii) auditor rotation and opinion shopping
- Quality of audit work
  - (i) rigour of the audit process
  - (ii) incidence of audit failures
  - (iii) cumulative knowledge
  - (iv) investment by audit firms
- Cost of audits
  - (i) competition in the audit industry
  - (ii) 'first time through' audit costs
  - (iii) cost of management time
- Other practical considerations
  - (i) audits of specialised industries
  - (ii) impact on freedom of choice
  - (iii) natural occurrence of rotation

### ***Conclusions***

The review of research and publications has indicated that there is a significant amount of opinion and conjecture compared to the empirical evidence and studies that exist. It should also be noted that the research and studies in many cases had been performed or written in excess of 15 years ago and that the extent of more recent material is limited. The most recent empirical studies are those performed in Spain and Italy referred to above.

The research carried out shows that there are arguments for and against mandatory rotation. The perceived benefits of mandatory rotation can be summarised as (i) an improvement in audit quality due to the avoidance of over-familiarity with the client and its management and the opportunity for a fresh approach to the audit, (ii) a better perception of auditor independence, and (iii) the benefits of competition. On the other hand, it is generally recognised that there are (i) additional start-up costs affecting both the auditor and client, (ii) adverse effects on the quality of the audit due to a

lack of familiarity in the first and early years of the audit, (iii) a lack of incentive if the audit is about to change hands and (iv) the signals that may be given out currently when there is a change of auditor will be lost.

As indicated above, the recent reviews in Australia and the Republic of Ireland concluded that, in balancing the arguments, the costs of mandatory rotation outweighed the benefits. The SDA Universita Bocconi paper suggests mechanisms for focusing on single partners, rather than on audit firms through partner rotation, the role of the second partner, 'peer review' and controls carried out by the 'vigilance authority', proposals that are largely, if not wholly, in place in the UK.

### ***Other considerations***

Areas not considered in this paper but which are, or may be, relevant to reaching a conclusion about the need for mandatory rotation include:

- the frequency of rotation eg three years, five years or longer and, for example, the likelihood that the shorter the period the higher the costs of the audit and client management time.
- whether there is, at least in the short term, the possibility or probability of a lack of choice when appointing a new firm eg (i) acting as an expert witness may rule out one or more firms from being appointed and (ii) the auditor of a client's competitor may rule that firm out from seeking appointment.
- whether problems such as those in the previous bullet point would be exacerbated if a firm could not be re-appointed for a number of years.
- the impact of any other steps which have been mooted, such as the banning of the provision of non-audit services to audit clients – for example, a firm providing non-audit services might not be able or might not wish to give up that work and therefore rule itself out as a potential auditor.
- whether the issues that rotation is perceived as addressing will be better dealt with by proposals concerning the role of non-executive directors and audit committees.

## **2 Scope of review**

### **2.1 Background and purpose of review**

There has been much discussion regarding the contributory factors behind the collapse of Enron<sup>1</sup> and the lessons to be learned. These discussions have related to other recent corporate failures and difficulties, both in the UK and abroad.

These discussions have focussed on a wide range of issues - the quality and extent of corporate reporting, the roles and responsibilities of executive and non-executive directors, audit committees, auditors and regulatory bodies.

This paper focuses on only one of the topics under discussion, namely the length of the auditor-client relationship and its effect on the effective performance of auditors and the proposal for the introduction of mandatory auditor rotation as a viable solution to dealing with the over-familiarity threat.

The concept of mandatory auditor rotation is that a company's auditors should provide services for a defined period only, after which they should be replaced by a different firm of auditors.

The focus of this paper is to identify current UK requirements, and the evidence and research available relevant to this concept.

### **2.2 Methodology and approach to the review**

This paper aims, firstly, to identify and summarise the current regulatory situation and then moves on to identify and summarise the potential benefits and drawbacks of mandatory rotation highlighted in publicly available research and opinion published by regulatory or authoritative bodies (including findings of Governmental Reviews such as the Irish Review and Ramsay Report), academics and other interested parties (including the studies by SDA University of Bocconi in Italy and by Arrunada and Paz-Ares in Spain) and to consider the extent to which empirical evidence is available to support or refute the advantages and disadvantages of mandatory auditor rotation.

This review has been carried out as follows:

- (i) Review of current UK regulatory requirements
- (ii) Searches for published reports, research and opinion

Searches for relevant publications have been carried out using databases and other available information including:

- a number of databases, primarily libraries and journal databases maintained by the Institute of Chartered Accountants in England & Wales, Australian Accounting Research Foundation, Institute of Chartered Accountants of Australia, Canadian Institute of

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<sup>1</sup> This paper does not consider the contributory factors behind the failure WorldCom which came to light during the finalisation of this paper.

Chartered Accountants and the American Institute of Certified Public Accountants

- bibliographies of relevant research papers
- internet searches
- review of Governmental research primarily the Irish Review (Ireland) and the Ramsay Report (Australia).

(iii) Review of material and identification of nature of research performed

A detailed review of the material collated has been performed, focussing on identification of the arguments for and against mandatory rotation and the bases for those arguments, aiming to distinguish between expressed opinion, balanced consideration and argument, and full empirical studies.

(iv) Identification and summary of the key research findings

The key findings are presented in section 4 to this report, summarising the identified benefits and drawbacks to mandatory auditor rotation and the extent to which these are supported by opinion or research.

All comments set out below in this report are extracted from the research and publications reviewed.



### 3 Current regulatory framework

#### 3.1 United Kingdom

In the UK, the actions and conduct of the auditors are governed by a combination of Law, Regulations and Guidelines. All have aspects that relate to auditor independence and, within that, the need for safeguards in relation to acting for a prolonged period of time.

This section provides a brief outline of the provisions, both mandatory and advisory, which are currently in place in the UK.

##### 3.1.1 *Legal requirements*

Under the Companies Act 1985 s25, an auditor has to be a member of a Recognised Supervisory Body (RSB) and be eligible for appointment under the rules of the RSB. Under Schedule 11 to the Act, ICAEW has, *inter alia*, to have rules and practices that are designed to ensure that:

- company audit work is conducted properly and with integrity
- persons are not to be appointed as company auditors in circumstances in which they have an interest likely to conflict with the proper conduct of the audit.

The ICAEW's rules and practices are set out in the Audit Regulations which were submitted to the DTI in support of the ICAEW's application to become an RSB. The Regulations are binding on auditors of companies and include Regulations that:

- a Registered Auditor (ie one registered under the Regulations) must not accept an appointment or continue to act as an auditor if the firm has any interest likely to conflict with carrying out the auditor properly (AR 3.01)
- a Registered Auditor must make arrangements so that all principals and employees maintain the principles of independence and confidentiality set out in the Ethical Statements issued by (ICAEW) Council (AR 3.02) – see 3.1.2
- a Registered Auditor must always conduct audit work properly and with integrity (AR 3.03)
- a Registered Auditor must 'consider its independence ... and record this before it accepts appointment or reappointment as auditor' (AR 3.04).

##### 3.1.2 *ICAEW Ethical Statements*

The ICAEW 'Guide to Professional Ethics' sets out the Fundamental Principles, in brief to:

- behave with integrity
- strive for objectivity
- accept only work for which he is competent

- perform work with due skill, care, diligence and expedition with proper regard for technical and professional standards
- conduct himself with courtesy and consideration.

The Statements supporting these Principles address a number of specific areas, the most relevant of which, in the context of auditor rotation, is Statement 1.201 - 'Integrity, Objectivity and Independence', which in Section A deals with the objectivity and independence required of an auditor.

Paragraphs 4.79 to 4.82 deal specifically with the risk of 'acting for a prolonged period of time' and requires that, for listed companies, the audit engagement partner cannot act for more than seven years and cannot return to that role for a further five years (para 4.80).

The power of the ICAEW to enforce ethical standards is, by the Royal Charter and Bye-laws, entrusted to the professional conduct committees, each of which is independent of the Council. The Investigation Committee considers complaints against the conduct of members and member firms and is empowered to initiate disciplinary action. In cases which give rise to or include questions of public concern, the Committee has, in the past, referred the matter to the Joint Disciplinary Scheme for investigation and disciplinary action (in future the Investigation and Discipline Board will take over this role).

### **3.1.3 *Financial Services Authority (FSA)***

The FSA Listing Rules do not extensively comment on the conduct of auditors but rather focus on the requirements for audited financial statements and other relevant reports. However, under the conditions for listing, the rules do state that 'the auditors must be independent of the applicant and comply with the guidelines on independence issued by their national accounting bodies' (ie in the ICAEW's case the requirements outlined above).

### **3.1.4 *Combined Code on corporate governance***

Further support for the auditor independence requirements comes through in the 'Combined Code' on corporate governance, published in 1998 by the Hampel Committee and the London Stock Exchange, which consolidated the existing Cadbury and Greenbury codes and added some additional requirements.

Within section D of the Code, auditor relationships and requirements are considered including the requirements that:

- there should be a statement in the financial statements regarding the responsibilities of the directors and of the auditors
- the board should establish arrangements for maintaining an appropriate relationship with the company's auditors
- the board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non-executive directors, should be named in the report and accounts.

### 3.1.5 Auditing Standards

Statements of Auditing Standards (SASs) published by the Auditing Practices Board detail the basic principles and essential procedures with which the auditors are required to comply.

The detailed SASs address auditor responsibilities, audit methodology and reporting requirements. These therefore set out the basic requirements of an audit, detailing approaches to audit tests, evidence and quality control.

SAS 240 (revised) *Quality control for audit work* recognises that auditor independence needs to be reflected directly in the audit process and specifies, *inter alia*, the following:

‘Before accepting a new audit engagement firms should ensure that they:

- (a) ...
- (b) consider carefully whether there are threats to their independence and objectivity and, if so, whether adequate safeguards can be established
- (c) ...and
- (d) comply with the ethical requirements of the professional accountancy bodies in relation to changes in appointment.

Further SAS 610 *Reports to directors or management* specifies that auditors of listed companies must, at least annually, disclose in writing to the audit committee, and discuss as appropriate:

- all relationships between the audit firm (and its related entities) and the client entity (and its related entities) that may reasonably be thought to bear on the firm's independence and the objectivity of the audit engagement partner and the audit staff
- the related safeguards that are in place
- confirm in writing that the firm is (i) independent within the meaning of regulatory and professional requirements and (ii) the objectivity of the audit engagement partner and audit staff is not impaired.

## 3.2 Other countries

The European Commission has recently issued a Recommendation *Statutory Auditors' Independence in the EU: A Set of Fundamental Principles* on 16 May 2002. The Recommendation does not require mandatory rotation of firms but does require mandatory partner rotation on listed clients after seven years. It differs in some respects from the UK requirements, namely:

- it allows a return after two years (not five years as in the UK)
- it applies to ‘public interest clients’, not just listed clients
- in a group context, extends to key audit partners other than the audit engagement partner.

The International Federation of Accountants requires partner rotation but not rotation of firms.

No countries within the EU, with the exception of Italy, currently have a system of mandatory audit firm rotation.

Some examples of approaches adopted in different countries are shown below. The list is not exhaustive.

### **3.2.1 *Italy***

The system applies to firms auditing listed companies under the rules of the stock exchange regulator CONSOB. This affects roughly 20 firms which audit listed companies whereby the auditor is appointed every three years with a maximum of three cycles (ie a total of nine years). (The UK has an annual requirement for appointment of auditors.)

### **3.2.2 *Countries where mandatory rotation has ceased***

Prior to 1995, Spain had a system of mandatory audit firm rotation relevant for all larger audit practices that dealt with listed companies. Spanish audit law, under article 8.4 of the Ley de Auditoria de Cuentas (Audit Law) and 204.1 of Corporations Law, stated that a company's auditors could not be reappointed once the period of his appointment, a minimum of three years and a maximum of nine, had concluded (Ref 8). This system ceased in 1995.

In the past 10 years, mandatory auditor rotation of various forms has been dropped in Slovakia, Latvia, Turkey and the Czech Republic.

### **3.2.3 *Countries currently considering rotation***

Mandatory rotation is being seriously considered by senior government officials in Brazil following the bankruptcy of two major banks. It is proposed to apply to financial Institutions initially and then all listed companies from 2004. Rotation would be required every five years with auditors eligible for reappointment after three years.

In Austria, the issue has been debated recently and regulators have proposed introducing rotation.

## 4 Review of research and publications

The review of the research described in section 2 has shown that there are a number of key themes of arguments, both for and against, mandatory rotation. These are predominantly concerned with the expected impact of mandatory rotation on:

- auditor objectivity and independence
- quality of audit work
- cost of audits
- other practical considerations.

It is noted that the research and publications reviewed detail a significant amount of opinion and conjecture, but less empirical evidence and studies have been obtained and performed. The two most recent and relevant academic studies are those conducted in Italy by SDA University of Bocconi (2002) and in Spain by Professors Arrunada and Paz-Ares (1995).

800 UK Finance Directors responded to a survey by Financial Director in March 2002. The result showed that 57% favoured a system of mandatory rotation. This can be compared to a study performed in 1993 which that showed that 33% of finance managers and 29% of investment analysts in the UK were in favour of rotation (Garcia-Benau, Humphrey and Turley, 1993).

However, the robustness of these polls may be questioned as it is unclear as to the methodology adopted for the surveys, the questionnaire design and the basis for the views expressed. In particular, the results appear to reflect the views of only those who responded.

### 4.1 Auditor objectivity and independence

#### 4.1.1 *Rotation as a means of enhancing independence*

The improvement of auditor objectivity and independence has been argued within the publications reviewed to be a primary reason for the introduction of mandatory rotation. The publications postulate that long-term audit relationships can become too comfortable, with auditors identifying too closely with management and losing their professional scepticism.

This is accompanied by the view that auditors might smooth over problems due to the financial rewards of maintaining a long-term relationship with a client. Businesses could easily threaten to find another auditor if the present auditor did not agree with managements' opinion.

However, although there has been much discussion and conjecture regarding the potential positive impact of auditor rotation on objectivity and independence, the review of research and publications indicates that academics, professionals, regulators and other interested parties have struggled to identify direct evidence that this is would be the case.

Publications tend to be primarily opinion-based or cite indirect evidence that indicate that independence may have been impaired.

The belief that rotation would enhance independence was originally put forward by a variety of individuals and committees. These included the Cadbury Committee (*'The Financial Aspects of Corporate Governance'*, December 1992), the Irish Review Group on Auditing (*'The Report of the Review Group on Auditing'*, 2001) and the AICPA (*'Statement of position regarding mandatory Rotation of audit firms of publicly held companies'*, 1992). However, the groups all subsequently concluded that the disadvantages of rotation outweigh the advantages. The AICPA also explains that this suggestion has been studied by a number of influential bodies in the US, including the Public Oversight Board, Commission on Auditors' Responsibilities and the National Commission on Fraudulent Financial Reporting, all of whom concluded that the perceived benefits of rotation audit forms are outweighed by the associated costs.

Further, some parties have argued that the improvement in objectivity and independence cannot be supported.

In Spain, Professors Arrunada and Paz-Ares (1995) performed a detailed study entitled 'The economic consequences of mandatory auditor rotation'. This included a critical examination of the argument that a lengthy auditor-client relationship may be prejudicial to the auditors' neutrality and impartiality. Their examination of this argument focused on the presumption that collusion between the client management and the auditors may be facilitated in a lengthy relationship, and that the expectation of economic gains for the audit firm may impair their judgement and independence. Following their review of existing studies and mathematical modelling of the relationship between return on assets for audit firms and the length of the audit relationship, Arrunada and Paz-Ares concluded that mandatory rotation may actually harm auditor independence based upon the following key findings:

- collusion between auditor and client may arise in the short term and is not necessarily dependent upon a long-term relationship. Hence auditor rotation will not eliminate this risk
- continuity of the auditor over time increases the likelihood that any wrongdoing by the client management will be discovered
- mandatory rotation reduces the basic economic incentive, which encourages audit firms to be independent due to the value placed upon the audit firm's goodwill and reputation.

#### **4.1.2 *The perception of objectivity and independence***

Although the evidence reviewed has not shown that rotation improves independence, the perception of independence is arguably just as important.

The US Senate Subcommittee on Reports, Accounting and Management has argued that mandatory auditor rotation adds substance to the public's perception of independence. Most support for this view comes from articles and Press comment.

If this holds true, it would follow that more confidence may be placed in the opinions expressed by auditors (*opinion cited by Petty & Cuganesan, Australian Accountant, 1996*).

However, these arguments are not based upon detailed empirical study.

In one of the few empirical studies on the topic, a questionnaire-based study performed in North Carolina, in which a sample of 176 questionnaires were sent to audit partners, commercial loan officers and financial analysts, the resulting responses showed no evidence of a significant relationship between tenure and the perception of auditor independence (*Shockley 'Perceptions of*

*Auditors' Independence: An Empirical Analysis*, 1976). This study concluded, therefore, that any policy to reduce average tenures through mandatory rotation may have little positive effect on perceptions of auditor independence.

#### 4.1.3 Auditor rotation and opinion shopping

The practice of opinion shopping is where companies appoint auditors who are most likely to agree to management's views about whether accounting treatments are acceptable.

The argument that mandatory rotation prevents opinion shopping works on the basis that auditors would have less economic incentive to accept inappropriate views and that management will not be able to select and stick with the one auditor who is willing to relax their objectivity.

Research into voluntary auditor switching has often been used as evidence to support this view finding, for example, that companies voluntarily change their auditors:

- after receiving qualified opinions (*Chow and Rice, 1982*)
- because their auditors are conservative in their application of accounting standards (*Krishnan, 1994*)
- because they may be able to secure a more favourable opinion (*Craswell, 1988*).

However, the above findings do not necessarily constitute firm evidence of opinion shopping and other studies have indicated different interpretations of the results. For example, the research by Chow and Rice (1982) shows that firms switch auditors more frequently after receiving qualified opinions, but the new auditors selected were not auditors with a proven history of rendering proportionally fewer qualified opinions. Thus, although firms may switch, they are not necessarily 'opinion shopping'. In addition, Chow and Rice (1982) and Smith (1986) found that when qualified firms switched, they did not receive more clean opinions.

More significantly, mandatory rotation would hide the fact that firms were opinion shopping, as a change of auditors would be normal rather than an unusual event attracting attention as it does under the current system.

A significant study of 132 failing firms showed that failing firms had a greater tendency to switch than healthier firms (*Schwartz and Menon, 1985*). Mandatory rotation would mask the valuable informational effect that a change of auditor gives to the market.

## 4.2 Quality of audit work

The expected impact of mandatory rotation on the quality of audit work considers the following factors/evidence:

- the impact on the rigour of the audit process
- incidence of audit failures
- the role of cumulative knowledge developed by audit teams
- investment by audit firms.

#### **4.2.1 Rigour of the audit process**

A number of the publications and research reviewed have argued that long-term audit relationships may result in ineffective audits due to auditors becoming:

- less rigorous due to a learned confidence in the client and over reliance on prior year work papers (*Brody & Moscové, 1998*). This may create a tendency to anticipate results rather than keeping alert to subtle but important changes in client circumstances
- more likely to increase materiality thresholds. A study performed by Bates *et al.* (1982) demonstrated that in the absence of rotation the materiality threshold was set at an average of \$365,000. When there was rotation of the audit firm, the threshold was only an average of \$201,000
- less likely to report irregularities in the client's financial statements as auditor tenure lengthens (*Knapp (1991) citing a paper by Raghunathan et al. (1987)*)
- less likely to resolve audit issues identified. In the US, for example, Waste Management, W R Grace and JWP have been identified as three cases in which, in the context of a long-term audit relationship, an issue was identified by the auditors, but then not resolved (*Turner, 2001*).

Further, Chris Dickson, executive counsel at the Joint Disciplinary Scheme, has expressed his opinion that an auditor will perform a more thorough and sceptical audit and will be more inclined to fix any problems encountered, if they know that there will be a new auditor scrutinising their work in the near future.

These factors and comments could be taken as support that the audit firm, over the longer term, becomes less rigorous in their approach and an error (intentional or unintentional) is more likely to be missed, and that auditor rotation could enhance audit effectiveness and quality.

The Metcalf subcommittee's staff considered this serious enough to recommend mandatory rotation as a possible remedy (US Senate, 1976), although the system was never implemented.

However, these arguments are based largely on opinion rather than objective evidence and the consideration of the 'audit failures' below does, to a certain extent, question the validity of these views.

The research by SDA Università Bocconi also raises the possibility that competition, with its lowest fee offer, could be inadequate to justify the audit work.

#### **4.2.2 Incidence of audit failures**

There is an argument that the incidence of 'audit failures' may provide objective evidence of ineffective audits.

The research and publications reviewed resulted in the key findings, summarised below, which seem to refute the view that mandatory rotation would reduce the instance of audit failure.

Author	Research	Results
Raghunathan <i>et al.</i> (1994), US, 1994	Review of the incidence of SEC enforcement actions	<ul style="list-style-type: none"> <li>initial indication that actions were more common in long-term engagements of more than five years</li> <li>an alternative analysis of the data demonstrates that it may be argued that actions were also more common in the first year of an audit</li> </ul>
Quality Control Inquiry Committee of the SEC Practice Section, US	Review and assessment of 406 cases of alleged audit failure between 1979 and 1991	<ul style="list-style-type: none"> <li>allegations of audit failure were found to occur almost three times as often when the audit firm is performing its first or second audit of the company</li> </ul>
St. Pierre and Anderson, US, 1984	Examination of 129 cases of auditor liability in which 30 had 'new' auditors (less than three years)	<ul style="list-style-type: none"> <li>although representing only 23% of the total, cases involving new auditors accounted for 43% of auditor performance errors and 43% of the cases of client fraud</li> </ul>
National Commission on Fraudulent Financial Reporting, US, 1987	Review of fraud-related cases	<ul style="list-style-type: none"> <li>a significant number of fraud-related cases involved companies that had recently changed their auditors</li> </ul>
Independent Commission on Auditors' Responsibilities, US, 1974 to 1978	Study of sub-standard audit performance	<ul style="list-style-type: none"> <li>several problem cases were first or second year audits. The study was not conclusive but indicates greater risk associated with new audit clients</li> </ul>

The most-quoted comment regarding the potential increase of audit failure that could be caused by mandatory rotation is that of former SEC Chief Accountant John Burton. He is quoted in the American Institute of Certified Public Accountants' Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies (1992): 'In the overwhelming majority of situations...the problem in these cases arose from too little involvement by the auditors in the activities of their clients, rather than too much. A significant proportion of cases arose in initial

audits where the main pattern was normally one of the client misleading the auditor rather than conspiring with him'.

On the basis of the presented evidence, the AICPA Statement of Position referred to above concluded that mandatory rotation should not be introduced based largely on empirical evidence that demonstrates that there is a higher instance of audit failures in the early years of an engagement. The paper concludes that this is due to the lack of knowledge of the client by newly appointed auditors that is critical to early discovery and resolution of problems that may threaten a business. This is considered further in section 4.2.3 below.

The strength of evidence from detailed studies, therefore, appears to rest with the case against mandatory rotation.

However it should be noted that a review of auditor changes in an environment of voluntary auditor switching, as the reports quoted above generally are, may result in a skewed sample of companies who are 'voluntary changers' of their auditors. Such companies might be those that are in financial distress or have a poor reputation. Under a mandatory rotation system, companies changing auditors would not have the same characteristics.

#### **4.2.3 Cumulative knowledge**

In the course of an audit, the audit team accumulates extensive knowledge of the client's business, systems and personnel. Many of the publications and research reviewed comment that, under a mandatory rotation system, this knowledge would be lost at each change of audit firm.

There is little direct empirical evidence in relation to the argument that a deeper knowledge and understanding of the client's business and operations and systems would result in a more effective audit. However, the considerations of audit failure above did lead the AICPA to conclude in their Statement of Position Regarding Mandatory Rotation of Audit Firms that problem audits occur much more frequently when the auditor lacks a solid base of experience with the client's business, operations and systems.

The Report of the Review Group on Auditing in Ireland in 2001, suggested that audit quality would be detrimentally affected by the removal of experienced personnel from the audit team. The logical extension is that audit quality would be affected by a change in the whole team ie the firm.

The SDA Univerista Bocconi research identifies two factors:

- the largest number of partner suspensions by CONSOB (the Italian national commission for listed companies) related to the first year of appointment, implying that there is a negative impact on the quality of audit work in the first year of appointment
- the highest frequency of qualified opinions occurs during the third year of an appointment when it is presumed that the audit firm has acquired a deep knowledge of the client. The supporting table in the research paper shows another, but lower, peak in the sixth year.

In the light of limited empirical evidence, the key considerations and discussion areas included in the papers reviewed have focussed on the following:

- Business complexities

It is often commented that the increasing complexity and size of many modern businesses, in terms of technology, geographical spread and structure, business processes and financial

control procedures, means that it takes an increasing amount of time and achievement of a steep learning curve to thoroughly understand the business and its operations. Further, this is expected to be an even greater hurdle to effective audits in specialist industries, such as banking and insurance sections. Other considerations in relation to specialised industries are outlined in section 4.4.1.

Detailed knowledge is required in order that the auditor may be able to identify critical areas of high audit risk.

- Financial reporting complexities

The increasing complexity and continued development of accounting standards means that a detailed and in-depth understanding of the business complexities is required in order to ensure that the auditor is able to fully consider the impact of alterations in financial reporting requirements. Further, accounting issues may often affect more than one accounting period, such as asset impairment, goodwill and employee benefits, meaning that understanding historical periods and results is instrumental in ensuring the appropriate adoption of changes in financial reporting requirements.

Many parties have expressed concern over the negative impact of mandatory rotation on the depth of auditor knowledge and understanding of the audited company. These include the Cadbury Commission in 1992, the AICPA in its Statement of Position paper of 1992 and the Australian Ramsay Report in October 2001.

#### **4.2.4 *Investment by audit firms***

A further impact on audit quality related to the introduction of mandatory rotation is purported to be the potential reduction in incentive for audit firms to invest in the development of the audit process, effectiveness and efficiencies. This is expected to arise due to the lack of long-term commitment. Key concerns commented on in the publications reviewed centre on:

- the likely lack of investment in new audit technologies (*Arrunada and Paz-Ares, 1995*)
- the likely lack of investment in people to perform the audits (*Arrunada and Paz-Ares, 1995*) resulting a lower quality auditor in the profession.

This would have a consequent effect on the quality of audit work and also on the ultimate cost of audits.

### **4.3 Cost of audits**

The cost of audit is expected to be impacted by mandatory audit rotation largely due to the impact of:

- competition in the audit industry
- ‘first time through’ audit costs
- costs of clients’ management time.

#### **4.3.1 Competition in the audit industry**

There have been many commentators on the perceived excessive concentration in the audit market, particularly as regards the dominance of the large firms with the view that mandatory rotation would increase competition and hence reduce audit fees.

##### **(i) Impact of competition on market share**

The argument that mandatory rotation prevents concentration first appeared in the Metcalf Report (1976).

A review in Spain seems to support this view where Arrunada and Paz-Ares (1995) quote information from Spanish sources that show that, upon introduction of mandatory rotation, the market share by billings of non-Big Six auditors in Spain increased from 27.56% to 40.10% of the statutory audit market.

However, this study also concluded that hourly rates in real terms dropped by 6.49% at the same time, therefore suggesting that the real increase in billings of non-Big Six auditors would not be so significant.

Further, they explain that industrial organisation theory has generally demonstrated that a high degree of concentration is not always indicative of a lack of competition.

The empirical evidence available is limited but the SDA University of Bocconi research found that:

- competition is greater in the voluntary audit segment, where there is no mandatory rotation requirement) than in the listed company sector where the market share of the then Big Six was over 90% in 1992-1997 (the UK equivalent was 80% *Beattie and Fearnley, 1998*)
- mandatory rotation has not led to small- to medium-sized firms being given the opportunity to compete with the large audit firms. On the contrary, the research report speculates that it has even contributed to the collusive behaviour found by the Italian Antitrust Authority (January 2000) of the large audit firms making agreements between themselves to refer audit clients.

(ii) Impact of competition on audit fees

Arrunada and Paz-Ares (1995), through their detailed review and mathematical modelling of audit costs, argue that mandatory rotation could cause decreased competition and a consequent increase in cost to the client as there would be a reduction in the incentive for audit firms to be efficient. They argue that any initial dip in fees to capture clients on the introduction of the system would be amply recovered by the auditors in subsequent years.

The Italian research found that, at the end of the nine-year period, fees for services are similar or lower than those of the previous auditor.

(iii) Practical considerations

Even if competition may be proved to increase due to rotation, regulators will need to consider whether there are enough audit firms of sufficient size and quality to support a system of mandatory rotation. This is particularly relevant for multinational businesses that require a large firm auditor.

With the prospect of there being only four large firms, recent opinion quoted in the publications reviewed is that mandatory rotation poses significant practical problems. When it becomes time for rotation, certain companies, primarily the large, complex, global businesses, will be restricted in the available choice of firms and require a large firm to meet its needs. In addition, the choice of audit firm is further restricted where conflicts arise, such as where one firm already provides non-audit services that are incompatible with being the auditor or may audit a main competitor.

#### 4.3.2 *'First time through' audit costs*

Numerous studies have concluded that the costs related to the regular switching of auditors are unacceptably high and outweigh the potential benefits of mandatory rotation. The increase in cost is due to the fact that the incoming auditor has to start the audit from scratch and gain the necessary experience of the client's business, operations and systems. Any efficiencies developed by the previous auditor are also lost.

Arrunada and Paz-Ares (1995), explain that, first time through costs will include explicit time spent by the auditor in the following areas:

- familiarisation with the company's accounting procedures and internal controls
- assessment of continuity of procedures and accounting policies adopted by the company
- review of historical accounts, comparatives and opening balances
- review of tax structure and exposures
- creation of a permanent archive of background information and knowledge.

Similarly, the research by SDA Universita Bocconi found that more man-hours are necessary, together with more qualified resources, and that this 'training period' is never less than two to three years for complex international groups. In the first year, it could lead to an increase of up to 40% in the man hours required.

The key empirical study quantifying the increase in cost was performed by Ridyard and Bolle (1991) in which a survey of European audit firms revealed that start-up costs were estimated at 15% of all costs for a new client in which the audit firm had industry experience and 25% when the audit firm had no industry experience.

All these first time through costs are initially incurred by the audit firm, but many researchers or commentators believe that it is likely that these costs would result in higher audit fees over the longer term.

### **4.3.3 Cost of management time**

As well as the explicit additional costs incurred by audit firms likely leading to an increase in audit fees, certain researchers also have considered the implicit cost of the management time employed in selecting new auditors and familiarising them with the company's business, operations and systems.

Not only does the auditor change process incur costs as outlined above, it is also argued to be highly disruptive to business operations.

Empirical evidence of this increased cost to management is limited and these assertions are largely based upon an understanding of the audit change process. However the research by SDA Universita Bocconi found that the client has an increased burden on 'managers, personnel and internal auditors' in supplying necessary information about 'corporate governance, internal control systems, organisational structure, market relations and so on'. This concern over increased costs to management has also been expressed in a significant number of publications including the Ramsay Report (2001), AICPA Statement of Position Regarding Mandatory Rotation of Audit Firms (1992) and review of 'Economic Consequences of Mandatory Rotation' by Arrunada and Paz-Ares (1995).

Further, the awareness of businesses of the disruption caused by auditor change are objectively shown in a questionnaire based research by Beattie and Fearnley (1995) in which 35% of businesses considering change due to dissatisfaction with fees did not change auditors to avoid disruption.

## **4.4 Other practical considerations**

### **4.4.1 Audits of specialised industries**

Specialised industries have been argued to be especially vulnerable to a reduction in audit quality due to mandatory rotation (Petty and Cuganesan, 1996). This is due to the fact that only a small number of audit firms may have partners and staff with specialised knowledge of these industries and a business may be forced to rotate to an auditor without this specialism.

Arrunada and Paz-Ares (1995) have further developed this argument by pointing out that audit firms will have little incentive to invest in specialised industries with few clients, as they will not be able to capture an adequate portion of the market to recover the investment. The authors underline the significance of this point by quoting empirical studies that confirm the value of specialised experience (Ashton, 1991; Eichenseher and Danos, 1981).

The issue of lack of investment in specialised industries is being investigated as part of the ongoing research at the University of Bocconi in Italy (2002).

#### **4.4.2 *Impact on freedom of choice***

Although not necessarily an independence issue or a quality issue, there is a view that mandatory rotation would deny the client the opportunity to select their own auditors (*Irish Review Group (2001), The Ramsay report (2001)*)

#### **4.4.3 *Natural occurrence of rotation***

The AICPA 1992 Statement of Position pointed out that a review of the executive management of the largest 100 industrial concerns listed in the 1991 Fortune 500 and of the 50 largest bank holding companies at 31 December 1990, showed that turnover of staff was high enough to continually renew the auditor-management relationship is continually renewed even without auditor rotation.



## 5 References and research

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