AUDITING AND CORPORATE GOVERNANCE

Impact of Mandatory Audit Firm Rotation on Quality and Independence

Explore how mandatory audit firm rotation influences audit quality, auditor independence, and the financial implications for companies.

AccountingInsights Team

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Mandatory audit firm rotation has emerged as a regulatory measure aimed at enhancing audit quality and independence by requiring companies to change their external auditors after a set period. This approach seeks to prevent long-term relationships that might compromise objectivity in financial reporting, affecting investor confidence and market stability. Understanding its implications helps stakeholders assess whether such regulations bolster the integrity of financial statements or introduce new challenges.

Impact on Audit Quality

Mandatory audit firm rotation has sparked debate about its effect on audit quality. Proponents argue it can provide a fresh perspective, as new auditors may bring innovative approaches and heightened scrutiny to financial statements. This change could uncover discrepancies or inefficiencies overlooked by long-standing auditors. For instance, new auditors might apply different analytical procedures or risk assessment techniques, improving the detection of material misstatements.

Critics, however, caution about a potential decline in audit quality during the initial years of a new auditor's tenure. The learning curve associated with understanding a company's complex financial systems and industry-specific risks can lead to errors or omissions. The Public Company Accounting Oversight Board (PCAOB) has noted that the first few years of an audit engagement often see higher audit deficiencies as auditors familiarize themselves with the client's operations and controls.

Frequent rotation of audit firms can disrupt the continuity and depth of institutional knowledge developed by long-term auditors. This knowledge is vital in industries with intricate regulatory environments, such as banking or pharmaceuticals, where understanding historical context and previous audit findings is crucial. The International Auditing and Assurance Standards Board (IAASB) highlights that auditor familiarity with a client's business is essential for delivering high-quality audits.

Auditor Independence

Auditor independence is fundamental to credible financial reporting, ensuring unbiased assessments of a company's financial health. Independence encompasses two aspects: independence in fact, referring to the auditor's actual objectivity, and independence in

Mandatory audit firm rotation is viewed by some as a way to strengthen both forms of independence. Regular auditor changes minimize the risk of relationships developing that could impair objectivity. This measure aims to create an environment where auditors feel less pressure to align with management interests, enhancing the reliability of their reports. For example, the Sarbanes-Oxley Act of 2002 introduced rules to limit audit partner tenure, aligning with efforts to maintain independence.

However, some experts argue that rotation might shift focus from independence in relationships to pressures associated with acquiring new clients. The pursuit of new business could compel audit firms to offer non-audit services, potentially compromising their objectivity. The European Union's Audit Reform of 2014 includes restrictions on non-audit services alongside mandatory rotation to address such risks.

Cost Implications for Companies

Mandatory audit firm rotation introduces significant financial considerations for companies. Transitioning between audit firms often incurs substantial costs due to the need for new auditors to familiarize themselves with the company's financial landscape. This onboarding process involves extensive data sharing, meetings, and training sessions, which can be resource-intensive and time-consuming.

Companies may face higher audit fees during the initial years of engagement with a new firm. The learning curve for auditors to understand the intricacies of a company's financial systems and the need for more detailed reviews in the early stages can result in increased billing rates. A study by the Financial Executives Research Foundation indicated that companies could experience audit fee increases of up to 20% in the first year of a new engagement, as auditors invest additional effort to mitigate risks associated with limited familiarity.

Frequent auditor changes might also necessitate adjustments to internal controls and compliance frameworks, requiring additional investment in technology and personnel to maintain adherence to financial reporting standards such as GAAP or IFRS. Companies operating in jurisdictions with stringent regulatory requirements may need to allocate extra resources to ensure compliance with local statutes and tax codes, such as the Internal Revenue Code in the United States.

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Should firms periodically change auditors?

JLOCEFF
JLOCEFF

June 27, 2011
3 minute read

Public company oversight group studying whether move would lower failuresSANTA ROSA -- The Public Company Accounting Oversight Board, the entity that oversees firms that audit public companies, is considering term limits on relationships between auditors and public companies.

The PCAOB was formed out of Sarbanes Oxley. Because of SOX, it became mandatory that any accounting firm that audited public companies would be required to change the partner who performed the audits regularly.

Now, and not for the first time, the board is considering switching the firms themselves every so often.

"There was a fear that if a given CPA firm gets too close to a company it will impair their objectivity," said Carol O'Hara, shareholder in charge of the North Bay practice of Burr Pilger Mayer. "But so far, there has not been a requirement on public companies to force them to rotate their auditors."

It was in 2002, when Congress first considered requiring firm term limits during the debates that ultimately led to the Sarbanes-Oxley Act.

At that time, it was agreed that the idea required more study.

[caption id="attachment_35717" align="alignright" width="220" caption="James Doty, Public Companies Accounting Oversight Board"][/caption]

"The PCAOB has now conducted annual inspections of the largest audit firms for eight years," said James Doty, chairman of the PCAOB. "Our inspectors have reviewed more than 2,800 engagements of such firms and discovered and analyzed hundreds of cases involving what they determined to be audit failures."

He said more than 1,500 inspections of smaller domestic firms and of non-U.S. firms have also been done.

"These include multiple inspections of hundreds of those firms. And our inspectors have identified hundreds more cases involving what they determined to be audit failures," he said.

The question of switching firms is not as simple as just who does the audit, said Ms. O'Hara. There is a question of familiarity of the entity being audited and its practices.

"When you have one firm serving an institution for a number of years, you have a great idea where the risk area is," she said. "There are many public companies, thousands, and most have good auditors. Don't change a rule based on the bad ones, have stricter enforcement for the firms that come up with negative audits from the PCAOB. Most CPAs take their relationship seriously."

Mr. Doty said it is because of the audits the board has done that have shown poor judgment on the auditor's side that he believes it is up to the PCAOB to take up the debate about firm tenure and "examine it with rigorous analysis and the weight of evidence in support and against."

"I don't have a predetermined idea as to whether the PCAOB ultimately should adopt term limits. My only predilection is that the PCAOB deepen the analysis of how we can better insulate auditors from client pressure and shift their mindset to protecting the investing public," he said.

"As such," he said, "the board plans to issue another concept release to explore whether there are other approaches we could take that could more systematically insulate auditors from the forces that pull them away from the necessary mindset.

"We expect to issue this concept release around the same time that we issue the concept release on the auditor's reporting model, in order that they can be considered together in a holistic manner."

Ms. O'Hara said she thinks the biggest threat is that the quality of audits will suffer.

"After Enron, a lot of attention went to audits and people wanted a lot of time spent on audits," she said. "Now people are trying to cut costs and this should not become a commodity shopping. It is quality."

Earlier this year, European Union Internal Market Commissioner Michel Barnier said he plans to introduce draft legislation in November to so the concentration of auditing work is not solely among the Big Four firms.

"This is an ambitious agenda," said Mr. Doty. "Rethinking the structural foundation for auditing is not only in the best interest of investors, but in the best interest of auditors and preparers."

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Financial Management

Audit Firm Rotation vs. Audit Partner Rotation

Written by Bostrom

Currently, public companies are required to rotate engagement partners every five years; there is no requirement in the U.S. to rotate audit firms. While non public companies and non-profit organizations are not required to rotate audit firms or audit engagement partners, they need to think about the quality of their audits.

First, a little background on PCAOB, audit firm and audit partner rotation – and then some information on how non-profits can help ensure a sound audit.

Congress established the PCAOB, a non-profit corporation, to oversee the audits of public companies to help protect investors and the public interest by promoting informative, accurate, and independent audits. Apparently, its concern is that long-term relationships with audit firms may create problems with objectivity or independence (even though the audit engagement partner is rotated every five years). As expected, the large accounting firms, the American Institute of Certified Public Accountants (AICPA) and several large corporations and non-profit organizations came out against an audit firm rotation requirement. A large accounting firm (Ernst & Young) believes that mandatory rotation would come at a great expense to audit quality.

Studies have shown that audit failures come at a much higher rate during the first three years of an audit engagement, indicating a significant learning curve in the first three years of the engagement for the external auditor, especially with large public companies. The AICPA opposes mandatory rotation due to costly and unintended consequences. It believes that mandatory rotation would hinder the ability of the audit committees to oversee external auditors. The AICPA believes that audit committees should be further strengthened and encouraged to take a more proactive role in overseeing the independent auditor, which would include selecting (or retaining) the most qualified firm for the job. In a letter co-signed by 31 large public companies and large non-profit organizations, they believed that mandatory firm rotation, if implemented, would harm corporate governance, reduce audit quality, diminish the role of audit committees, increase the incidence of undetected fraud and increase costs. Even the PCAOB recognized that mandatory firm rotation would represent a significant change in practice and would increase costs and cause disruptions for companies and external auditors. Former SEC Chairman Richard Breedon favors a system of rotation (10-12 years), but with an opportunity for extension if a PCAOB inspection indicates that there is no loss of independence. Former U.S. Comptroller General Charles Bowsher suggested implementing a system of rotation that would be limited to 25 to 40 of the very large companies. His argument: the cost issue related to rotation would be diminished by the very large budgets of these companies.

So, as the debate continues in the large public company world, what should the non public companies and non-profit organizations consider to ensure that they obtain quality audits?

1. A quality audit starts within the organization. An organization should strive to use qualified accounting professionals who prepare periodic financial statements for review by the board of directors (BOD). The organization should have strong internal controls and adequate segregation of duties.

2. Budgets. An organization needs to prepare budgets that are reviewed and approved by the BOD. Results need to be reported and compared to budget and variances need to be explained and understood.

3. Audit committee. Organizations should consider forming audit committees that hire and communicate with the outside auditor.

4. External auditor. The organization should hire an auditor that is well-qualified and has experience in the organization's industry. The firm should be right-sized. A small, local firm is not well qualified to audit a large, public company. Also, a large national firm may not give a small client the proper attention it needs to provide good value to the organization.

5. Partner rotation. As discussed above, public companies are required to rotate partners every five years. The AICPA believes that this procedure provides the necessary "fresh look" to ensure objectivity. Non public

companies and non-profit organizations are not required to rotate partners, but may want to consider the benefits of this process for their organizations.

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How to weigh the pros and cons of auditor rotation

SBN Staff | 2:22 am | November 1, 2015(https://sbnonline.com/2015/11/01/)

Some organizations switch auditors regularly — that can mean going to a new firm or just getting a new lead auditor — but there can be both advantages and disadvantages to this practice.

Although the Securities and Exchange Commission regulates how often public companies need to switch lead auditors, there's no requirement for anyone else to do so. It's individually determined by the organization.

"I don't have any hard evidence, but my perception is that very few of our clients utilize audit rotation; most don't bid it out periodically," says Mark Van Benschoten, CPA, CGMA, a principal at Rea & Associates (http://www.reacpa.com/).

Smart Business spoke with Van Benschoten about best practices for auditor rotation, including the benefits and drawbacks.

Why do some companies rotate auditors?

Auditors are supposed to be independent of their clients, closely scrutinizing their operations. Some feel if they're with the same auditor too long, the auditor may lose objectivity and won't ask hard questions. They also may feel that if the auditor has always tested the accounts receivable this way, then he or she may continue to do so — even if it's no longer the best method.

Another reason is price. Companies may keep bidding audit work out, believing that an audit firm provides a lower price for new clients in hopes of gaining additional work.

What are the drawbacks to audit rotation?

If an audit firm is familiar with an organization, it knows what reports to ask for and where to get them. It also learns the company's terminology, which streamlines the audit process. Auditors can be more effective after they've gone through a couple of audit cycles because they have institutional knowledge.

Although switching to another firm may cost less upfront, in the long run, you might experience the indirect cost of your time — or, more specifically, the extra time you'll have to spend training the new firm and familiarizing them with your operations. Or, it's possible that the final bill is higher than anticipated because the auditor had to undertake additional work, like bookkeeping. There's also a cost to a deficient audit. If the auditor missed something, such as an organizational weakness that encourages fraud, the company ends up paying more later.

How can employers determine if it's time to rotate auditors or stay put?

You need to get a sense of how your audit relationship is going through some kind of auditor evaluation. Do you have a relationship with your auditor? Do you only see him or her once a year? You should have ongoing communication. Do you feel comfortable calling your auditor with a question? Is your auditor knowledgeable about your industry?

Talk to your staff about the audit itself. Was it done timely? Are the auditors pleasant to work with? Are they demanding? Did they respond to all questions? Are they always dealing with new audit staff?

You don't want an audit to be such a laborious task that your people dread it. It should be a positive working relationship, where both parties are striving for effective and efficient audits. Financial information is most useful when it's timely and accurate. If you sacrifice one for the other, you diminish the value.

Before you switch, think through what you're trying to accomplish and what's giving you angst. What do you want that you're not getting now? You need to have some basis, so when you get proposals you have some measure to evaluate them by.

Don't just implement auditor rotation because everyone does it. For example, if you want a fresh set of eyes, make sure that you're really accomplishing that by changing auditors. You may decide to stick with the same firm for its institutional knowledge but just request a new partner to work with.

What else is important to know about the audit process?

There needs to be a relationship between the auditor and the board or audit committee, as well as several people in management. The auditor shouldn't just deal with the CFO, for instance, because he or she might lead the auditor down a path that narrows the vision. If an auditor is talking to others it gives a broader perspective as to what's going on.

Insights Accounting is brought to you by Rea & Associates (http://www.reacpa.com/)

Q&A #18 – Is it reasonable to use the same CPA firm to do our audits for more than 6 years?

Q&A Jul 29, 2020 • Written By A. Michael Gellman (CPA, CGMA)

Question: My nonprofit has used the same CPA firm to do our audits for the past 6 years. In the past we have generally tried to change CPA firms after 5 to 6 years, because we understand that it's generally a bad practice to have the same firm handle our audits for too long. However, in light of the current disruptions related to the pandemic, we are considering sticking with the same CPA firm for another year or two. Is this reasonable to do under the circumstances?

Answer: This is a very common and important question that must be considered on a regular basis. The key to the answer is defining and establishing what is the "regular basis" in your governance related financial statement audit management practices.

Auditor continuation, rotation, and selection processes and practices vary widely from organization to organization. Having a defined set of working rules that establish an auditor rotation pattern will provide the basis for a solid answer to this question.

There are basically two key considerations that inform best practices in this area:

> *Consideration #1* – It is not a best practice to change audit firms too often, as this is inefficient and can be costly in time and dollars, as well as to the organization's reputation. This statement speaks for itself and is understandable. Changing audit firms every year or ever other year is generally a sign of underlying problems.
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> *Consideration #2* – It is not a best practice to stay with the same audit firm forever or for a very long time. Even if the audit firm provides excellent services, Board members and the general public might perceive the organization as being averse to audit firm rotation. This can lead to questions about whether the audit firm is sufficiently independent.

A typical auditor rotation pattern, which I see often, is a three-year cycle. A new audit firm is expected to continue for three years. After three years, a new search for audit services and RFP process is implemented. For this search the current audit firm can participate and be eligible for selection. Three years later another search for audit services and RFP process is implemented, but this time the current audit firm would not be eligible to participate. Thus, the established procedure is to search for audit services every three years with an audit firm eligible to provide services for no more than two consecutive three-year cycles. I have also seen four-year and five-year patterns with some modifications.

Now to your question: during an unusual time like the crisis that is occurring now, is it reasonable to deviate from established procedures? The answer can often be yes, especially when the crisis-driven disruption could lead to the organization being in a much different position in the future (for example, ending up smaller in size, a candidate for merger or acquisition, relocating, or ceasing operations entirely and dissolving).

If the current crisis is not having a material effect on the organization, the current audit rotation cycles should not be changed even if there are temporary internal staffing pressures.

> ***Planning Tip*** *– Make sure that* ***every year*** *the audit committee and/or the Board of Directors address auditor continuation as part of its regular duties, even in the middle of a 3, 4, or 5-year cycle. The audit committee and/or Board should document all relevant factors and make an annual recommendation to continue or not continue with the current audit firm. This demonstrates an on-going and active evaluation process and provides a time and place to document any unusual circumstances that might affect auditor continuation.*

ave a question you would like to submit to SE4N, send it to us using the contact form and we will er answering it in a future post. Please do not send confidential information.