Global Network of Director Institutes

Mandatory Audit Firm Rotation: GNDI Perspective

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Background

The Global Network of Director Institutes (GNDI) was founded in 2012. It brings together member-based director associations from around the world with the aim of furthering good corporate governance. Together, the member institutes comprising the GNDI represent more than 100,000 directors from a wide range of organisations. This paper describes the global perspective of GNDI in relation to **mandatory audit firm rotation (MAFR).[1]**

Independently audited financial statements are critical to capital markets. While some companies can survive on earnings alone, most need the additional cash flow from debt or equity sources—and these sources need audited financial statements to lend or invest with confidence. Without having reliable audits from independent audit professionals, many companies could find it difficult or even impossible to attract the external capital they need.

All developed economies today require independent audits of publicly held companies' financial statements, and the audit firms that perform these adhere to a myriad of standards for independence. Yet year after year and decade after decade, some companies that have received clean audits experience unforeseen financial crises. And at those times, rightly or wrongly, the attention of the media, investors, and regulators focuses on auditor independence—sometimes pointing to the long tenure that many larger audit firms have had with their clients. With some auditors serving particular companies for as long as a half century, how can these firms be truly independent, some ask. It is important to acknowledge that an audit provides reasonable and not absolute assurance on the financial statements of a company with respect to fraud and error. An audit does not provide a guarantee as to the future sustainability of a company[2].

In light of the long tenure of auditors of some companies, one concept that continually resurfaces in public debates on auditor independence is the notion of MAFR. In some cases, the topic is moving from discussion to rulemaking. From time to time, in response to financial crises, some countries have passed rules for limiting duration of audit engagements, with limits generally ranging from 5 to 10 years. Other countries have avoided passing absolute mandates, but have proposed or implemented alternative means to achieve greater auditor independence. In recent times, in the long tail of recession following the financial crisis of 2008, the issue has revived in many countries as they seek to move toward or away from MAFR.

In light of the renewed interest in MAFR, the member organizations of GNDI have reviewed current trends. Overall, it seems that the once-vigorous move toward more MAFR mandates seems to have slowed and even reversed. Some countries that enacted early mandates have softened them in recent years. Meanwhile, in countries or regions where a MAFR rule is pending, there is considerable opposition that appears to be preventing MAFR from becoming the law of the land. Yet this issue is far from settled at this time, as any new financial crisis may revive the topic again.

GNDI Perspective GNDI supports the objectives of enhancing auditor independence, objectivity and professional skepticism but does not believe that MAFR is the best approach for achieving them. MAFR imposes a regulated time limit on tenure in order to address the perception of an institutional familiarity threat. However, audit partner rotation rules and expected personnel changes in both the company and the audit firm can mitigate such threats.

GNDI believes that the board of a company or its audit committee is best placed, with the experience and intimate knowledge of the company's business, to determine when the interests of the company would be better served by a change in audit firm. The timing for such a change is likely to vary between industries and geographies, and will also depend on the specific circumstances of individual companies.

GNDI accepts that a different approach to the audit of a particular company, such as would occur with a change of audit firm, may bring benefits to that company. However, the decision to recommend such a change is a decision for the board and the audit committee of the company, taking into account the costs associated with rotation of the audit firm compared to the benefit of a fresh perspective.

GNDI's view is based on the following concerns with MAFR:

- MAFR would result in losing the cumulative audit knowledge gained over years at arbitrary intervals. However, it should be noted that when the same audit approach is followed continuously, there may be an increased risk that errors remain undetected.
- MAFR would increase the amount of time management spends during a transition on educating the new auditors on the company's operations, systems, business practices and financial reporting processes. Shareholders indirectly bear those costs.
- A regulatory time frame that sets out when MAFR should occur does not provide the flexibility to enable companies to defer an MAFR when it is at an inopportune time (e.g. during a major transaction) and is not in the best interests of the company's shareholders.
- MAFR may reduce the ability of audit firms to accumulate sector/ industry expertise and impact on the ability of audit firms in attracting and retaining talent in specialized industries or remote locations.
- MAFR may increase the complexity of audit compliance within global companies, as there may be differing audit rotation requirements in various

jurisdictions.

- MAFR would reduce the accountability and responsibility of the audit committee for periodically assessing the performance of the auditor and, based on that assessment, for determining if, and when, to require a rotation or tendering of the audit.
- MAFR would also eliminate the right and ability of shareholders to determine who their auditors should be and when it is necessary to change their auditors.
- The imposition of mandatory time limits that restrict a company's choice of auditor is an artificial impediment to the free deliberation of the board or its audit committee.

GNDI strongly recommends that regulators not adopt MAFR for the foregoing reasons. GNDI believes that there should be a focus on improving the quality of the audit, by reinforcing the board or its audit committee's responsibility for the oversight of the audit, audit firm and quality and where necessary enhancing the expertise of the audit committee and potentially expanding communications between the audit firm and the audit committee. Further work may be required to ensure that users of financial statements increase their understanding of the role and nature of an audit, thus narrowing the audit expectation gap.

GNDI further cautions regulators from major jurisdictions to not act unilaterally on this matter as it could require issuers from other countries that have international operations to have to comply notwithstanding that their head office is in another country.

The balance of this paper surveys key MAFR developments around the world and summarizes certain key academic findings.

Key MAFR Developments around the World

Australia enacted in 2004 an audit partner rotation period that requires the rotation of an audit engagement partner after 5 successive years for listed entities. In July 2012 the *Corporations Act, 2001**[3]*** was amended to allow a listed entity to extend the rotation period up to a maximum of 7 years, subject to the approval of the board of directors prior to the end of the 5 year period. The board is required to pass a resolution approving the extension of the audit engagement partner's tenure. They are required to state that this would not have an effect on the quality of the audit and would not give rise to a conflict of interest.

Brazil enacted a 5-year rotation rule in 1999 and softened it in November 2011. The Brazilian securities exchange commission, the *Comissão de Valores Mobiliários (CVM) in* CVM Instruction No. 509 (issued November 16, 2011) lengthened the 5-year rule to 10 for companies that have a Statutory Audit Committee (*Comitê de Auditoria Estatutário* - CAE),1 which aims to control the internal and external auditors. According to CVM Instr. 509/2011 companies that install and maintain the CAE pursuant to the conditions required by said instruction may hire an independent auditor to provide audit services for up to 10 consecutive years.

Canada had a mandatory audit firm rotation policy for banks but ended it in 1991, in favor of a principles-based approach due to its unintended consequences.[4] Canada has mandatory audit partner (not firm) rotation – seven years with a five-year cooling off period. A recent "Enhancing Audit Quality" initiative in Canada strongly recommended against the adoption of MAFR.

Europe (see also United Kingdom) has a mixed history: For the European Union in general, a November 2011 regulation, still pending as of April 2013, would introduce mandatory rotation of audit firms after a maximum period of 6 years. This period may be, under certain "exceptional circumstances" (not defined) extended to 8 years. Where a public-interest entity has appointed 2 or more statutory auditors or audit firms, the maximum duration of the engagements will be 9 years. Again, on an "exceptional" basis, such duration may be extended to 12 years. It also provides for a cooling-off period before the audit firm is able to carry out the statutory audit of the same entity again. In order to ensure a smooth transition the former auditor is required to transfer a "handover file" with relevant information to the incoming auditor. [5]

Summarizing MAFR and related rules for all 27 EU member countries is not practical, especially in light of this pending rule. However, the following highlights may be instructive:

- Austria adopted a 6-year MAFR mandate in 2004.
- Italy adopted a 9-year MAFR mandate in 2003.
- In December 2012, the Netherlands legislature voted to require MAFR rotation every eight years for public interest entities, commencing on 1 January 2016.
- Spain no longer has an MAFR mandate. Previously, it had an MAFR with a maximum audit term of 9 years and mandatory rebidding every 3 years. However, as in the case of Canada, the MAFR had unintended negative consequences. [6] Thus Spain rescinded this in 1995 in favor of a rule that says by allowing that after the expiration of the initial period (minimum 3 years, maximum 9 years), the same auditor can be re-hired by the shareholders every year. Several years later, in 2002, Spain mandated rotation of the audit team every 7 years.

Malaysia does not have a law mandating MAFR. This is not included in the Malaysian Code on Corporate Governance issued by the Securities Commission Malaysia in 2012.[7] However, it does have a professional standard for auditors that mandates the rotation of audit partners, similar to standards in New Zealand and the United States. Paragraph 290.151 of the bylaws for the Malaysian Institute of Accountants stipulates that for public interest entities, an individual shall not be a key audit partner for more than five years. After such time, the individual shall not be a member of the engagement team or be a key audit partner for the client for two years. The cooling-off period for the purposes of auditor rotation is extended to five years for financial institutions, which recognizes the significant learning curve that auditors of financial institutions face. The rotation requirement applies to the auditor but not to the audit firm. This is consistent with both Malaysian and international standards, and also takes into account the high level of concentration of audit firms of financial companies in Malaysia.***[8]***

New Zealand's *Corporate Governance in New Zealand Principles and Guidelines**[9]*** released by the Securities Commission New Zealand sets out the recommendations with respect to auditor rotation. Section 7 on Auditors states in 7.4 that "No issuers audit should be led by the same audit partner for more than 5 consecutive years (i.e., lead and engagement audit partners should be rotated from the engagement after a maximum of 5 years).This is similar to the U.S. alternative discussed below.

South Africa, in section 92 of the *Companies Act 2008*, provides for audit partner rotation. In this country, "an individual may not serve as an auditor or designated auditor of a company for more than 5 consecutive financial years". If an individual has been an auditor or designated auditor of a company for 2 or more consecutive years, and then ceases to be an auditor, the individual may not be appointed again until after the expiry of at least 2 further financial years. As of March 2013, the Institute of Directors in Southern Africa is in the process of finalizing guidance on MAFR rotation via its King Committee and its Audit Committee Forum.

The United Kingdom published a new provision in its corporate governance code in September 2012[10], which recommends a re-tendering of the audit mandate every 10 years for FTSE 350 companies. UK listing rules require companies to either comply with this rule or to explain why they have not done so – the so called "comply or explain" approach used by large listed companies in the UK. On the basis of this new provision, it is possible for the current auditor to retain the audit mandate if it proves itself to be superior to other bidders in the re-tendering process. This measure is not equivalent to MAFR, but pursues the same objective of seeking to open up the external audit to more competition.

The United States does not currently require auditor rotation. However, over the past 10 years, there has been continuing interest in this topic. When Congress hammered out early versions of *Sarbanes-Oxley Act of 2002*, some legislators argued for audit firm rotation. In the end, the law did not mandate MAFR. Instead, it required rotation of lead and review audit partners every 5 years, as well as imposing other changes on the practices of auditors and audit committees. In 2003, the General Accountability Office(GAO) studied MAFR and concluded that the time was not right for this approach. The GAO said that the Securities Exchange Commission and the Public Company Accounting Oversight Board (PCAOB) should give further study to evaluate the adequacy of Sarbanes-Oxley measures before implementing MAFR. In August 2011, the PCAOB issued a concept release on Auditor Independence and Audit Firm Rotation[11], with a deadline that was November 19, 2012. During the comment period, the PCAOB received more than 600 comment letters, mostly opposing MAFR. These negative views on MAFR were echoed throughout 2012 as the PCAOB held a series of public hearings around the country on the topic. Meanwhile, in a related development, on August 15, 2012, the PCAOB adopted Auditing Standard No. 16, Communications with Audit Committees, and Amendments to other PCAOB Standards. Some comment letters say that given this standard, MAFR is no longer necessary. Other letters assert that further changes are needed, but most advocates of change recommend voluntary rather than mandated standards.

GNDI Member Comment Letters

A number of GDNI member organizations have commented on current or pending MAFR rules.[12] To visit the GNDI member organization websites, go to GNDI.org.

Key Academic Findings

There have been many studies on the impact of MAFR. It is beyond the scope of this paper to review all the academic findings. However, two studies may be of interest.

- One recent study, an April 2012 report by Kathleen Harris and Scott Whisenant concluded that while MAFR may have overall good effects, it has negative effects during the period of implementation from 1 year before to 1 year after the change. "These results highlight the importance, particularly to regulators of audit markets, of considering ways to mitigate the erosion of audit quality when making the transition to new auditors under MAFR rules." This compared unfavorably to performance of firms where the change of auditors was voluntary rather than mandated.[13]
- Previously, one of the most extensive studies of MAFR—a 2005 study by Italian researcher Mara Cameran - reviewed the findings and conclusions of 26 reports by regulators or other representative bodies from around the world. Of the 26 reports, 22 conclude against the benefits of MAFR while 4 were in favor. The study also looked at 33 academic studies (9 opinion-based and 24 based on empirical evidence). The majority did not support MAFR.[14]

GNDI Conclusion

Although GNDI supports the objectives of enhancing auditor independence, objectivity and professional skepticism and overall improving the quality of the audit process, it does not believe that MAFR is the best approach for achieving them.

The challenges with MAFR, as outlined above, include the loss of audit knowledge, increase in time and expense, loss of flexibility, loss of industry specific knowledge, increase in global complexity, reduced accountability and are an impediment to strong corporate governance.

GNDI urges regulators to oppose MAFR and to consider the unintended negative international consequences of adopting MAFR.

[1] Style note: This paper cites various documents involving terms for auditors. In some cases sources spelled out the years ("five"), and in other cases, the sources used the number ("5"). For the sake of consistency and for easy scanning of the document, we will use the number rather than spelling it out.

[2] International Standard on Auditing 200 Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing. See paragraph 3, 5 and A1.

[3] Section 324DA Limited term for eligibility to play significant role in audit of a listed company or listed registered scheme.

[4] "Spain and Canada reported that they previously had mandatory audit firm rotation requirements. Generally, reasons reported for requiring mandatory audit firm rotation related to auditor independence, audit quality, or increased competition for providing audit services. Reasons for abandoning the requirements for mandatory audit firm rotation related to its lack of cost-effectiveness, cost, and having achieved the objective of increased competition for audit services." Source 'Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation' http://www.gao.gov/assets /250/240737.htmlNovember 21, 2003.

[5] Source http://ec.europa.eu/internal_market/auditing/reform/index_en.htm

[6] See Note 4.

[7] http://www.mia.org.my/new/downloads/circularsandresources/circulars/2012/21/MCCG_2012.pdf

[8] http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2012/02/21/000333037_20120221232504/Rendered/INDEX/669290WP00PUBL0C00FINAL0V1.10016FEB.txt

[9] http://www.fma.govt.nz/media/178375/corporate-governance-handbook.pdf

[10] The UK Corporate Governance Code, September 2012, para C.3.7 (http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx)

[11] http://pcaobus.org/rules/rulemaking/docket037/release_2011-006.pdf; ttp://pcaobus.org/Rules/Rulemaking/Pages/Docket037.aspx

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825404

[12] See for example Letter of December 4, 2011, Re: Request for Public Comment: Concept Release on Auditor Independence and Audit Firm Rotation,
PCAOB Rulemaking Docket Matter No. 37

http://pcaobus.org/Rules/Rulemaking/Docket037/538_NACD.pdf

[13] Kathleen Harris and Scott Wisenant. "Mandatory Audit Rotation: An International Investigation." April 11, 2012. http://web.ku.edu/~audsymp/myssi/_pdf/Harris Whisenant April 2010 2012 final double spaced.pdf

[14] Mara Cameran et alia *The Audit Firm Rotation Rule: A Review of the Literature, from the* SDA Bocconi School of Management Research Paper Series http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825404

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